Meeting of the Federal Open Market Committee Meeting
September 27, 1994

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 27, 1994, at 9:00 a.m.

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

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

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

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

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

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

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

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

Ms. Browne, Messrs. Davis, Dewald, Lang, Rolnick, Rosenblum, and Vander Wilt, Senior Vice Presidents, Federal Reserve Banks of Boston, Kansas City, St. Louis, Philadelphia, Minneapolis, Dallas, and Chicago respectively
Mr. Sniderman, Vice President, Federal Reserve Bank of Cleveland
Ms. Krieger, Assistant Vice President, Federal Reserve Bank of New York

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CHAIRMAN GREENSPAN. Who would like to move approval of the minutes for the August meeting?

SPEAKER(?). So move.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection they are approved. President McDonough.

VICE CHAIRMAN MCDONOUGH. It is my pleasure, Mr. Chairman, to move the election of Frederic Mishkin as associate economist. Rick, as he is known to his friends, has just joined the Federal Reserve Bank of New York as our head of Research. He is a distinguished tenured professor at the Columbia Business School, and we are very happy to have him join our staff.

CHAIRMAN GREENSPAN. We need a vote on that motion; would somebody like to second it?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. We welcome Rick to this organization. Peter Fisher, would you start us off?

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

CHAIRMAN GREENSPAN. Questions for Peter?

MR. BLINDER. I have just one, Peter. You mentioned the potential responsiveness of dollar/yen to rhetoric as much as to what happens on September 30th; whose rhetoric? Let's take it as axiomatic that it won't be Lloyd Bentsen's.

MR. FISHER. I think it's rhetoric on either side--the United States or Japan. And in this country it's rhetoric from anyone who is perceived to be expressing the inner thinking of the Clinton Administration.

MR. BLINDER. Not Congresspersons?

MR. FISHER. I don't think Congresspersons would be the issue; but anyone who the market could plausibly think is expressing the inner views of key Administration officials, whether in the Treasury or elsewhere, could be a source of pain to the markets.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Peter, I have a question on the proposal in the memorandum. The suggestion just struck me as unusual. Central banks in these relationships normally deal with one another for strong reasons. I was surprised that the Bundesbank wanted to move in this direction. I guess I'm just wondering if there is anything deeper going on here that you can sense. Are they perhaps signaling or does this imply somewhat less cooperation or a less cooperative spirit on their part with us?

MR. FISHER. On the contrary, let me make a couple of points. First, most major central banks are much more advanced than we in having some direct dealings in foreign currency government securities markets and in direct activity in those markets through private custodians. I would say that we probably are the only G-10 country that does not have an account with Euro custodians, just as an example. That is a normal activity of most of the other central banks. Indeed, the Bundesbank really has been, if you'll forgive the expression, babysitting us by allowing us to keep rather large amounts of reserves on their balance sheets. We have had quite preferential treatment--

So, I really would turn the point around. I think that direct participation in the government securities market is increasingly the norm in terms of the investment of foreign currency reserves.

MR. BROADDUS. They are operating in our markets?

MR. FISHER. They certainly operate in our markets in that fashion--Joan could perhaps tell you more about that than I could--and certainly in the German market that has developed quite a bit over the last five to eight years. We actually have been receiving quite preferential treatment from the Bundesbank. So I would say in response to your observation that their tolerance for the slow rate at which I have been managing to move off their balance sheets shows rather high levels of friendliness and cooperation.

CHAIRMAN GREENSPAN. President McDonough.

VICE CHAIRMAN MCDONOUGH. I have a follow-up on Governor Blinder's question. If there were to be rhetoric of a warlike nature from Japanese government officials, I would assume that the effect on the dollar/yen could also be quite dramatic.

MR. FISHER. Absolutely, yes. I meant to include that in my initial remarks. It could come from either side.

VICE CHAIRMAN MCDONOUGH. I think it might be worth reminding the Committee that the present Minister of Trade and Industry has in fact had some very tough comments to make, and he would be the official who could very well be deemed to be the appropriate spokesman from their side.

MR. FISHER. I would remind the Committee--as I think I mentioned at our last meeting--that when the dollar dropped July 30th, 31st, and August 1st on the announcement of Super 301, my view was that rhetoric coming from the Japanese side had caused that drop, albeit as I mentioned last month in rather thin markets in New Zealand.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Peter, on the memorandum, what kind of increased risks do we incur by moving to a private party and not working with the central bank?

MR. FISHER. Well, there are a couple of different layers of risk we have to consider. On the one hand, the Bundesbank as a custodian is really not remotely providing the level of service that private sector custodians are capable of offering in terms of attention to detail and quality.

It's a very big business and it's very hard for them to manage. It's not a business they are in, really. So, on one level we reduce risks at a sort of operational level by going to a custodian whose business it is to manage other people's securities and make sure they are all in the right place at the right time. Another risk that gets reduced is simply the importance of having the tri-partite agent manage the collateral value--that is, ensuring that there is always enough margin held for the repurchase agreement. Now, the Bundesbank simply won't even provide that service. We would be doing that ourselves at some remove from German market custody arrangements.

Those are two risks I would see going down quite a bit, indeed with some services being made possible only by using private sector custodians. The principal risk that we face is the rather complex and subtle legal one of our confidence in the custody arrangement. That is, do we have the confidence that the legal underpinnings are such that the securities will always be our own, and we won't have to worry about the loss of principal? That is the principal risk and one that the major providers of these custody services know that they are in the business of addressing. But the whole RP process we will be going through is really focused on ensuring that we have confidence in the custody arrangement. The final risk is the delivery-against-payment risk. Most of the private sector solutions offer greater precision and clarity in reducing that risk actually than the Bundesbank currently does, but we take comfort under existing arrangements that it's the Bundesbank that is providing us the service. But actually the Bundesbank does not currently assure us in any legal way that we have true delivery against payment for our purchase of the few existing government securities with low remaining maturities that we hold. I hope that's helpful.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. With regard to your answer to Al Broaddus, are there more comprehensive changes in processes that would be desirable than are proposed here? If so, what stands in the way of implementing them?

MR. FISHER. I will mention one thing that I may want to bring back to the Committee in February. The System Foreign Account is currently limited in its investments to maturities not exceeding twelve months. When that limit was put in place, it was a simple and relatively effective means of insuring that we did not take too much price risk. But it also was based on the notion that we would make sure we were always liquid. Now, in my view this has resulted in a slight irony. We have accumulated a fair amount and have the potential of accumulating more of the decayed securities with a remaining life under one year--German government securities--since I can't buy anything longer than 12 months. Now, while that limits the price risk, it subjects me to rather high levels of liquidity risk. This stuff is not highly liquid. In terms of having liquidity and the assurance of being able to get out, I would much rather have some portion of the System Account invested in actively traded five-year issues, for example. What I have been intending to do, and this is part of the process, is to exhaust my existing authority so I could look this Committee in the face and say that to do any more of what I need to do I need to change the maturity ceiling. And so I would very much like to have the authority and the ability to invest in repos. It's a very flexible, liquid instrument. Perhaps after we have begun that process, we would consider changing the maturity ceiling to a duration ceiling where the Committee would specify that the overall portfolio should not have an average duration of longer than X and no subportfolio should have a duration of longer than Y. This would permit having some small portion--10, 15, 20 percent--of the portfolio invested in the actively traded five-year securities. I'm not there yet myself in terms of our management planning, but the repo business is something, if we could get it organized, that would be the principal, and really the only, next step I would see.

CHAIRMAN GREENSPAN. Could we arrange a facility with the Bundesbank to discount those securities or to take a loan and use the securities as collateral?

MR. FISHER. The Bundesbank officials are rather firm in not wanting to give us any assurance of that. Now, whether they would if asked is uncertain, but they are very firm in not giving us any advance comfort.

CHAIRMAN GREENSPAN. The purpose of a central bank is to create liquidity.

MR. TRUMAN. They're reluctant to do it even in their own market these days. You may have noticed that they just stopped issuing short-term paper. We didn't know that was going to happen. The proposal would take two steps forward, but at the same time take one step back in terms of the overall goal. Notwithstanding President Broaddus' comment, the goal is to get off the Bundesbank's balance sheet,

So, to get off their balance sheet, given that they don't offer any other kinds of facilities like the investments in dollars that we offer, we are left with a limited number of options. There is one other consideration about how fast we should go and how we should do this and that is that the Federal Reserve Bank of New York, of course, also invests the foreign exchange reserves of the Treasury Department. Although we are not tied to following exactly what they do, I think it would be on the whole constructive to bring them along at roughly the same time in this process. So, we think a wholesale change in what we are doing would be more difficult. Peter and I have had extensive discussions with the Treasury about their plans. On the whole, I think they are pretty much on board. They may be just a little behind us in terms of thinking this all the way through.

CHAIRMAN GREENSPAN. Go ahead, Tom.

MR. MELZER. Thanks, Alan. Peter, are there practical constraints in terms of how much we can do? In other words, if we put all of our reserves into the repo market, I think we would probably be in excess of 20 percent of the market. What would represent a practical limit there? Secondly, what are the practices in terms of collateralizing a repo initially and what sort of mark-to-the-market provisions do they have? Is it comparable to our repo market here?

MR. FISHER. Starting with the last, yes, it is comparable. There is a range of practices that runs from being identical to our market to being somewhat less collateralized at the margin than our market. But the range exists. The repo market in European government securities has really been evolving from infancy in--

MR. MELZER. So you could pretty much specify what you wanted in that regard?

MR. FISHER. Yes. Certainly we couldn't put all our reserves into the repo market, and I wouldn't want to. I would imagine always trying to have some balance between directly held or under repo government securities in the BIS and perhaps some amount still at the Bundesbank; we'll have to decide how much. Having a diversity of institutional arrangements as well as maturities is part of our goal.

MS. LOVETT. We spent a lot of time talking to people in the repo markets as we proceeded, and we learned some hard lessons in that market here. I think there has been some concern that as these repo markets are developing in Europe market participants have not quite learned from our mistakes. So we have been trying, both at the central bank level and with U.S. dealers who have a presence in these markets overseas, to let them know how important it is to maintain margin and all of the other good practices. As they are evolving, they are taking a look at some of the early history here and learning from it.

MR. MELZER. Thank you.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Peter, you said a good bit more than usual about the Mexican peso this time. Is that just because they had an election in August or is this a reflection of the prospect that we are going to be paying more attention as they increase their role as our trading partner?

MR. FISHER. The length of my remarks this time was really premised on the fact that we had gone to some efforts anticipating the election and I wanted to follow through. I suppose I could have summarized my remarks by saying how smoothly the Mexican markets and the peso went through the election.

MR. TRUMAN. As a technical matter, we still have an offer outstanding to the Bank of Mexico through the end of Friday of this week, September 30. So that's another reason to keep the Committee updated on the situation.

MR. MCTEER. I understand that in May Mexico replaced Japan as our second largest export market, but in July Japan took second place back again.

MR. FISHER. Yes. My own focus on it is not following the trade account as much as the anticipation that New York banks and dealers, who are in the list of 100 firms planning to open offices in Mexico City, will be trading peso instruments more actively. As a footnote to that, I would note that I asked my counterpart at the Bank of Mexico whether he wanted me to include the dollar/peso in our turnover survey of the foreign exchange market. Some banks had suggested it to us,

I presented this conundrum to my counterpart and explained that this survey was for next April. He thought about it and said, "yes."

CHAIRMAN GREENSPAN. Okay, any further questions for Peter? If not, Joan Levitt.

MS. LOVETT. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Did I say "Levitt?" I meant "Lovett." I'm sorry.

MS. LOVETT. I answer to either. [Laughter] [Statement--See Appendix.]

CHAIRMAN GREENSPAN. Questions for Joan?

MR. PARRY. In the intermeeting period there has been a lot of discussion of the exact wording of the announcement that we made in August. Do you think that that has had any impact either on Desk operations or in markets in general?

MS. LOVETT. The part of the statement that was released in August that has captured a lot of attention--and some people have likened it to the sort of attention that Talmudic scholars give--is the "for a time" phraseology. The rest of the announcement followed the format of earlier announcements. It has not had an impact on our operations; it has not affected us in any way that differs from the earlier announcements. That is to say, people see that the Committee has been announcing its policy moves and that has tended perhaps to give us a little more flexibility in our day-to-day operations. I'd say more than a little flexibility until we come right up to a Committee meeting. What we have noticed is that each time we come up to a Committee meeting, there is still this question about whether we are paving the way for a policy change. That has not dissipated. The "for a time" concept immediately after the August meeting was taken by most people in the market to mean until November 15. That was the "nuance" that they put on the statement. But as you can see from the data that have come out since the August meeting and the market's reaction to it, I don't think they feel that the Committee is hard-bound by it. It has been a factor in that people perhaps have responded more slowly to the data on the theory that, having said this, the Committee would like a longer period of time to review information as it comes in. So, the response to the numbers, say the PPI number, was muted because (a) it was the first number like this and (b) since it was the first, the Committee presumably would want more evidence. But I don't think the market thinks that the Committee would overlook the data if it were overwhelmingly conclusive.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Joan, for most of this year I have been trying to understand the behavior of the yield curve, in particular the part between the 1-year and 2-year maturities. After our February action, we saw a sharp steepening over the next several weeks between the 1-year and the 2-year rates. After the mid-August tightening action, we saw a complete pass-through initially on the short end--everything shifted up--without the 2-year moving. In fact, we even got a rally from the 2-year maturity on out. So we got a flattening of the yield curve between one year and two years. Now it has widened back out again to the point that last Friday we had a 100 basis point spread between the 1-year bill and the 2-year note. So, the 1-year rate, one year forward, is 7-1/2 percent. I look at that and shrug my shoulders. I don't know what to make of that discontinuity in the yield curve. From 2 years out to 30 years I don't see anything odd about the yield curve; under one year I don't see anything odd. But I can't make sense out of the 1-year to 2-year sector. Can you?

MS. LOVETT. I don't want to use a technical argument here because I don't think technical arguments carry weight for long periods of time, but I will say that an awful lot of money has been kept in the short end of the market because people are very cautious; most people feel that rates are going higher still, and the short end has been a beneficiary of that. The 2-year rate in particular has been the subject of some debate in the market. A lot of people look at the spread of the 2-year note over the funds rate as being too narrow to be sustained, but that abstracts from the fact that there has been a fair amount of interest in staying short. That perhaps is what has kept that segment of the curve relatively low. Bill rates were so low that the segment that you point to between one and two years may have been depressed beyond what fundamentals would call for. People are questioning the spread of the 2-year rate over the federal funds rate at this stage of the cycle, given the prospect of further Fed moves. And I think some people feel it's hovering around the low end because of defensive moves.

MR. KOHN. Beyond the technical aspect, the issue I believe is what the market is building in for our prospective actions. As new data have come in, market participants have built in a steeper trajectory of Federal Reserve tightening actions not only over the next few months, taking out the effects of "for a time," but for the years beyond that. Certainly, since early this year, we have seen huge moves in these intermediate-term forward rates because of the strength of the economy and changing market estimates of the likely Federal Reserve action needed to counter the inflation pressures.

MS. LOVETT. We see, as I mentioned, that people have ratcheted up somewhat further their views about prospective tightening. We see that in the futures contracts for December and in market commentaries. We see it through early next year. Not everyone, as I mentioned, is completely sure about where prices are going to be. There is still a fairly wide discrepancy in that.

CHAIRMAN GREENSPAN. Any further questions for Joan?

MR. BROADDUS. Joan, the two camps you mentioned at the end of your statement--is that majority 51 percent or 85 percent? Seriously, can you give any sense of what the majority is?

MS. LOVETT. At the time I first wrote this earlier, I would have described it as a narrow majority, but over the past week or so I would say it probably has become a more comfortable majority. I think that's the way things have shifted over the past week. People really got caught up in the numbers released last week. They were a big surprise.

MR. BROADDUS. Thank you.

CHAIRMAN GREENSPAN. Further questions? If not, would somebody like to move to ratify the actions taken since the last meeting?

VICE CHAIRMAN MCDONOUGH. So move.

SPEAKER(?). Second.

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

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

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

CHAIRMAN GREENSPAN. Questions for either gentleman?

MR. BLINDER. I have a couple.

CHAIRMAN GREENSPAN. Go ahead.

MR. BLINDER. I have a couple of questions for Mike. I should have asked these yesterday at the Board briefing but I forgot. The first question is not meant to be a joke, but has to do with the employment report that's coming out at the beginning of next month and the baseball strike. What are you expecting the baseball strike to do to that number? What do you project that number to be?

MR. PRELL. Implicit in the third-quarter payroll forecast is an increase of about 250,000 for September.

MR. BLINDER. Working in the strike?

MR. PRELL. This includes in essence no particular assumption for the strike. We have made some back-of-the-envelope calculations, and it is conceivable that it could have a measurable effect. But many of these people are part-time who might have found something else to do. We had the start of the exhibition season for football; they may have been employed as vendors for football games. There just seem to be too many imponderables here to make it a very big factor in the estimate for September.

CHAIRMAN GREENSPAN. Of course, personal income and wages and salaries collapsed! [Laughter]

MR. PRELL. There would be some loss of hours.

CHAIRMAN GREENSPAN. The average hourly earnings approach is infinity for that group.

MR. BLINDER. It's not the players that were--

MR. PRELL. It could be a few tens of thousands, conceivably.

MR. BLINDER. I raise it because there was a lot of talk in the summer that the World Cup was adding to employment. I said to myself baseball's got to be bigger than the World Cup--in America, anyway.

MR. PRELL. In retrospect, the numbers through August looked as if there might have been a World Cup effect--if you look at the areas of employment that might have been sensitive to that. There was that falloff in August. So, there might be some upside bias, all other things equal, in our forecast because we didn't make allowance for a big effect from the baseball strike.

MR. BLINDER. Okay. The second question has to do with Okun's Law and the 2-year projection. From the end of 1994 to the end of 1996 you have in the Greenbook forecast roughly a 2 percent real GDP growth. If potential is growing at 2-1/2 percent, that suggests a gap of a percentage point which suggests to me a rise in the unemployment rate conditioned on that forecast of about 1/2 percentage point. You seem only to have about a 1/4 percentage point rise. I was just wondering about that.

MR. PRELL. We are, I think, well aligned with Okun's Law models if you take where we are as the jumping point.

MR. BLINDER. From now.

MR. PRELL. Right. Clearly, you can get a variety of results depending on what your starting point is, but we looked at this both in terms of the simple rule of thumb of an Okun's Law model working from where we are as well as in terms of models that can reach back a ways and take into account some of the errors that have occurred and so on. This looks as well aligned as our forecasts ever are, gauging this by our miscellaneous Okun's Law models.

MR. BLINDER. Okay, thank you.

MR. PRELL. I should note, Dave Stockton reminds me, that implicit in this forecast is potential output growth more like 2-1/3 percent than 2-1/2 percent.

MR. BLINDER. That's almost enough to square the circle right there.

MR. PRELL. I'm sorry, I should have noted that.

MR. BLINDER. Thanks.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I'd like to ask a question about imports. In the forecast for the third and fourth quarters the growth rates of imports are the lowest we've seen since, I think, about 1991. Clearly, the direction of effects from exchange rates is supportive of this, but it seems as though it's a rather unrealistic slowing given the strength of final demand in this country.

MR. TRUMAN. I think that's right if you just rely on the microeconomic indicators. There are three factors that I think would produce essentially this result. One is that we had what we think is a bulge in consumer goods imports in the second quarter. We suspect that has to do with either some combination of China or spread of sanctions against China, and/or movements in the seasonals in terms of the timing of imports as they relate to fall purchases.

MR. PARRY. So they showed up in inventories?

MR. TRUMAN. Part of that has shown up in the level of inventories coming out of the third quarter. The second factor is that there also was a bulge in oil imports in the second quarter--this certainly is a big difference in terms of 1987 dollars. And again we are getting the effects, in fact we are looking for a decrease, in the third quarter as inventories have gone down a bit. The third factor is that there was also a considerable increase in imports of computers, which in real terms had a big impact. And consistent with that, we are anticipating in the July data at least a drop-off in computer imports. So, some of that has to do with these longer-term factors, but the sharp change relates to our interpretation of these volumes.

MR. PARRY. I see.

MR. PRELL. Mr. Chairman, I might bring to the Committee's attention a late-breaking piece of news here this morning. The Conference Board released its survey for September. The headline is that consumer confidence registered its third consecutive monthly loss in September, declining 2 points. In June the index had registered 92.5 but it is now at 88.4. The punch line in this release is that "the current level of consumer confidence has been associated in the almost 30-year history of the survey with a reasonably lively economy." So it's consistent with the notion that consumer sales have slipped a bit but are not far below the higher levels that we reached earlier this year.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Mike, this is a follow-up to Bob Parry's earlier question to Joan. In Part II of the Greenbook, Section III-1, there is a sentence that says: "The press release announcing the August policy moves was widely interpreted as indicating that subsequent action was on hold, at least for a few months, and longer-term rates initially fell somewhat." Is that saying that you think the rates fell because of the "on hold" phrase as opposed to the action itself?

MR. PRELL. Well, this is open to varying interpretations! [Laughter] Certainly, as we perceived it, that announcement has been an element in the sense that it gave traders a period of safety in which they didn't have to worry that every bit of incoming economic data would necessarily carry with it the risk of a tightening action. So, they probably were a little more relaxed about the near-term outlook.

CHAIRMAN GREENSPAN. I think there's an interesting answer to that. Most of those adjustments that we see are the dealer responses as distinct from those of the retail pension funds and the like. If you are a dealer and you believe that the chance of the Federal Reserve lowering rates approaches zero, all of the unexpected shocks have got to be on the up side. So if you're taking a long position in, say, 10- or 30-year securities for a trading play and you know that we are not going to do anything for a while, that is one discontinuity you don't have to be concerned about. But if there's a concern, if there is a Damocles Sword overhanging the system, you are very reluctant to hold inventories net long. And as a consequence of that, it is very likely to be a combination of both of those. In other words, the 50 basis points implies that we will not be active for a while, and then the statement reinforces that. That is just another way of saying to the bond dealers that it's safe to hold inventories, at least so far as potential unexpected Fed policy is concerned.

MR. MCTEER. It's sort of interesting that we seem to be in a situation where we could get a positive market reaction either by tightening or announcing we are not going to tighten.

CHAIRMAN GREENSPAN. I think both. I think the notion is that we tightened and said we are not going to tighten further. It's an effect of the tightening and the statement that nothing is going to happen thereafter. That was essentially our basic thrust as you remember at the last meeting, and I think the markets responded to that double effect.

MR. KOHN. You can see in the fed funds futures that we showed on the chart in the Bluebook that futures for the next few months went up because we tightened by more than people expected, but the rate then sort of flattened out and it was revised down for the months farther out. Whether that was the result of the announcement or of the tightening action is a little hard to sort out. I think it was also a bit of a knee-jerk reaction. The last time the Fed announced something like this, in May, intermediate- and longer-term rates went down, and so as soon as markets saw something like that repeated, those rates started to decline. Within three days the decline had been reversed, though the subsequent rise in rates didn't really occur until much later.

CHAIRMAN GREENSPAN. I think bond dealers would prefer that (1) the Fed never did anything, (2) that no one released any statistics, and (3) that everything was trading incrementally. Under those conditions they would feel comfortable. Any further questions? Cathy.

MS. MINEHAN. I'm interested in the change that you mentioned between August and now. You gave several reasons and the material we've been getting gives several reasons. But in your mind can you prioritize what was the main reason why your forecast and the implicit amount of tightening changed as much as they did from August to now?

And what do you think most hangs in the balance subsequent to this meeting? What data coming in are you most looking at?

MR. PRELL. Well, I think I highlighted the numbers that struck us as most important.

MS. MINEHAN. Is there one out of that?

MR. PRELL. I think our sense of the momentum in the consumer sector was altered by the combination of the August retail sales and the upward revisions to the prior months. Private economists had become very enthusiastic about the signs that consumers really had moved to a more cautious spending posture. So this certainly suggested that there was still a willingness to spend and also a willingness to borrow; we still have considerable growth in consumer credit, and consumer sentiment is holding up well. So, I think our perception of where the consumer is has been altered. I noted two other factors: One, at least through the current period--this does not necessarily tell you very much about the next few months--there is a considerably greater degree of strength in manufacturing than we had perceived earlier; and, secondly, the housing data just have not shown the erosion of activity that we had anticipated. We still see things as slipping but not at the pace that we had expected earlier.

So this certainly suggests that one of the key channels through which we would have thought that interest rates would damp aggregate demand is not working with the force that we had anticipated. This has its corollary, too, in all probability, in the fact that purchases of household furnishings and appliances have remained very strong; that was the notably strong element in the consumer spending report through August. There just has been no sign of tapering off there. So, those were key factors suggesting greater momentum in aggregate demand. At the same time, the employment data and the initial claims suggested that we were still getting a lot of growth in payrolls. In all likelihood, we were getting a little tighter labor market than we might have anticipated. On top of that--

MS. MINEHAN. You don't have to go through your whole presentation! I was just looking for--

MR. PRELL. Right, capacity utilization is much higher. So, given the momentum, given the slack, we have felt that somewhat greater tightening is probably needed in order to hold the pressures in the economy down to something like those we had in the forecast by the latter part of 1995.

MS. MINEHAN. And what would you be looking for in the next data coming in? Would you be looking particularly at the consumer side?

MR. PRELL. We will be looking at all of these things. We currently are anticipating some bounceback in orders for nondefense capital goods. If we got another very weak report, it might cause us to revise our view of what the trend is in capital spending, which has been giving good impetus to the expansion. Obviously, we'll be looking at those other indicators of response to interest rates, which might be the housing sector and consumer durables. And we'll be looking at what goes on in the financial markets to see how things are proceeding through those channels.

CHAIRMAN GREENSPAN. Further questions for either gentleman? If not, who would like to start the round table? President Forrestal.

MR. FORRESTAL. Thank you, Mr. Chairman. As I have been reporting for several months now, activity in the Atlanta District remains quite healthy and we see that trend continuing in the future. We are benefiting not only from the cyclical gains in activity that have been experienced around the country, but also from continued in-migration from other parts of the country. On the retail side, the back-to-school sales were mixed, but retailers nonetheless are quite optimistic. Many of them are adding to their inventories and they expect strong holiday sales. As a matter of fact, they are looking at nominal sales gains of 6 to 9 percent. Automobile dealers are confirming that model shortages constrained sales over the summer, but they are confident that the problem is being solved, and they expect sales to accelerate in the fourth quarter. Those constraints, as we know, are basically in the popular models. Tourism has been mixed in the District. We have had quite a lot of rain and that has contributed to weakness in the central and southern Florida areas, which has been a negative. Also, the slowdown in visitors to Florida from Europe has not been completely offset by growth in travel from Latin America and Asia.

Manufacturing activity also rebounded in August after a lull in July--that's a seasonal factor. The strength is pretty much across the board--in motor vehicles, chemicals, health care, textiles, carpets, and paper. The weaknesses are in apparel and military contracts. The outlook for capital expenditures is improving; manufacturers in the District actually are adding to capacity and the District continues to attract new facilities from elsewhere. On the other hand, weak natural gas prices incrementally pushed down District rig counts and, with the price of natural gas being below $2, that probably will continue. On the housing side, we did have a deceleration of sales of single-family homes throughout the District, but prices are moving up nonetheless, and that's in the face of inventory shortages. Construction was hampered by the bad weather that I already have mentioned. Multifamily markets continue to improve and the occupancy rate is increasing around the District generally. Commercial real estate is doing somewhat better, although activity remains at somewhat low levels. In financial services, commercial lending demand is stronger than it has been, and it is about offsetting the softness that we are seeing in consumer loans. Growth in District payroll employment has been about half a percent higher than in the nation as a whole.

On the price front, we are getting reports of rising prices of raw materials. This is not something very new; we have been hearing this for a while, but the reports of rising raw materials prices and other input prices are increasing. Nevertheless, our contacts are reporting that they are not able to pass these higher costs through to finished goods because of competitive pressures.

On the national economy, our forecast continues to be somewhat stronger over the entire forecast horizon than the one shown in the Greenbook, although we too see a deceleration in growth. Part of the difference is the assumption about monetary policy. We did not build in any additional tightening of rates. But I think we also have a difference because of our view of the policy lags in the price determination process. We have inflation edging higher until at least the middle of 1996, and that's partly due to our estimate that the responses to policy changes made so far will take a little longer to feed through. We do see a cyclical peak in the CPI sometime during 1996. Our forecast really incorporates the view that the current pressure on prices is due to aggregate demand growing more quickly than aggregate supply.

We believe that our efforts to reduce inflation over time may already have filtered into price- and wage-setting behaviors so that these cyclical pressures are seen as temporary as opposed to a sustained trend toward higher inflation. I think the recent behavior of labor costs, after a long period of falling unemployment, provides some support for this position. If this is the case, perhaps we can tolerate some small rise in inflation as the business expansion matures. It is possible, of course, that wage and price determinations are dominated by institutional features that, as has been discussed, in part involve an inertia to all of these processes. If this view is correct, once inflation starts rising and people build higher inflation into their expectations so that it persists indefinitely in the absence of forceful policy action, we have to act in a way that shows an absolute <u>zero</u> tolerance for higher inflation.

It seems to me, Mr. Chairman, that our policy behavior over the last several years, perhaps going back as far as 15 years, has increased our credibility as inflation fighters. From this standpoint, the outlook would strike me as one that we should be pleased with. This is a picture, it seems to me, of an economy entering the mature stages of a business expansion and moving toward a peak in its rate of growth with very few imbalances. It is an economy where the rate of inflation also rises to a peak, but one that is significantly lower than in previous expansions and that, it seems to me, is quite desirable. It is possible that, in this optimistic framework, the structural responses to our past policies may have raised the economy's potential to grow as well. I think both of these scenarios, whether you adopt the inertia or the cyclical peak thesis, are reasonable interpretations of recent data, but at this point it strikes me pretty forcefully that it's simply too early to determine whether we should be worried or not. Thank you.

CHAIRMAN GREENSPAN. Thank you. President Parry.

MR. PARRY. Mr. Chairman, a number of signals suggest that economic conditions in the Twelfth District are improving. The current data indicate that the number of payroll jobs in the District rose 1.2 percent over the 12 months through August, the strongest annual growth that we have seen since 1990. Moreover, payroll employment data for a number of states are expected to be revised up substantially when the 1994 state benchmarks are released next March. We already know that there will be large upward revisions in California, Arizona, and Washington, and several other western states may see substantial revisions as well. I should note that systematic revisions in the state data do not necessarily mean that national payroll series also will be revised up, since the national figures already include bias adjustments that generally are not used in compiling the individual state data. Utah, Nevada, and Idaho had the nation's fastest growth in payroll employment during the past 12 months. In Oregon, Washington, and Arizona, the pace of growth is less robust but appears to be picking up.

In California, it now looks as though the economy bottomed out and remained essentially flat roughly from early through mid-1993. At the last couple of FOMC meetings, we pointed to the bottom as being at the end of 1993, but these revisions in payroll data have changed that picture somewhat. However, the subsequent recovery that we have seen has been slow, sporadic, and uneven across sectors. While retail sales jumped 2.4 percent in the first quarter of this year, they fell back .6 percent in the second quarter. The unemployment rate remained stuck around 9 percent, just a little less than the present rate. Aerospace manufacturing continues to shed jobs at a double-digit annual rate.

Turning to the national economy, real GDP growth appears to have slowed somewhat from the robust pace in the first half of this year. However, growth is likely to average slightly above its potential rate in this half of the year. Moreover, at present levels of short-term interest rates, I would expect to see a modest increase in the pace of the expansion in 1995, putting growth a bit above the potential rate in that year also. Labor and product markets currently appear to be tight. This impression was reinforced by the sizable increase in capacity utilization rates in the most recent release. While estimates of what constitutes full utilization in product or labor markets are inherently uncertain, it seems safe to say that without a further increase in short-term rates such as that contained in the Greenbook, there is a significant risk that inflation will be on an upward trend in the next few years. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The Third District economy continues to grow at a moderate pace, less strongly than the rest of the nation. Total employment is growing, although slowly. Retail sales are expanding with strength notably in durables, particularly in autos. Residential construction on the whole is flat--down a little in some areas, up a little in others. Manufacturing continues to do well; it is growing, but not quite as fast as earlier in the year. Banks are reporting increasing loan volumes including increases in lending to small businesses. There also are reports of a fairly general slippage in underwriting standards--always the bank down the street, not the bank you're talking to. The outlook suggests that the pace of growth in the District will continue to moderate, although I must say I am hearing more concern about what rising interest rates might do to business prospects. We clearly have gotten people's attention; higher rates are on their minds, and they are talking more about it. Wage pressures remain subdued. Except for input prices, inflationary pressures have not changed much in the District. The competitive environment stressed over and over by business people seems to be making it difficult to pass on higher input prices.

My reading of the national economy is that the expansion is slowing but that we are likely to get more growth than we expected for the next quarter or two rather than less. The strength in retail sales coupled with that in business equipment and faster growth among our trading partners provide the underpinnings for continued growth in demand and job creation. And with excess capacity dwindling, the inflation risks are clearly in view. The major uncertainty, however, is what lies beyond the next quarter or two when some of the slackening of pent-up demand and lagged effects of previous interest rate hikes will be felt more fully. The skewing toward greater upside risk may well continue beyond this year or there may develop more of a balance between too much or too little demand going into next year. For that reason, it strikes me that this is a time where we ought to have additional monitoring of economic developments as the preferred course.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. The economy of the Second District actually improved over the last several weeks. Retailers were quite pleased with August sales--reporting year-to-year gains of 3 to 8 percent depending somewhat on the area. Demand in interest-sensitive markets such as housing, cars, and light trucks slowed, however. In the labor markets, the unemployment rate fell a bit in August to 6.9 percent in New York and 6 percent in New Jersey, and payrolls grew in July by 30,000 in New York and 10,000 in New Jersey. People are worried about personal income tax collections going forward; as a proxy for personal income, they grew by 3 percent in New York and 5 percent in New Jersey in the most recently available months. Something that has improved, perhaps at the expense of Florida, is tourism which has rebounded in New York City. A possible explanation is that the press is playing up very strongly the "law and order" approach of the new mayor and the new police commissioner. Although the crime statistics have not changed very much, people are feeling safer. The hotel room occupancy rate is up to 77.6 percent, which is a 5-year high. The New York airports are bustling and Broadway attendance is up 15 percent compared to last year. The convention business is coming back.

On the negative side, it appears that there is a hole of about $1 billion in New York City's budget for this year, which is now into its third month, and so there will be a further reduction in City employment. The talk is a cutback of about 7,000 jobs. Perhaps more important over the longer run for the financial services industry is that Swiss Banc Corporation has just announced that it is going to be moving a good deal of its activities, including its trading, to a building that is being constructed in Stamford, Connecticut, a place that already has a lot of empty buildings. When their new building is finished in 1997, they will be moving most of their New York-based activities there. As I think all of you know, the conventional wisdom has been that trading activities have to be in places like Manhattan or the City of London, and so for a major bank like Swiss Banc Corporation to be flying in the teeth of that conventional wisdom is really quite important. If it caught on, it could take a lot of very highly rewarded jobs out of New York City where they are very much needed.

The national economy appears to have less near-term momentum than we thought earlier, but fundamentally our forecast is about where we were at the last meeting. That is, we expect growth of real GDP to stay in the 2-1/4 to 2-1/2 percent range in the second half of this year and into 1995. So, we have a soft landing occurring but probably not soon enough to avoid a pickup in consumer price inflation from roughly 2-3/4 percent in 1994 to around 3-1/4 percent in 1995.

Although we believe the risks in this forecast are fairly well balanced, there is a range of uncertainty about the strength of growth over the rest of 1994. In particular, as the Greenbook would suggest, there is a significant risk of stronger near-term growth than we are projecting. So, an alternative path of short-term interest rates, other than staying where they are, may in fact be necessary to combat the inflationary tendencies that could come up. What we are really concerned about is that the near-term risks to our forecast are symmetric but we think they are quite large, since the strength and sustainability of the rebound in consumer spending are unknown.

Given the firming of the price data and the significant risk that a surge of consumption could push growth above 3 percent, we think that there are two alternative feasible paths for policy. One would be to stay about where we are and the other would be to firm policy at an appropriate time by about 50 basis points. As we compared our forecast with that of the Greenbook, what we came down to was that the Greenbook forecast looks like our upside number. That is, if all the risks that we see for stronger economic growth were to materialize, we would be about where the Greenbook is. We don't deny that that is possible, but it is the upside rather than the midpoint of our forecast. So, I think we are as far away from the Greenbook forecast as has been the case since I have been attending these meetings.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. In the latter weeks of summer through late August, there were some indications of a deceleration in overall activity in our District. We saw some slowing in retail sales and some softening in manufacturing and service-sector activity. That was reflected in our Beigebook summary this month. But the more recent reports from business contacts, directors, and others now seem to suggest that this slowing, if it occurred at all, was transitory and that the expansion in our region is back on track. At all three of our September board meetings--in Baltimore, Charlotte, and Richmond--director comments were generally positive across industries and across regions within the District. Consumer spending, including back-to-school sales, seems to be strong. Manufacturing activity appears to have reaccelerated. Tourist activity, Bill, also has been strong in our District. Nonresidential construction activity is continuing to improve. A few days ago, we got reports that a couple of large firms in Charlotte have committed to build 800,000 square feet of additional warehouse space in the next couple of months. On the residential side, we are seeing a measurable increase in apartment construction. We had not seen that for some time. So, again, after a lull it looks to us as though the overall pace of activity in our region has moved back up.

The apparently renewed strength in our District economy currently seems, to me at least, to be consistent with the strength of the most recent national data on production and sales. Taken as a whole, this information suggests to me that the deceleration in the national economy that appeared in the summer was temporary and that the expansion overall still has a lot of momentum. In this situation, I think the 3 percent projected growth rate of real GDP for the second half of the year is plausible, but as I think you said, Mike, it could be higher. Of course, the full impact of our earlier policy actions this year probably has not been felt yet. The sense I get from our directors and other business contacts is that the interest rate increases that have accompanied these earlier actions are likely to be associated with, at most, a fairly modest decline in the growth of the national economy in the months ahead. The strong recent growth in investment activity, both fixed and inventory investment, is certainly not suggestive of a business expansion that is about to run out of steam.

Mr. Chairman, let me just make a couple of comments with respect to the inflation outlook. I don't disagree with the Greenbook's inflation projection, but it's a bit unsettling to me that the staff is now projecting a consumer price inflation rate of about 3-3/4 percent by the first quarter of next year. I find it even more disturbing that for the first time we are beginning to see, not a lot, but a fair number of private forecasts of inflation rates of 4 percent or higher toward the end of 1995. Moreover, it seems clear that inflation expectations are rising at least in the financial markets. The bond rate is now at its highest level since back in the 1990-1991 recession despite our August move. I recognize that a lot of things can affect bond rates in the short run, but a bond rate that is persistently over 7-3/4 percent, as it has been now for some time, suggests to me that the longer-term inflation expectations of market participants is something closer to 4 percent than the 3 percent rate for the CPI that the staff is projecting for the second half of 1995 and on into 1996. That says to me that we still have a credibility gap. Market participants do not yet seem to be convinced that we are going to take the actions we need to take to achieve our own internal inflation forecast. So, I think it's essential that we find a way to reaffirm our commitment to price stability at an early date.

Let me just say very briefly, Mr. Chairman, that one way to deal with the credibility problem might be to consider announcing explicit multi-year inflation rate targets leading to price stability, as has been done in some other countries--say 3 percent for 1995, 2-1/2 percent for 1996, and so forth. Right now, it seems to me, we are between a rock and a hard place, between a lingering credibility problem, on the one hand, and the concerns that a lot of people understandably have about further tightening action on the other. If we announced explicit inflation targets and committed ourselves clearly to achieving those targets, that might buy us a little more flexibility at least with respect to the timing of our short-term policy actions. In the absence of something like this, though, I think we need seriously to consider some sort of policy action later in the meeting.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. I tend to concur with both the staff and the markets that both nominal and real fed funds will be higher six months from now than they are today. That doesn't mean we should feel any compelling need to move today. And what I would like to do is to take a look at what I think are two important events that will take place between now and our next meeting, and they were touched on by Peter Sternlight earlier on [Laughter]--

MS. LOVETT. Do you mean me?

MR. LINDSEY. Oh, I'm sorry!

MS. MINEHAN. It's ghosts.

MR. LINDSEY. His ghost is here; he is haunting me. Okay, good, so much for my credibility!

MR. BLINDER. Let the transcript be amended!

MR. LINDSEY. Yes, if that's possible.

CHAIRMAN GREENSPAN. That's okay, Peter was replaced by Joan "Levitt." [Laughter]

MR. LINDSEY. I would highlight two dates. The first is September 30th and that was mentioned earlier. That's the deadline for the negotiations between the United States and Japan and the issue of rhetoric comes up. I think the situation there has worsened in the last few weeks and that has to do with the changing perception of the bargaining position of the two countries. Beginning with the United States, I think it is clear to the Administration that its confrontational approach to the Japanese has been an unmitigated disaster. The U.S. bargaining position today is substantially weaker than it was 12 or 18 months ago. We used what would normally be a weapon of last resort, dollar devaluation, and we used it inexpertly, and the Japanese economy seems to have survived it. Indeed, the market reaction to this inexpert diplomacy has been so adverse that it has hurt the Administration's claim to have brought long-term interest rates down. The political ramifications have been negative and I think that fact is now widely appreciated within the Administration. So as of a few weeks ago the Administration, from what I was told, was looking for a graceful way of surrendering. In effect, the Japanese were told that they could basically set the terms as long as they made noises about how painful those terms were, the intent being to save face for the United States.

On the Japanese side, the choice is a tougher one. It's whether to take that offer and presumably buy peace for the rest of this Administration's term or to try for something more. In general, I think politicians over there seem inclined to favor a deal that would be sufficiently mild to get them through the next Japanese elections, but it would have to be demonstrably mild. I think the current LDP-socialist alliance, which represents the anti-reformist portion of Japanese politics, would find it a particularly sweet irony to score such a victory, given that this Administration failed to cut a deal with two clearly more pro-United States and pro-reform governments earlier in the year. However, some politicians and the bureaucracy see enormous potential for getting even more by holding out, and I think this was what the hawkish comments suggested earlier. The fact that the United States has been defeated by the Japanese is widely appreciated in the Japanese government, and as a result the option is there for a humiliation of the United States that would be made clear by a negotiated defeat, which so far has not entered U.S. political consciousness. The gains for the Japanese by forcing a humiliating set of terms on this Administration or at least avoiding a face-saving exit by the Administration would mean not just two years of peace, but perhaps a period of peace lasting several Administrations. That would mean in effect that future politicians would have been scared from using Japan-bashing as a weapon. Of course, this Administration can't accept humiliating terms five weeks before our elections, so the possibility that neither side may blink is I think pretty high, and the result for the markets could be tumultuous.

The second date that we should be paying attention to is October 16th, which is the date of the German federal elections. I am a bit of a political poll junkie and those polls coupled with the Bavarian elections on Sunday suggest to me that Mr. Kohl is unlikely clearly to win a fourth term. Too many things have to go right. The Free Democrats have to make the 5 percent threshold to get into Parliament; I think they probably will, but it's no sure thing. The PDS, which is the Party of Democratic Socialism--my, how names change --probably won't get the 5 percent, but they are probably going to get into Parliament another way, which is to win three seats outright, as they probably will in East Germany by direct vote, and get their full proportional share. So, somehow they have to fail to get those three seats. The far right has to fail to make the 5 percent threshold as well. And assuming all these things go right, the blue/yellows or the Christian Democrat/Free Democrat vote has to be greater than the red/greens, or Social Democrat/ecologist vote. Any one of those events may be likely, but I think the chances of all of them going the right way seem to be quite small. As a result, I think what we are going to see is the Christian Democrats and Social Democrats agreeing to a coalition. The markets know what that means, namely an inexpert, compromising, and vacillating German government for four years with the growth of both right and left on the fringes. That would not be good for Europe; it would not be good for Germany; it would not be good for the bond markets.

In sum, if things go wrong on September 30th, we could face some combination of foreign currency bond market problems. If things go wrong on October 16th, I think the result would be a short-term appreciation of the dollar coupled with a general sell-off in worldwide debt markets in the longer term. In either event, the potential need for an adjustment in U.S. rates is possible. I'm going to be quite specific. I made my views on the efficacy of foreign exchange intervention fairly clear several meetings ago, and I won't go into that again, but my suggestion this time is that if intervention is requested, we make explicit that it be accompanied by a change in policy and in particular that it be accompanied by a change in policy of 50 basis points. Frankly, Mr. Chairman, I think that having that be the policy of this Committee would strengthen your negotiating power in resisting what most people in this room find distasteful. But hopefully we will survive both September 30th without a need for foreign exchange intervention and October 16th. And if we do so, no rate increase would be needed and we can come back to the normal considerations of monetary policy in November.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. New England's recovery remains respectable in terms of the data, but the pace and feel of economic growth lead me to conclude that we may still be experiencing the lull that we thought was there nationally during the summer. In July, employment growth was just under 2 percent for the region as a whole over the previous year or nearly a full percentage point below national levels. Earlier in the year, regional growth had tracked national levels a little more closely. As in the past, employment growth in the region varies considerably by state, with Massachusetts and New Hampshire employment growing at just under 3 percent, that in Connecticut nearly flat, and Vermont and Rhode Island employment beginning to flatten as well. Growth in service jobs remains dominant, with two-thirds of the job growth in New England over the last year occurring in services. However, we are beginning to see an upturn in manufacturing, a fact that has engendered some optimism. Consumer confidence rose slightly in August, but here again it is not what it was earlier in the year. In general, New Englanders have expressed less of a sense of growing optimism over the past year than is true nationwide, with local consumer confidence readings moving up less than 10 points versus over double that for the nation as a whole. Perhaps these consumer confidence figures account for the general spending malaise reported by our retail Beigebook contacts.

Continuing this tale of moderating growth, construction employment has been essentially flat for three months, new housing activity is slowing, and significant commercial construction has yet to materialize. However, both housing permits and the value of residential construction contracts remain considerably above year-ago levels. Retailers and manufacturing contacts report very little cost pressure in contrast to more widespread reports of raw materials cost increases six weeks before. And where there are price increases, we also see the inability due to competition to pass on those price increases. Finally, while the overall volume of District bank lending is growing at a pace over that of 1993, such lending in the commercial, real estate, and personal loan categories is growing at a quite moderate pace compared to national trends. I don't think that has anything to do with the banks' willingness to lend because we hear the same kinds of things that people hear nationally--that there may be some deterioration in the credit standards at the bank down the street. There has been some news about that locally in the papers, but we don't see a tremendous degree of growth in the actual bank lending data.

I should note two bright spots: First, there was a great summer tourist season in the Northeast, similar to New York, with reports from Maine, the Boston area, and Cape Cod quite strong. Second, commercial real estate markets seem to be tightening, at least in specific areas. Vacancy rates in downtown Boston have declined substantially and some experts are predicting new construction as early as a couple of years from now, with serious renovations of older buildings in the meantime. That contrasts very sharply from what people were thinking when I first arrived in Boston three years ago. At that time, people were talking about sort of a 10-year horizon before anybody would risk building something new in Boston.

On the national scene, we concur with the Greenbook that the prospects for the third and fourth quarters look stronger than expected. Labor markets are tight; external growth is stronger. Inflation, while perhaps not accelerating as yet, has stabilized and may be showing signs of turning upward. So we are in harmony with the forecast of increased rates over the last half of the year, but the amount and the timing we believe are an issue. Looking at a range of private sector forecasts, none seems to project as much tightening as the Greenbook though they achieve similar rates of GDP growth and a moderation of inflation during 1995. So, we are a little agnostic about the degree of tightening, but we agree that the risks are on the up side.

CHAIRMAN GREENSPAN. Thank you. President Jordan.

MR. JORDAN. The District economy is quite strong overall. In fact, there really isn't an area or sector of the District that I would call weak. Tourism has been very good; maybe it's a spillover from New York, I don't know, but everybody talks about having had a record year of tourism, especially in northeast and northwest Ohio. Agriculture had its third good year in a row, which means all the ag sector banks have done very well. In fact, all of the banks in the District are reporting that they are in very good shape; this is the strongest year in decades. Residential construction is very good. We have had some reports of increasing house prices, but we hear mostly about increased building activity and not concerns about prices. Nonresidential construction has picked up a fair amount and that relates to capacity issues that I want to come back to in a moment. Motor vehicle production essentially is at capacity, whether it's trucks or autos. All of the suppliers as well as the assemblers are saying that they are at capacity levels and expect to stay there for at least the balance of the year. Retail sales were quite good through Labor Day but then dropped off for the balance of September--not in a way that worries people, but there was a noticeable slowing of activity. Labor markets generally are characterized as tight throughout the District. Even some areas that were complaining before about being sluggish or soft now say that there has been a pickup. In some communities, people associated with retail or fast food operations actually complain about a shortage of teenagers, if you can imagine such a thing! [Laughter]

MS. MINEHAN. A shortage of teenagers who want to work.

MR. JORDAN. We were especially interested in the question of capacity in the manufacturing sector and put the question directly to a broad array of manufacturers--the whole spectrum whether it's capital goods, machine tools, motor vehicle-related, and so on. Consistently, reports are that they are at capacity and are looking to expand capacity. Then we turned the question to pricing, and we found no pattern at all. In fact, it was the rare exception where somebody said that price increases were going to be a response to capacity limits and backlogs. They really want to increase their ability to meet the demand that they see through output, not price increases. That led me to be very curious about the Wall Street versus the Main Street attitudes. When we look at bond yields, mortgage rates, the price of gold, the exchange rate--all these sorts of things suggest an inflation premium. So, we asked people--directors, small businesses, large manufacturing companies, other nonmanufacturing businesses--whether they were more concerned about inflation, less, or the same compared to two or three months ago. And with only one exception out of dozens of business people we talked to, they said the same or down, with the majority saying down. So from a Main Street standpoint, people are not acting or sounding as though they think that inflation is picking up. In that sense, I don't think we have lost ground in terms of trying to achieve a situation where inflation is not a major factor in decisions of households or businesses.

I'm puzzled by the international financial markets. One way of reading them is that we are seeing a hike in inflation concerns and awareness in those markets.

Regarding the national economy, I still am not inclined to think of what has happened in the past four quarters as a classic increase in aggregate demand fueled by monetary/fiscal stimulus or something like that. A year ago, we had gone through a significant period, several quarters at least, of a disappointing economy. And we were waiting for the rebound--waiting for economic activity to pick up--and were getting to the point of thinking it was not going to happen. The Greenbook forecast for a year ago had a middling expansion out through 1994. We then got the pickup and we have had four quarters of fairly good growth. But I choose to interpret the majority of that as having been the effect of a transitory increase in the level of economic activity in response to, if you will, the diminishing of the head winds--the depressants being less of a factor --rather than being fueled by aggregate demand kinds of factors as in the past. There may be some element of that. If so, we have to say with the advantage of hindsight that if we think this pickup basically has been demand-driven, then we overstayed our accommodative policies late last year and early this year--that we were fighting against the head winds longer than maybe was necessary and should have backed off the accelerator a little sooner.

But I don't think that is the lion's share of the way to interpret this. If I am right about what these last four quarters have told us, then as this transitory increase in economic activity is completed, the rate of change naturally will diminish. Second derivatives have to go negative. I don't see signs that tell me that we have to use the term "tightened too little" or necessarily even "too late." I would have expected that if moving up to the 4-3/4 percent level from the 3 percent level in the funds rate was behind the curve, then we would have seen symptoms of that in reserves, central bank money, demand deposits, other things suggesting that there was something in the marketplace moving equilibrium interest rates up much faster than we were moving. I don't see that out there. As implied in my question earlier to Joan, the yield curve may play a part in that. Why does the yield curve from three months out to a year look okay? What we have been doing on the funds rate does not look to me like either too low a level or one that came up too slowly. But I have problems with what happens between the 1-year and the 2-year maturities. Why is the 1-year forward rate for the 1-year maturity 7-1/2 percent? It leaves me in a position of thinking that we should not totally neglect the information that is coming from reserves, money, and credit and debt measures that say that right now we are in a good position; give it a little more time.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. The Tenth District economy remains strong, but there are some signs of slowing. By that I mean slowing to a pace more in line with the national rate, so the regional economy is still very strong overall. We are seeing some slowdown in residential construction which suggests that some of the earlier policy moves may be having an effect, but the slowing is modest. We also are seeing some slowdown in the ag area and what happens there will depend a lot on prices. Our energy sector remains sluggish. On the other side, we have manufacturing that is very strong, especially the durables side and automobiles. Our services industry is very strong and our retail sector is strong. Commercial construction, in contrast to residential, appears to remain fairly good, and we still are seeing some scattered shortages in the labor market. We also are hearing continued comments about resource price pressures in steel and in paper manufacturing. This has been going on long enough that individuals in these firms feel that something has to give. Their margins are coming under pressure and how much more they can be squeezed is on their minds. So, in contrast perhaps to our other contacts, I think they are thinking about inflation.

As we look forward, we do think the District economy will continue generally strong. There may be some further slowing, particularly in the construction area, but we think manufacturing will remain good in the context of strong national demand and as the foreign sector has its effect on our manufacturing. Overall, conditions in our District are generally good and I think they will stay that way for some time.

On the national level, we see growth slowing slightly this year, but we think it will stay above the potential rate and remain above 3 percent on the year. We think that's also true for inflation as we end out the year. Looking beyond that, and assuming we hold monetary policy unchanged, we see some slowing of the expansion next year toward the natural rate. But we still see an environment where inflation is rising in a 3 to 3-1/4 percent range. So that is a concern to us as we look to the future for the economy, especially as we see our own District remaining fairly strong. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, economic activity in the Seventh District remains relatively strong. Most reports indicate an expectation of continued growth in the near term, with the possible exception of residential construction. Manufacturing activity remains robust but has been impacted by capacity constraints as has been mentioned before. Most of these constraints in automobile production should be resolved this fall except for some selected, very popular models where shortages are expected to continue into next year. Auto suppliers in the District report that orders remain very strong and that production is "maxed out." The heavy duty truck industry is also at capacity. Our contacts in retailing generally report that sales growth has continued at about the slower pace seen in the second quarter, with several noting some improvement more recently. Retailers generally are optimistic about sales over the rest of this year. For the most part, inventories are in good shape, and many retailers indicate that they plan to increase their stocks in the near future. Competitive forces continue to hold down prices to consumers. Labor markets in our District have continued to firm up. Demand for temporary workers in our region is very strong, with these firms having to pay wages that are 5 to 10 percent higher than last year to attract workers. Recruitment costs may be rising more generally. We have had reports of bonuses being paid to hire engineers and truck drivers, for example. However, we have had few reports of any significant upward pressure on the wages of permanent workers. Some employers reported that they do not expect higher union wage demands in the coming months, and others believe that they can offset higher wages through productivity increases.

Purchasing managers throughout the District report that prices have been in an upward trend this year. Increases in prices for container board, chemicals, and aluminum have been particularly pronounced in recent months. Some manufacturers have fixed-price supply contracts that protect them from price increases for the remainder of this year. For example, auto and commercial equipment manufacturers will now be negotiating new steel supply contracts for next year. However, manufacturing contacts at our recent meeting in Milwaukee continued to express skepticism that inflationary pressures would prove significant or long-lasting, citing the intense and continued competitive pressures that have been mentioned here before. Agricultural conditions in the District remain quite favorable. Estimates which had already pointed to a near record corn crop and a record soybean crop have been raised slightly. These crops are maturing at a faster than normal rate, reducing the possibility of harvest losses.

Our overall macroeconomic outlook for the second half of 1994 is largely consistent with the Greenbook. We concur with the Greenbook assessment that little slack remains in the economy. The only difference concerns the quarterly pattern of real growth. We expect slightly weaker real GDP growth in the third quarter followed by slightly stronger growth in the fourth quarter, and this discrepancy primarily reflects differing assessments of the timing of production patterns in the automotive sector.

If I could, I just want to comment on the U.S./Japan negotiations and the September 30 deadline.

CHAIRMAN GREENSPAN. Do you want us to ask what your affiliation is in this regard?

MR. MOSKOW. Just an observer from Chicago at this point without having had any contact with any of the participants. These are complex negotiations, as we know, under at least two different statutes. I think that Governor Lindsey's scenario is possible, but I would say the probability is higher that the parties will reach agreement on some of the issues. If that's true, then I would not expect any major negative impact on the currency markets.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. First, with regard to the Ninth District economy, the objective measures of economic activity suggest that the regional economy remains strong. The anecdotal evidence--of course there is always a danger of paying too much attention to that--suggests that activity has even picked up another notch, which is pretty remarkable because the regional economy has been operating at quite an accelerated pace for an extended period of time. Nevertheless, business people seem quite positive about recent developments virtually across the board. Labor markets have tightened further and jobs are certainly readily available. Despite those circumstances, there is still no widespread evidence of building inflationary or wage pressures, but I think it is fair to say that there are more scattered indications of growing inflation and wage pressures. It is by no means widespread, as I suggested, but as we listen to people comment about input prices and about what is happening in specific labor markets and so forth, there certainly is more talk today about inflation than there was a few months ago. Even some of the business people who have been quite skeptical of our concerns about inflation, thinking that we might be worried about a phantom, have started to acknowledge that there may be a little more to it than they at least thought earlier. It's also true that when we talk to bankers--I think this came across in the FAC minutes but it comes across almost everywhere--if anything credit is a good deal more readily available today to small and medium-size businesses than it was a year ago or even less. It does not appear that our moves toward higher interest rates have had any restraining effect in that sector.

With regard to the national economy, it may be slowing, but not very much in my view, although I will admit that depending on how the inventory numbers play out, we could get some readings of real GDP that suggest a slowing. My reading of the incoming data at the national level suggests there is a good deal of momentum in the expansion. I guess the only way I can describe it is that it looks strong. I do think this will be accompanied by some acceleration of inflation as the Greenbook suggests. Bob Forrestal raised an interesting point that this may be just a temporary, cyclical spike that we need not get very worried about. But it seems to me that identifying whether it's a temporary spike as opposed to something more durable may turn out to be exceedingly difficult, and certainly history doesn't provide very much comfort on that score.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Eleventh District business conditions remain good and essentially unchanged from my last several reports. There are no significant new straws in the wind except perhaps on the fashion front where I understand that mohair is gaining in popularity. I'm told that the Eleventh District produces 90 percent of the country's mohair. We have a lot of "mos." [Laughter]

MR. KELLEY. That shows you how much demand there is for more hair! [Laughter]

MR. MCTEER. There's a lot of dust being raised by companies getting ready to do business in Mexico under NAFTA, and unfortunately there are some signs of non-tariff restrictions replacing tariffs as a barrier to trade.

In August, I reported complaints by some small banks of very aggressive competition in lending from larger banks. We have had people examining that more carefully and their early reports are that that is more a matter of price and spreads than standards.

I can't really add to anything that has been provided to us or reported here today on the national economy except my caution that we should keep an eye on the further slowing of all of the monetary aggregates and bank reserves, especially in the context of a fiscal policy that's not as expansive as we used to see it. I understand that that has not been a problem today, but we shouldn't forget about the aggregates; we should see what is going on there and keep them in mind.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. Despite hopes to the contrary, the fact is that inflation has turned up. Projected strength in demand, which is a view we would certainly associate ourselves with, may well add further to inflationary strains. In the past three months, both retail sales growth and industrial production have accelerated. Payroll employment growth continues to be strong. Correspondingly, as has been mentioned, capacity utilization has risen well above its 1967 through 1993 average of about 82 percent. A rebound in auto production in August and recent announcements of auto sales and production schedules point to improving growth in industrial output through the end of this year.

In the Eighth District, auto production has been booming in the third quarter, and producers recently have boosted production plans for the fourth quarter. Production at Ford and Chrysler plants in St. Louis is planned to rise by about 11 percent from the third quarter and by more than 2 percent from year-ago boom levels. Auto industry officials continue to see sales constrained by supply as producers reduce output in some areas to retool and make capacity improvements. Overall in the Eighth District, there has been some leveling in economic activity but at a very high level inasmuch as we had recovered to near capacity far faster than the nation as a whole. Nonetheless, employment in the District remains robust as the unemployment rate hovers near its lowest level since August 1974. Reports of labor shortages in certain trades and geographic areas are increasing in my judgment. For example, in the construction trades, there are now reports of shortages throughout the District. In certain areas that had been very successful in attracting new business--areas like Bowling Green, Kentucky and Jackson, Tennessee--regional development efforts are being altered to reassure new and expanding businesses about the continuing availability of labor. Jackson, for example, recently has announced a six-month hiatus in recruiting large business prospects. In some areas, there are shortages even of unskilled labor, although these are being offset in certain cases by hiring immigrant laborers from Mexico, for example in northwest Arkansas. Turnover rates are very high. Firms report having to hire two to three apparently qualified workers--and that implies screening a lot more--at this unskilled labor level for every one that pans out. While reports of wage pressures have been isolated so far, broader-based pressures seem incipient given these developments in labor markets.

Business executives in the District are also seeing evidence of price pressures from rising costs of steel, paper products, and a variety of raw materials from both foreign and domestic sources. Despite continued competition in product markets that limits their ability to pass on costs, it would not take much, in my judgment, to crystallize price increases in such an environment. In fact, an interesting aside, somewhat contrary to the report of the view of the National Association of Manufacturers, is the view I am getting from manufacturers in our District. They perceive that the marketplace they are operating in is so competitive that to enable them to stay competitive, they would like us to take action to contain what they see as emerging price and wage pressures.

One final area I wanted to comment on is inventories. Of course, many economists have been concerned that the second-quarter buildup foreshadows slower demand growth ahead. However, again based on conversations I have had with business executives in the Eighth District, my general sense is that the buildup was intended. Let me give you just one example. Last week we had a meeting outside of St. Louis, and a manufacturer of steel for industrial and commercial buildings with operations not only in our District but the upper Midwest and the West told me that his lead times from suppliers are now two to three times above what he would normally expect and that he in turn has pushed out his delivery schedules for his customers to probably twice what they normally would be. As a result, to prevent further delays in meeting his customers' demands, he has begun to order raw materials in anticipation of orders that really have nct materialized. I will say, however, that when I asked him whether he was willing to build speculative inventories based on the prospect of further increases in prices of materials, he said no. By the way, he has seen two steel price increases so far this year totaling 10 to 12 percent and another increase has been announced and seems very likely for the beginning of the year, So far, all that is going on, at least in this sample of one, is the building of additional inventories against expected final orders.

CHAIRMAN GREENSPAN. This is a manufacturer of what?

MR. MELZER. Steel products for industrial and commercial buildings--warehouses, light industrial buildings, strip shopping centers, that sort of product.

To conclude, I'm very concerned about inflation no matter what measure one looks at. In July and August, consumer prices accelerated to an annual rate of 4.1 percent and producer prices to an annual rate of more than 6 percent. Inflation is certainly headed in the wrong direction if price stability is our goal.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mr. Chairman, I suspect that the death yesterday of the Administration's health care reform scheme may well result in a reversal of some of the recent declines in consumer confidence. On the other hand, the upcoming election will tend to focus attention on voter dissatisfaction with government and support continued uncertainty. My own view is that the export sector may in fact do better than the Greenbook forecast, and consumers may continue recent spending patterns more strongly than the Greenbook projects. The abrupt drop in GDP growth projected by the staff for 1995 seems to me to be inconsistent with the projected levels for autos and housing starts. As a result, I continue to believe growth in 1995 will be somewhat stronger than the staff forecast and may indeed require further restrictive action by the Committee. But I'm not convinced that we have yet seen the full impact of our previous policy moves or that the future direction of policy is clear enough at this time without more hard data. I certainly admire the inflation reduction and containment achieved in some other countries, but I find the social price paid in those countries in terms of prolonged recession and very high unemployment unacceptable for the United States. I would rather pursue a more moderate course designed to ratchet core inflation down over time and not be distractedly concerned by occasional temporary upward blips in the CPI. Consequently, I think we need more information and a very sensitive foot on the brakes.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. First, very briefly a quick summary of where I am: The inflation news since the last FOMC meeting certainly has not been very helpful, but I don't think there is much evidence that inflation is going to take off on us. We may have some inflation creep on our hands as the Greenbook suggests, and I'll speak a little more to that in a second. In real activity, as Mike Prell and many others have observed, there is an impressive and, certainly to me and perhaps others, a surprising amount of momentum still out there and that may be slowing. When we gathered last time, we tightened 50 more basis points and that, of course, is only just now going to start to have an impact. The impact of earlier tightenings is, of course, still in the process of unfolding. So in short, I think we have an interlude here to see what develops. The slowing may spread and stretch out a little. On the other hand, it may turn out to be very brief and we may continue to get very strong data that may call for another move rather soon.

If I can take one more minute, Mr. Chairman, let me share with you a concern that I have. If inflation creeps up at all, and it certainly appears that that is likely, many here could regard that as insignificant or temporary and not be terribly concerned about it. But I think we probably need to be prepared for a rather major and stronger bout of inflation jitters in the economy, and we may want to think about how we might be able to handle that. There is a perception that the economy is in a very mature, perhaps even a late, stage in the cyclical expansion. Everyone perceives that we are operating more or less at capacity now. For a long time in this country, people would expect in a period like this to see inflation take hold and be at its most virulent. I think that until we actually go through a full cycle without a substantial inflationary surge, there is going to be a concern that history will repeat itself, and I can understand that. And if inflation starts to show some upward creep, there almost inevitably will be some concern that, okay, the game is on, here we go again.

There are at least two risks in that. First of all, it could have a certain self-fulfilling prophecy element to it through the expectations channel and it may make itself stronger than it needs to be or might inherently be. Second, I can see it forcing long rates considerably higher than we are comfortable with or think that they ought to be through an enlarged inflation premium. That could be an overly and unnecessarily negative event. So, I have a concern regarding what we may be looking at in the marketplace in the near future, Mr. Chairman. Even if we are not terribly concerned based on the specific evidence that we see at hand, I think there could be some market concerns that would work their way through the economy in a negative way.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. I agree with the central message of the Greenbook that most of the new information that has accumulated during the last six weeks points to continued strength in aggregate demand.

The incoming data do not yet provide any significant evidence of a sufficient slowdown in real GDP growth. However, this is not based on a great deal of evidence. A lot more data will be coming in over the next month that will clarify whether this impression is correct or not. I personally am concerned that we have put quite a bit of restraint into the pipeline, a good share of it quite recently, and it may yet make its impact felt. Under the Greenbook assumption of an additional 100 basis point rise in the funds rate, I am considerably more pessimistic than the Greenbook about the 1996 forecast for real growth. For example, in the MPS model the impact of such a tightening becomes really discernible only after about four quarters, namely by early 1996. And after eight quarters, such a rise would take about 0.9 percent off real GDP. That leaves me with a sense that a forecast of 2.2 or 2.3 percent real growth in 1996 may be overly optimistic with that added restraint.

A key question now concerns the behavior of prices--whether there is evidence at this stage that inflation is accelerating. This in my view is an especially important issue given our concern with inflation as an ultimate policy goal and also the feeling that the economy is operating at close to potential where there is a decided risk that inflation could begin to creep up. But here my analysis differs somewhat from the staff forecast. In particular, I think we are seeing and will continue to see for a time an increase in the relative prices of raw materials and imported goods. These higher prices will feed through into the CPI for a period of time, causing a temporary increase in the rate of inflation but not a permanent increase in the trend inflation rate, or worse yet, an acceleration in inflation. I think the increase in inflation will be temporary even if there is only enough restraint to hold the unemployment rate at its present level, roughly the natural rate given staff estimates. And I think the markets have overreacted to the increase in producer prices in August.

Now, the Greenbook is also forecasting that consumer price inflation will be up for the next three quarters and then will return to roughly 3 percent by the end of 1995, and I agree with that forecast. My difference with the Greenbook concerns whether or not a period of unemployment in excess of the natural rate is needed to get inflation back into line. I think not, but the Greenbook thinks that it will require a period of unemployment in excess of the natural rate in the latter half of 1995 and 1996 to subdue inflation, and that's something more than a quibble because it does govern one's view about how much additional restraint it is going to take to hold inflation at its present level.

To elaborate just a bit, I think we are witnessing now a perfectly normal cyclical phenomenon, namely, the relative prices of primary commodities and raw materials tend naturally to increase with the level of domestic and more importantly world economic activity. The prices of these materials have been increasing rapidly all year, but from initially depressed levels. I expect these prices to rise further due to faster global growth, but then I expect them to stop rising once economic activity stabilizes. Similarly, we have had a significant depreciation of the dollar, which is causing and will probably continue to cause for a time a rise in the level of import prices. But the staff doesn't expect the dollar depreciation to continue and so we should expect import prices also to rise and then stop rising.

My conclusion is that these shocks should feed into faster CPI inflation only for a time, and once the adjustment is complete, inflation should revert toward its previous level. I expect this to occur even if the CPI increase feeds partially through into wages, although the greater this feedback, the longer this temporary burst in inflation will persist. I agree with Governor Kelley that there is a danger that inflationary expectations can overreact. Historically, I think the evidence on the likely pass-through of temporary price shocks into wages is quite inconclusive.

The only caveat I want to add in this analysis is that I'm assuming along with the Greenbook that the unemployment rate is not going to be allowed to fall below the natural rate--and that means not very much lower than it currently is--for any significant period of time. With respect to the question of whether or not we are below the natural rate, I think wage behavior provides the best direct evidence. The fact that wages have been so well-behaved, with average hourly earnings rising only 0.2 percent last month, for example, convinces me that we have not overshot the natural rate.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. I have only a few points to make and since probably half the people around the table are as hungry as I am, I will make them quickly. I wasn't planning to say anything about the trade negotiations; but since it was brought up, and lest silence be construed as assent, let me just say that I disagree 99-1/2 percent with what my colleague, Governor Lindsey, said in his assessment of what's likely--

CHAIRMAN GREENSPAN. It means you agree with him on 1/2 percent?

MR. BLINDER. I think 1/2 percent is on track, and I'll leave it at that.

On the forecast, largely for reasons having to do with inventories, which I brought up at the last FOMC meeting and certainly with the staff, I would look for the third quarter to be weaker than in the Greenbook. By pure arithmetic, some of that difference is going to show up in a stronger fourth quarter. So, this is not a major disagreement. But, on balance, it leads me to a somewhat weaker second half of 1994 than the Greenbook forecast. Conversely, I'd expect a bit stronger first half of 1995 than the Greenbook. Note that the projected further tightenings of monetary policy built into the Greenbook forecast could not possibly be slowing down the economy in the first half of 1995. So, whatever is in the staff forecast for the first half of next year has to have been built in by the previous tightenings. I don't think we have tightened enough to slow the economy down to 1.8 percent in the first half of next year. Accordingly, I'd expect the first half of 1995 to be a bit stronger than in the Greenbook. But over the next year there may not be much difference between the way I see things evolving and the way the Greenbook sees things evolving in total. Now, for the eight quarters in 1995 and 1996, the average growth rate in the Greenbook is about 2 percent. I don't find that to be a very satisfactory target. If we have not yet overshot capacity, and I don't believe we have although one can't dismiss that hypothesis completely, the economy does not need to grow at 2 percent for two years in order to keep inflation from rising. If we have already overshot, then indeed we do need something like that.

Regarding inflationary pressures, I think we should realize, maybe more than we do, how concentrated the industrial pressures are in the United States right now. There are lots of stories coming out of the manufacturing core of the economy about tight markets, very strong capacity utilization, strong order books, good sales, etc. They are all true. But they are very much concentrated in durables manufacturing, which in round numbers is 10 to 12 percent of value added in the U.S. economy. If you look at the demand side rather than the production side and look back at the last year, we have had buoyant growth over the year, which has scared a lot of people. The four quarters ending in the second quarter of 1994 had a growth rate of 4 percent. It's the only time that we have had a four-quarter period with growth as high as 4 percent in this entire business recovery. In previous business recoveries, one four-quarter period of 4 percent would not have scared anybody and, indeed, would have left the FOMC thinking that things weren't looking that great.

More important than the 4 percent, I want to call attention to the fact that that growth was highly concentrated. I looked at these numbers last night. I knew the qualitative story, but I was surprised at the quantitative dimension. We all know where it was concentrated--in business fixed investment, consumer durables, and housing. Those three sectors account for roughly 1/4 of GDP on the spending side. I'm not talking about value added weights because a lot of that is imports, which is a point I'm coming to. Those three sectors of the GDP over the last four quarters registered an 11.3 percent rate of growth. This means by the laws of arithmetic that the rest of the economy, the other 75 percent, registered a 1.6 percent growth rate over that period. Those three sectors, of course, leaving aside housing for now, are where the price pressures are--either current or incipient. If you looked at the Greenbook forecast for the next two quarters and took housing out of the fast-growing sector, the result would be even more extreme. We don't expect housing to be part of the fast-growing sector going forward; the staff doesn't; none of us do. But, leaving housing in the fast-growing sector, those three sectors in the Greenbook forecast are projected in the second half of this year to grow at a 6 percent rate and the rest of the economy at a 1.8 percent rate. If I moved housing over the sectoral line, that spread would be exaggerated because we are expecting a slowdown in housing.

Regarding the point that I was making about inflationary pressures, many people in popular discussions point to international capacity as a safety valve on U.S. inflation. This is greatly exaggerated because roughly 90 percent of what we consume or use is produced at home. The place where it has the most validity, however, is exactly where the pressures are right now--in business fixed investment, where over 40 percent is imported, and consumer durables where I don't remember the fraction that is imported. Those are precisely the sectors where we are seeing pressure. It is in this very limited part of the economy where the international safety valve is most important.

Finally, I want to align myself fully with the comments Jerry Jordan made earlier. I have been worried for some time, and I am becoming increasingly worried, about the disjuncture between the Main Street view of inflation and the Wall Street view of inflation. I just want to point out an implication: None of us is sure this disjuncture is actually a fact; I suspect it is, as Jerry does, but it is hard to know for sure. If it is a fact, the implication is that real interest rates look a lot higher on Main Street than they do on Wall Street, and we should be mindful of that. If that hypothesis is correct, that's likely to mean that there is more punch in what we have already done than we realize. Thank you.

CHAIRMAN GREENSPAN. Finally, Governor Phillips.

MS. PHILLIPS. I guess I am left to bat clean-up in an era of a baseball strike, and I'm not quite sure where that leaves me! The economy clearly is going into the fourth year of this upturn and the third year with above-potential GDP growth. As Governor Blinder just described, we are seeing a lot of the strength in manufacturing of consumer durables and in business investment, especially equipment spending. The labor markets appear very strong. Job generation has totaled over 3 million jobs this past year. Housing activity clearly has slowed. The question is more on the consumer side. We appear to be seeing some slowdown there. As we have heard around the table, there is some disagreement regarding the extent of the slowdown, where it is and so on. Part of this may be that consumers have worked through the bulge in their pent-up demands following the recession and also have worked through the housing bulge when people buy lots of consumer durables following their housing purchases. I think most people would suspect that we should be seeing some slowdown. I was a little surprised to see the discussions of a potential Christmas spree spending now being reported. The international picture should be strengthening and at least not be a drag on the economy. I certainly recognize that this is not a large part of the U.S. economy because we have such a large domestic economy. Nevertheless, looking at these various pressures, it's a bit hard to escape the conclusion that most of the slack in labor and product markets is used up, and we are starting to see the effects on the price side. I think we are beyond the point of a preemptive strike. Barron's yesterday was even talking about urging people to dig back into their closets and find their "Win" buttons. [Laughter]

MR. BLINDER. We each have one, Mr. Chairman! [Laughter]

MS. PHILLIPS. Then you are well prepared. I think some of the numbers that have already been cited here recognize that we are seeing some show-through of price pressures even in the CPI, particularly in the last couple of months. We have all been citing producer price pressures in the last few months, and there are lots of good statistics to quote with respect to producer prices and also commodity prices. While much of the pressure on commodity prices has not shown through to final consumption prices, it would nevertheless be a danger signal if commodity and other producer prices stayed at elevated levels for a sustained period of time. I think it is interesting that the argument on inflation now appears to have shifted somewhat. There appears to be fairly broad acknowledgement that we are seeing more price increases. The question now appears to be whether the increase is permanent or a short-term cyclical blip. Maybe because Bob Forrestal went first today, he was the first to surface this argument. But I quote Gary Stern's stern warning about the problems of identifying whether it is a blip or whether it is more incipient or creeping price increases, something that's likely to infect the CPI for the long term and in fact move on into the wage sector.

Turning to the financial market side, the stock markets, I think, have shown quite amazing resilience in light of the interest rate increases. Stock prices are being sustained, I think, by earnings at this point, so we are getting a healthier relationship between prices and earnings. Bond markets are certainly nervous, and I think this is well demonstrated by Peter Fisher's art work in his charts, but it's not the wild roller coaster that we saw in the first part of this year, at least for the United States. Bank credit markets are showing significant strength. So, when all is said and done and perhaps with a mild caveat for mortgage markets, the capital markets are producing a cost of capital that is clearly supportive of investment and expansion.

Now, while all of these signs for the economy appear very strong and the recent revisions have been upward as is certainly well documented in the Greenbook, I think there are some clouds on the horizon--the so-called downside risks. We have already talked about the spending slowdowns. We still have some pressures in the labor markets on account of the whole re-engineering story. We have defense and other sources of fiscal restraint and the continuing need to address whether the deficit is going to be coming back into play, particularly for the out years. Much of the strength that we have seen, I think, is dependent on productivity gains, and it's questionable as to whether or not we are going to continue on the 1990s trajectory for productivity or whether we will revert to the 1980s trajectory. Balance sheet strains could reemerge following the strong credit growth and the merger and acquisition activity that we are seeing. Finally, I'd mention the monetary aggregates. It's hard to believe that the weakness that we are seeing in the monetary aggregates is not going to have some effect. On balance, I think the outlook looks good, but there are downside risks.

CHAIRMAN GREENSPAN. Thank you. Coffee is available. Let's break for coffee and return.

[Coffee break]

CHAIRMAN GREENSPAN. Don Kohn, would you start us off?

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

CHAIRMAN GREENSPAN. Questions for Don? If not, let me start out. I think the evidence is fairly solid that the industrial momentum that we have been seeing in recent months has a head of steam behind it; we can see it in the order books; we can see it in the backlogs; it's fairly widespread. But as Governor Blinder pointed out, the growth in industrial production this year clearly has been concentrated to a significant extent in durable goods and has been especially heavy in areas related to capital goods. But these areas are where inventories are rising most and why they are crucial to measures of industrial pressures and overall pressures. In tracing this phenomenon over the last year or two, we are aware of a very rapidly dropping inventory/sales ratio when calculated to exclude the margins of trade. In other words, factory-valued inventories as a ratio to consumption have been falling at a fairly dramatic rate until very recently. Indeed, the decline has been enough to hold the level of real inventories to a very slow growth path until very recently. As we discussed at previous meetings, all we have to do arithmetically is to take the "just-in-time" decline in inventory/sales ratios and flatten them out and inventory investment surges. Indeed, that is what apparently is happening at this stage; it's where the second-quarter run-up in GDP occurred.

I'm a little skeptical that the reduction in the rate of inventory investment in the third quarter is going to be all that substantial. The reason rests on the question of whether increasing backlogs suggest that lead times are stretching out, as Tom Melzer pointed out with respect to his one-observation sample. The stretching out is confirmed by the lagged deliveries, but it is not confirmed by the lead times that are reported by purchasing managers. So it's not clear yet exactly what the full state of play is, but it is clear that lagged deliveries tend historically to have been a more potent indicator of what the inventory situation really is. In any event, it's quite inconceivable that the August industrial production increase of 0.7 percent was substantially or all an increase in consumption. There is no evidence of that. The implication is that there was a substantial increase in inventories in August when one factors in reasonable numbers on imports and exports of various industrial materials.

That's not the same thing as saying that that is what is going to show up in the deflated book value data. The inventories implied in the industrial production numbers or the real inventory data produced for autos, oil, some steel, and a variety of other actually measured totals don't quite square with the book value data, which tend to be a little flaky. My suspicion is that the deflation process is very tricky as one goes from book value to constant dollars; it's a weak statistic. But I think both sets of data, whether one is deriving them from the industrial data themselves or from the book value data, show that the decline in inventory/sales ratios has come to a halt and may very likely be tilting up ever so slightly at this particular stage. This is what one would expect as the economy begins to approach capacity limits and backlogs begin to stretch out. The normative desired levels of inventories tend to rise because obviously if firms are trying to protect their production schedules, the time it takes to get deliveries of new materials from suppliers will largely dictate what we used to call "safety stocks" in evaluating the inventory situation. Safety stocks at this stage are probably rising slightly. There is no evidence of major shifts, but it's very unlikely with the backlogs picking up as they are that these safety stock numbers are not moving at least somewhat higher. This suggests that the second-quarter number, while it may be somewhat hard to interpret, is not in any regard suggesting an overhang of inventories or providing any evidence that those inventory accumulations are unintentional. If they were, we would see it in the orders data. Although it may well be that the data we will see tomorrow for durable goods orders will give us a different signal than we have been getting, to date there's very little in the anecdotal reports or in other data that suggests that orders have simmered down in any material way.

The question on which I think we have to focus at this point is whether there is an inventory recession threat at the end of this cycle. Because if there is a significant pickup in inventories that is perceived to be voluntary, past history has always raised the question as to whether that pickup is overdone. It is unlikely, I might say, that monetary policy can restrain inventory accumulation by higher short-term interest rates. The reason basically is that since inventories are there to protect production schedules, the contemplation of inadequate stocks at any particular time weighs very heavily on purchasing policies. There would need to be some extraordinarily high interest rates to impede the accumulation of inventories when they are perceived to be necessary for sustaining production. In any event, it's fairly obvious that we are not dealing with a loan availability problem because with the very high degree of securities holdings by the commercial banking system we can get a very large loan/deposit ratio increase with a big shift from securities into loans and no bank credit expansion. So the factors subduing inventory accumulation have to come from the final sales side. If there is an effect, it's got to be because residential construction and existing home sales are slowing down, with the result that sales of household durables are slowing down. This means the realized capital gain on the sale of existing homes that has a big impact on durable goods spending is also going down. When that sort of thing gets going, inventories will back up very quickly. Consequently, the concern that one might have that the inventory building will be overdone and lead to an inventory recession a year or two out becomes essentially moot.

Price pressures are building with the rise in backlogs and delayed deliveries. But I must say I was somewhat impressed--I don't know if my memory is faulty--that while everyone around the table, with few exceptions, was talking about stronger activity, even if you chose different words, I did read your comments on inflation as implying slightly less upward pressure on prices. There was surprisingly little talk of more price pressures around the room. I'm not sure one can make very much of this, but if prices were in the process of accelerating at this stage, I think we would have heard more around the room on that point. But that is scarcely a scientific judgment.

One other important issue that I think we probably ought to focus on at this stage is the extent to which profit margins are rising. They are moving up, or at least they had moved up at a very abrupt rate until very early this year, which is another way of saying that unit consolidated costs have been rising much less than prices. Indeed, if one looks at the data, as inadequate as they are in the national income accounts, we are getting a spread of well over a percentage point in the rate of change between unit costs on the one hand and prices on the other. What that suggests is that productivity obviously is moving up and unit labor costs are being contained. The discussion we had previously indicated that the rising costs of raw materials were not moving into final goods prices and that those rising costs are being absorbed by the subdued behavior of unit labor costs. But the presumption that there has been no pass-through at all is belied by the fact that margins are opening up. When margins open up, what we are observing is in effect an ability on the part of a lot of producers to move the price level.

Now, we are saying that inflation is 3 percent. Well, 3 percent is not a small number; it is not small over the long run in the consumer area. But granted it is not that good, it is less than that for goods at the final CPI level; it is probably more than that at the PPI level. I was a little concerned, even though in the last published report the CPI was reasonably contained, that the PPI core number was somewhat higher. Moreover, it apparently was being held down by still faulty seasonal adjustments, at least if we take our doubly seasonally adjusted processes to heart. If we doubly seasonally adjust the seasonally adjusted rate of change of core PPI inflation, the last observation was, I think, at least 0.1 percent higher than the published number. So I think what we are observing is the opening up of margins in much of the underlying structure. But unit labor costs apparently have been so well contained by productivity gains at this stage that cost pressures have not flowed into final goods prices.

The question that we confront at this stage that has been raised at this table, really for the first time in a broad sense--it started with Bob Forrestal and everyone just sort of picked it up--is the possibility of a short-term blip in the final goods price data. If we look at business cycle patterns, we usually find that there is a cycle in prices. The question that we have to ask ourselves is how much we care. How much are we concerned about it so long as the peak-to-peak inflation rate in the business cycle gets progressively lower and the trough-to-trough level of price inflation gets progressively lower? That implies a long-term downtrend. But as a number of comments around this table have indicated, we can not make the simple presumption that we can get an inflation blip and say "Well, it's a blip." The trouble with most blips is that they can be identified as such only in retrospect. There are far more announced blips that turned out to be permanent changes than there are blips in the historical record. So, we have to be very careful about viewing a blip as something that doesn't give us considerable concern.

However, it is true, with profit margins up to the highest levels we have seen in well over a decade, that if pressures begin to increase the rate of growth in unit costs, history also suggests that there is a tendency for profit margins to start downward in the later stages of the cycle. So there is a good deal of potential absorption of final prices here that could occur as a consequence of declining margins. Indeed, there is a significant decline in profit margins in the Greenbook, and as a consequence, while the staff forecast has a very modest acceleration of inflation, implicitly the underlying costs obviously are accelerating at a far faster pace. I think that is a reflection of an expectation of a slowdown in productivity gains, which to date have been the major factor in suppressing the pass-through to final prices.

As a consequence of all of this, one has to ask why we are this far into the business cycle expansion without the types of price pressures that we have seen on previous occasions. I raised this as an issue before, and I'm beginning to suspect that we are going to find out whether or not the extraordinarily still muted money and credit aggregates really matter. In other words, we are approaching a point where we will get interesting tests as to whether inflation is a Phillips curve phenomenon or a monetary phenomenon. If we look at it from a Phillips curve point of view or its equivalent, slack in the industrial area, then we are on the edge of some severe inflationary pressure if we are getting rising inventory accumulation. If, however, we think that prices are a monetary phenomenon, we are more likely to see the types of changes that occurred prior to the 1930s where we had a noninflationary long-term environment largely locked in by the gold standard, but periods of significant pressure during which inflation never really took hold, because the credit aggregates never really took hold, as they couldn't in that type of environment. So, this particular business cycle may be about to tell us a lot or, I fear, it may be mushy where the end result will be somewhere in between, so we won't learn very much. Reality tends to do that to us more often than not!

I do think, as a number of you have mentioned, that the issue of the subnormal growth in monetary and credit aggregates has to mean something. There is something there. We have argued that M2 or M1 are awful as indicators and that the monetary base is terrible, but we are in the business of creating money. We are a central bank. If we think all of that is beside the point, I think we've got to worry about a number of things we are doing. It may turn out that it's beside the point, but I don't think we can make that presumption.

My impression of what is going on, pending the outcome of this academic debate, is that we have to assume that the pressures are there; the risks of making alternate assumptions I think are just too dangerous. If that is in fact the case, I would agree with the staff's version that more monetary policy restraint is probably to be expected. The reason is that we have seen stronger GDP growth than we had anticipated and we won't know until 1995 or beyond if what we are looking at is a situation where monetary policy suddenly has turned weaker as a restraining force, maybe because of the inventory situation, or if the policy is as strong as ever but just more delayed. We may find that there is some significant new underlying strength in the economy, which is offsetting what has been a significant impact from monetary policy actions already taken. It is true that there are significant lags in monetary policy, but remember these are distributed lags. It's not that nothing happens for a year or 15 months and then suddenly the effect is felt. There is a gradual progression of effects. We have to presume at this particular stage that we are running under the projected impact. If we assume that our judgment about the basic economy's underlying strength ex monetary policy has not changed significantly, that assumption is rather dubious. But what this suggests is that we do know something about the effects of monetary policy actions to date; we know that their effects are there and moving. What we don't know, and will not fully know until 1995 and later, is how powerful in retrospect the underlying expansionary forces were.

My own impression of all of this is that I suspect we are going to need to move further somewhere along the line. I would doubt very much that the degree of restraint that is in the pipeline at this stage, including the significant rise in long-term interest rates over and above what would ordinarily be expected from short-term interest rate changes, is enough to give us the type of more subdued--excuse the expression--"soft landing" that we would all like to see. I think that the subdued money and credit growth does suggest that we are not particularly behind the curve. It's a difficult judgment to make, and one that I don't think we have strong analytical tools to give us any insight into.

We have another issue here that has been raised by a number of people. Because of our statement "for the time being" in our last move on August 17--which most people interpreted to mean that we would not move at this meeting and would not move until the November 15th meeting--we have to have strong evidence to move more quickly. My suspicion is that we probably could get through to the November 15th meeting. If we do move then, I think that would probably require us to move another 50 basis points and probably move the discount rate as well.

My own inclination at this stage is to go with "B" but be asymmetric for the reason that Don Kohn was mentioning, namely, we have a good deal of data coming in around the middle of October that could very readily indicate that our underlying view of the momentum of the economy was too soft and that this expansion is accelerating faster than we had expected. If that occurs--if the data are an undesirable surprise--there will be significant market turmoil. And if we allow it to simmer for the whole month until the next meeting--remember, this is a seven-week interval--I think it could create inflationary expectations that might be more difficult to rein in than if we moved in mid-October. What I'm saying is that at this stage we are getting close to the point where the data do matter because we've been under restraint long enough that we should begin to see some signs of its slowing impact on the expansion. If we don't start to see that pretty soon, that will suggest that this economy is not growing at 3 percent but closer to 4 percent. It's not all that difficult to engender that type of outlook. Now, I think that's a low probability outcome, but I don't think it's one that can be readily dismissed.

I have come to the conclusion, and I'd like to lay it out for debate, that we should not move today. We don't have to and I don't think it's appropriate to move today. We should be prepared to move if necessary before our next meeting, but hopefully we will be able to get through to the next meeting. If we are able to do that, I think we will probably have managed policy better than we have any reason to believe we should be able to do. Obviously, if the numbers come out in an adverse way, we will be on a telephone conference as usual for the type of consultation and discussion that we have had in the past. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, from what we know and can observe today and based on the discussion around the table, I think the right thing to do today is to retain interest rates at their present level. I think we have removed all the accommodation from monetary policy and are the closest we can get to a neutral position. I believe we removed it at the right time and along the right firming path. It is possible that the risks may be essentially balanced, but they probably are not. Therefore, I think an easing of interest rates before the next meeting is highly unlikely, and a tightening of monetary policy could be called for by incoming data over the intermeeting period. Therefore, I agree with your recommendation that an asymmetric directive tilted toward tightening is appropriate.

I do not believe that the statement that we made after the August meeting should keep us from tightening today if we really thought it was the right thing to do. I'm against tightening today because I don't think it is the right thing to do. That statement should not make us feel at all unwilling to change monetary policy between meetings if the data indicate that is the appropriate step to take. I do believe making such statements makes sense; I think the statement we made in August served a useful purpose. But the incoming data in the meantime may lead one to believe that waiting until the November 15th meeting just may not be possible. On the other hand, I am not at all convinced that the credibility argument demands, because there's a greater probability of a tightening move than we might have thought at the last meeting, that we have to tighten today. When the next move takes place, as you already mentioned in your presentation, it would likely be a move of 50 basis points. I agree very strongly that that would be the appropriate move--that it should be either zero or 50. I think a 25 basis point move, if that should present itself as an idea to anybody, could very easily and almost certainly would be inappropriately construed as either indicating a degree of timidity, which would not reflect the view of the Committee, or worse still would indicate a compromise. So then somebody could write a learned article about the hawks and the doves and who did what to whom, and that at the end of the day we did 25 basis points because we couldn't decide which of the other things to do.

CHAIRMAN GREENSPAN. You mean the hawk and the dove combine as a turkey. [Laughter]

VICE CHAIRMAN MCDONOUGH. So, Mr. Chairman, I firmly agree that "B" tilted toward tightening is the appropriate policy decision.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I would support your recommendation. However, I would note that there are inflationary pressures in train. I think they are fairly evident, and we might be well served if we were to act sooner. Therefore, I would support your asymmetric proposal, and if the data come out at all strong, I would encourage you to move before the November meeting.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. I'd also like to support your recommendation and just say a few things. I do take seriously the fact that we, so to speak, gave our marker in August, and we should only be willing to take that marker back if the evidence was overwhelming that we couldn't wait. I think the evidence is not close to overwhelming. The first sentence of the second paragraph of the Greenbook said "the largest effects of the interest rate increases to date may yet lie ahead, but whether they will prove sufficient to prevent a buildup of inflationary pressures is unclear at this juncture." I think that is exactly right; I agree with that 100 percent. That says to me that "B" asymmetric is the right policy. We have to remember that most of this restraint is probably still in train and the price effects will come even later. I want to be clear--the reason that I support the asymmetry is not that I think there is a strong presumption that we are going to have to move between meetings. We might; but as Bill just said, the probability that we're going to reduce interest rates before the next meeting is zero. The probability that we are going to tighten is certainly not zero, and that for me makes it sensible to have an asymmetric directive.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, since I believe that a blip is a blip is a blip, I would support your recommendation. I, too, don't think we're going to need to move in the intermeeting period, but I think it's wise to have the asymmetry as an insurance policy. I agree with your proposal.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I'm comfortable with leaving the funds rate unchanged at 4-3/4 percent. I don't prefer asymmetric directives. I would not dissent from it, but I have two concerns about it. One is that an asymmetric directive toward restraint tends to get the Committee associated with being anti-growth. That's because we have to react to incoming data and the psychology of the market is driven by the perception of those data in a context that tends to cast the Committee as being anti-employment or anti-growth. Since I don't think the purchasing power of money is reduced by more output or more employment, I have trouble with that. My other concern is worrying that the asymmetry is going to wind up being cited prematurely in some publication or wire service as an indication that we have cocked the gun again, and if that happens, I won't be very happy about it.

CHAIRMAN GREENSPAN. You are against the whole notion of asymmetry in the directive?

MR. JORDAN. Yes. I think it gets us into a lot of trouble because of the way it gets interpreted.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, it seems obvious that since our last meeting, pressures on capacity in product and labor markets have grown as have prospects for higher inflation in the future. Thus, it seems to me that we should raise the funds rate again fairly soon. I don't think we have to do it today, but I certainly would prefer an asymmetric directive tilted toward raising the rate if incoming data imply greater pressures for future inflation. Thus, I would accept your recommendation.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I support what you propose, Mr. Chairman. I normally don't like moving intermeeting, but I think the chances are we probably should this time.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I support your recommendation, Mr. Chairman. I hope that in casting my vote I will be resolving in my own mind that the Committee not be inhibited in any way in the timing of a move by the proximity of the election.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I agree with your recommendation.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, I continue to think the economy has a lot of momentum. In this situation, it seems to me that inflation expectations are rising. The bond rate is now at its highest point since the 1990-1991 recession. I don't know what the curve looks like--I've never seen it. I'm not sure what its character is, but I think we are still behind it. I think we are going to have to move further, and frankly I just don't see a compelling reason to delay that move. On the contrary, there is at least some risk in not acting at this stage. Aggregate demand is strong and in that kind of situation, especially if it strengthens further, inflation pressures inevitably are going to grow, and inflationary expectations will grow. Against that background, if past experience is any guide at all, that could eventually put us in a situation where all the choices are bad. We have been there before, and it's no fun. So, I would prefer to move. My choice would be alternative D.

CHAIRMAN GREENSPAN. "D"?

MR. BROADDUS. "D" as in David!

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I find myself in substantial agreement with Al Broaddus and for many of the same reasons. It seems to me that the economy has a good deal of momentum. I'm not at all confident that we are moving toward a sustainable path at this point. I think the banking system is in the process of supporting rapid growth, and this may well occur without any significant change in the size of its balance sheet, just a change in composition. I think the evidence suggests that, so far at least, we have not moved particularly early or particularly forcefully relative to historical experience, so I'm not persuaded that we're ahead of the curve. Finally, I hope I'm wrong when I say this, but I'm concerned about our ability to analyze the price data and come up with all these fine reasons why something unusual is going on and the rise in prices won't last. We can tell those kinds of tales, but I must say that that kind of analysis has led to past policy errors, and I'm afraid I'm reminded of one of Yogi Berra's expressions about "deja vu all over again."

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I find myself very much torn at this stage. I have a great deal of sympathy for what both President Broaddus and President Stern have said. I feel, given that the economy has been operating near full capacity for some months now and that the statistics keep coming in much stronger than we anticipated, that the data over the next couple of weeks are likely to be strong. On the other hand, while I think the risks are on the up side, the timing of further increases is something that has both an economic component to it and a political component to it. I would trust your judgment in this sense that maybe the best timing would be a little later. So, I would be in favor of your recommendation. I think the risks are on the up side. I think it's likely that we'll move during the intermeeting period. So, I would be in favor of the asymmetry as well.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I support your recommendation, Mr. Chairman, and I do trust your judgment on timing, although I would like to associate myself with Jerry Jordan on my general feelings toward asymmetric directives.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I think a tightening probably is going to be necessary at some point, but again the question is when. I do give credence to this question of credibility, and it seems to me that the evidence is not persuasive that we need to move now. I prefer to give the tightening that's in the pipeline a chance; again, I'd cite the monetary aggregates. So, I agree with alternative B and being prepared to move. On balance, I'm not enamored with asymmetry, but I think the chances of tightening in the intermeeting period are more likely. So, I'd support that.

CHAIRMAN GREENSPAN. Governor Kelley.

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

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I support the recommendation. I do not believe we should move today, but we certainly should be prepared to do so between meetings.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. I support your proposal, Mr. Chairman. I think it's conceivable that sufficient evidence could accumulate over the next month or so to warrant a rate hike before our next meeting, but it would take quite a bit to convince me that further tightening prior to the next meeting is in order.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Alan, I'd favor "D" combined with a discount rate increase; I'd do the 50 basis points now. I think it's necessary to contain the emerging inflationary pressures, and I also think it's necessary to make longer-term progress toward price stability. I think, as you and others have observed, that waiting simply makes our job more difficult and raises questions about credibility. I guess I interpret financial market developments much as Al Broaddus did. With the bond rate at the highest level since the recession and more sensitivity in foreign exchange markets, I think credibility is an issue. To the extent we lose it, it makes this process much more expensive for everybody. It's not just a matter of the credibility of the institution; what really matters is how it impacts the real world.

I think to the extent we maintain our credibility, longer rates will be lower than they otherwise would be.

With respect to the language, I personally think there have been significant developments, and I think there is a danger in that sort of language. One can make the argument that the existence of that language actually has undermined some of our credibility because of concerns about whether in fact we would act on a timely basis. The information in terms of the real economy, prices, and financial markets frankly has been quite strong in this intermeeting period, as far as I'm concerned.

Let me make one final comment about the monetary aggregates. I, too, would normally be quite concerned about the very slow growth of the narrower aggregates in 1994--as you know I tend to focus more closely on the narrower aggregates that we can actually influence--but I think their growth has to be viewed in the context of a tremendous monetary impulse in 1991 through 1993. You have heard me say it before, but the base grew $100 billion over that 3-year period. I think in a sense there is a liquidity overhang and that needs to get worked off. I might also observe--

CHAIRMAN GREENSPAN. Does that include U.S. currency abroad?

MR. MELZER. Yes, that would be in the base. But in any event, I view that as a very stimulative impulse, the effects of which may still be playing through. In the mid-1980s--actually I think it was mid-1988 to mid-1989--we also had very slow growth in the base and reserves for about a 1-year period. That was on top of two prior years of very sluggish growth in the narrower aggregates. So my feeling would be that, yes, growth of the narrow aggregates has been slow, but in the scheme of things it hasn't been all that slow for that long. I might also observe that there are, as you well know, some very significant technical factors that are impacting M1, including in particular the mortgage refinancing phenomenon. Our guess is that that took 7 percentage points of growth out of M1 in August, and our best guess would be, abstracting from that, that M1 probably is growing somewhere in the area of 4 to 5 percent. But we'll see. I don't think on a short-run basis these aggregates are particularly helpful to us in any event. I think they have to be looked at over long periods of time.

CHAIRMAN GREENSPAN. Okay, I think the modal consensus is on "B" asymmetric. Would you read the language?

MR. BERNARD. I'll be reading the wording on page 13 in the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with modest growth of M2 and M3 over the balance of the year."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

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

CHAIRMAN GREENSPAN. Let me say that under our new procedure for announcing our decisions, Don Kohn thinks that 2:15 p.m. is the appropriate time to announce anything coming out of the meeting, including a statement such as we have made in the past that no action was taken. We violated that last time largely because we finished our meeting early and a lot of staff members came into the Board Room from outside, and security was an issue at that point. So, I request that no one mention anything that occurred within this meeting even to your associates outside until the 2:15 p.m. announcement time when Joe Coyne, I gather, will be making the statement that the meeting is over. Is that correct?

MR. COYNE. It will be something similar, I think, to what we did in July.

MR. KOHN. That is, we will say that the meeting is over and we don't have any further announcement, rather than that we didn't take any action.

CHAIRMAN GREENSPAN. Yes, no further announcement.

MR. KOHN. Right. And the other point to remind the Committee, Mr. Chairman, is that the asymmetry remains confidential until seven weeks from Friday.

CHAIRMAN GREENSPAN. Okay, and the next meeting is November 15. Let's adjourn for lunch.

END OF MEETING