Meeting of the Federal Open Market Committee

November 15, 1995

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 Wednesday, November 15, 1995, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Blinder
Mr. Hoenig
Mr. Kelley
Mr. Lindsey
Mr. Melzer
Ms. Minehan
Mr. Moskow
Ms. Phillips
Ms. Yellen

Messrs. Boehne, Jordan, McTeer, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Forrestal, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, respectively

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

Messrs. Davis, Hunter, Lindsey, Mishkin, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors
Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Mr. Madigan, Associate Director, Division of Monetary Affairs, Board of Governors
Mr. Simpson, Associate Director, Division of Research and Statistics, Board of Governors
Mr. Reinhart, 1/ Assistant Director, Division of Monetary Affairs, Board of Governors
Mr. Ramm, 1/ Section Chief, Division of Research and Statistics, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Beebe, Goodfriend, Lang, Rolnick, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Richmond, Philadelphia, Minneapolis, and Dallas, respectively
Messrs. Gavin and Kopcke, Mses. Krieger and Rosenbaum, Vice Presidents, Federal Reserve Banks of St. Louis, Boston, New York, and Atlanta, respectively
Mr. Stevens, Consultant, Federal Reserve Bank of Cleveland

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1. Did not attend portion of meeting covering the monetary policy discussion.

Transcript of Federal Open Market Committee Meeting
November 15, 1995

CHAIRMAN GREENSPAN. Good morning, everyone. Regrettably, this is Bob Forrestal's last outing. I would be inclined to give him five or six votes for this meeting, but I don't think that authorization is statutorily available. But spiritually we would like to do so. We'll be saying more to Bob at lunch, and we look forward to seeing him there. In the interim, would somebody like to move approval of the minutes of the meeting on September 26?

MS. MINEHAN. So move.

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. Peter Fisher, you have the floor for a while.

MR. FISHER. Thank you. As you can see on the agenda and also on an outline of my remarks that has been circulated with some attached charts, I am going to take up four topics separately. I will be asking for the Committee's questions and relevant vote at the end of each of the first three topics so that we can get through this rather meaty portion of the agenda in an orderly fashion. I will turn first to the report on foreign exchange market developments and Desk operations. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Peter? I guess your report sounded pretty complete as anticipated. Why don't you go on?

MR. KOHN. The Committee needs to ratify the Mexican swap renewal.

MR. FISHER. The Mexicans paid down part of their swap line drawings, and I rolled over the remaining portion on October 30 for the third time. I am requesting Committee ratification.

CHAIRMAN GREENSPAN. The Committee will remember that we will be covered either by Mexico or the U.S. Treasury--by February, I believe.

MR. FISHER. Yes, at the end of January.

CHAIRMAN GREENSPAN. So, this is a relatively safe activity unless, of course, you know who or what doesn't pay! [Laughter]

SPEAKER(?). So move.

CHAIRMAN GREENSPAN. It has been moved. Is it seconded?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. All in favor say "aye."

SEVERAL. "Aye."

CHAIRMAN GREENSPAN. The "ayes" have it. Peter, continue.

MR. FISHER. Thank you. [Statement continued--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Peter?

MR. LINDSEY. I just want to get something clear. Do any of these reciprocal arrangements with other central banks potentially involve warehousing funds for the Treasury, should the Treasury want to engage in foreign exchange transactions?

MR. FISHER. No, I don't see how. At the very bottom of the list of our swap lines that I have given you, you can see that the Treasury has two swap lines of its own with Mexico and the Bundesbank.

MR. LINDSEY. They are separate.

MR. FISHER. They are entirely separate. So, I cannot see any way that a drawing on the System swap lines would have any necessary connection with System warehousing for the Treasury.

CHAIRMAN GREENSPAN. Further questions for Peter? If not, is there a motion to renew the swap agreements that mature in December?

MS. MINEHAN. So move.

CHAIRMAN GREENSPAN. Second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. All in favor say "aye."

SEVERAL. "Aye."

CHAIRMAN GREENSPAN. The "ayes" have it.

MR. FISHER. Thank you. Before turning to my report on the domestic markets and operations, I would like to give the Committee a bit more background on the Desk's cooperation with the Japanese monetary authorities in managing the liquidity of their portfolio of U.S. government securities as part of their broader effort to aid the dollar liquidity of the Japanese banks. [Statement continued--see Appendix.]

CHAIRMAN GREENSPAN. What is the market saying now, if anything, about a possible spike in the funds rate at year-end?

MR. FISHER. A spike in year-end rates is always there. I don't think it's out of line with--

MR. KOHN. The market has built in a spike of about 1 or 2 percentage points as best we can guess. We have to make an assumption about what the market is thinking the federal funds rate will be and then subtract that to estimate the spike.

MR. FISHER. But it's entirely in line with the normal end-of-year pressures.

MR. KOHN. Yes. If anything it may be a little less.

CHAIRMAN GREENSPAN. So, you can't really disassociate our actions from the spike.

MR. KOHN. Right. It's a highly conditional forecast. But, if anything, it appears that the markets are expecting slightly less of a spike at year-end this year than they have at this point in recent years.

MR. FISHER. But the problem there, just to go into detail, is that we have to look at the futures contract for December, take account of the limited probability of a Committee action to ease in December, and then look at the December contracts. The market normally does some smoothing in its pricing of the futures contracts. If there is an assumption of an aggressive easing in policy three months out, the end contracts tend to edge down a little and to provide a bit of trend line toward that lower funds rate. That makes it hard to judge futures prices.

CHAIRMAN GREENSPAN. I assume that to a large extent the Japanese have been a factor in the year-end spike over the years. Does that propensity exist in other currencies where the Japanese are heavily involved?

MR. FISHER. Yes.

MR. TRUMAN. In some degree, it has occurred in the yen market itself. That is one of the phenomena.

CHAIRMAN GREENSPAN. The year-end spike?

MR. FISHER. Well, their fiscal year-end is March 31st, and there is some pressure in their funds market then. There are occasions when the deutschemark money market experiences rather sharp spikes. These stem both from the German banking system and from foreign demand of which the Japanese may be a part, but I don't think quite as significant a part as in our market.

CHAIRMAN GREENSPAN. That is a year-end, December 31st spike?

MR. FISHER. Yes.

CHAIRMAN GREENSPAN. Can we infer what the market forces are abstracting from our actions by looking at the potential spike characteristics in other currencies where Japanese banks are operating, like in London?

MR. TRUMAN. That would be a little difficult. One of the problems is that two things are going on with Japanese banks at this point. One is the Japanese year-end premium. The other is the general Japanese risk premium. I think it's a little difficult, for some of the reasons that Peter just pointed out with respect to the funds futures, to separate which of the two you are dealing with. You can make an assumption, such as attributing it all to the year-end pressures, but there is some leakage in this process. And you have a phenomenon that whatever the pressures are, they are in both the yen markets and the dollar markets. I think that's presumably where most of it is. There may be a little in the sterling markets.

CHAIRMAN GREENSPAN. Okay. I don't want to press that; I don't think it's a big deal. I am just curious. Other questions for Peter? President Minehan.

MS. MINEHAN. I have a couple of questions. On the Japanese funding situation, I know that all this planning is being done within the normal framework of Desk operations. I don't know about the rest of you, but the headlines in The New York Times about this special funding arrangement hit me as a surprise when I read them at 7:30 one morning. If there is going to be a briefing of Congress, I wonder whether the Committee also could be briefed. It's not that we are going to say anything necessarily; it's just to make us feel a little bit in the loop when these things come out in the press.

CHAIRMAN GREENSPAN. My recollection is that we thought the arrangement was so routine and so inconsequential that it did not enter anybody's mind to raise it. And, indeed, the way it came out was so distorted that I got numerous telephone calls as a result of a comment by Ralph Nader on the radio that we were bailing out the Japanese and that his listeners should call the Federal Reserve to complain. When I finally talked to Senator D'Amato, who had raised all sorts of questions, he said he wished he had heard that explanation earlier. It would have averted the excessive criticism that was voiced. The problem existed because there was a miscommunication between us and Jim Leach; he didn't realize that he should not talk about this because that made it sound like a much bigger deal than it was.

MS. MINEHAN. Do we have these informal understandings with other central banks, other than the Bank of Japan, that if they run into dollar or liquidity problems (a) their banks are not to come to us and (b) there may be some way in which we can, within the normal procedures, help them with their funding?

MR. FISHER. The answer is no. Some central banks realize that if they are talking about $500 million or $1 billion, they can sell bills to the Desk and we will execute such transactions for them relatively effectively. There are some less subtle or more anxious central bankers who approach the Desk to ask if we can guarantee that we will do a $5 billion repo with them if they need some liquidity suddenly. What they want to avoid is having to sell the securities outright and having to take a gain or a loss. We explain to them that, no, we don't provide guarantees. So, the question frequently comes up conversationally in that way. As I say, the subtler central bankers understand that when relatively small amounts of Treasury securities are involved we can help them by either selling the securities in the market or taking them into our portfolio. The larger amounts are not in the nature of what we do routinely and that was the tenor of our conversations with the Japanese when larger amounts were clearly what they were interested in.

MR. TRUMAN. President Minehan, I think one dimension of this that Peter did not include in his report, because he gave a lot of background and the report was already long enough, is that there is a particular problem, which I am sure you will appreciate, in terms of the payments system.

MS. MINEHAN. Oh yes.

MR. TRUMAN. We have staff who have worried about this general problem of foreign-held dollars in the payments system for at least a decade to my knowledge. In some sense, because of the size of the Japanese banks and their role in the international financial system, they are a particular problem and this arrangement or procedure is designed to deal with that problem. One dimension would have almost a pure payments system set of consequences, but I think we all recognize that it is a general dollar payments problem and that it is not unique to Japanese banks. In principle, U.S. banks could have the same problem elsewhere. Although this arrangement was set up because of the current situation with respect to the Japanese banks, it is part of a general problem and I don't think we have a standard set of procedures to deal with it.

MS. MINEHAN. I totally agree and I certainly understand what you are talking about. The implication that we would do things after hours, after the securities wire closes and all of that, did seem to me to be a move that it would have been interesting at least to know about.

MR. TRUMAN. Certainly. As the Chairman explained, it got publicity when it was not intended and the latter was somewhat premature in any case.

MS. MINEHAN. The second question that I had was on the new procedure relating to your operations in coupon issues. Peter, is it your intention over this three- or four-day period, for however long you might spread your coupon pass, to pick certain portions of the yield curve on any given day as opposed to preselecting from a number of points on the yield curve?

MR. FISHER. Yes. We would try to choose an area of the yield curve, say, the two- to three-year area or the five-year area, define it for the dealers, and then take propositions only in that portion of the curve.

MS. MINEHAN. And you don't think that will have any disruptive effects on that given day?

MR. FISHER. It might the first few times that we use the procedure. But my hope is that things would smooth out over time, as the dealers got used to it and they saw that we are like any big customer who might come along and buy up a certain maturity. I also want to be clear. I don't think we would necessarily be mechanical about day one, day two, day three, day four and conduct these transactions on consecutive days. We might do it that way; we might break it up and have a day fall in between depending on what other things are going on--a bill auction, for example.

MS. MINEHAN. Is it part of your plan to discuss this with major market participants outside of New York?

MR. FISHER. The community to talk to first and foremost is the dealers, wherever they are located, since they are the ones who have to do the bidding and put in the propositions.

MS. MINEHAN. Right.

MR. FISHER. Obviously, once we begin it we'll have to have guidance for Peter Bakstansky in our press office and figure out what we are going to say more generally so that the Fed-watching community doesn't jump on it and misinterpret it.

MS. MINEHAN. It might be useful to talk to Fidelity among others.

MR. FISHER. Yes.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Peter, your description of the arrangements with Japan and the very unfortunate press reports and confusing stories relating to all that and now this discussion following Cathy's question just emphasizes in my view how obsolete swap agreements are in this environment. In the case where a country has very substantial amounts of dollar-denominated assets that they want to convert into dollar balances, frankly, this "ain't" the mechanism to use. Swaps were set up in a period when we needed to get access to some foreign currencies that we did not have or when our foreign central bank counterparts needed to get access to dollars that they did not have. But in today's world we need a mechanism for them to be able to convert dollar-denominated assets into dollar balances. I looked down your list of foreign central banks in our swap network and I see fairly small swap lines: Norway, $250 million; and Denmark, $250 million. What is the probability that we would draw on these swap lines or that they would be in a situation where they needed to draw on them to get dollars? If I recall correctly,

So, if in keeping with the original intent of the swap line network a central bank wants access to dollars because they don't have any, we don't want to give it to them. Therefore, when and how is there an appropriate use of swap agreements today, holding the Mexico discussion for a later meeting?

MR. FISHER. You are raising a good point. I think we have always thought of swaps as a bit of a hybrid. Given our focus on having a short-term means of repayment, we have tried to think of the swap lines, or I try to think of them, as merely a liquidity arrangement with a central bank like the Bundesbank, notwithstanding the fact that they hold a lot of U.S. government securities. Conceptually, I think the swap line can still be used, but obviously its use is problematic given our concern about the short-term means of repayment if a borrower really runs through every asset in sight. In the episode to which you refer, there certainly was a sense, and related anxiety, on our part that they did not merely want to draw on the swap line as they ran out of assets but that they already had gone deeply into debt. We weren't going to be the first creditor in line. Returning to the Bundesbank example, what has clearly eclipsed all this is an increasing sophistication in the liquidity management of the portfolio of the Bundesbank. As I have described to the Committee in the past, they maintain a large amount of immediately available liquidity in case they need dollars for intervention purposes and they structure their portfolio accordingly. So, the likelihood that the Bundesbank is going to look to the swap line for liquidity purposes is quite low. As the Chairman said a year ago, we realize that the swap lines are somewhat anachronistic, but getting rid of them could be more painful than carrying them forward. I think we might all benefit by rethinking the nature of our central bank cooperation. Maybe when we are through with this exercise with the Japanese and have been repaid on the Mexican swap line, it might be useful for the Committee to review the purpose of these cooperative facilities.

CHAIRMAN GREENSPAN. Peter, it strikes me that these swap line renewals, for which there basically is no longer any financial or economic purpose, have become exchanges of Christmas cards that serve to maintain our relationships with various central banks. Even at a 3 percent inflation rate, these lines are gradually becoming de minimis. If we wanted to get rid of them, there is a very simple way of doing it: We would talk to the Germans and say "look, this makes no sense, let's cancel it." Once we cancel the Bundesbank arrangement, the rest of them will just go away because it will be perceived that if we do that to the Bundesbank then doing that to Norway, for example, will not be considered a withdrawal of Christmas card privileges. So, I think it may be appropriate to do something at some time. It's just not credible under any reasonable circumstances that these swap lines will be activated. It's probably best not to have something on our books that has no operational significance. I think we might consider acting on your suggestion of looking at this after the Mexican swap issue is settled. It's conceivable that we ought to review this then and decide what we wish to do. We may just decide to leave the swap line network alone and let it wither on the vine.

MR. TRUMAN. My assumption--it's a very safe assumption, Mr. Chairman--is that in the case of the Bundesbank and the Bank of Japan you would be giving a signal by cancelling the swap lines. For the reasons you cited, some people would not want to do that and we therefore have a problem with respect to the Norwegians, which is a particularly bad example. My perspective on this has been, as I may have said before when we have had these discussions, that the time to rationalize these arrangements is in the context of European monetary union, if they get to the third stage of having a European central bank. In that case most of these countries would have an arrangement with the European central bank. Since Norway is outside the union, you would have a slightly complicated situation, but a number of these swap lines would be captured in that arrangement. Now, if we want to do away with them completely, that is a different proposition. I think it is also worthwhile to think about whether we could imagine using swap arrangements in the context of payments system problems. In that case, as President Jordan suggested, we obviously would need more than $250 million. It would be a very different operation. Because these arrangements always have the characteristics of lender-of-last-resort arrangements as well as helping through what could be just glitches in the payments system, they are not easy to orchestrate.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. I have the view that these arrangements have long outlived their usefulness. I have been in Peter's position and largely have argued that we may as well renew them because not doing so would be a newsworthy event. Each year there usually was something happening so that we didn't want that newsworthy event to occur. It would seem to me that, without mandating that a year from now Peter and Ted come back with a proposal not to renew the swap lines, we should become reasonably active in an effort to work out a more meaningful alternative that probably would include ending the swap lines. Whether or not one needs to substitute for them some notion of how we would cope at a time of some real liquidity need, I think terminating the swap arrangements would be a step very much in the right direction.

CHAIRMAN GREENSPAN. Are you suggesting some formal or informal agreements--bilateral agreements in a sense?

VICE CHAIRMAN MCDONOUGH. I don't think that we would need even an informal agreement, as our discussions with the Bank of Japan have suggested. If a need comes along and we have the kinds of relationships that we now enjoy with the other central banks, at that time we can sit down and figure out what if anything has to be done. If the approval of the FOMC were needed, we would ask for it. I think I would prefer that approach.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. Peter, you mentioned that on Thursday and Friday, some of the Treasury securities maturing on November 15 started to sell at some discount. How much was it? I was on an airplane at that time, and I didn't see the market quotations.

MR. FISHER. Those securities had already been selling off a bit, and that's rather awkward for a security with a short remaining maturity.

MR. BLINDER. That's why I was asking.

MR. FISHER. The amount is small in absolute terms, but it is noticeable that dealers are turning them down.

MR. BLINDER. I meant the yield to maturity, not the prices.

MR. FISHER. I don't know it off the top of my head, I'm afraid. I think we discussed it in the document we submitted as a special report. Sandy--please go ahead.

MS. KRIEGER. Because those November 15th coupons are so close to maturity, the smallest increment in price that you can see on the screen is 70 basis points of yield. If I tell you that it traded with a 1/256 change in price, I am telling you 70 basis points, which is incredibly dramatic. But I can't observe anything that is smaller than that on the screen.

MR. BLINDER. I see.

MS. KRIEGER. A better comparison would be the bills that mature on the 16th, which also were of somewhat uncertain value then, but unfortunately I don't know the change in yield. That is an easier comparison because it's a shorter instrument.

CHAIRMAN GREENSPAN. Did those come back after the announcement?

MS. KRIEGER. Yes. There does not seem to be a distortion in the November 30 coupons.

CHAIRMAN GREENSPAN. Any further questions for Peter on this? President Hoenig.

MR. HOENIG. Mr. Chairman, I just want to comment on the background of the informal arrangement with the Japanese. The memo that we got was very helpful. In the phone calls that I received, there were two issues that warranted some explanation. One was that the arrrangement was a bailout, and I think that notion followed upon the Mexican deal. The other was that the discount window was somehow involved and that we would be lending at the basic discount rate to subsidize the Japanese. Dispelling those distortions became the duty of the day. I think these issues are still a matter of concern among some individuals in the market or in the banking industry, or wherever else the distortions persist. I think it was good that we got the memo and as much information as we did because we received a lot of phone calls related to this fear of subsidizing the Japanese.

CHAIRMAN GREENSPAN. In fact, the purpose of our discussion with the Japanese was mainly to dispel any notion of subsidization. If it were not for the fact that they are such a large presence in this banking system, there really would not be an issue. But if they were to run into trouble, we could be dealing with very large numbers.

MR. HOENIG. I think the individuals I spoke to realized that. That's why they were saying that if a problem were to occur, we might get involved in a discount window loan; and lending at the basic discount rate would mean a big subsidy. The issue was why would we allow that, and on and on it went. Because they had this piece of misinformation, their concerns multiplied very quickly.

CHAIRMAN GREENSPAN. It happens. Further questions for Peter? Train wreck?

MR. FISHER. We need a vote to ratify the domestic operations.

CHAIRMAN GREENSPAN. I missed three out of three! [Laughter]

SPEAKER(?). Move approval.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. I hope there is nothing to ratify in the next segment!

MR. FISHER. No, no, I'm not seeking another vote. [Statement continued--see Appendix.]

Mr. Chairman, I would be happy to answer any questions from the Committee on this final part of my report. But maybe you are all tired of listening to my voice, and I wouldn't mind if you pass.

CHAIRMAN GREENSPAN. Never! President Melzer.

MR. MELZER. Peter, I would just like to say that I endorse the position you just expressed. I think there are a lot of risks associated with that. We have to evaluate things as they develop, but I wholeheartedly support what you are saying. Ultimately, I think it runs to even broader issues like the independence of the central bank and our commitment to long-term price stability and those sorts of things.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. I agree very much with Tom and I certainly endorse that position. I wonder if I may ask a related question, Mr. Chairman. Is it possible that in some of our operations other than Desk operations, things like Fedwire, we might wind up inadvertently making loans to the Treasury? Has that kind of possibility been considered?

CHAIRMAN GREENSPAN. An inadvertent overdraft?

MR. BROADDUS. Yes. In our Fedwire rules, as I understand it, we guarantee final payment at the end of the day. If on the day the Treasury defaulted we guaranteed some of these payments, could we be caught at the end of the day in an overdraft position? It seems to me it is the same kind of issue. I guess there is an array of possibilities.

CHAIRMAN GREENSPAN. It's illegal for us to grant an overdraft to the Treasury. The only condition under which it exists is inadvertence. I assume I have that right.

MR. KOHN. Correct. Reserve Bank and Board staff have been talking to Treasury people about procedures to follow to avoid the concern that President Broaddus just expressed, so that wires wouldn't be sent if funds were not going to be available. We want to ensure that Treasury staff sending those wires understand that and simply would not send them. Those are among the procedures that have been under discussion between the technical staffs at the Treasury and the Federal Reserve. The Treasury is fully aware of the position that Chairman Greenspan just stated--that we cannot lend to them directly. If they got into an overdraft position, it would have to be entirely inadvertent. Therefore, in their financing operations, they have been talking about keeping their cash balance fairly high to avoid the possibility that funds would clear that would put them in overdraft inadvertently.

MR. FISHER. In recent months and years, we collectively have been targeting a balance of about $5 billion for them. But we all recognize that forecasting the Treasury balance is in part an art, not a science, and the risks exist. But it's in the nature of a forecast that we are always forecasting tonight what the cash balance will be when we wake up tomorrow morning and then tomorrow what it will be when we make payments on the Treasury's behalf. We at the Desk were very pleased that the Treasury made their announcement as early as possible this week because of the various uncertainties we would face in our forecasts of their balances if we waited until the 11th hour to worry about default and the market did the same, and given the computer systems that release payments early in the morning. So, the

Monday morning announcement was very much what we had urged on them in terms of the number of days that we needed for guidance.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. This is admittedly a very airy-fairy contingency if we don't think this default is going to happen. But let me go back into the mindset that you were in a minute ago. How many government securities issues are there, something like 300?

MR. FISHER. 260 something.

MR. BLINDER. How many of those do we own a piece of? Almost all?

MR. FISHER. Virtually all.

MR. BLINDER. How many of them do we actually buy and sell?

MR. FISHER. On any one day?

MR. BLINDER. No. If I watched you for a whole quarter, how many issues might you have dealt in either doing repos or buying outright or anything?

MR. FISHER. Most of them.

MR. BLINDER. Right. Therefore, what kind of signal would you send if you told the market that these 55 issues are being shunned by the Federal Reserve, that we are not accepting them.

MR. FISHER. It would send a very negative message.

MR. BLINDER. Isn't that what you are suggesting?

MR. FISHER. No, I said nothing in my remarks that suggested that. I said the Desk was eager to find a way to demonstrate that they would be accepted as collateral in temporary operations.

MR. BLINDER. But we wouldn't do open market operations? I thought that's what you said.

MR. FISHER. Temporary operations are open market operations.

MR. BLINDER. What were you suggesting? I missed it.

MR. FISHER. My point was that I did not think that an intentional preemptive strike to buy the particular defaulted securities outright would be an appropriate action in the circumstances that I mentioned.

MR. BLINDER. I thought we were talking about purchases in the market.

MR. FISHER. Yes, we are.

MR. BLINDER. I guess I am confused.

MR. FISHER. We do outright purchases relatively infrequently --to wit my discussion about coupon passes--a handful of times a year. I am suggesting that we raise that to three or four handfuls a year for reasons of operational simplicity without changing the amount we would buy over the course of the year relative to reserve demands. The question is whether we take defaulted securities in temporary operations. In repo operations, we take whatever securities the dealers offer. We are not going to announce in advance that we are going to turn down any particular Treasury security in repo operations. The idea that I urge the Committee to put on the back burner for much later consideration is the question of whether we would buy outright preemptively those particular issues that the Treasury had defaulted upon.

MR. KOHN. That is, a special open market operation and not the normal course of business.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. I think the question has two aspects, Mr. Chairman. One is the purely practical view of people whose expertise is in markets, as mine used to be, as to what is the best thing to do to maintain an orderly market in the event of a default. I am in complete agreement with Peter's and Sandy's and Don's view that the best thing to do is to take these in repo operations because that would maintain their status as securities and keep them alive. That's by far the best thing to do. Then you can get into a question of high purpose. Is it in the best interest of the central bank to do it? That's the second question. I happen to agree with Peter on that one, too. This is one case where pure pragmatism says we should do what they suggest, and I think high principle leads us to the same conclusion. But we don't even need to get into the high principle. Pure pragmatism is such an absolute no-brainer that that's what we ought to do in any event.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I am going to follow up on what Governor Blinder said. If you are taking whatever is offered on the open market, might there not be a propensity for you to buy securities in default or potential default that people might have questions about? If you are willing to take whatever is offered and you are not willing to discriminate against defaulted securities, won't you end up taking a disproportionate number of them?

MR. FISHER. If they were presented to us as propositions for temporary overnight or four-day System operations, and they were at the better end of the prices, we would look at what are the best prices and draw a line at an amount that meets our objective. My desire would be for the Desk to be indifferent to what the CUSIPs are, whether the CUSIP underneath is one that has missed a payment or not. Now, maybe these securities will end up among the better prices; that's a likely hypothesis if the dealers are on their toes. They might be a large portion of what we did or they might be only a small part of our overall operation given the uncertainties about the volume we would be doing. So, yes, there is a certain likelihood that we would take in some, or many, or all of them in temporary operations where the legal risks of an extended duration of a Treasury default remain with the dealer.

CHAIRMAN GREENSPAN. Implicit in your question is that when we conduct our operations, a certain number of securities are offered in the market and we choose to buy or not to buy. As a practical matter, all securities are offered in the market at all times. There are active prices on all of them. Thus, it's not as though there is a limited block of securities out there that would disproportionately include defaulted securities. As a practical matter, all securities in the market are offered in indeterminate amounts and that would presumably include all of these defaulted securities. I think the critical issue implied in your question is that, if these defaulted securities are being priced at significant discounts and we buy them, we get criticized for buying U.S. Treasuries at a discount. If we don't buy them, we get criticized for not buying them at a discount. It's an impossible situation. But I suspect that should this occur, it's going to be very fuzzy as to what is in the market, at what price, and who is selling what. The question we have always had on the table implicitly is not whether or not we should do overnight RPs or something of that nature. It is whether we should make direct purchases and inventory the securities in the System portfolio. The implication of not doing it is that we would resell them in the market, which raises even more interesting questions. It's a question of whether we do a pass on defaulted securities. I suspect that has a lot of implications that raise some technical questions, as Peter is suggesting. President Minehan.

MS. MINEHAN. Beyond the technical issues, aren't we dealing with a moral hazard situation in the sense that if we show ourselves ready to close all the gaps when these situations occur, the chance of their happening with greater frequency increases? I think it's entirely appropriate to come at it from the point of view of financial stability. The only question I have is whether being willing to use matured securities as collateral and to do repo operations in matured securities says that we are willing to accept the moral hazard up to a certain point where we, arguably, need to do that for the sake of stability in the markets and financial stability for the country as a whole, but beyond that we will not go. I think that's a perfectly appropriate message to send and position to take, but I think that it's not just on the outright operations that we run the risk of running counter to a high principle. We run that risk doing *anything* with these matured securities. I think what Peter has proposed is defensible, but I don't think we take ourselves out of the arena of the problems that he mentioned simply by drawing a line and not doing coupon passes in matured securities.

CHAIRMAN GREENSPAN. Any further questions for Peter on this issue? If not, let's move to Mike Prell and the staff report on the economy.

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

CHAIRMAN GREENSPAN. Questions for Mike? President Parry.

MR. PARRY. Mike, in Part II of the Greenbook, there is a reference to the prospect that manufacturing capacity growth is going to be revised up in light of some surveys in 1993 and 1994 and also the new investment that has occurred in 1995. I wonder how much of an effect these pending revisions will have in terms of the staff's assessment of price pressures in various product markets and also what impact it might have on either the level or growth of potential?

MR. PRELL. At this point we don't see anything in the cards that is going to change the picture materially. We have had relatively rapid expansion of capacity in our forecast, and the incoming data in the updated survey on investment have supported that. We will be revising our numbers on production and capacity utilization, but my sense from talking to people who are engaged in that work is that this isn't going to change the picture materially. Basically, we think we have something that's pretty much parallel to our assessment of the labor market. We are a little on the tight side of what would be "nonaccelerating" inflation over time.

CHAIRMAN GREENSPAN. On the CPI, what do the numbers look like with an additional decimal point?

MR. PRELL. I don't know that. I just looked at the rounded data here which show a core CPI increase last month of exactly .3 percent, but I don't have the data with the Board staff's estimate.

MR. BLINDER. They are short on staff up there; they can't give you two decimal places!

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Mike, I have a couple of largely unrelated questions. I will take them one at a time. Your projections in the Greenbook of nominal GDP for 1996 and 1997 have been revised up from the previous Greenbook. Nevertheless, nominal spending growth, after accelerating a bit to a little over 5 percent in the third quarter, is on a downward trend to under 4 percent in the second half of 1997. That was true before and it is still true in the latest Greenbook where it is down to the 3.8 to 3.9 percent range for the second half of 1997. Your forecast now also assumes a 5-3/4 percent fed funds rate--and I will make some remarks about that not appearing to be as restrictive as previously envisaged--and the bond market has rallied because markets thought that we would lower the funds rate. If you take that away, it says bond yields are now expected to go back up from current levels while both nominal growth and real growth are going down. I am trying to imagine how those work out, especially how they would play out in the marketplace if people actually saw things that were reported along the lines of the Greenbook projection. What that means is that in the latter part of the projection period, you would have nominal interest rates running 2-1/4, 2-1/2 percentage points or more above nominal GDP growth. What kind of stories would you tell about the anticipated inflation component of nominal interest rates versus the reported inflation rates that you project, or the anticipated or ex ante real rates as opposed to the real growth rates in your GDP projections? I have trouble reconciling what you say about financial markets, nominal interest rates, and your projections for the economy.

MR. PRELL. We have discussed this in the past, and as I said, we pondered this question of whether having nominal interest rates running higher than nominal GDP growth over time is an unnatural relationship. It strikes one as being something that is unsustainable. We think of this, in terms of government budget positions and so on, as a relationship that's unsustainable. But over limited periods of time, this relationship clearly has varied tremendously, and there isn't a very compelling short-run macro story that pushes you toward equilibrating these things or having the nominal GDP growth rate higher than the nominal interest rate. Certainly, our view in formulating this revised forecast is that, given real interest rates in the current environment--one in which we are experiencing ample availability of credit, and we looked at all the other parameters of financial conditions at this point--these real interest rates are not creating quite the damping effect on aggregate demand that we anticipated earlier. But we do expect that they will create some drag on final demand and that we will have this tapering off in the growth of consumer and business expenditures. We think there is a coherent story here. But it does in essence have implicit in it, if you like that model, a relatively high natural real rate of interest for the forecast period.

MR. JORDAN. Right. It implies de facto a progressively more restrictive policy stance.

MR. PRELL. We have intermediate- and long-term rates rising in nominal terms, but we see no reason to think that inflation expectations for the intermediate to long run will change materially. The 3 percent inflation that we are forecasting is very much in line with what private forecasters are expecting. I think the survey evidence suggests that expectations for inflation over the intermediate run probably run in the 3 to 4 percent range. I don't think that would change a great deal. You are correct in noting that the uptick in real interest rates has a damping effect in the forecast. It's one of the things that contributes to the deceleration of fixed investment, residential and nonresidential, and gives us this moderation in growth going forward.

MR. JORDAN. My other question relates to productivity. I very much welcome the discussion of higher productivity growth that was in the Greenbook--a sort of level effect and rate of change effect, the way I read it--as far as it went. But it didn't go so far as to change the perceived output capacity situation versus the inflation rate. We have this 3 percent inflation rate; we just sort of drove to it. Once here, it seems we can't get away from it. I want to offer an alternative way of reading the numbers and get your reaction to it. I read a little of this in the Greenbook, but it just didn't go as far as I thought it might. We not only have had a lot of investment in business fixed investment, to which Bob Parry was referring, but also a very substantial increase in business spending on training, both internal and external. The response to the perceived tightness of the labor market--the Chairman commented at an earlier meeting about the insecurity of capital over the life of a given technology--has led companies to increase markedly the amount that they are spending to train their workers. Resorting for efficiency reasons to economic jargon, that says to me that the horizontal axis does not measure the supply and demand for labor in homogeneous units because the quality of the labor force is changing, perhaps especially at the entry level. That says to me that the inflation potential that you would have thought associated with a given physical capacity has to be different. It's not a one-time level effect to the extent that there is this persistent investment in human capital going on coupled with the changes in technology. Whatever you previously thought would be the inflation rate associated with some output potential, it has got to be lower. I don't see, in the Greenbook discussion or the projections, any allowance for those kinds of dynamics to lead to a lower rate of inflation than historical experience would suggest.

MR. PRELL. Let me make several comments. I probably won't be able to achieve absolute coherence here. In a sense, we have introduced a supply shock into this forecast to the extent that we have lowered our NAIRU and in essence have raised the potential output ceiling. On the trend of potential output growth, the analysis that we have offered is that when one looks at data--not on a 1987 fixed-price basis, but on a more recent base year or chain-weighted basis--recent evidence of surprises in productivity growth disappears. We seem to be running on a trend that has been in place for well over a decade, something on the order of a percentage point in these terms. It doesn't suggest that we had a big surprise in the last couple of quarters. It doesn't suggest that there has been a radical revolution over this decade relative to where we were running before. Now, that may mean there was a mismeasurement, as Chairman Greenspan noted earlier. There may be components that could be added in and so on, but those add to both potential and actual measured GDP and don't alter the output gap. So that doesn't imply anything different about the pressures on the inflation side.

Training is an interesting question. I would remind you that training costs money. It's a cost, as you've characterized it, of production. It would have to be made up on the price side. So it's not a free good. Second, I am not sure how clear the data are. I think there may be bits and pieces around about how much expenditures on training have increased. I am not well versed in that, but I have certainly seen anecdotal reports of it here and there. Some of the stories I have seen over the years have suggested that a lot of this training goes to managers--upper level people. They are getting all kinds of training that may not have particularly obvious payoffs in production. I could cite the training here at the Federal Reserve. [Laughter] It will be five years before my colleagues in HRM hear that and in the interim you are all sworn to secrecy! [Laughter]

CHAIRMAN GREENSPAN. But they aren't the only ones who care! [Laughter]

MR. PRELL. Furthermore, a lot of this training is remedial. Many of you have reported what directors and other contacts have told you about how it's really hard to find workers who are literate or numerate. A question might be raised as to whether they have to spend more and more money just to maintain the quality of labor input that they are accustomed to. In a sense, one of the reasons for some of this investment in computerization--I have speculated about this with my colleagues, who would rather I not say this--may be to make up for some of the deficiencies of the work force. A simple example is something like fast food outlets where workers are able to tell you what you owe them without having to enter in any numbers. They just punch a button that has a picture of a "Whopper" or whatever it is. I think we need to be a little cautious here in thinking that there is a revolution in progress leading to an improvement of the labor force.

We all recognize that achieving the gains in productivity that might potentially result from the investment in high-tech information processing equipment will only be achieved when people know how to use the equipment, reorganize production processes accordingly, and the whole infrastructure is developed. Maybe it's still ahead and maybe we are not optimistic enough going forward. But from what we can see to date, we feel pretty comfortable with our assessment of the trends in potential output.

MR. JORDAN. Just one follow-up thought: You remarked that training is a cost that needs to be passed through to prices. This is not the case if it really is improving the value of what workers do. Even if it is remedial, to the extent that the value of the marginal product of the work--that's what I meant about the horizontal axis units are not homogeneous--you are in effect shifting the labor supply function. Then, for the same ECI, you would not expect to see the same associated consumer price index that you previously would have associated with it. I don't know how big that is, just its direction.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Actually I have two questions about this path, particularly of household durables spending. The fourth quarter of 1995 number seems high. Is that a growth rate of 11.3 percent? Is that a misprint?

MR. PARRY. Isn't it mainly computers?

MR. PRELL. This is consumer durables spending excluding motor vehicles in our forecast, As we have suggested, we think there will probably be some improvement in sales of appliances and home furnishings in connection with the surge in home sales that we saw over the summer; reports seem reasonably favorable into early fall. Second, we anticipate that there will be some considerable strength in home electronics, computers, and other such items--hardware and software.

MR. LINDSEY. Is it basically a Christmas phenomenon and then it falls off next year?

MR. PRELL. Obviously, the housing element flattens out. We have a weaker motor vehicle contribution in the first quarter. Yes, this is a big Christmas for computer buying in our thinking. I don't want to get too fancy about this. Obviously, whether the sales occur in December or in January isn't of great moment for the GDP forecast--and certainly not for monetary policy--because the production might occur anyway on this schedule.

CHAIRMAN GREENSPAN. Incidentally, is computer software a consumer durable good?

MR. PRELL. Yes, and I think it gets counted with books and other things and in many cases probably is bought at the same outlets. That's one of the real problems in gauging the actual level of expenditures.

CHAIRMAN GREENSPAN. What actually is being sold is a disk or something that is hard.

MR. PRELL. The question is whether it lasts very long or whether you have to go out and buy a new one next year when you buy your replacement computer. That is where it's counted.

MR. LINDSEY. Second part of the question. You've got PCE growing fast.

MR. PRELL. Let me just say this. The incoming data have been weaker and that would be a component of this downgrading of the PCE that I suggested would be appropriate at this point.

MR. LINDSEY. I have been trying to eyeball it. Is PCE generally growing a little more quickly than income?

MR. PRELL. As you know, the personal saving rate is 4.4 percent in the forecast and it has been 4.4 percent. So, nominal expenditures are roughly keeping pace with nominal income.

MR. LINDSEY. Then why does the forecast go off the cliff in the third quarter of 1997?

MR. PRELL. Probably inadvertence in the forecasting process. Let's take a look again. The latter part of the year is weaker in 1997. The saving rate is down because of the intra-yearly tax pattern that we have and our assumptions about how people will spend their tax cuts.

MR. LINDSEY. But you have consumption down and, in particular, durable purchases are down in the third quarter of 1997.

MR. PRELL. We do have a deceleration going on at the end of 1997 in general.

MR. LINDSEY. I see.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. Mike, what you are saying about productivity prompted a question that I didn't think of before. If you feed through the investment burst, so to speak, of the last three years into the capital stock and into a production function and it does nothing to total factory productivity, what should it do to labor productivity? How much of a fillip to labor productivity ought we to have gotten from this?

MR. PRELL. As you may recall, it wasn't until quite recently that levels of investment got to the point where we were really adding rapidly to the capital stock. My sense is that those people who would try to approach estimation of what labor productivity should be through a production function find some pretty substantial rates of increase in labor productivity in 1987 dollars. My recollection is 1-3/4 percent.

MR. BLINDER. I would take your previous criticism as being valid. We probably ought to view those in 1994 dollars or chain weighted. Otherwise, we could get excited about something that is not there.

MR. PRELL. Indeed, how strong investment has been is obviously important to the story.

MR. BLINDER. These numbers aren't in my head. But even though some of the chain-weighted numbers have been low, it is still the case that "K" has been growing significantly faster than "L." Labor productivity is still growing at 1 percent a year, right?

MR. PRELL. Yes.

MR. BLINDER. "L" has been rising for three years, but I don't have the number in my head. Do you know how much it has increased?

MR. PRELL. I don't have the number in my head for what you would derive from a production function approach. But I know from talking to people like Larry Meyer and from our own quarterly model work that one could argue for a somewhat higher number than we have embedded in our forecast.

CHAIRMAN GREENSPAN. Net?

MR. BLINDER. Yes, net.

CHAIRMAN GREENSPAN. That has been going up.

MR. PRELL. That's all a matter of model estimation. There is still the question of what the actual experience has been. The simplest way of looking at this is, if you believe in Okun's law and, admittedly, it is not a precise relationship in every time period, that there is nothing in the behavior of the unemployment rate that would suggest that we have been grossly underestimating the growth potential of output.

MR. BLINDER. I agree with that. Suppose you did this calculation and it came out--I'll make up a number, because I don't know what it is--that it should add .4 percent on first principle to labor productivity. That means total factor productivity decelerated because the evidence is as you said; I'm not disputing that at all.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. For some time now, I have been asking people in Boston if we can learn anything about the current situation or be better informed about the current situation by looking at the late 1980s experience and seeing how long we were below our estimate of the NAIRU at that point before inflation started to accelerate. They keep telling me that we are nowhere near as far below the NAIRU now as we were then, and we were that way for a longer period of time in that period. Given the recent small uptick in hourly compensation and where we are with the unemployment rate, I don't debate your choice of a new NAIRU. I think it's closer to what we had been thinking it was. But I just wonder whether prospectively we are starting to see something like what we saw in the late '80s. Or are you really thinking of this as just minor noise here?

MR. PRELL. I think some would argue that what we are seeing that is reminiscent of the late 1980s is this undaunted optimism on my part. [Laughter] There is a distinct chance that this will be declared Prell's second folly and that we inched toward a somewhat greater degree of optimism on how low the NAIRU might be just when things were starting to turn.

MS. MINEHAN. You have!

MR. PRELL. We were somewhat seduced at that time by the run of good experience after we had hit what we thought was probable NAIRU territory. As we saw the unemployment rate moving in the 5 to 5-1/2 percent zone, we got a little more optimistic than in retrospect we should have and there is the risk that that is also the case at this point. In terms of sheer econometric tests, you can't say that the experience that we have had over the past year, a relatively brief period, deviates in a statistically significant way from what model predictions would have been based on a NAIRU as high as the roughly 5.9 percent that we had before we made this change, or even numbers in the low sixes. Compensation per hour numbers have begun to push the envelope a bit. But if you look at reduced form models with prices, there is certainly no inconsistency with a higher NAIRU. I think we have cautioned, at least implicitly in what we've said, that we are making an assessment of what we see going on now and what is likely to be going on in the near term in light of all the factors affecting the economic environment. It is not necessarily the case that we can expect the NAIRU to be permanently lower than what we have previously thought it to be. There may have been some short-run favorable supply side effects, so to speak, that helped push the short-run NAIRU below where we thought it was, and it may pop back up. We need to be very cautious and continue to watch this. Some people point to the other compensation-per-hour numbers that come out in the productivity cost release, and conclude that that has turned up--Larry Meyer, for example, and that's perhaps because it fits his model. It is true that there certainly has been no deceleration in core CPI this year. The latest data are a little worse than they have been for the last few months. But given the average hourly earnings and the slight uptick in the core CPI, I would rather have had the numbers go the other way than have had my neck stuck out this time.

CHAIRMAN GREENSPAN. Governor Blinder raised the question before the meeting as to which week the unemployment rate survey will be taking place. Since the 12th is on a Sunday, do they look at the previous week or this week?

MR. STOCKTON. My understanding, Mr. Chairman, is that if the government shutdown extends beyond this week, they will not be in the field next week with the household survey. This week is the reference week and next week they will be out in the field actually doing the survey.

MR. PRELL. There is also possible irreparable damage to the November CPI estimate because they normally have people out in the field all month getting quotes. Those people presumably are not out in the field now. If they get back soon, this may not lead to any major miscues in the estimates, but there is still a potential problem for the estimates.

CHAIRMAN GREENSPAN. Any further questions from anyone? If not, who would like to start the roundtable? President Hoenig.

MR. HOENIG. Mr. Chairman, the Tenth Federal Reserve District continues to be relatively strong. Since the last meeting, for example, payroll employment in our District continued to grow faster than the national average. District manufacturers continue to operate at or near full capacity. In recent surveys, many of them suggest that their operations have pretty much rebounded from the summer slowdowns. In addition, retail sales have been solid throughout the District and most of the retailers we have talked to expect a good holiday season. Our directors are reporting that commercial construction activity continues to be fairly brisk, offsetting a bit of a slowdown in home building. Reflecting the generally healthy tone of the economy in our District, growth in bank credit has picked up recently, supported by gains in consumer and real estate lending. While our economy is generally stronger, there are a couple of areas that have shown some weakness: energy and agriculture. Low oil prices continue to hold down activity in the District's energy industry, and financial losses in the District's cattle industry are likely to limit the improvement in farm incomes, which some of us were expecting. Wage and price pressures remain relatively subdued despite the overall strength of our regional economy and despite some spotty reports of wage pressures at the lower end of the wage scale.

On the national level, the outlook in my opinion remains favorable. By that I mean that, on the real side, I am looking for growth to be about 2-1/4 percent over the next several quarters. While I note the strength in the third quarter, I see economic activity returning to this more moderate pace as we move through this quarter into next year. But even with this slowing, the economy remains fundamentally strong in my view, except for government spending and inventory investment. I expect most other sectors to contribute to growth over the next several quarters. A growth rate in a 2 to 2-1/4 percent range is entirely appropriate, I think. This is especially true with the economy continuing to operate a bit beyond capacity, by most measures at least. With regard to inflation, I believe that we need to continue to be cautious. I'm pleased with some of the more favorable inflation numbers. But despite this morning's report, I think it is important to acknowledge that core CPI inflation is likely to rise this year over last, and with resource use still at fairly high levels, wherever one believes the NAIRU is, we are not likely to see a real easing in inflation below that 3 percent mark as we go forward. I think that has to be kept in mind as we proceed from here. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Thank you, Mr. Chairman. Conditions in the Southeast, in the Sixth District, have not changed very much since the last meeting. We continue to enjoy moderate economic growth in most sectors and relatively low inflation. It is interesting to note that the economy in the Southeast, and I think this is generally true of the nation, has made a successful transition from the rapid growth in the first three years of the current expansion to the more moderate growth that we have experienced this year.

Looking at some particular sectors, we have seen a rebound in household spending in early November after some special factors, including Hurricane Opal, had depressed retail sales in October. In spite of this rebound, extensive holiday sales promotions have already begun that will extend the holiday shopping season by at least several weeks. I have seen some reports in the last few days indicating that retailers in the Southeast are expecting sales to be 7 percent above last year's, which I think is a little better than what is reported generally in the nation. In the Atlanta area, they are expecting about an 8 percent increase, which is really quite good. It remains to be seen whether they will achieve those or not. Sales of consumer durables other than autos have strengthened recently along with the second wave of home building. In the real estate area, activity in residential markets has been stimulated by recent declines in mortgage rates. Nashville and Atlanta remain the strongest markets, but other Southeast metropolitan areas also have had quite good growth relative to last year. In the multifamily sector, demand is really strong, and it is not uncommon to see ninety percent occupancy rates in that market. Commercial construction is also expanding throughout the District and speculative office and retail developments are regularly reported now. In manufacturing, our regional manufacturers' survey indicates that the pace of growth in the Southeast has slowed somewhat since July, and that survey includes housing-related manufacturing and auto production, which had been strong previously. The same survey continues to show quite modest pressures on prices at both the input and final product levels, and the expectations are for little change in such prices. The Southeast, and especially Atlanta, are experiencing growth in tourism in both traffic and revenue. The Olympics are guaranteeing a draw of about 2 to 3 million visitors next summer, which is expected to spill over into each of the District states in one form or another. So, the outlook for the Southeast continues to be quite good on both the output side and in terms of prices.

With respect to the national economy, for the first time that I can remember, our forecast and the Greenbook forecast are about the same. Both forecasts agree that the 4.2 percent real growth of the third quarter is unsustainable. Our forecast shows real growth in the 2-1/4 to 3 percent range quarterly through 1997 and inflation in the 2-1/2 to 3 percent range quarterly. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, economic growth in the Twelfth Federal Reserve District has accelerated through September. Recent California employment growth has been significantly faster than for the United States as a whole. Very rapid growth has continued in Utah and Oregon. Although Nevada and Arizona show signs of cooling, they are growing very rapidly. Idaho and Washington also are growing more rapidly than the United States as a whole, but with some areas of weakness. The limited information that we have on activity in October suggests less robust economic expansion. The official California employment and unemployment figures for October suggest some slowing, although other state data indicate that the recovery is still on track. Boeing's 23,000 machinists located in the state of Washington are continuing a strike that was begun in early October; the strike is likely to pull down overall economic activity in that state in the fourth quarter. I might note parenthetically, as you may have seen, that Boeing received an incredibly large order from Singapore Airlines for their new 777. In California, there is an ongoing debate over creation of higher paying jobs versus lower paying jobs during the state's prolonged recession. During this period, the shift from higher to lower wage industries has been more rapid in California than in the nation as a whole due primarily to large reductions in defense-related employment. More recently, we believe that this trend has been reversed, due largely to job creation in high-tech-related sectors since those sectors have been growing very rapidly in the last year or so.

Turning to the national outlook, our forecast shows real GDP growth averaging about 2-1/2 percent or somewhat more through the end of next year. In our view this would leave the economy with some resource constraints in labor and product markets even if the NAIRU has fallen a bit. Recent inflation news, as we all know, has been favorable. Although I hope it continues in this vein, it seems to me there are some reasons to worry about whether that will happen. First, there will be upward pressure on inflation to the extent that the economy is pressing on full employment. Second, I believe there are reasons to be skeptical of arguments that the moderation in employment cost inflation over the past year will be a major factor holding down price inflation for long. As was mentioned by Mike, most of the slowdown in the employment cost index since 1993 has been in benefits, especially health care costs. This has caused employment costs to decelerate since mid-1994. However, in the long run this should affect only the level of benefit costs with presumably no permanent effect on compensation inflation. Second, research at our Bank and in the academic literature--and I would cite here work done by Robert Gordon and also Yash Mehra from the Richmond Bank--questions the direction of causation between wages and prices. We don't talk about that very much. This work suggests that more often than not, these two variables are brought into alignment by wages adjusting to prices rather than the other way around. So, despite the favorable CPI numbers in recent months, the unusual decline of labor cost inflation relative to price inflation during the past year or more could be resolved in large part by somewhat faster wage inflation in the future. In this regard, I found the Greenbook projection of rising labor costs in 1996 and 1997 certainly plausible. Taking these factors into account, I end up concluding, as did Tom Hoenig, that I don't see us making any progress in 1996 and 1997 in reducing inflation below this year's rate. Under the assumption of a roughly constant funds rate, our forecast shows the CPI at around 3 percent in 1996 and 1997, a little above this year's 2-3/4 percent rate. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Sometimes the District reports make me think about 12 pistons in a reciprocating engine, with some rising and some falling. It's hard to cut through it and know whether the engine is well tuned and humming along or not. The Fourth District is definitely a piston that is coming down. I've been struck by how consistently the reports from our Bank's business advisory council, our directors, and the other people that we have talked to have been in the negative direction since our meeting in September. People are pulling down their expectations, not only to finish out this year but also for the first half of next year. It may simply be because the District is so heavily influenced by automobiles. Our manufacturing employment as a share of total employment is running about twice the national average so that when autos and trucks and even agricultural equipment soften--and they are distinctly softening--everything else and everyone's attitudes also downshift. That's pretty uniform throughout the District with the exception of the area around Lexington and the Georgetown automobile facility that is still expanding. Everyone else is reporting that it is much easier to hire than before. Their order books are softening; their backlogs are down. There are almost no reports of the type we were hearing for a while about commodity prices of various types being the source of new inflation. Other than some pickup in residential construction around the District--and people say they think that is related to lower mortgage rates--we see people mostly pulling back on the previous optimism.

I worry about these kinds of anecdotal reports adding up over time to the mirror image of two years ago when we started to sense that the head winds were dissipating. In terms of the things that we are concerned about, that kind of information we have about real economic activity translated for me into saying in the context of two years ago that the real equilibrium interest rate was starting to shift up. If we don't make some adjustment, we will wind up with a de facto easing of policy relative to where we think it ought to be.

If I am right about things going in the opposite direction of two years ago, we should start to see a pattern of people being surprised that the economic indicators are coming in weaker than they previously had expected. We are hearing it not only in consumer goods but also in capital spending. I would call that a downward revision in the equilibrium real rate. We would be in a posture of winding up with a more restrictive policy relative to what is going on in the economy than we may later consider to have been appropriate. I don't make forecasts anymore, but I do listen to the forecasts of my staff. They tell me with a fair degree of confidence that real GDP growth this quarter will come in somewhere between minus 1 and plus 5 percent. [Laughter] I'm not sure what to make of it, wherever it falls in that range. But looking to next year, I am very troubled by that persistent 3 percent inflation rate shown in the Greenbook. If that's the most likely outcome, in the sense of being consistent with the forecast of economic activity and the assumed stance of policy, then it's unacceptable. But I don't have any basis for saying that it's wrong and that it's too high. If I were still in the game of making forecasts, I would tell people that it is more likely to come in below those numbers than above those numbers.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The regional economy in the Philadelphia District is mixed. It is performing in the range of steady to improving slightly. Manufacturing continues to grow, although the pace appears to be waning. Retailers are disappointed with sales and concerned about the outlook for holiday sales. Even discount stores are now seeing smaller increases than earlier in the year. Auto sales have eased with the end of incentive programs on '95 models and slow deliveries of '96 models. Real estate activity has been running at a nearly level rate. Office vacancy rates are coming down only slowly if at all, and residential sales are flat. Commercial and industrial lending is moving up some, with a slowing of credit card lending. Employment gains are anemic but still better than earlier in the year, and wage gains continue to be in the 3 to 4 percent range. Attitudes appear to be more cautious than upbeat.

Turning to the national economy, it just does not have the feel of a 4 to 5 percent growth rate. The statistics appear to be telling us a relatively fast growth story, and the anecdotal information indicates a more moderate growth story. I'm inclined to give more weight to the anecdotal evidence. Consumer spending appears more consistent with the more moderate growth path, as does manufacturing. I would view the 4 to 5 percent growth that we seem to have had as more of a statistical aberration than a basic underlying trend. The outlook for inflation is probably in the 3 percent range for next year. While I believe we are all committed over time to a stable price environment, I think we have to be realistic about this. We are in a very mature phase of the business cycle and it would be a major accomplishment by historical standards just to keep inflation from rising at this point in the cycle. I think there will be opportunities to have further disinflation, but my expectation is that we will have to wait for a more conducive phase of the business cycle for that to be achieved.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, on balance, the Seventh District's economy is performing at a very high level, generally stronger than the national economy and with some sectors or industries at or near capacity. The District's manufacturing sector expanded in October, while manufacturing contracted nationally. The purchasing managers' surveys from across the District in Chicago, Milwaukee, Detroit and western Michigan all indicated expansion in October, while the national figure dropped below 50. However, there are some areas in manufacturing where I think caution seems to be called for. I say this recognizing that our manufacturing firms are now operating at very high levels. In my view our situation is not the same as the one Jerry Jordan described for the Cleveland District, where he said that growth actually is starting to decline, but there are areas in our District that we have to watch carefully.

One area is light motor vehicles. October sales of such vehicles were below September's, and our contacts indicate that sales in early November have not shown any significant improvement so far. Of course, this is the early part of the month, but without a pickup from the recent sales pace, it's highly likely that production plans will be trimmed further this quarter. Medium- and heavy-duty trucks is another area where caution seems appropriate. Net orders have declined substantially, but manufacturers do not plan to cut production this quarter as much as might be expected. Although inventories will be increasing, several manufacturers indicate they will wait for the new year before reassessing their production plans. Finally, the steel industry needs careful monitoring. Steel production in our District has been at very high levels, but spot prices for steel have been dropping sharply.

District retailers generally were pleasantly surprised with the early November sales gains, particularly after October's lackluster performance. However, retailers are still in a gloomy mood, in part because of weak catalogue sales, and they are boosting sales promotions. Retailers with a national presence noted that sales at stores located in our District generally were stronger than nationally. A note of caution, however: A large national trucking firm reported that large discounters were significantly slower in taking holiday shipments this year as compared with previous years. The housing sector in our District is very strong. New and used home sales in the Midwest led the United States in September and October. Builders in Chicago and western Michigan are struggling to keep up with demand.

Labor markets remain tight. Unemployment rates in our District range between 3.3 and 4.8 percent. We are now receiving more reports of rising wage pressures, especially for low skill entry-level jobs. But these increases do not yet appear in the data, as a third-quarter employment cost index for the Midwest was roughly in line with the nation. We have received an advanced copy of Manpower Incorporated's first-quarter 1996 hiring plans survey results, which will not be publicly available until early December. The national results indicate that business hiring plans for the first quarter of 1996 will remain at the high levels reported for both the third quarter and the fourth quarter of this year. Hiring plans for Midwest firms continue to be stronger than the national survey results. Our contacts at that they feel the first-quarter results generally tend to be a good indicator for the full year. They also indicated that wage pressures were very low, but firms they service are expecting increases to become larger next year.

One of the major developments in the agricultural area, of course, has been the sharp increase in grain prices: Wheat prices are the highest in twenty-one years and corn prices are the highest in eleven years; a year ago, corn prices hit a seven-year low. While it is not entirely clear how much food prices will be affected, the farm price increases this year have been bullish for suppliers of farm equipment. More generally, price patterns in our District do not seem to have changed much since our last meeting. Nonagricultural commodity prices continue to be soft. Paper board, gypsum, and steel scrap prices have all edged down.

Turning to the national picture, our outlook is broadly in line with the Greenbook. We generally agree with the Greenbook's assessment for fourth-quarter GDP growth in inventories, although the anecdotal information we are receiving points to further inventory correction early next year. Our overall forecast is for a bit more economic growth next year than the Greenbook, and we are slightly more optimistic on inflation, but the differences are not really large.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you. We recently have had meetings with our directors and our advisory council, and several themes emerged from those discussions. Many of them are not new, but I think they are worth emphasizing because they were universal. The first of these themes was that labor markets are very, very tight across the District and across skill and experience levels--everything from unskilled, inexperienced workers to college graduates, MBAs, and so on. While that was reported by virtually everybody who commented on it, they also commented that despite the fact that those labor markets have been tight for quite some time, there is no real sign of any acceleration in wage increases or price increases across the District. Also, credit is readily available. There has been a striking lack of reports of difficulty in finding credit. Real estate construction markets have strengthened and are continuing to strengthen. The manufacturing sector, in contrast, is pretty sluggish outside of the paper industry. If there is one group that is concerned about current industry conditions and where the economy is likely to be going, I would have to say it is the manufacturers. Those we have talked to who do business internationally say that outside of Japan they are seeing improved business. Japan appears to be, as we know, largely a case unto itself at the moment. Finally, those who commented on this issue indicated that capital spending today is being driven by technological change rather than interest rates. They would not argue that interest rates are altogether inconsequential, but they seem to feel that they really have to continue to introduce new technology in order to remain competitive.

With regard to the outlook for the national economy, I share the view evidenced in the Greenbook that we will see a continuation of respectable real growth from here. It will not be at the pace of the third quarter, but I don't see any reason to doubt that the economy will continue to grow at a pace in the neighborhood of 2 or 3 percent on average over the next several quarters. With regard to the inflation outlook, I must admit to a fair amount of uncertainty. If I had to write down a number, I would probably write down something like the 3 percent in the Greenbook. But if there is one thing that really has surprised me in the past year or maybe two, it has been the fact that despite tight labor markets, rapid growth in demand, and tight product markets we have not seen any acceleration of inflation. I have a tinge of optimism regarding the inflation outlook, and if I were to err I would guess that we might do a bit better on the inflation side than that number I would write down.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, New England continues its gradual expansion from the trough of the recession, but recent data suggest that even the moderate growth pace of earlier this year has slowed a bit. As usual there is good news and bad news--or at least downbeat news. Let me cover the downbeat first and finish on a more hopeful note.

During the first eight months of 1995, New England added jobs at only about a third the pace of the prior two years. National job growth has slowed in recent months, but New England's decline has been sharper. The region had been adding jobs at about two-thirds the national pace since the recession ended, but recent data show that our job growth has slowed to about half the pace for the nation as a whole. Among the states, Rhode Island maintains its ranking as the basket case, with employment continuing to be below that of the year before. Connecticut is barely growing at all, while the remaining states have had, at least in New England terms, relatively healthy job growth. Manufacturing employment continues to shrink, but the pace of contraction has slowed a bit. The cause of the recent regional employment slowdown therefore lies outside manufacturing; employment growth in finance, government, and transportation has come to a relative standstill. I should note that despite the trend to smaller government, the share of government in the employment pie in New England is expected to grow. This is because the Bureau of Labor Statistics now classifies Indian-run casinos as "other local government." [Laughter] One wonders about this! Without casino-related job growth, Connecticut clearly would have continued to be our basket case, because that is where most of Connecticut's job growth has come from. Despite this, unemployment remains relatively low in New England at least in part because of weak labor force growth and outmigration. Recent estimates show that the labor force actually has shrunk by about 200,000 since the recession ended while the number of establishment jobs has expanded by about 325,000. We maintain a decent unemployment rate but largely because the labor force is shrinking. Adding to the downbeat news from local labor markets is considerable softness in retail sales. This undoubtedly reflects weak consumer confidence, which is below year-earlier levels.

Now to turn to a little hope: There are bright spots in New England. High-tech businesses are booming, at least certain kinds of high-tech businesses. So much so that one contact said his company was constrained not by demand but by a relative shortage of silicon wafers and glass yarn. Software designers are in short supply, and the industry itself is beginning to regard 25 to 30 percent growth rates as disappointing. A contact at a major software company located both in California and New England said he will be moving some jobs to Massachusetts because shortages are even worse in California. Wages for these workers have risen only a modest 4 to 5 percent, however, due in large part to the value of stock incentive programs that are being used increasingly to reward highly paid workers. Tourism has been another bright spot, with significant gains over even last year's strong performance.

Finally, I don't know if this is hopeful or not, but loan growth at large District banks has slowed considerably from its earlier pace. It had been slower than for the nation as a whole throughout the recovery. Most of this weakness lies in commercial and industrial loans, and some of this is due to uneasiness about large bank mergers, which we think have redirected some business to smaller banks in the District.

Turning to the national scene, we had a rather healthy internal debate among the economists on my staff. It's a serious debate because I gather money has been wagered on what the direction of the Committee's next move ought to be, up or down. The fact that we can make good arguments for both positions, I think, underscores the Bank's general agreement with the Greenbook forecast. As I see it, that forecast shows a fairly good outcome with relatively balanced risks. Actually, it was a bit more upbeat than I had expected, possibly because the third-quarter numbers have been such a surprise. In that regard, I think that the foreign growth numbers projected by the staff may be overly optimistic, and I really don't know what to believe about the numbers associated with the federal budget crisis. Your crystal ball is probably as good as any on that one. On the other hand, I really do think that the impetus provided by low interest rates and booming financial markets, combined with where we are in terms of the unemployment rate, does play out in the direction of an upside risk, and I would buy into a few of the concerns that President Parry mentioned in his comments. I am concerned that we may not continue to be successful in keeping inflation at the projected 3 percent rate.

MR. KOHN. Mr. Chairman, may I interrupt a second? Secretary Rubin announced a little less than a half hour ago that he is disinvesting trust funds, in particular the Civil Service Retirement

Fund as well as the G-fund, by enough to permit the Treasury to raise some $60 billion in the market. This now gets them up to the last business day of December.

CHAIRMAN GREENSPAN. Did he say that or is it our estimate?

MR. KOHN. I believe he said the $60 billion would get the Treasury through December 30. He did it by using the $21-1/2 billion in the G-fund as everybody expected. But apparently he must have made a finding that this crisis, or this debt limitation problem, could go on long enough to enable him to disinvest about $39 billion of the Civil Service retirement fund. This suggests that he found it might go for about a year or so.

MR. PARRY. Couldn't that announcement in itself have the impact of slowing down progress in resolving the budget problem?

MR. KOHN. In the last few days, attention appears to have shifted to the appropriations process and the debt ceiling issue has come off the table. There was some presumption that the Secretary had enough tricks in his bag to keep it off the table for a while.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, Part II of the Greenbook starts out with the statement that the recent news on the national economy is unusually "conflictive." I wasn't sure that was a word, so I looked it up and as always the staff was right. It is a word and it is a good word! [Laughter] It is a good word to describe conditions in our District as well as in the country as a whole. I will cite a couple of examples. Furniture, as most of you probably know, is a major industry in our region, and each fall there is a so-called "furniture market" in High Point, North Carolina where all the major manufacturers and a number of major retailers come together. That market was held a few weeks ago, and it was said to be the weakest in five years. In sharp contrast, the CEO of a sizable chain of retail furniture stores said that his business had picked up significantly in recent weeks. Elsewhere, textile and apparel manufacturers tell us that conditions in their industries have softened a great deal lately. At the same time, there are pockets of substantial strength throughout the District in such diverse activities as chemical manufacturing in West Virginia, the expansion of high-tech facilities in Virginia and North Carolina, and tourism in South Carolina. Commercial construction is said to be quite strong throughout the District. Auto sales have softened in some places but are much stronger in other places. So again, "conflictive" seems to be a good word to describe the kind of reports and information we have been getting recently.

Boiling it all down, my sense is that in the aggregate conditions in our District have not really changed a great deal since the last FOMC meeting. I think steady growth at a moderate pace continues to characterize our regional economy. However, as Larry Lindsey reminded me at breakfast this morning, our District is more at risk than other parts of the country to any near-term shock stemming from the current fiscal situation; our region would bear a disproportionate share of such a shock. One other point that might be worth mentioning about our region--it might extend beyond the region--was brought up at a joint meeting of all three of our boards last week. Chairman Greenspan was there. At that meeting, several bankers expressed the view that loan quality was deteriorating in our region and around the country and that loan margins generally had narrowed and competitive pressures had intensified. Six or seven bankers made that sort of comment and only one took exception to it.

With respect to the national economy, I have to admit that I was a bit surprised by the magnitude of the upward revision in the forecast. I have been reading these Greenbooks for a long time, and this was a significant upward revision, especially if a comparison is made with the previous forecast in some of the out-quarters. I think the level of real GDP at the end of 1996 is about a percent higher than it was in the September Greenbook. I recognize that with the more recent retail sales figures you may revise your forecast down a bit, Mike, but I take it that on net it is going to be generally the same picture. The Greenbook makes a good case for that revision. Aggregate demand does appear to be significantly stronger than we thought it was not too many weeks ago. Business investment, especially in computing equipment but in a lot of other things as well, is still quite robust. There is still a lot of thrust in housing, and we certainly see that in much of our District. The latest labor market reports, as the Greenbook mentions, suggest that income will be growing rapidly enough to sustain at least moderate growth in consumer spending in the period ahead. Clearly, none of this negates the downside risks that are still there, and I think the retail sales report yesterday was a good reminder of that. But it does suggest that the risks on the up side are also there and they should not be ignored.

This brings me to what seems to be the main implication of the revision. It moves the projected path of the economy away from one that might have seemed to be a bit below the economy's potential to a path that may be very close to potential and conceivably even a little above it. This obviously has implications for the inflation outlook, and I think they show up in the projections. They are not dramatic, but they are there if you look at the numbers closely. In particular, as I recall, the September Greenbook showed the core CPI inflation rate gradually declining over the course of the projection period. In this Greenbook, it stays almost exactly constant at 3 percent. Some people might look on that as an optimistic forecast, but I think it is a move in a direction that we don't want to see. Tom Hoenig and Bob Parry have made this point before. I think we should be concerned if we see no further progress toward price stability until 1998 at the earliest. And, obviously, with the revision in the projection, there is some risk that we could get into a situation where the inflation rate begins to drift slowly upward. That prospect should be a concern and it is what struck me most in the projections.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mike, I was interested in your comment that the current situation reminded you most of developments in the late 1980s. I wasn't here then. What I remember about 1988-89 is the cover of Business Week that asked "Have we repealed the business cycle?" If I were to put a cover on this Greenbook, I too would say "Have we repealed the business cycle?" At the least, your forecast puts off any perceptible slowing for another six quarters--until mid-1997. I'm suspicious of that. I hope I'm wrong, but I have a number of quibbles, particularly on the international side, and one major concern that has to do with the consumer debt situation. We continue to have a robust forecast and robust debt growth. The Greenbook rightly notes that consumer debt levels have moved up. In the last 2-1/2 years, consumer debt as a percent of disposable personal income has risen 2-1/2 percentage points from about 16 percent to about 18-1/2 percent. One way of looking at that is that 40 percent of growth in PCE in the last 2-1/2 years has been financed by higher non-housing consumer debt. The reason I am more concerned about that than the Greenbook and the reason that we are going to have some problems is two-fold: first, I think that the quality of income that consumers are receiving makes that debt level worse than what it is perceived to be; and, second, there is the view that the stock market can be a panacea for the deterioration on the liability side. I don't believe that is accurate.

Let me start with the income situation. Although personal income has been rising at a respectable rate, not all personal income flows through to spendable income for the consumer. Although that is true for wages, that is not true for substantial portions of interest and dividends. One check on that is simply to look at income tax data. Now, if you receive more than ten dollars a year in either interest or dividend payments, that income is reported to the IRS. So, it is not a question of evasion; any received interest or dividend income by a taxable entity is going to show up in the income tax data. Yet, only 30 percent of personal interest income is reported on income tax returns. That includes nontaxed interest. The same thing is true for 50 percent of dividends and 65 percent of business income. If you define spendable income, you can either include transfers or not include transfers. The numbers I have don't include transfers, but that doesn't change the story. What you get is a picture of the income situation that suggests there is a lot less spendable income out there than what we have perceived. By itself that is not a disturbing fact. What is disturbing is that over time the relationship between spendable income and disposable personal income has been deteriorating. For example, spendable income in 1988, as I just defined it adjusting for what actually flows through to household checking accounts, amounted to about 61 percent of disposable personal income. In 1995, that fell to 57.4 percent. So we have had roughly a 6 percent decline in the base, what I would call the denominator, which we should be using to measure debt service burdens. That means that the 18-1/2 percent that we scored in the second quarter of this year has a ratio of debt to disposable personal income that, after adjusting for the deterioration in the composition of income, would really be a number like 19.7 percent. That would be a record high substantially above anything that we have seen. Obviously, with the average of spendable income to disposable personal income falling, it is even worse at the margin, and the last year has been the worst year to date.

The second issue is whether the very substantial stock market gains could in fact offset this deterioration on the household liability side. It is an obvious statement to say that people who own stocks are the same people with credit card debt. But if you take a careful look at the distribution of stock market wealth, it becomes increasingly implausible to believe that a rise in stock market wealth could actually be the cause of any kind of sustained expansion in consumer spending. For example, 31 percent of dividends go to the .8 percent of households at the top of the income distribution and half of all dividends go to people over 65. Actually, among the non rich, substantially more than half of all dividends go to people over 65. I don't know if we have any detailed studies of the marginal propensity to consume, but if you are counting on stock market wealth, which I'm using dividends to apportion, dividends would be a rough signal that a lot of that increase in stock market wealth is--I'm going to use the word--"wasted" on people who are unlikely to spend a large portion of it and certainly unlikely to be the people who are running up this consumer debt. To try and probe that a little further, if in fact stock market wealth is going to be the leading cause of consumption expansion, we would expect it to permeate down at least into the $75,000 to $100,000 income class. There are about 4 million households in this income range; there are about 4 million households that are richer than that. We are talking here about the 92nd to 96th percentiles of household income. If we are expecting a wealth-led increase in consumption, they clearly should benefit. Yet half of all households in this income class receive no dividends at all, suggesting that they have no stock market wealth. And 71 percent of households in this category under age 65 receive no dividends at all, suggesting that they have no stock market wealth. Of the remaining 29 percent in this category--about 1 million households that received dividends--the average dividend is about $3,000. The median dividend is about $600. If you figure that there was a 40:1 price to dividend ratio, that would mean that even among the 30 percent of this relatively wealthy class that got dividends and owned stock, their portfolio is only about $25,000. The gain in their portfolio was on the order of $6,000. To expect that small a group and that small a gain to somehow sustain consumption spending seems implausible to me. So, I have to believe that the problems that we all acknowledge on the liability side of the household balance sheet are real and can't be offset by improvements on the asset side of the household balance sheet. I think this is going to show up, for example, in continuing declines in auto sales. I don't know that we are going to have a recession, but I do know that this type of increased risk in household balance sheets will mean that whenever there is a misstep--a shock if you will--in some other portion of the economy, it is going to spill over into the consumer sector with magnified effects. I think that means we have substantially heightened risks on the down side. That is my quarrel with the Greenbook.

I would like to say one other thing about the economy and that has to do with the current budget negotiations. We have 800,000 federal employees who are furloughed and close to 1-1/2 million who are not receiving paychecks. Now, that is a lot on the spending side. If these people are actually liquidity constrained, it is in effect a sudden 1-1/2 percent rise in the unemployment rate, which would amend forecasts about what is going to happen to consumer spending, particularly in the fourth quarter. Staff has estimated that each week that we continue to have an impasse takes .3 point off the fourth-quarter growth rate. Well, it looks as if we have one week for sure according to this morning's papers and, as I read the rhetoric, I don't see where this is going to end any time soon. As we start adding up the weeks people are not getting paychecks, we begin to get a little nervous about how this might spill over. Secondly, if it is resolved, the direction in which it most likely will be resolved would be a compromise on the Medicare side. I think that would be unfortunate and I believe the bond markets particularly would view it as unfortunate. It would mean that we would get the short-run cuts on the discretionary side, that is, the layoffs in the government sector. But it also would signal to the bond markets that we are not going to be getting our arms around government consumption over the long haul. The effect of that would be that yields on intermediate- and long-term securities would tend to rise. The big rally in securities markets has not come from proposed cuts in funding for the National Endowment for the Arts but from proposed cuts in Medicare and long-term government consumption on the order of a trillion dollars. So, I am afraid that the kind of compromise that we most likely are headed for will give us the worst of both worlds--short-run contraction in 1996 due to layoffs plus a run-up in intermediate- and long-term rates that will adversely affect the auto industry and housing starts. I am substantially more pessimistic than I was, and I am much more pessimistic than the Greenbook.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. The good news is that this year's CPI inflation likely will be less than the members of the FOMC forecast in July. The acceleration that was widely expected at the beginning of the year has not materialized. Although the staff analysis cites temporary decreases in energy prices and a deceleration in medical care costs, it says little about the contribution of monetary factors. Last year's slow growth of the narrow and broad monetary aggregates likely moderated this year's inflation. On the other hand, I don't consider the current stance of monetary policy as being unduly restrictive. Growth of both the broad monetary aggregates and bank credit has accelerated this year. If we adjust for sweep accounts, there has been some growth in M1 as well. In addition, firms have turned to the capital markets for financing as long-term market yields have fallen and stock prices have risen.

The bad news is that neither the staff nor the public apparently sees any deceleration of inflation in sight. Respondents to the Philadelphia Fed survey expect CPI inflation to accelerate to 3-1/2 percent in the first half of 1996, roughly comparable to the staff's projection of 3.3 percent. Households in the Michigan survey on average expect inflation to accelerate to about a 4 percent pace next year. We should be concerned, I think, when the public expects inflation to accelerate and not to fall further after it has been held below 3 percent for several years in a row. It is true that expectations have inched down a bit; we can see that in long rates and in some of the surveys. But no one expects inflation to fall to 2 percent or below anytime soon. We simply do not have the credibility that at least I think we would like. It is important to protect recent gains and to make further progress toward price stability. At some point, a statement in that regard with respect to our intentions would help. It is a topic we have talked about before.

The Eighth District economy, like the nation's, continues to operate at a high level, as growth slows to a sustainable rate. Transportation equipment has been exceptionally strong. Orders for both military and civilian aircraft have increased. District auto production was up 34 percent year-over-year during the third quarter, and it is expected to be up 45 percent during the fourth quarter. The exceptional strength in St. Louis auto production, as I have mentioned before, is due to the particular models built there, mainly light trucks and sports utility vehicles. In Arkansas, Tennessee, and Kentucky, the poultry industry continues to expand aggressively. Throughout the District, residential construction is picking up and office vacancy rates continue to decline. There are some signs of cyclical weakness, however. District unemployment rates, although still low by historical standards and below national averages, have risen about 1/2 percentage point on average over the last year. Layoffs at large corporations, such as General Electric, are attributed to weak domestic demand for appliances. On the other hand, announcements of plant closings by Brown Shoe and Fruit of the Loom, for example, more likely represent structural adjustments than signs of an impending downturn. In the banking area, "unchanged" is the key word in an Eighth District survey of senior loan officers. Loan demand has leveled off after rising sharply all year. In fact, at large reporting banks, loans have risen about 11 percent over the last year. Although there has been some increase in the consumer loan delinquency rate, it remains well below the level attained before the last recession. The poor weather conditions this year have reduced crops and have led to low agricultural stocks, a comment that Mike in particular made, which may well result in markedly higher food prices next year.

Nationally, the economy continues to operate at a high level, with growth slowing to its 10-year average rate. It is important not to repeat the mistakes of the past. It now seems likely that we will get through this business cycle with a peak of inflation well below the 6 percent rate that occurred in 1990. But, frankly, that is a pretty low standard to set for ourselves. The mistake made in previous business cycles was to inflate the money supply in a misguided attempt to stimulate growth. In every case, fighting the subsequent inflation contributed to recession. The outlook for the real economy is optimistic today because inflation has not accelerated. The worst thing we could do is to repeat the mistakes of history, most recently in 1986. That is, we should not allow an acceleration of inflation that would require a sharp reversal in policy later on. What we should be doing is looking to move the inflation trend lower.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Not very much has changed in the Eleventh District since the last FOMC meeting. Employment growth remains strong; it is weaker than it was in 1994, but it is stronger than that of the nation. At the margin, the expansion of high-tech industries is accounting for a large portion of our employment growth. To give you some longer-term statistics, over the last six years high-tech employment has grown four times as fast as total non-agricultural employment in Texas and more than twice as fast as high-tech employment in the nation. The growth of high-tech industries has been tightening the market for office space and other nonresidential real estate in our major cities. This is primarily in the outer edges of the cities, though, rather than the inner cities. Single-family home construction has picked up. Single-family permits rose at a 10 percent annual rate in the third quarter, and many homebuilders are raising their forecasts for 1995. This strength has been driven at least as much by business relocations as it has by lower mortgage rates. Many Austin and Dallas firms are recruiting heavily from out-of-state because of tight labor markets for certain skilled workers, engineers and programmers primarily. The Mexican border area remains a weak spot. At our board of directors meeting last Thursday, all of our directors' reports were up except for El Paso and Brownsville. Earlier in the year, we kept hearing reports that businesses have been through and have survived other peso crises. But there seems to be a lot less bravado these days than there was in the early months of that crisis. Retail merchants continue to shut down. The limit on how much Mexican citizens can buy in the United States without paying a duty when they cross the bridge back into Mexico has been raised back up from $50 to $400 on November 1st. But given the cut of about 50 percent in the purchasing power of the peso on the other side of the border, it is probably going to be irrelevant at this point.

On the national economy, I am pleased to see the less binding view of supply-side constraints in the potential rate of growth contained in the staff forecast. This accords well with my own views and recent economic results. The broad outlines of the Greenbook forecast seem to me to be about right and reflect the fact that growth momentum has been stronger than we suspected and inflationary pressures a touch weaker than we had thought earlier. I differ from the Greenbook in that I think the rates of real growth forecast for 1996 and 1997 do not appear to call for an upward revision to the inflation forecast in those years. Mike started off his briefing by talking about retail sales. I might just mention that although had a terrible October, they report that nationally the first two weeks of November have been very strong.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The private sector economy of the Second District grew moderately in recent weeks. In September, private payroll employment rose at an annual rate of 1.2 percent in New York and 0.9 percent in New Jersey. In October, the unemployment rate fell from 6.8 to 6.3 percent in New York State and was unchanged at 5.8 percent in New Jersey. Loan officers are reporting that demand for most types of consumer and nonresidential loans at small and medium-sized banks was higher than it was two months ago. Consumer confidence also improved in October, rising 12 points in the mid-Atlantic states. That still leaves the index at the lowest level of the nine regions reported by the Conference Board. Consistent with that low level of confidence, the levels of retail sales and existing home sales have fallen sharply over the last four to six weeks. The major problem in the District continues to be the lack of business confidence in the economic climate, which stems especially from the attitude of government in the city and state of New York. The problem, I think, is actually getting more severe. We had a seminar last week co-sponsored with the Academy of Sciences on regional economic development in the tri-state area: New York, Connecticut, and New Jersey. It provided an opportunity for the private and public sectors to talk to each other, which they don't do as often as one might like. Rather dramatic were the two senior businessmen who spoke, the CEOs of American International Group and Pfizer, both of whom are board members of the Reserve Bank. They talked about why it would make sense to reduce substantially the number of employees in New York City. The following morning the Mayor was talking about how he was trying to improve the business climate in New York City, and I suggested to him that he better increase his pace. We actually put him together with the two business executives at a meeting yesterday.

On the national level, we have been concerned, as all of you have, about the explanation for the rather benign performance of inflation in the last couple of years. Rick Mishkin and the staff have been pulling apart everything that they can think of that would be normal causes both on the demand-pull and cost-push sides of inflation. Essentially, the only thing we can find that is not performing pretty much as it has over the last 10 years or so is labor compensation, which is considerably lower than any model results based on performance before the last couple of years. I think the only problem is that nobody, including us, is very certain of exactly why that benign inflation has been happening. There are various bits of psychology, sociology, and political science that people are attributing to it. But I think the real fact is that nobody knows or is absolutely sure why it is happening. Therefore, it is rather risky to predict that it will continue to happen. On the other hand, we don't know whether that is certain, either. It makes us rather concerned about our forecast in general. The reason we have been so anxious to try to figure this out is that the Bank has been very good in its growth forecast over the last couple of years and until very recently was overestimating CPI growth. Now we know why we were overestimating it, but that does not give a pure sign of where to go in the future.

We do, however, find ourselves unusually at variance with the Greenbook, not on the CPI forecast where we were bickering with them a year ago but rather on real growth. For example, in looking at real GDP based on current policy, whereas the Greenbook has 2-1/2 percent growth in 1996, we have 2.1 percent. For 1997 the Greenbook has 2.3 percent; we have 1.9 percent. There are three major sources of this difference. We find the expansion rather long-in-the-tooth, and therefore we are less confident about the growth of business fixed investment than the Greenbook is. We are somewhat weaker on net exports, and we are a fair bit weaker on housing. For example, the Greenbook has 1.45 million housing starts for next year; we have 1.4 million. Actually, that makes both the Greenbook and the New York Reserve Bank higher than the consensus. We are about equal with the Greenbook on the forecast of the CPI. Therefore, we are looking at a situation in which a maintenance of current policy may in fact not be appropriate. So, we have been doing some modeling based on what would happen if the funds rate were to drop by 1/4 percentage point sometime late this quarter and by another 1/4 percentage point early next year. That gives us a somewhat better mix. It does very little to the CPI forecast even though we are not assuming that the current wage restraint will necessarily continue. But it does crank up GDP growth by .2 percent from 2.1 to 2.3 percent in 1996 and from 1.9 to 2.2 percent in 1997, not highly robust growth because we do continue to have the view that monetary policy should be somewhat restrictive to continue to work for stable prices. What we are concerned about is whether it is somewhat too restrictive at the present time.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. I must say that I welcome the more optimistic projection in the Greenbook this time. For what it is worth, my judgment would be right with the staff.

Despite the long-in-the-tooth expansion that we have had, I have believed and continue to believe that there is more potential for upside surprise than downside. I am sure it is not an immutable law of economics, but it seems to me that the U.S. economy has a natural tendency to rise unless something pushes it down. On balance, I don't see anything right now that looks to be sufficiently strong to produce that result. If you look down the list of the different elements of GDP, and Al Broaddus ran through that list to some extent a while ago, on balance it looks moderately positive with some components being stronger than others, as one would expect. That is what the Greenbook says; that is where they are.

That said on the optimistic side, I must say that I do want to identify with Governor Lindsey on his remarks about consumer debt. He has done a lot more serious work on it than I. But I have been, and I think Larry has been, crying "wolf" on this subject for some months now. Obviously, we have been premature so far, but I think some day we are going to have a reckoning on this. I don't know when that might be or how it might play out when it comes. Perhaps because I feel a little bit bruised about having been Chicken Little so far, my best guess is that it is probably going to be out beyond our present forecast period. If we are going to get a shock, I think that could be where it will come from. It does seem to me that it is going to take a shock to push this economy into unacceptable economic sluggishness. We live in a dangerous world, of course, and the potential shocks are out there. Consumer debt is one of them. We can easily identify others. One is what is going on politically right now, and what impact that might have. One can envision a shock from fiscal drag, although I certainly cannot see that happening in 1996 at this point. Net exports could be disappointing; I hope not. At any rate, if we get a shock, it is difficult to anticipate where or when it might come. If we get a shock, we will just have to deal with that. Other than that I have to say I am pretty optimistic.

On the inflation side, with the very high utilization rates of our human and physical resources, I think we have been getting remarkably good results. It is a little difficult for me to see how the inflation picture is going to improve, although I guess in recent months it has had a slight tendency to improve. Maybe today's news will be a straw in the wind in the other direction. But so far, it is very difficult to see much by way of upside push there. I do think that given our high utilization level, an upside risk potential could become apparent as time goes on, and we will have to be very careful about that going forward.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. At our last meeting we said that we would know more at this meeting, and now we are all scratching our heads. We do know more, but now we are trying to figure out what it means. We may well be in another fourth-down situation. I agree with Mike Prell that forecasting is a truly humbling profession. We have all had the opportunity to reevaluate some things since the last meeting. As Mike chronicled for us, a number of the statistics have come in stronger than were anticipated at that meeting: GDP, industrial production, and consumer spending. The export situation seems to be improving as the economies of our trading partners appear to be on the mend or strengthening. At 5.5

percent unemployment, the labor market appears to be a bit better than expected. Except for today's CPI news, the recent inflation news has been better than expected. Evidence appears to be gathering that the NAIRU may be lower than 6 percent. Business fixed investment projections look a bit better than we had earlier thought. The recent productivity numbers are above trend, unless one has made the mental conversion already to chain weights.

What are the implications of this reevaluation? Taken together, all this information may indicate that labor and product market constraints are not quite as tight as historical precedents would suggest. Monetary policy may not be as restrictive as we had earlier thought. I think that the financial markets are consistent with that observation. Stock prices are up; bond prices are up; the yield curve has flattened during the intermeeting period; the dollar has been steadier. The cost of capital still favors business spending on investment. Credit market demands have flattened a bit in the most recent data, but they are still indicative of a propensity to spend. Perhaps the folks who have suggested that the risks are on the up side are right; maybe we have missed the soft landing and are ready for another takeoff. Alternatively, it may be time to adjust our thinking to chain-weighted statistics. The data seem a bit more consistent, or at least more explainable, using these statistics.

In spite of the "conflictive" evidence, I continue to believe, similar to Mike Prell, that the best outlook is for moderate growth. In coming to this somewhat unexciting conclusion, I continue to look at the labor markets as a key. People, except for Federal government people, are working. Employment growth has slowed, though, to the point where we are just dealing with demographic increases. People are still mobile. I think the reengineering that we have gone through continues to create some uncertainty. All of this is, I think, showing up in the wage situation. We are not seeing increased wage pressures, though perhaps we will. Perhaps at some point workers will be able to exert enough influence to move wages and real income to higher levels, but we don't appear to be at that point yet. That indicates to me that spending is going to be cautious. We also have to consider the fiscal budget situation. The longer this debate drags on, I think the more uncertain the effects are going to be. Otherwise, and aside from the budget situation, there do not appear to be major imbalances in the real economy or the financial markets.

In sum, I am sticking to the story of moderate growth, and I will go even a bit further in view of the strong third-quarter data and the financial market signals. It is possible that the probability distribution around a mean of potential growth has narrowed a bit.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. I am not going to say anything about my District economy because you do not want to hear about it! My one anecdote would be that the traffic was unusually light driving in this morning. I will leave it at that.

I was very comfortable with the September Greenbook forecast. Like Al Broaddus, I was struck by the large size of the revision in the latest Greenbook. It was a considerably larger revision than I made mentally based on the third-quarter GDP report. Specifically, the shock to the staff, and I guess to me, of about 1/2 percentage point on the level of GDP--that is 2 percentage points on the growth rate for a single quarter--led the staff as Al noted to raise the level of GDP in the middle of 1997 by about 2-1/2 times that much, by about 1-1/4 percentage point. We discussed this yesterday at the Board meeting. I personally would have been inclined, and still am, to be suspicious about the third-quarter GDP report--in two dimensions. One is that there were certain flukish aspects, which is not atypical. The other involves the deflator. I keep staring at the translation of the nominal GDP into real GDP by using a 0.6 percent deflator. Fortunately, we are behind closed doors here. I never predict data revisions in public because it is a stupid thing to do. But in the quiet of my own study, I expect that to be revised.

CHAIRMAN GREENSPAN. In 1987 dollars?

MR. BLINDER. In 1987 dollars, yes.

CHAIRMAN GREENSPAN. The transcript will be visible five years from now.

MR. BLINDER. Yes. [Laughter] I know it is on the transcript, but fortunately no one will know I said that for five years. I don't have to say it publicly.

MR. PRELL. In fact, we may not publish another number in 1987 dollars! [Laughter]

MS. PHILLIPS. You are saved!

MR. BLINDER. That is a very good point. I would have been inclined to boost the forecast between September and now by less. Now, I don't want to overstate that point. Adding .7 percentage point to GDP in a two-year period is well below the ability of anybody to forecast, but one does have to make a point estimate somewhere. So, I'm not saying that the staff's judgment is wild. It just seemed a bit sporty to me. [Laughter]

MR. PRELL. I'm a sporty kind of guy!

MR. BLINDER. Yes, that's right. They are prone to things like that. That is what happens if you work at the Federal Reserve a long time! [Laughter] I had two things on my desk that I could easily pick up to compare. The Blue Chip forecasters--now, that is a consensus, of course, so their forecast is going to move less--changed their 1996 and 1997 cumulated growth rate by zero between a month ago and now. Larry Meyer changed his forecast by .1 percentage point in each year; so he moved up 1997 by .2 point. Those are samples that happened to be on my desk and that I looked at this morning before I walked in. A notable feature of the new forecast, to which Al Broaddus and Jerry Jordan made reference, is that the implicit equilibrium real funds rate in the forecast now is 2.75 percent, which it was not the last time. You can just see that by the behavior of the economy with a constant unemployment rate and a constant inflation rate. That happens despite a budget deficit, which is now down to about 2 percent of GDP and falling and, more importantly I believe, is projected to fall. It ought to be expected that government budget deficits move ex ante real interest rates.

That seems rather high to me based on past experience when we have had deficits of that size in this economy. Again, it's not wildly high, just a bit on the high side. One reason, though not the only reason, for the staff's upgrading of the GDP forecast is that long rates are 30 basis points lower now, give or take a little, than they were at the time of the September FOMC meeting. I pointed out the following to Mike Prell yesterday, and I will just point it out to everybody here today. The reasons given in the market for the further notch down of long rates are the following four--I think this is the whole list: increased expectations of Fed easing, lower reported actual inflation and implicitly expected inflation, more optimism about deficit reduction, and perceptions of a weakening expansion of economic activity. The changes in the staff forecast between the last Greenbook and the current Greenbook, which no longer assumes any Fed easing, include a little more pessimism about inflation, less deficit reduction, and stronger GDP growth. Now, I don't mean to imply that I think the staff is wrong. The bond market is a lousy forecaster. I believe our staff can probably educe evidence that they forecast GDP better than does the bond market; I am sure they can. But I bring that up because I do worry about the internal consistency of the forecast. If the strength in the forecast is largely predicated on lower real interest rates, but the reasons in the market for the lower real interest rates contradict those in the staff forecast, it will not come true. More specifically, it suggests to me that if the staff forecast starts coming true, bond rates will rise substantially and I would suppose more than is built into the forecast.

One final point: At the last meeting many of us characterized the Greenbook as too good to be true. I believe I was one, but I didn't go back and check the transcript. That was the last Greenbook. This one is better. The risk to me in this Greenbook forecast looks disproportionately on the down side. Some of you may remember that for a long time the biggest risk to me in the staff forecast has been the so-called train wreck. Nine months ago it was well into the future; two months ago it was getting close; and now we are in it. The government lockout is a vastly greater event than the Boeing strike by a factor of 40 or something like that. In the first place, this is going to have, as Governor Lindsey and someone else said, a sort of standard Keynesian effect on aggregate demand. There are fewer people working; they don't have as much money to spend. It also has the potential to scare people and shatter confidence just at a time when the economy is teetering as to where it should be. Further, it has the potential--knock on wood that it won't happen--to rattle financial markets, as we are all well aware. I think that is a danger.

The second downside risk to me is the weakening economic outlook in all the G-7 countries. I don't want to exaggerate that risk. I don't think this is a huge difference, and developments in Mexico may be a bigger deal for us potentially than the G-7. Finally, with about 1/8 the weight that Governor Lindsey put on it and 1/4 the weight that Governor Kelley put on it, I would list consumer debt problems as the third set of downside risks. I have a hard time thinking of upside risks that are of comparable likelihood. Thank you.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. I will just conclude the roundtable by echoing my agreement with a number of the points that already have surfaced in this discussion. Certainly, from my perspective the incoming data flow since our last meeting has contained surprises and the surprises do necessitate some rethinking of the underlying momentum in aggregate demand and also the inflation risk. The staff's view is that the news points to significantly greater underlying strength in aggregate demand and a modest reduction in inflation risk. I certainly agree with both of those assessments in a qualitative sense, but like Governor Blinder and a number of other members I guess I question whether or not the new forecast does represent something of an overreaction to one month of really rather perplexing economic news. In the September Greenbook, the staff forecast an unemployment rate of 6.2 percent in the fourth quarter of 1997 accompanied by a real federal funds rate of 2.8 percent. The current forecast envisions an unemployment rate of 5.7 percent in the fourth quarter of 1997, namely 1/2 point lower or as Governor Blinder put it 1-1/4 points higher on real GDP, along with an unchanged federal funds rate of about 2.8 percent in real terms. The staff, I would guess, has concluded that the recent news has not just a transitory effect--it's not just a statistical aberration as Ed Boehne put it--but has permanent significance.

A look at a method that I thought was useful for summarizing how much the staff's forecast has changed would be to measure this in terms of the equilibrium real federal funds rate. One can infer from the alternative simulations presented in the Greenbook that the equilibrium real federal funds rate, which I am now defining as the real federal funds rate in 1997 that would be consistent with a given fixed unemployment rate, has been revised upward by about 130 basis points since our last meeting. In other words, the IS curve has shifted up by about 130 basis points over the last month according to the staff. I think the staff procedure for generating the current forecast is easily defended on statistical grounds because surprises in demand do appear to have persistence. Nevertheless, I hesitate to accept the conclusion at this point that one month's confusing data should occasion such a large revision in our assessment of the economic outlook, especially when there is a variety of indicators pointing to greater softness in the economy. These would include--and all of these have been mentioned--anecdotal reports from industry contacts, yesterday's weak retail sales reading, sluggish auto demand, evidence of rising consumer debt problems that Governors Lindsey and Kelley have emphasized, today's IP number, softness in the purchasing managers' survey, a rising moving average of initial claims for unemployment insurance, and signs of softer growth in European economies. All this is coupled with impressive commitments to fiscal consolidation. And finally, of course, we have the current train wreck, which could impair household finances and spirits going into the Christmas season. Rather than quibble with the details of the staff's point forecast, I would prefer to reserve judgment for a while and await further clarification from incoming data, assuming that the government shutdown doesn't actually end up eliminating the continuing data flow.

On the inflation front the news since our last meeting, it seems to me, has been on balance favorable. I was particularly impressed by the reading on the core PPI which has remained unchanged and the fact that intermediate goods inflation has registered its second monthly negative. But most important, as a number of you have emphasized, is that total hourly compensation grew at a mere 2.3 percent in the third quarter, and I guess it is that continuing restraint in the employment cost index that justifies the downward revision of the NAIRU and the improvement in the inflation forecast. I think the revisions in the staff's natural rate assumption and in aggregate demand reflect a response to data surprises that we don't fully understand. But in this instance I would emphasize that the reaction is based on a lot more than a single month's data. I certainly would agree with Bill McDonough's assessment of the evidence here. We now have had about six quarters in which the rate of growth in nonfarm compensation, as measured by the ECI, has been falling in spite of continued low measured levels of labor market slack. It does seem from my standpoint, and I assume from the staff's and Bill's as well, that most of the models we monitor have been consistently surprised. The surprise has persisted; it is substantial. Our models are overforecasting, if I understand the evidence properly, on the order of .7 percent in the annual growth rate per quarter, and cumulatively this certainly is a statistically significant surprise. Of course, I also agree that we need to be careful here and not overreact to the information. I think the staff has been cautious. They have not yet concluded that we are witnessing a permanent structural shift. I agree this may end up being a transitory supply shock. I do remain perplexed that the moderation in compensation and unit labor costs has not yet translated into a reduction in core inflation. I would also agree that price-price Phillips curve predictions, while slightly off the mark, remain essentially on track.

At our last meeting I argued that the economy suffers from what I called a "termites in the basement" problem. It is a bias toward below trend growth the further out one goes in the forecast. It stems from insufficient momentum in private spending to compensate for growing fiscal drag and the real federal funds rate remaining at its current level. As I try to move away from the data and simply focus on economic fundamentals, I find it difficult to understand what components of demand can be expected to replace lost government spending on a persisting basis over the longer term unless there is continuing impetus from interest and exchange rates. I think that financial markets share this view. Indeed, the Greenbook acknowledges that the present level of real long-term interest rates is conditioned on both the expectation that there will be deficit reduction and the expectation that short-term rates eventually will fall gradually. I think the expectation of a cut in the funds rate in the not too distant future, as Peter Fisher emphasized, is built into the current structure of fed funds futures so that a failure to validate that expectation is most likely to lead to a backup in long rates. While the current Greenbook forecast calls the markets' views as well as my own into question and indeed the Greenbook may turn out to be right--I have an open mind on this--from my perspective the level of uncertainty has increased. I would like to wait and see what the Christmas season and the budget negotiations hold in store, but I consider the preponderance of risks at this point to be on the down side of the Greenbook scenario.

CHAIRMAN GREENSPAN. Thank you very much. I hope coffee is there.

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

MR. KOHN. Thank you, Mr. Chairman. I will be referencing, by the way, the last chart in the Financial Indicators package. If you don't have that with you, I think Carol Low has some extras. I would like to begin by discussing a new chart that appears at the end of that package and use that as a transition into a discussion of the current stance of policy. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. What happens to your Taylor chart if you extend it back before 1987?

MR. KOHN. It doesn't look very good, but I don't know what "very good" means. That is, the Taylor rule does not track what actually happened, particularly over the previous seven or eight years in the Volcker era. Real funds rates were considerably higher than the Taylor chart would have suggested.

CHAIRMAN GREENSPAN. How does it look before the 1980s?

MR. KOHN. Perhaps Governor Yellen or Governor Blinder will remember better than I, but it seems to me that the federal funds rates were too low. That would confirm the notion that policy was easier than it should have been to achieve price stability. Do you remember?

MS. YELLEN. For the late 1960s and early 1970s I think that's right.

MR. BLINDER. It clearly doesn't fit the ups and downs in that period.

MR. KOHN. No, it doesn't do a very good job.

MR. BLINDER. It was developed for you, Mr. Chairman, not for Paul Volcker! [Laughter]

MR. KELLEY. It looks the way it should!

CHAIRMAN GREENSPAN. John used to work for me in the private sector and maybe he read my mind better than I do. Questions for Don?

MR. PARRY. John's choice of .5 for each coefficient is convenient pedagogically. Have you ever looked at estimating it? The two coefficients are quite different if you use estimates. As you can see, they produce much higher federal funds rates. I think in the most recent period the coefficient on the income variable is closer to .8 and the coefficient on the price variable is about .3.

MR. KOHN. Yes. I think it matters a lot over what period one is estimating it. Of course, I think John picked those in part out of some experience with large-scale modeling exercises, such as were carried out under the aegis of the Brookings Conference a couple of years ago. I think they also were picked because they looked reasonable. The bottom panel is a statistical exercise and that does show pretty high weights on the unemployment gap, the resource gap--

MR. PARRY. Yes.

MR. KOHN. Some of these estimates don't show the FOMC paying much attention to inflation.

MR. PARRY. It's a closer representation of what the Fed actually did than just the selection of the .5 and .5.

MR. KOHN. It's fitted to be a close representation of what we did.

MR. PARRY. Okay.

MR. BLINDER. I just want to make the point with regard to the last argument that you mentioned, Don, in your prepared remarks. Since the gap is a forecast of inflation, you could read that as the expected change in inflation.

MR. KOHN. Sure.

MR. BLINDER. I would not quite translate getting a zero on the second coefficient as an indication that the Committee did not care about inflation. One can reinterpret this as indicating that the only thing the Committee cares about is the level and rate of change of inflation.

MR. KOHN. Right.

MR. BLINDER. It admits of that interpretation.

MR. KOHN. Yes, although I would have to think about that a little. The fact that everything goes to the output gap suggests that you are not particularly sensitive to what the inflation rate is when you close the gap.

MR. BLINDER. That's right.

MR. KOHN. You need something on that inflation target to provide you with a nominal anchor it seems to me.

MR. BLINDER. That's correct.

MR. PARRY. The other thing that's interesting is that the constant is about 2.7 as opposed to 2.0 and, of course, that's the real rate.

MR. KOHN. Yes. I am not sure what John Judd did at the San Francisco Bank, but when we fit this the constant actually embodies both the equilibrium real rate and the Committee's inflation target. So, you have to make an assumption about one to separate out the other.

CHAIRMAN GREENSPAN. Further questions for Don? If not, let me start off. Frankly, I didn't find the roundtable particularly surprising. It had pretty much the mixed flavor of what is going on in the country District by District. In retrospect, the strength in the third quarter was not all that surprising considering that the economy was coming off a very weak set of developments after the early weeks of this year. As you will recall, we had particularly serious concerns about the adjustments that were going on in inventories that we felt could conceivably tilt the economy into a decline. Indeed, there was one meeting which I found somewhat distressing back in July where the general tone of our discussion was that all the risks were on the down side even though virtually everyone was projecting moderate growth. One got the impression that if we had a choice of a second opinion on the economy, it clearly would have been down. That was a time when, as I recall, we were getting very severe contractions in steel markets, industrial prices were weakening, inventories were backing up in a number of areas of the economy, and it was only as we worked our way through the probabilities that we concluded that we were moving beyond the point of the maximum risk of a recession. Under those conditions, I think we would expect to get a "pop" in the economy when the downside pressures begin to ease. This occurs in the markets generally, and I think it occurs in the economy. I don't think that surge should be viewed as a change in trend, and indeed the more recent indications, as a number of members have noted, are that the economy at this stage can best be described, at least temporarily, in terms of its sogginess. The economy is not deteriorating, but it clearly has lost a good deal of the momentum that it had during the summer. It is, however, difficult to make very much of that because as best I can see the evidence does suggest that the economy is still undergoing some inventory correction. It is still coming off a fairly weak motor vehicles sales pattern. A crucial issue at this stage relates to what is going to be happening to Christmas sales in terms of setting the tone, if I may put it that way, for the trend in retail markets. We need to remember that sales in November and especially in December have a disproportionate effect on fourth-quarter consumption expenditures. Such expenditures in the fourth quarter are not a simple average of seasonally adjusted October, November, and December because the monthly seasonals for those months differ so dramatically. Certain items obviously will account for a very substantial part of the quarterly total in a several-week period just before Christmas. I don't want to overemphasize that, but I think the point that is implicit in the Greenbook--that there is a likelihood of a significant recovery in November and December--is still on the table. Indeed, the early data are at least suggesting that Christmas sales are doing a little better.

The major problem that we have so far as policy is concerned is that while the economy seems to be as close to middle ground as one ever sees it, it's not clear which way it is going. In that regard, no change today strikes me as the most appropriate response, and I will get to the "train wreck" issue in a minute. What I think is unclear at this stage is what we will be wishing to do at the December meeting if this economy continues to be as soft as it is. As I indicated previously, I think that at some point we should be looking toward a somewhat lower real funds rate in 1996. Whether we will get there in part in December or wait until later, I don't have any particular notion. But I do agree with the Greenbook that, if the economy is coming back and we are getting anywhere near the numbers in the Greenbook forecast, at that level of activity we probably ought to be quite cautious in how we move.

There is one important issue with respect to the budget negotiations that I think we have to keep in mind. If we lock ourselves into a "no change" position pending what happens in those negotiations, we could find ourselves sitting and doing nothing as the economy is changing and the markets are changing while the Congress and the President continue to diddle on this issue. We have argued in the past, and I think quite correctly, that it has never been appropriate for the Federal Reserve to "make a deal" with the Congress or the Administration to take some action if a budget is produced and irrespective of whether it is credible or not credible. I think we all have agreed, as best I can judge, that the response that we make is to the markets. If the markets believe that the budget deal is credible, long-term rates will come down and we will get an abnormality in the term structure of rates if short-term rates remain unchanged. So the pressures on us to ease policy would come from the markets and the term structure, not from the budget deal. The market is what would induce us to move. Conversely, if the economy is softening, or indeed strengthening, the mere fact that the negotiations are under way should not be all that relevant other than what conceivably could happen should be part of our outlook. The mere fact of negotiations should not induce us to take action because I think that could turn out to be very unfortunate monetary policy.

I would therefore suggest that while it is terribly important to have the members' judgments about what the negotiations are going to produce, I don't think that should be an overriding issue with respect to what we do or what we do not do. Incidentally, with the outlook as mixed as it is, I would not rule out a surprising acceleration in this expansion. There is nothing in this outlook that is undermining the structure of the economy. So it would not be surprising, as Governor Kelley indicated, that if no adverse events occur this expansion could suddenly take off. Profit margins still seem to be reasonably stable. The order pattern and some of the high-tech industries are really quite impressive. We do not yet know how long this malaise, if you will excuse the expression, in the industrial area is going to continue. In the steel industry, despite the significant declines in steel sheet prices, the order patterns are looking better. Fairly recently, U.S. Steel has been reporting a much better outlook. So, I think this is a two-sided issue. We really are not going to get a good fix on the industrial sector for a while. And I am not certain that it matters all that much because the economy does not appear to be threatened at this stage, and the urgency of moving quickly one way or the other is not there. I suspect that the latest CPI is probably an aberration. We don't know that for sure, but the evidence of restrained unit costs and the existing high profit margins do not suggest a weakening economy. This is despite, as the Vice Chairman says, the fact that the expansion is "long in the tooth" and what we ordinarily would expect of an aging expansion. This economy does not have the geriatric characteristics that one would expect of an economy that is six or seven months beyond the average length of the post-World War II expansions. It doesn't look that way and it doesn't feel that way. Nonetheless, I think what we have to be aware of is that if this economy fails to pick up and continues to be soggy into the next meeting, the evidence in favor of a move at that time would probably become more compelling than it is today.

At this point, I would recommend that we do nothing and hope that an unchanged policy turns out to be where we can be for quite a while, as the Greenbook assumes. I am agnostic, frankly, on whether we should have a symmetric or an asymmetric directive, and I would very much appreciate that those of you who agree with "B" also stipulate where you think the intermeeting symmetry ought to be. Those who lean toward a change at some point would, of course, favor asymmetry in one direction or the other. So, that is my recommendation for this meeting. Who would like to comment? President Forrestal.

MR. FORRESTAL. Mr. Chairman, first of all I would like to associate myself with the remarks that Governors Yellen and Blinder made with respect to the risks to the economy. Secondly, as I argued last time, it seems to me that interest rates are on the high side relative to inflation and to history. No matter how we think about the Greenbook or the revisions there, I think that we are in a period where economic activity is best characterized as moderate, and in both the Greenbook forecast and our own forecast, moderation is the key word throughout the forecast horizon. At the same time, we have relatively low inflation and, given the federal funds rate of 5-3/4 percent, we have a real interest rate of around 3 percent. Over time in my view such a rate is going to inhibit investment, job creation, and economic growth. That is not going to happen now, to be sure, and I don't think it's critical that we move today, but there are a lot of long-term and short-term arguments that, on balance, lead me to the conclusion that the level of the federal funds rate is too high, that it will have to be reduced eventually, and that any reduction will not have much of an impact on inflation. I would therefore be inclined to move right now. So, if you were to give me those three or four votes, Mr. Chairman, I would cast all of them in that direction. [Laughter]

CHAIRMAN GREENSPAN. I said "five."

MR. FORRESTAL. Okay, five.

MR. STERN. That's almost enough!

MR. FORRESTAL. But, again I would like to emphasize that I don't think it is critical in any sense that we move today. It certainly will not hurt to wait, but I believe we really need to think about the implications of maintaining the current policy.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, for the reasons that you outlined I agree with your analysis and I support your recommendation of "no change." Because I don't think we should be trying to guess which way the economy is going at this stage, I feel that a symmetric directive is quite appropriate.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, I certainly agree with your recommendation for "no change." I am not agnostic on the symmetry; I think we should have a symmetric directive. The staff forecast and the revision in that forecast have made me more aware of and more sensitive to the upside risks in the outlook than perhaps I was before. I think it's premature to take a position even through the symmetry of the directive as to what our next move might be. I think we gained a huge amount of credibility in 1994 by preventing the strength in the economy that emerged really quite quickly in late 1993 and early 1994 from becoming a boom, and I would hate to do something now that might diminish that credibility or put it at risk.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I, too, agree with your overall policy position, Mr. Chairman. I also agree with the concept of keeping the directive symmetric. I do see the risks as being reasonably balanced, not so tilted to the down side as some believe. I agree that we should not have our hands tied by the current and prospective debt impasse on the part of the federal government, although I wonder how this will play out going into the future. If even by the next meeting we were to see--and that may be unlikely--an unexpected acceleration of growth, something that might make us want to change interest rates by raising them rather than lowering them, I wonder how an asymmetric directive toward ease would play out in that environment. Whether or not that scenario turns out to be the case, I wonder if we will find that monetary policy will be somewhat hampered if the budget negotiations drag on for a period of time. I hope they won't.

CHAIRMAN GREENSPAN. Something is going to have to give at some point.

MS. MINEHAN. One would think so.

CHAIRMAN GREENSPAN. What may happen is that we may begin to get a piecemeal deal. Instead of a full blown agreement it may come piece-by-piece-by-piece.

MS. MINEHAN. Yes.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. Mr. Chairman, I find myself very much of a mind with Bob Forrestal. If the third quarter had come in weak, say under 2 percent, I am sure I would be arguing strongly for a cut today based on four arguments: (1) the weakness in the economy; (2) the very good inflation performance; (3) the high, by almost any standard, real federal funds rate--all of those are familiar reasons; and, (4) is something that you alluded to and Cathy Minehan just alluded to in a different way. I am becoming increasingly uneasy about the Federal Reserve being cast in a role that we don't want as the rewarding or punishing father who looks at the President and Congress and says "You did well so I am cutting interest rates," or "You did poorly so I am raising interest rates." We really do not want to be in that position, which is another virtue of making a small rate cut disassociated from a budget agreement. I think this is a factor that we should think about because we are very much in danger of being pigeonholed into that posture. But, of course, the third quarter of 1995 did not come in weak; it came in quite strong. I already said that I don't buy the staff's extrapolation of that upward revision into 1996 and 1997. Nonetheless, the third quarter is what it was and it brings us into 1996 at a higher base level of resource utilization, and that certainly seems to be reality or a reasonable guess about reality. And as noted, the staff also claims that the equilibrium real funds rate is about 2-3/4 percent despite the heavy deficit reduction. Again, I was skeptical about that. I want to point out, though, that if the staff's forecast and estimate of the equilibrium real funds rate are correct, I definitely agree, as Don said, that we should not be cutting interest rates. If I bought into that entirely, these arguments would evaporate. It's possible that the staff is right, but I don't think so. And it still leaves intact two of the four reasons. The reason I said I was very much of a mind with Bob is that the strength of the economy in the third quarter really destroys any argument that there is an urgency to this, that we can't wait five weeks. I couldn't possibly argue for that proposition. Thus, while I could support a small cut now if the Committee were going in that direction, I could also support waiting until the 19th of December, but I would very much favor an asymmetric directive toward ease.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support the "no change" in "B." I think there is enough uncertainty in the economy, and it is on a moderate growth, low inflation kind of track. My sense, and it's entirely judgmental, is that the federal funds rate is on the high side of where we will want it going forward and that we will need to adjust it downward within the next several months. However, at this point, given the uncertainties about the outlook, I would be inclined not to prejudge policy in any way and, therefore, I would go for a symmetrical directive.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I agree with your recommendation and I also would prefer symmetry. It seems to me that we have had a modest temporary increase in the real funds rate, but I think we ought to be willing to accept that. Our forecast and that in the Greenbook expect some pickup in inflation. That suggests that the increase in real rates is temporary, and until we see that that is an incorrect forecast, I can't see a good reason to move today. So, my preference clearly would be to leave the nominal federal funds rate constant at this point.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I favor "B" symmetric at this meeting. I might say a word or two about what we might consider going forward from here. It seems to me that the degree of sogginess in the economy in the meeting five weeks from now will be one issue, but I think an equally important issue will be the path we want to put inflation on. One way of looking at the work on the Taylor rule is, of course, that policy is overly restrictive. Another way of looking at it is that it's appropriately restrictive because we want to bend inflation down further from here. Where that leads me is that we need to have a discussion and try to get agreement at some point on whether we want to try to move toward lower inflation deliberately as opposed to opportunistically. I think that's a key issue and I don't have a way of judging what we ought to do in December without coming to some understanding about that.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, our inflation forecast remains encouraging. We expect inflation over the period to be a little lower than that forecast in the Greenbook. But despite appearing benign at this point, I think the inflation picture requires careful and continuing monitoring. I certainly don't want the Committee to give up the gains that we have made against inflation in previous years.

However, if there are further improvements in inflation that exceed our expectations, I think a modest reduction in the federal funds rate would be called for. But given the rapid growth of GDP in the third quarter, it would be very premature to reduce the funds rate at this meeting; I don't think there is any urgency. Thus, it seems appropriate for the Committee to take no policy action at this time, and I agree with your recommendation of "no change" in the funds rate. With respect to the directive, although I personally agree the risks on the outlook are on the down side at this point, I would still support a symmetric directive.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I can see the argument that the real fed funds rate may be a tad on the high side, but I have to say that so far it's hard to see where it has put much of damper on credit extensions or the stock market or the housing market. I can easily envision the possibility that events may unfold, conceivably fairly quickly, that will make a policy change desirable, but I certainly favor "no change" for now. There are two broad reasons in my mind for having an asymmetric directive, the second building on the first. The first is to send a signal about some imminent perceived risk. The second is to facilitate an imminent policy move. I just don't see either of those as germane right now, and consequently I would strongly prefer a symmetric directive.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. On the Taylor rule, I think that even if we were to take it at face value, it implies downward pressure on inflation. It has an implied inflation target of 2 percent. Current monetary policy appears to be tight on that rule, but even if it were on the money it would be putting downward pressure on inflation. So, on the basis of the Taylor rule, current monetary policy is tighter than simply putting downward pressure on inflation. My second thought is on the yield curve. Governor Blinder mentioned the four reasons why we had a bond market rally. One is not only a decline in inflation, but the perception that inflation will continue to drop. I suppose Jerry would agree that either the staff is right or the bond market is right. The bond market also sees an increased chance of federal deficit reduction. It sees a weakening expansion. And here I suppose the length of the tooth becomes important. Although there are not the excesses in the economy that suggest extreme risks to the expansion, what happens as the tooth lengthens--is that the way to say it? Help me out.

VICE CHAIRMAN MCDONOUGH. It lengthens.

MR. LINDSEY. It lengthens! My teeth are going the other way! [Laughter] Well, as the tooth lengthens, increased risks begin to appear and we may already have detected some. I think the consumer is one of those risks. The international picture is another, be it instability in Japan and Europe, which I don't see as growing, or in Mexico. The risk of a fiscal misstep is still another that could tip the economy over. So, I see the yield curve as signalling that in fact we should be reducing rates today. I also want to associate myself with Governor Blinder in the "let's not get caught flatfooted" waiting for the Congress and the President to act. It is conceivable that they will not produce a fiscal agreement for fiscal 1996. The government could be operating on a continuing resolution forever. So, we certainly don't want to wait that long.

CHAIRMAN GREENSPAN. Less than forever is better.

MR. LINDSEY. Less than forever is better, yes. I think today actually would be a very opportune time to move for exactly that reason. The public disenchantment with the budget process is high and going to get higher. That in itself is a shock. But I think the Fed would be sending a very appropriate signal that we are above the process in all meanings of the word "above." So I would support a reduction in the funds rate today.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. I favor alternative B. I believe it maintains a stance of policy that is somewhat restrictive. It is very difficult to define exactly how restrictive, but I think that's quite appropriate given the inflation outlook. I would say that looking forward we need to be particularly vigilant with respect to the possibility of rising inflation expectations and inflation. For that reason, I strongly prefer a symmetric directive. As Al Broaddus and some others have mentioned, asymmetry at this point would signal that we are quite happy with 3 percent inflation and we implicitly define that as our view of price stability. I also agree with what Gary Stern said about the importance of how we make decisions going forward and having that discussion with respect to whether we want to reduce inflation systematically or simply act opportunistically.

Finally, I think that trying to coordinate our actions with different possibilities on the fiscal front based on how an action might be perceived later is the wrong way to think about the issue. We have to make the best call we can today based on the fundamentals as we see them. If the fundamentals argue that we should act later, we should worry about managing perceptions at that time. I don't hear anybody making that case, but we have to be very careful that we don't justify an action that is not supported by the fundamentals and is based instead on the view that the perception of what we did was better than if we did act on the fundamentals.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. "B" symmetric.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Ditto.

CHAIRMAN GREENSPAN. The loquaciousness of this group is truly remarkable! Vice Chairman.

MR. KELLEY. We are now averaging down!

VICE CHAIRMAN MCDONOUGH. I will reverse the trend toward the lack of loquaciousness, whatever that is. I am somewhat surprised by the commentary today because I thought one of the things that we managed to do at the February 1994 meeting was to move away from finetuning the economy from one quarter to the next and toward an anticipatory monetary policy. If that's so, we ought to be more worried about what happens a year from now or two years from now than we are about what happens next week, about which we can do nothing. Based on my own Bank's view of the economy in late 1996 and 1997, I think the appropriate thing to do today would be to ease. At the same time, the confusion created by the very strong third quarter and what it may tell us about the economy going forward is sufficient to move me to the point of being comfortable with doing nothing at this meeting. But I am sufficiently convinced of the likelihood that monetary policy is too tight and therefore has to be adjusted that I would prefer an asymmetric directive toward easing. It's always difficult for me to get overly excited about symmetry or lack of symmetry, but I think the latter would make more sense in terms of being consistent with an anticipatory monetary policy.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. We moved to the 6 percent level on the funds rate at the beginning of this year in the context of coming off a year of over 4 percent real growth. The final quarter of last year saw 5 percent real growth. Not only the central tendency of the inflation forecasts of this group for 1995 but also the forecasts of a large majority of business economists, the Blue Chip list, The Wall Street Journal list, and so on had inflation accelerating considerably in 1995. Now, if 6 percent was the correct level in retrospect to have prevented the overshooting and spillover of excess demand and rise in prices that some people were worried about and we have now downshifted into a period of slower real growth and maybe less adverse inflation consequences, then clearly the nominal 6 percent federal funds rate was too high or too high to be sustained. It was the right level to foster the downshift, but it has become increasingly restrictive as the economy has decelerated toward growth in the area of 2 percent. So, I thought the fed funds rate decline of 1/4 percentage point in July and the reason given for it were exactly right, namely that we were less concerned about future inflation.

When I look at the Greenbook forecast and the assumption of a 5-3/4 percent funds rate for the next two years, I say these don't compute. Either the nominal GDP forecast in the Greenbook--and some split between output and prices--is wrong, or that 5-3/4 percent funds rate is too high. So, I would like to be able to decide when the right time to lower the funds rate may be--not to ease policy, not to make it more stimulative, but when to avoid having it become inadvertently more restrictive than it should be to get to our objective. My problem is that the Greenbook's projection of inflation at a 3 percent rate forever doesn't give us a good basis for lowering the funds rate. For us to lower the funds rate when the Greenbook projection is at 3 percent inflation--and it seems that a majority of this group thinks that's about right--would be to send the wrong message even if we are trying to maintain the same thrust of policy by lowering the funds rate. So, either I have to argue that I am convinced that inflation is going to be lower than the Greenbook projection and try to be persuasive--which I am not prepared to do--or else I have to acquiesce and say that a 3 percent inflation rate is acceptable--and I am not prepared to do that either. So, while I would like to be arguing in favor of lowering the funds rate I don't have a criterion for doing so and I am stuck with saying leave it alone until we come up with a good rationale for lowering it.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. I would associate myself with the analysis presented by Presidents Forrestal and McDonough and Governor Blinder, although, Mr. Chairman, at the end of the day I support your policy suggestion for "no change" at today's meeting. I continue to think, for reasons I have given before, that the real funds rate remains on the high side, especially from the longer-term perspective of supporting growth toward the end of the forecast period. I certainly would admit that the staff analysis this time around has created some doubts in my mind and I would value having additional information to resolve some of those doubts. At the end of the day, therefore, I can certainly support your suggestion of "B." On the symmetry issue, because I see the risk as being on the down side from that longer-term perspective, I would prefer an asymmetric directive although I do not think that we will need to move during the intermeeting period in the absence of a significant shock. So, symmetry could certainly be an acceptable outcome. I am worried about becoming frozen by the budget negotiations and also appearing at the end of the day to be ratifying some Congressional actions. I think that concern does tend to support Governor Lindsey's suggestion of a move today. However, in the end there are enough uncertainties in my mind about the forecast that on those grounds I would not favor a move today.

CHAIRMAN GREENSPAN. As I read it, the modal value of this group's preferences is marginally "B" symmetric. That's where I sense it to be and I will propose that sort of directive for a vote.

MR. BERNARD. The draft of the operational paragraph is on page 16 of the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, slightly greater reserve restraint or slightly lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
Governor Blinder	Yes
President Hoenig	Yes
Governor Kelley	Yes
Governor Lindsey	No
President Melzer	Yes
President Minehan	Yes
President Moskow	Yes
Governor Phillips	Yes
Governor Yellen	Yes

CHAIRMAN GREENSPAN. The next meeting is December 19th and for those of you who can make it, we adjourn for lunch to honor our departing colleague.

END OF MEETING