Prefatory Note

This transcript has been produced from the original raw transcript in the FOMC Secretariat's files. The Secretariat has lightly edited the original to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcript was not fully edited for accuracy at the time it was produced because it was intended only as an aid to the Secretariat in preparing the record of the Committee's policy actions. The edited transcript has not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Meeting of the Federal Open Market Committee
January 30-31, 1996

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, January 30, 1996, at 2:00 p.m. and continued on Wednesday, January 31, 1996, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Jordan
Mr. Kelley
Mr. Lindsey
Mr. McTeer
Ms. Phillips
Mr. Stern
Ms. Yellen

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Messrs. Hoenig, Melzer, and Ms. Minehan, Presidents of the Federal Reserve Banks of Kansas City, St. Louis, and Boston, respectively

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

Messrs. Lang, Lindsey, Mishkin, Promisel, Rolnick, Rosenblum, Siegman, Simpson, Sniderman, 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. Slifman, Associate Director, Division of Research and Statistics, Board of Governors

Mr. Rosine, 1/ Senior Economist, Division of Research and Statistics, Board of Governors
Mr. Reid, 1/ Economist, Division of Monetary Affairs, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Beebe, Ms. Browne, Messrs. Davis, Dewald, Goodfriend, and Hunter, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Boston, Kansas City, St. Louis, Richmond, and Chicago respectively
Mses. Krieger and Rosenbaum, Vice Presidents, Federal Reserve Banks of New York and Atlanta respectively

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1/ Attended portions of meeting relating to the Committee's review of the economic outlook and establishment of its monetary and debt ranges for 1996.

Transcript of Federal Open Market Committee Meeting
January 30-31, 1996

January 30, 1996--Afternoon Session

CHAIRMAN GREENSPAN. This is, as you know, our organizational meeting and I turn the figurative gavel over to Governor Kelley to run the proceedings.

MR. KELLEY. Thank you, Mr. Chairman. It happens that I am the senior member of the Board present, and so I have the honor of asking for nominations for the Chairman of the Federal Open Market Committee for the year ahead.

MS. PHILLIPS. I nominate Alan Greenspan.

MR. KELLEY. Thank you. Is there a second?

SEVERAL. Second.

MR. KELLEY. I hear a motion and a second. Any other nominations? Hearing none, I declare the nominations closed. All in favor say "Aye."

SEVERAL. "Aye."

MR. KELLEY. Opposed? Congratulations, Mr. Chairman.

CHAIRMAN GREENSPAN. I love democracy! [Laughter]

MR. KELLEY. At the Chairman's request, I will proceed very quickly to the Vice Chairmanship where nominations are now declared open.

MR. MCTEER. I nominate William J. McDonough, President of the Federal Reserve Bank of New York.

MR. KELLEY. Thank you. Any seconds?

SPEAKER(?). Second.

MR. KELLEY. That one came a little slowly, Bill. [Laughter] Any other nominations? If not, I declare the nominations closed. All in favor of Mr. McDonough for Vice Chairman signify by saying "Aye."

SEVERAL. "Aye."

MR. KELLEY. Opposed? Congratulations, sir. Mr. Chairman, do you want to proceed from there?

CHAIRMAN GREENSPAN. Yes, I'd like to turn it over to Normand Bernard to read the list of proposed staff officers.

MR. BERNARD. Thank you, Mr. Chairman. For:
Secretary and Economist, Donald Kohn
Deputy Secretary, Normand Bernard
Assistant Secretary, Joseph Coyne
Assistant Secretary, Gary Gillum

General Counsel, Virgil Mattingly
Deputy General Counsel, Thomas Baxter
Economist, Michael Prell
Economist, Edwin Truman

Associate Economists from the Board:
David Lindsey;
Larry Promisel;
Charles Siegman;
Tom Simpson; and
David Stockton

Associate Economists from the Federal Reserve Banks:
Richard Lang, proposed by President Boehne;
Frederic Mishkin, proposed by President McDonough;
Arthur Rolnick, proposed by President Stern;
Harvey Rosenblum, proposed by President McTeer; and
Mark Sniderman, proposed by President Jordan

CHAIRMAN GREENSPAN. Would somebody like to move that list?

SEVERAL. So move.

CHAIRMAN GREENSPAN. Are there any questions or discussion? If not, without objection I declare it official.

The next item on the agenda is the selection of a Federal Reserve Bank to execute transactions for the System Open Market Account. Do I have any nominations?

MR. KELLEY. Mr. Chairman, I will nominate the Federal Reserve Bank of New York.

CHAIRMAN GREENSPAN. Is there a second?

SEVERAL. Second.

CHAIRMAN GREENSPAN. Without objection. We also have to select the Manager of the System Open Market Account. Our current incumbent, as you know, is Peter Fisher, and unless I hear objections I will presume that he is required to remain in office unanimously. Thank you. Mr. Fisher, now that you are re-anointed, you may go forward.

MR. FISHER. Norm, should we go on to the authorizations?

CHAIRMAN GREENSPAN. Let's get those out of the way, sorry about that. We need to. Peter can't open his mouth until we review the Authorization for Domestic Open Market Operations, but that clearly is a theoretical issue. You all have received the text of the Authorization and without objection I will assume that it is renewed. We also have to review the foreign currency instruments--the Foreign Currency Authorization, the Foreign Currency Directive, and the Procedural Instructions with Respect to Foreign Currency Operations. The current versions of these instruments were circulated to the Committee. Then, of course, you have also received a review of the "warehousing authority" incorporated in both the Foreign Currency Authorization and the Foreign Currency Directive. Does anybody have any comments with respect to any of those documents? If not, I will need two votes. The first vote will be on the Foreign Currency Authorization, the Foreign Currency Directive, and the Procedural Instructions. Would somebody like to move these items?

SEVERAL. So move.

CHAIRMAN GREENSPAN. Without objection. Secondly, we need reauthorization of the warehousing authority. Would somebody like to move that?

SEVERAL. So move.

CHAIRMAN GREENSPAN. Without objection. Thank you very much. A document also has been sent out to you with proposed changes to the Program for Security of FOMC Information. The memorandum, I think, was reasonably straightforward. Does anybody wish to make any comments or ask any questions? If not, without objection I will presume that it is authorized.

Finally, we come to our regular meeting agenda, and I seek approval of the minutes of the Federal Open Market Committee for the meeting of December 19, 1995.

VICE CHAIRMAN MCDONOUGH. I move approval.

CHAIRMAN GREENSPAN. Without objection. Peter, you have awaited your turn and you may now proceed.

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

CHAIRMAN GREENSPAN. Can you explain why the arbitrage that has been put in place by a number of hedge funds--that is, borrowing yen, converting to dollars, and investing in dollars unhedged--does not total more than the $30 to $50 billion that I hear bandied about? Are those numbers anywhere close to being correct? I find them very low for that type of arbitrage in which there is a very substantial potential for a sizable return. Let me say that it is not an arbitrage transaction; it is double positioning.

MR. FISHER. Right. I have thought of it, and I think the market thinks of it, as two distinct positions. In one, they are long dollars against yen. Secondly, they choose a sector of our yield curve, say the five- to ten-year area, in which to be long. They may have borrowed yen somewhere on their balance sheet as well, given the low yen interest rates. I don't have any better estimates of what the total positions are in these transactions than the one you cited, Mr. Chairman. I think it is a type of transaction that has been talked about more than it may have been adopted. It has pointed the overall market in a direction of confidence in those two trades. That is, its principal impact has been in getting people to think that the dollar was going to appreciate and that there might be value in investing somewhere along the U.S. yield curve. That has given people greater and greater confidence.

CHAIRMAN GREENSPAN. I am not talking about the U.S. yield curve. I am just saying that it seems attractive to go out and borrow yen at 1/2 percent or whatever, convert the yen to dollars, and invest the proceeds in 5-day U.S. instruments. The exchange rate would have to fall fairly substantially to offset the gains in that sort of play. So, I am quite surprised there is not more of that type of positioning.

MR. FISHER. There are a number of financial intermediaries who manage discreetly where they choose to borrow and the size of their positions. I don't think that is being picked up in what people talk about as the "hedge fund" trades. The traditional investment banks simply look around the world to finance themselves at the lowest cost they can. There are people who do that within their hierarchies, and there are other people who choose where they should be investing. I assume there is a good deal of that kind of funding operation going on. That may be what you feel is missing in the estimates.

CHAIRMAN GREENSPAN. Let me ask another question of you and perhaps Ted Truman. Four to six months ago, whenever new data on the total German economy were released, there was a general view that the data were of very poor quality and had to be appraised very cautiously. Do we have any subsequent view of whether or not the data are more reliable at this stage?

MR. TRUMAN. They are still putting out the data with warnings on them and that could continue for some time. They have had a number of changes in their statistical systems incorporating both their going to pan-German data and aligning their statistical systems with the European norms. It is not clear yet what can be interpreted as reliable data. In August or July they changed their CPI, for example, and all of a sudden they lost 1/2 percentage point on their rate of inflation.

CHAIRMAN GREENSPAN. That's better than the central bank!

MR. TRUMAN. I thought it was very clever myself. It eliminated the difference between the French and the German inflation rates!

CHAIRMAN GREENSPAN. Any further questions for Peter?

MR. MELZER. I want to ask Peter about these sweep accounts. Looking at the aggregate numbers, the introduction of those accounts accelerated markedly in January. Do you have any sense about how far that phenomenon has played out in the banking system? If it continues, what are the longer-term implications with respect to the reserve market? Obviously, reducing required reserves and making up for it by holding excess reserves is self-defeating.

MR. FISHER. I am afraid we all think it can go a good bit further. Beyond that, I don't know if we have anything very scientific to offer you.

MR. KOHN. You are right, President Melzer. They did accelerate in January and also in December. We keep projecting that the adoption of sweep accounts will simmer down a little, and then another large bank or large bank holding company chain decides to adopt them and the reserves effect grows even faster. I should note that the banks compensate not so much by holding excess reserves, although that may happen in the short run as they adjust, but by holding clearing balances that they can use to pay for services. But that has been a small fraction of the reduction in required reserves, I think on the order of about 15 percent on average. So, the total required reserve balances do continue to drop. I think our projection indicates that once we got through this seasonal low, the rise in the seasonal demand for reserves would offset this trend, and we would be okay for a while. What will happen a year from now is another question.

CHAIRMAN GREENSPAN. Further questions for Peter? Peter, did you request ratification of foreign currency transactions as well as your domestic transactions?

MR. FISHER. I got repaid. You don't mind that I got repaid on the Mexican swap drawings!

CHAIRMAN GREENSPAN. We have to approve repayments?

MR. FISHER. You ratify that I accepted repayment.

CHAIRMAN GREENSPAN. Would somebody like to move to ratify Peter's acceptance of the repayment?

SPEAKER. So move.

VICE CHAIRMAN MCDONOUGH. I second that and move a favorable review of the series of dances he briefed us about. [Laughter]

CHAIRMAN GREENSPAN. Without objection. Would somebody like to move ratification of the Domestic Desk operations?

SPEAKER. So move.

CHAIRMAN GREENSPAN. Without objection. Let's now move on to the Chart Show with Messrs. Prell, Slifman, Stockton, and Truman.

MR. PRELL. Thank you, Mr. Chairman. We will be referring to the material that has been placed in front of you. It's entitled "Material for Staff Presentation to the Federal Open Market Committee." [Statement--see Appendix.]

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

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

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

CHAIRMAN GREENSPAN. Thank you very much. Any questions for any of the gentlemen? Mr. Parry.

MR. PARRY. Mike, I have a question about the weakness in the economy that we are experiencing at the present time. If I look at the quarterly projections in the Greenbook, it would appear that the weakness in the current quarter is temporary and is related to some extent to the weather. If you were to characterize the future quarters through the end of 1997, the period would actually show above-trend growth on average. Do you think that is a good characterization of the forecast?

MR. PRELL. I think I would characterize the growth on average after this quarter as being so close to the trend as not to be perceptibly different.

MR. PARRY. That's fine.

MR. PRELL. Our forecast does suggest that the recent weakness is likely to be a transitory phenomenon. In terms of the available information, the weakness has been highly concentrated, in effect, in the manufacturing sector, with producers moving quickly to gear production down in an effort to reduce inventory investment to a more sustainable level. Once that adjustment has occurred, we don't have a drag from inventory investment and we return to trend growth. This presumes that final demand is reasonably well maintained through this process and that we don't get a big contraction in employment that would reduce income in a serious way. That is the issue that was addressed by all of my colleagues in looking at some of the key sources of impetus to income and employment growth: business fixed investment, exports, and reasonably well-sustained consumer demand despite rising consumer debt burdens. Weather probably is a negative, but we have not attached a great deal of quantitative significance to that for the quarter as a whole. We think it is damaging in January, but that there will be a snapback over the next couple of months. Construction will resume and we will get essentially back on track by the end of the quarter.

MR. PARRY. The baseline policy assumptions keep the economy roughly at trend?

MR. PRELL. That is our judgment. As I have been careful to suggest, we would not say that we have come close to knowing these relationships with such precision that we would want to pinpoint the federal funds rate down to the nearest quarter of a percent. As best we can see at this point, a real funds rate that currently looks a bit above the historical average seems to reasonably balance the risks and foster sustained economic growth at a pace close to trend growth.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mike, I have just a quick question on the fourth-quarter projection. As you pointed out, total production worker hours are reported to be about the same for the fourth quarter as in the third quarter. I know these data don't move in lock step, but we did get a significantly stronger GDP result in the third quarter than you are projecting for the fourth quarter. Why did you mark the fourth quarter down? Was it mainly because of the anecdotal information?

MR. PRELL. Until very close to the end of our projection process, we had to rely very heavily on anecdotal information. Toward the end of the process, we received the PCE estimates for October and November and they are a big chunk of total expenditures. Those estimates did not suggest a very strong PCE contribution, which reinforced the anecdotal information in leading us to discount somewhat what we were seeing in the hours data. Looking at the behavior of the unemployment rate as another labor market indicator, we essentially had stability in that rate from the third to the fourth quarters, which would be broadly consistent with trend growth of output. Thus, 2 percent growth seemed a reasonable place to be. If I went solely by the anecdotal information, I might have been inclined to write down a lower number. The retail sales data we received this morning would trim a couple of tenths from our projection, all other things equal. I think we are in a reasonable ballpark, but at this point the range of possibilities clearly is very wide.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. All things taken into account, I am struck by your fairly benign forecast when I compare it with some of the rhetoric from a lot of other sources. I also was struck by your comment that if you were going to rely on anecdotal information, you would have written down a lower number. I feel that way also. Yet, when we look at the data, we still have this mix that looks pretty strong. I am referring to the housing data, to auto sales which don't look too bad despite a production cutback, and to personal income which looks fairly good even though consumption has bounced around a bit. Do you have any sense of why people seem to talk so negatively when things really don't look that bad?

MR. PRELL. It is always dangerous to judge these things by the anecdotal information, though sometimes such information provides an early sign of a development that we can't perceive yet in the data. With the lags we have experienced recently in getting the data, I think we may have to look at those anecdotal reports a little more closely than we might usually. On the statistical side, some of the indications of trends have not been unambiguous, and some of them have been surprisingly weak. Looking at the housing indicators, the recent pattern of single-family starts and sales has not been particularly robust. We had a spurt in the summer and then we had some slight softening in home sales and so on through November.

MS. MINEHAN. Permits are not too bad, though.

MR. PRELL. Permits look a little better. We are hopeful, looking at loan applications and so on, that there is an uptick in train, only temporarily interrupted by all this snow. Looking at the trend in capital goods orders, we have pointed out for some time that there was some moderation in their growth aside from computers. So, I think that even the data show hints of deceleration. We felt all along that that was coming and was appropriate if the Committee were concerned about not overshooting noninflationary levels of resource utilization.

Why are people so sour at this point? The people who do the surveys at the University of Michigan and the Conference Board have noted in their reports that they felt it was possible that the bad weather was having adverse psychological effects. They also point to the layoff announcements, which seem to have picked up in the last few months for large corporations. The AT&T announcement was particularly striking. The disarray and closing of the federal government, which affected hundreds of thousands of people directly, may have left people unsure about what kinds of stimuli were coming from the federal sector. These factors may have played a role, but the recent downturn in the confidence measures comes after several months of very slow consumption growth. So, I am hard pressed to point to anything very tangible to explain why we have had this moderation. I guess this is one reason we are in effect giving some weight to the possible indication of some financial distress at a time when the stock market has been booming. The latter is certainly an indication that someone does not feel too insecure.

MS. MINEHAN. Right.

MR. PRELL. Historically, we have not had recessions with the stock market going up. It would be astonishing if we were to see a much weaker picture without some softening in the stock market.

CHAIRMAN GREENSPAN. Mike, you did not mention motor vehicles in January, which is perhaps the weakest of all of these.

MR. PRELL. The anecdotal reports for that industry are quite weak and certainly tend to offset the report of a spurt in sales in December. But averaging through that, we still would come out with a moderate sales pace that is quite consistent with the trends that have been in place for a while. That does not rule out a downside surprise, of course.

CHAIRMAN GREENSPAN. Any further questions for any of the gentlemen?

MR. STERN. I have a question for Dave Stockton relating to Chart 17. It concerns this issue about compensation and labor market tightness. In the middle panel, you make an adjustment that, if I understand the red line correctly, raises the help-wanted advertising index. I would think the implications of that are to deepen the mystery a bit. The chart seems to be suggesting that, after the adjustment, help-wanted advertising was somewhat greater than it would have been measured otherwise, and that would seem to put more pressure on compensation than we got.

MR. STOCKTON. Indeed it does in some sense.

MR. STERN. I understood you to say the reverse.

MR. STOCKTON. What I meant to imply was that just looking at the unadjusted help-wanted index, the black line, might have helped to solve the mystery. One might have looked at that and concluded that there are many fewer vacancies at this point in time.

MR. STERN. Okay.

MR. STOCKTON. Given our view that it probably has become a less reliable indicator, we made the adjustment for the increased use of personnel supply agencies. But you are right; in some sense, the adjustment does not resolve the mystery. The adjusted index is a little below the highs reached in the late 1980s, but not very much.

MR. STERN. Right, thank you.

CHAIRMAN GREENSPAN. Further questions?

MR. MOSKOW. I want to add something on autos; I will be saying more later. We had conversations with one of the Big Three yesterday, and a couple of things came out on the picture for January. One is that they view the sales that they lost due to bad weather as just temporary. They expect to make those up. If somebody is going to buy a car, they are still going to buy it a week later or two weeks later when the weather clears up. Second, they did seem to detect a slight uptick in sales during the last couple weeks of the month--nothing to write home about, but sales did seem to be moving in the right direction.

MS. MINEHAN. Four-wheel drive vehicles no doubt!

MR. MOSKOW. No. Sales of light trucks have been strong all along. Obviously, cars sales are the area where there has been real weakness.

MR. PRELL. It's clear they have made a move to reduce their production this quarter.

MR. MOSKOW. Right.

MR. PRELL. They perceive that their earlier expectations were too rosy. We felt that was true all along, so the shock in terms of our forecast is milder. But it has played a role in our perception that this is going to be a pretty weak quarter.

CHAIRMAN GREENSPAN. Further questions? If not, who would like to start our roundtable? President Jordan.

MR. JORDAN. First of all, our District has a very large facility that has recently been added to our idle capacity and will stay idle for a long time--the Cleveland Browns' stadium. [Laughter]

I think Mike Prell made a remark that it was a bad January. It's always a bad January in my District. [Laughter]

MR. PRELL. It is unusual to have it here in Washington.

MR. JORDAN. In December, the Chairman remarked that the economy had the feel of a car that had its hand brake on. I think the economy not only has the hand brake on, but it has a flat tire. We may be talking about a 12-wheeler, not an 18-wheeler, at this table, but I know one of those tires is flat. We hear from large truck supply companies that their consensus forecast for sales of large trucks is going to be down 28 percent from last year.
think sales are going to be down that much; they say about 20 percent. Large truck sales set a record last year when they were 8 percent above the previous record in 1994. In any case, when activity in an industry of that size drops off that sharply, there is going to be a substantial effect. I am interested in what Mike Moskow said about autos. Maybe he will elaborate, because we are not hearing the same story from auto and auto supply companies in our District. They are much weaker. There are indications that firms in the steel industry are going to try post another price increase. They posted one last July; it did not hold. Even if a new increase holds, it will leave steel prices below their level in the first quarter of last year. Steel executives continue to tell us about the new capacity that will

be coming on line this year and next, so at least some of the folks we have talked to in that industry are telling us that they think steel prices are going to be under downward pressure.

One of the reports that caught my interest came from an executive of a banking company that operates throughout the region. He has seen a fairly significant pickup in commercial loan demand over the last couple of months. It turns out, however, that he does not see the pickup as a sign of economic strength but rather of weakness. He sees businesses hitting their bank lines because of cash flow constraints related to growing inventories that need to be financed. His conjecture is consistent with early signs of some deceleration in the District business situation that we are seeing and hearing about.

Let me turn to the Greenbook. I do not know whether to be encouraged or discouraged. On the one hand, when I look at the 3 percent inflation projection out through 1997, I can't find it acceptable if we have an objective of price stability. Either we have to have a different model because the current assumptions are not going to produce the result that we want, or we have to cave in on what price performance is acceptable. Don Kohn's presentation at the December meeting of an opportunistic framework for policy--where the Committee waits for something to happen--is a positive note. The last time there was a break in the inflation trend--from the 4 percent or so underlying trend rate that had prevailed for 7 or 8 years to a 3 percent trend rate--was in 1991. Our staff does a break analysis that says inflation has been on a 3 percent trend since 1991. My sense in talking with people, my staff in particular, and doing some reading about the 1990-91 period is that there was no indication at the time that a break was imminent. Only sometime later could we say that the trend broke and we were now operating at a 3 percent inflation rate. There is some tentative evidence that we could already be in the early stages of another break, but we are not going to know for a while. Even though the central tendency of the members' inflation forecasts prepared for this meeting shows a rate a little below 3 percent, but in that range, and the Board staff projection is 3 percent, that does not discourage me as much as it might normally. That's because I do not think we will be able to anticipate the next downward break in the underlying rate. I would like to finish 1997 with an inflation rate around 2 percent, and I do not see anything that persuades me that that is impossible from here. I don't really understand, using Don's framework of last December, how we can know when to be opportunistic and respond. A part of the explanation as to why the 1995 inflation forecasts of a year ago, our own and the Blue Chip, did not materialize was that we had a favorable productivity shock. If that is a good description of what happened, that we got lucky, there should have been some opportunity to lock in a break in the trend of inflation. I don't see that opportunity yet in the forecast.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. I wanted to talk about Cathy Minehan's perception of why people feel so grumpy and to do so in the context of the staff's Chart Show presentation. Larry Slifman very generously provided charts 11 and 12 a little early today, so I had a chance to look at them and at some of the data behind them. I am more pessimistic than the staff about the state of the household sector. My first observation is that, although the distribution of assets and debt--particularly the distribution of assets--does not look like an issue of rich or poor, I don't think the issue of rich or poor is the right way to look at it. If we look within each income class, we get a very different picture of the distribution of assets. Within each class, asset holdings are highly skewed. I have thrown out the very poor and the very rich income classes because there are problems in interpreting both of those. If we look, for example, at the $20,000 to $30,000 income class and the distribution of interest income within that class, the top 4.7 percent got 60 percent and the top 13 percent got 79 percent of the interest income received by that class. So, it does not matter that, broadly speaking, the $20,000 to $30,000 class has some assets. Of course they do, but those assets are concentrated in a handful of people within that income group. The same thing is true further up the income scale. In the $50,000 to $100,000 income class, the top 8.4 percent of taxpayers got 70 percent of the interest income received by everyone in that class. Again, asset ownership is very concentrated and is sorted not by income but by other factors. Age probably is one of them.

If we add it all up, we get some very surprising statistics: 1.9 million low to moderate income households with incomes under $30,000 got $29 billion of interest income. That is more than 16.5 million households earning over $50,000 received, including some making more than a quarter of a million dollars. Sorting this way does not, in my mind, overcome the fact that capital income is unequally distributed. It just happens not to be unequally distributed in ways that would show up in total income.

I would like to focus, in particular, on column 5 in chart 12. It shows financial assets greater than non-mortgage debt. I might mention first of all that I calculated my own financial position and to my delight I actually have financial assets greater than my non-mortgage debt. Perhaps I should pass that information on to the Bank of New York in Delaware! I am in the lucky half of people in my income class. But the fact is that half of all people, even in the well-to-do range, have non-mortgage debt in excess of their financial assets. Let us focus on the median rich person and see what has happened since 1992. In 1992, household financial assets, according to the flow of funds, totaled $16.5 trillion and non-mortgage debt was $1.2 trillion. For the person with the median income those two numbers were the same, but for the household sector as a whole, financial assets were 13.5 times non-mortgage debt.

A way to start a simple thought experiment is to say that 12.5/13.5 of financial assets do not count as far as the median well-to-do household is concerned. What has happened since 1992? If we were to have no improvement in that situation and no change in the distribution of financial assets or debt, household financial assets would need to have risen by some $4.3 trillion by my calculations to offset the reported increase in non-mortgage debt. In fact, the increase has been only about 3/4 of that amount. So, again, just taking the numbers in the table and assuming no changes in distribution, we have had a worsening of column 5 since 1992. In other words far more than half of upper income households, not to mention lower income households, do not now have financial assets that exceed their debt. I think even that result may be optimistic. The reason for that has to do with the Census Bureau report on what has happened to income since 1992. In the aggregate, income has done quite well. We have had roughly a 5 percent increase in household real income, but 77 percent of all the income gains went to the top 5 percent of households; 21 percent went to the next 15 percent. The remaining 80 percent of households shared only 2 percent of all the income gains over the last two years for which we have these data, 1993 and 1994. I would suggest that a lot of these people probably have had their debts worsen relative to their financial assets.

The last point I would make, and it relates to the top of chart 12, is that starting in the third quarter of 1994 through the third quarter of 1995, households have actually been net sellers of stock according to the flow of funds data. This is not counting capital gains. The reason why that might be troubling is that, in a booming stock market, they must be liquidating some of their holdings to pay off something. I would suggest, however, that households are in fact consuming some of their capital gains in order to cover shortfalls between their income and their consumption. So, there is reason to be pessimistic, not in the overall numbers but in looking more closely at the majority of households that have not been enjoying income gains and are trying to maintain levels of consumption. Thank you.

CHAIRMAN GREENSPAN. I would like to ask one question of Mike Prell or Dave Stockton or Larry Lindsey--whoever knows the answer. The directly held corporate equities to which Governor Lindsey has been referring include both closely-held small corporations and publicly marketable corporations. The equity that is available in the first case is obviously highly illiquid. Do we know what proportion of the directly-held corporate stock of households, excluding mutual funds, is traded on public markets?

MR. PRELL. I am sorry, but I do not have an immediate answer. I have seen estimates, but that information is not readily available to me.

CHAIRMAN GREENSPAN. I do not know the answer either, and I would appreciate it if someone could get the information. It might be useful to evaluate the extent of directly held stock in the context of Governor Lindsey's discussion in which he raised a considerable issue with regard to the financial condition of the household sector. President Parry.

MR. PARRY. Mr. Chairman, economic growth in the Twelfth District has been exceeding that of the nation in recent months. The western states of Arizona, Nevada, Utah, and Oregon continue to be among the fastest growing in the nation. Labor demand and the consumer sector have remained buoyant in these areas. Oregon's tax receipts grew fast enough in the last fiscal year for the state to issue a partial rebate in November, boosting holiday season retail sales. California had been holding down the District's overall performance, but its economy is now expanding faster than the rest of the United States according to data from the state. Even in Washington State, where many were worried about disruptions from the Boeing strike until it ended in mid-November, anecdotal reports suggest strong subsequent retail activity. Of course, District retailers did not have to contend with the paralyzing storms that locked up other areas of the country, and the December federal government shutdown noticeably hurt retailers in only a few of the most tourist-dependent areas.

Our District also seems to be relatively well positioned to weather sluggish demand growth in the European economies. Twelfth District states export more to newly industrialized Asian countries and Japan than to Europe. We are also producing a lot of high technology equipment for which export demand has been strong. These factors helped District exports to increase faster than total U.S. exports last year, excluding a decline in aircraft exports from Washington State.

Turning to the national economy, based upon recent anecdotal and financial data and the recently available monthly indicators, I think we can place a low probability on the economy going into a slump in 1996. Moreover, because of long lags, the inflation outlook this year--and I would say even next year--is barely affected by uncertainties about economic activity. I remain skeptical that the recent dropoff in inflation will be maintained. The unemployment rate remains somewhat below, and certainly is not significantly above, most estimates of the natural rate. In addition, the recent beneficial effects of lower health care costs on overall inflation are likely to dissipate in the future. As a result, I concur with the Greenbook in expecting CPI inflation this year to be at or somewhat above last year's rate. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The economy in the Philadelphia District was slowing during the final months of 1995, and this slower trend has carried over into 1996, aggravated by unusually bad weather. The retail sector has been soft. Holiday sales were below expectations, and January sales have been hurt by severe weather. Auto sales were fairly good in December but fell sharply in January. Manufacturing shows declining demand. Most manufacturers indicate that inventories are not at worrisome levels. Realtors by and large say that most markets are improving slowly. Vacancy rates for office buildings declined last year in many parts of the District. The notable exception was southern New Jersey. Rental rates rose in some areas and were steady in others. Landlord concessions were less significant last year. The demand for industrial space exceeds the supply. The demand for retail space, however, is soft except for large supermarkets and other very large retail operations. The residential market also appears to be better than it was earlier.

The outlook for the regional economy in 1996 is cautiously optimistic, with more emphasis on "cautious" than "optimistic." Business people are hopeful, but they are more concerned about the outlook now than they were six weeks ago. I sense more concern, more restlessness, more jitteriness, all of which would dissipate with a couple of good months or alternatively intensify with a couple more soft months. Price and wage pressures remain subdued, with fierce competition and job insecurity acting as dampers. The persistent downsizing, with layoffs at all levels regardless of performance, not only is undermining consumer confidence in the District but it is also undermining employee morale in affected companies. In fact, there has been modest job growth in the region, but the widespread perception is one of job loss.

Turning to the national economy, the most likely path for 1996 is moderate growth and contained inflation. I sense somewhat more downside risk to growth, however, than upside. I think the consumer sector is a clear risk, and the export sector is another source of uncertainty. The inflation outlook strikes me as more symmetrical; I think that the occurrence of less inflation is about as likely as the development of more inflation. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, the Fifth District economy is still expanding although probably at a somewhat slower rate in recent weeks. I get this information from several sources. We do some surveys, such as our regular manufacturing and service sector survey, which suggests some deceleration in both of these areas as in other parts of the country. We are getting a good bit of negative anecdotal information about retail spending. On that score, we have four sizable retail chains headquartered in Richmond, all of which have been reporting weaker sales for the month of December. Also, is the CEO of a large home improvement and building supply Many of you, I am sure, are familiar with it. He told us a couple of weeks ago that his sales had dropped in December. Not all of the reports that we are getting are weaker. Some reports, notably from West Virginia where much of the industrial activity in our District is located, have been on the more bullish side. For example, chemical producers there are still operating at close to capacity levels, and a big machinery manufacturer expects another year of good sales following a strong showing last year. On balance, however, I would have to say that these optimistic reports are in the minority. The bottom line is that business activity in our region generally appears to be moving ahead more slowly. I don't get the sense that activity is declining in any precipitous way as yet, despite the snowfall that shut down much of our District for a couple of days and despite the government shutdown, which I believe would have a larger impact on our District than on many others.

On the national scene, the information that we have received over recent weeks obviously is still incomplete, but it suggests on balance that the economy was at least holding its own through the end of last year. As I mentioned earlier, some of the best information that we have on the fourth quarter is the labor market data. They include what I believe is the most specific and comprehensive measure, production worker hours, and that was a reasonably strong figure. It was consistent with a fairly good GDP result in the third quarter. On the spending side, of course, we have anecdotal reports of weak holiday sales despite discounting. I don't think we can ignore those reports, but we have to wonder how much of this is really a reflection of weaker aggregate demand and how much may be a reflection of extraordinary structural changes that are taking place in that industry. In fact, a lot of the hard data for the fourth quarter are actually fairly strong. I have not had a chance to look at the retail sales data that were released today nor the consumer sentiment figures that you mentioned earlier, Mike, but I think I am correct in saying that the level of consumer spending in November was a couple percentage points higher than the third-quarter average. And until this latest consumer confidence figure was released, those data were holding up quite well. The series is volatile and the recent period in which that survey was taken was an unusually rough one. As a result, the consumer confidence data may not be a very accurate indicator of true sentiment. Apart from federal expenditures, I don't see any signs of precipitous deceleration in the other sectors of the economy. So, on balance, it seems to me that the information we now have says that the economy is "hanging in there," to use a slang phrase, at a fairly high level of activity in relation to capacity in many industries and in labor markets.

Finally, these Humphrey-Hawkins meetings give us a chance to focus a little more specifically on our progress toward our longer-term price stability objective. I have a couple of quick thoughts about that. On a fourth-quarter-to-fourth-quarter basis, the CPI has risen about 2-3/4 percent in each of the last three years. The Greenbook is now projecting that inflation will move up slightly to about 3 percent in 1996 and 1997. It also is projecting the same general pattern for the core CPI over that two-year period. Obviously, that would not be a huge setback, but it would be a move in the wrong direction and it would mean a couple of years without further progress toward our longer-term objective. Also, if we study the numbers carefully, I think we are beginning to see some faint, but nonetheless discernible, signs of a firming in wages and labor costs. A couple of points relating to this firming that I noted in reading over the Greenbook: the increase in average hourly earnings was 2.8 percent in 1994 and 3.2 percent in 1995. This may be evidence that the economy is operating in the neighborhood of the NAIRU without a lot of head room. Also, I noticed that the Greenbook is projecting a 3.1 percent increase in the employment cost index in 1997 compared with 2.6 percent in 1995. Again, none of this indicates a severe impending setback to our longer-run efforts to bring the inflation rate down, but it does suggest less progress than we should be looking for in the future. This should have some bearing on our discussion of both the short-term and long-term policy situation later on.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. New England grew more slowly in the second half of 1995 than in the first half, and its slowdown was more pronounced than that of the nation as a whole. Moreover, in terms of employment, the region saw a change in the types of industries experiencing either growth or at least declining trends in job losses. The region's manufacturing industries continued to lose jobs, but the rate of decline dropped a little below that of the nation as a whole. New England previously had been exceeding the national rate of job loss for most of this recovery. By contrast, the nonmanufacturing sector that has led our recovery, such as it has been so far, only grew at about half the national pace last year. The weakness was concentrated in the finance, real estate, and insurance areas where jobs declined from December to December, but retailing and transportation were also weak.

Reflecting the relatively favorable employment trends, manufacturing reported satisfactory results for the year, particularly the smaller firms. These firms are operating with some spare capacity as evidenced by a small survey that was done right after the blizzard to determine the impact of that weather phenomenon on production. The responses highlighted the fact that despite the closing of local production facilities for a day or two, most firms probably will be able to make up all the lost output within a month. Only one firm, a medical instruments producer, did not anticipate being able to make up the lost output simply because they already were operating at full capacity. Manufacturers also report few price pressures and no major concerns about labor costs or availability except for particularly high-tech specialties. Retailing, in contrast, had a very weak holiday season. While consumer demand was lackluster, we believe that retailers were affected as much by the fact that the New England region is more "over-stored" than elsewhere in the country. Sales for the regional chains have been disappointing despite heavy promotions, again partly due to the continued expansion of national superstore chains such as Wal-Mart. The commercial real estate market is said to be steady. Insurance contacts reported strong sales for the fourth quarter but indicated that their employment was flat to down.

On a state-by-state basis, the northern tier of states continues its pattern of relatively strong growth, while Connecticut and Rhode Island continue to lose jobs. Massachusetts is on a solid if not spectacular growth path and is the only New England state where current patterns of growth are well in line with historical patterns. Every other state is weaker than usual over a long period.

Turning to the nation, despite the lack of good data, a background of negative rhetoric, and the noise introduced by government shutdowns, snow storms, floods, and whatnot, I continue to be struck by the continuing sense of slow but solid growth in such areas as housing, overall employment, personal income, and auto sales --with some blips in January--and by the ebullience of financial markets. There is also a clear lack of any significant inflationary pressure, although there could very well be some uptick in inflation, as Bob Parry mentioned. It seems to me that we ought to be fairly happy with this set of circumstances and fairly happy as well with the Greenbook projections. In that regard, we have relatively few differences with the Greenbook projections. They strike us as a tad overly optimistic in terms of the foreign outlook, for example, but in general we agree. It is unlikely that we are going to see the straight line patterns through 1997 that are projected in the Greenbook. There is certainly some risk that this expansion is reaching a cyclical peak and that downside risks have increased somewhat. But that said, I still think that the near-term prospects look reasonably good, and we need to maintain some concern about where we are with respect to capacity constraints.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. To answer Cathy's question on changes in consumer confidence, I am struck by the fact that I have a pretty good report for my District, and I am beginning to wonder if I ought to give it or not! Our District economy continues to be strong overall with only a few signs of weakness in a couple of areas that I will mention. For example, gains in payroll employment during the fourth quarter were solid throughout our District. District manufacturers continued to operate at or near capacity, with a couple of exceptions. Good growth in the durable goods manufacturing sector has continued. Our directors report continued strength in commercial construction activity in many, if not most, parts of the District and even some modest pickup in residential construction. Capital and loans are still available and even plentiful in some cases.

Although the District economy is generally healthy, there are a couple of weak spots: energy activity remains sluggish despite some recent price increases, and continued financial losses in the cattle industry are hurting our farm income outlook even though crop prices are at their highest levels in some years. Wage and price pressures remain modest in the District despite overall strength in the economy. Labor markets remain tight in some parts of the District and some of our manufacturers continue to report shortages of skilled labor. Despite that, upward pressures on wages and prices remain subdued.

For the national economy, our projections are very similar to those in the Greenbook. On the real side, we agree that the outlook remains favorable, with real GDP likely to run at or perhaps a little below potential. Because of the mild overshooting in the level of resource use that we have experienced, however, I think we will see an inflation number that is comparable to last year's, about 3.0 or 3.1 percent. So, I think the Greenbook is a little optimistic on that front. Also, with growth running somewhat below potential, I expect unemployment to drift up a little this year. Still, we are essentially in agreement with the Greenbook, and we share the view that the economy is on sound footing at this time. Overall, the fundamentals remain sound or satisfactory as we look to the future.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, economic activity in the Seventh District continues to expand but at a moderating rate, as I mentioned at our last meeting. I sense that we are outperforming the rest of the country, with some sectors experiencing weakness and others strength. Fairly strong business activity was reported for farm and heavy equipment manufacturers, the light truck segment of the auto industry, the professional services sector, and the food segment of the retail services sector. The farm equipment manufacturers are benefitting from the high grain prices of last year.

The sectors that display some weakness include cars and heavy trucks as well as some retail segments. On balance, the reports from our retailers were mixed, indicating that January sales were coming in at or somewhat below expectations. Those expectations seem to be quite modest, with a couple of retail chains looking for January same-store sales to be about unchanged or up only 1 or 2 percent from last year. Our contacts among national retailers said that their Seventh District store sales were holding up better than elsewhere in the country, in part because our District weather has been relatively more favorable to date. Reports on retail inventories also were mixed; several larger retail chains were in good shape, while other retailers were still trying to trim their inventories. The effects of lackluster Christmas sales and excess capacity continue to have an adverse impact on District specialty retailers. Store closings continue to be reported in this sector. Seventh District respondents to the Senior Loan Officer Survey expressed concerns about retail trade lending, both for working capital and for real estate based loans. Housing activity is still fairly strong in most parts of the District, as shown by our data after adjusting them as best as we can for the weather.

In the motor vehicle industry, demand for light trucks remains fairly strong, but that is not true for cars and heavy trucks, as Jerry Jordan and I mentioned earlier. In terms of the orders for light trucks, the sales figures for January are particularly difficult to interpret because of the shifting of a few days' sales from early January back into December and, of course, the subsequent weather disruptions. To elaborate on what I mentioned earlier, January is not going to be a good month overall for auto sales, though sales improved slightly as the month proceeded. Our contacts suggest that auto sales nationwide will be in the low 14 million range in January. If we average that with December, the number will exceed 15 million units, which is a relatively healthy pace. Sales for the entire year in 1995 were 14.8 million units. Of course, there are incentives in place to boost sales, and those incentives have either been increased or they will be in response to inventory imbalances and the need to remain competitive. Mike Prell mentioned that first-quarter production plans for cars have been cut back further to adjust for high inventories. To give you some examples of the ripple effect of these production cuts, weakening order rates in January have been reported by our auto suppliers for mufflers, brakes, bearings, piston rings, and related products. So far, there has been no reduction in purchase orders for steel by the auto companies. As Jerry mentioned before, steel prices are down significantly. Two increases are scheduled and there is, of course, some uncertainty as to whether those increases will hold. Turning to the heavy truck industry, production will be down significantly from 1995, but output in 1996 should be closer to the normal trend. This is in line with what we talked about last fall when the orders were dropping significantly, but manufacturers were maintaining their production levels. Obviously, they had to catch up at some point. In 1994 and much of last year, it was orders from the large haulers that supported the market. More recently, the order rate has reflected demand from the small- and medium-sized shippers, with cancellations by the large haulers compensating for over-ordering last year.

District manufacturing activity outside the motor vehicle industry continues to expand, although at a more modest pace. The purchasing managers' surveys for Chicago, Detroit, and Milwaukee indicated expanding orders and production in December. In contrast, Detroit's auto component in the purchasing managers' survey showed contracting activity in western Michigan. In January, the Chicago purchasing managers' index, which should be coming out tomorrow and is confidential until then, is at 50.9, down from 54.8 in December. This is an indication of a continuing but more modest expansion in the early part of the year.

Economic activity in the agricultural sector has been mixed. Corn and soybean producers enjoyed a very good year, but livestock producers found 1995 particularly tough due in part to the high cost of feed grain. A growing shortage of corn combined with its high price may force livestock producers to liquidate significant portions of their stock in early 1996, increasing the volatility of meat prices. However, there is little evidence as yet that such a liquidation is starting. There is a great deal of uncertainty about acreage planning decisions for 1996 since Congress has not yet passed new farm legislation, which is particularly important for that industry.

Business loan growth at District banks has started to moderate in line with the general slowdown in fourth-quarter business activity. Credit quality generally remains quite good on the commercial side. On the consumer side, consumer debt burdens appear to be stabilizing and the rate of increase in consumer loan delinquencies appears to be moderating.

Labor markets generally continue to be tight throughout the District, especially in Indiana, Iowa, and parts of Wisconsin. Price patterns in the District do not seem to have changed much since our last meeting. Reports generally point to little upward pressure on prices. In January, the pricing component of the Chicago purchasing managers' survey was 53.8, down more than 2 points from December.

Turning to the national picture, we don't have any serious disagreements with the Greenbook outlook. We are still a bit more optimistic on both growth and inflation, but the differences are not large. We see the economy expanding near its potential growth rate this year. We do seem to be at the mature stage of the expansion, as Governor Yellen mentioned at the last meeting. The accelerator effects are dying out now. So, while I am sympathetic to the notion that the risks to the outlook are probably concentrated on the down side, I don't see any compelling evidence in the data that would suggest the economy will not grow at its potential rate this year.

CHAIRMAN GREENSPAN. Thank you. President Melzer.

MR. MELZER. Thanks, Alan. I have four major points that I want to make today. The first is that the Eighth District economy continues to grow at a slow but steady pace. Our average unemployment rate stood at 4-1/2 percent in November compared with 5.6 percent nationally. Payroll employment growth in the District outpaced that in the nation during the fall. Much of this strength can be attributed to our services sectors. Nonetheless, in manufacturing first-quarter auto production in the District is expected to be up substantially from its year-ago level; most of that jump is due to added capacity, primarily in light trucks and recreational vehicles. Retailers report that holiday sales were somewhat higher than last year's levels, although the growth rate was below that of last year. The number of nonresidential building permits is well above 1994 levels in the District's major metropolitan areas. Lenders report generally healthy loan demand and supply conditions, with the exceptions of middle market business lending and consumer auto lending.

Turning to the national perspective, my second point is that job creation has moved in line with projections for labor force growth. The average monthly gain in nonfarm payroll employment since April has been about 113,000, substantially below the rate of 280,000 per month that we enjoyed from January 1994 through March 1995. But the earlier rapid pace of job creation was unsustainable and widely expected to moderate. The more recent pace is consistent with the BLS projected rate of labor force growth of about 1 percent or 110,000 jobs per month. In addition, the job gains of November and December were reasonably robust according to this benchmark, and the unemployment rate remains low. During the intermeeting period very little other data became available, and it seems to me, as some others have said, that it is difficult to argue that much has changed since the last meeting with respect to the actual performance of the real economy.

My third point, and unfortunately one that I have had to make a number of times, is that virtually no gains were made on inflation during 1995. Consumer price inflation is expected to be about the same for all of 1995 as it was in 1994. For the current year, some analysts suggest that food prices will increase at their fastest pace since 1990. Mike Prell mentioned this, as did Mike Moskow. This is consistent with what I am hearing from who heads a major rice and soybean cooperative. He has been concerned about the combination of these very low carryover stocks, drought conditions in parts of South America, and what he sees as very strong export demand from the Far East. He envisions the potential of some possibly very large feed grain price increases in the course of this year. More generally, market participants and professional economic forecasters do not expect lower inflation in the foreseeable future. In their January newsletter, the Blue Chip group put CPI inflation at 3 percent through the fourth quarter of 1997. The Greenbook forecast is about the same. Longer-term inflation expectations have moderated somewhat, but these forecasts do not indicate any further progress toward price stability. Longer-term forecasts still have inflation running at about 3 percent.

We will talk more about this tomorrow, but in my view the Committee should develop a plan to move toward price stability and offer markets convincing evidence that it will be achieved in some reasonable time frame. One simple and direct way to convey our intentions to market participants would be to announce now the Committee's inflation forecast for, say, each of the next five years. In our Humphrey-Hawkins projections, we are asked to assume an appropriate monetary policy, and we prepared our 1996 Humphrey-Hawkins forecast based on that approach toward policy. In my view, that would begin with a CPI inflation target of about 2-3/4 percent this year, declining to about 1 percent by the year 2000. Our policy assumption would envision growth in 1996 around the high end of the central tendency ranges for nominal and real GDP and inflation near the low end of the central tendency range for prices.

My final point is that, based on financial market behavior and the growth of money and credit in recent months, it is increasingly difficult in my view to argue that monetary policy is restrictive. Longer-term bond yields have held their ground since the December meeting, and the relatively low long-term rates should help growth prospects in 1996 by aiding the housing industry, business investment, and mortgage refinancing activity. The stock market, of course, continues to set new records on the up side on a daily basis, and credit remains readily available. The broad monetary aggregates are growing at the top of the Committee's target ranges. I don't mean to suggest that that implies any action; it is just an indicator of where we are. Narrower aggregates adjusted for the effects of sweep account activity have been increasing quite rapidly in recent months. Financial market expectations of a 50 basis point reduction in the fed funds rate by midyear also incorporate a 3 percent inflation projection for as far as the eye can see. If that is not the goal of this Committee, then I think we had better think twice about fulfilling these expectations in the funds market.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. On our twelve-wheeler, the Eleventh District tire is not flat, at least not yet, but we do hear a strange hissing sound. [Laughter] Our directors and other contacts, as has been mentioned here before, are more pessimistic looking forward than the backward-looking numbers would suggest. I don't have an answer to Cathy's question, but it does remind me of something Richard Pryor said several years ago: "Who are you going to believe, me or your own lying eyes?" But at least looking back, 1995 was a good year in the Eleventh District. Our estimates indicate that employment grew over 3 percent in Texas, about 5 percent in New Mexico, and almost 2 percent in Louisiana. That contrasts with about 1.5 percent for the nation. Construction activity remained high, with single-family construction taking off in the second half of the year and all three District states registering double-digit growth in construction employment since the middle of the year. Building contract values are up sharply in New Mexico and are holding steady at a relatively high level in Texas. Trucking deregulation lowered in-state trucking rates and spurred a lot of warehouse expansion in Texas. It is taking some business from neighboring states where trucks previously had to hide out to avoid Texas regulations. Electronics and other high-tech industries continue to boom in the Southwest. In 1995, electronics employment surged 7-1/2 percent in Texas and nearly 12 percent in New Mexico. The three U.S. semiconductors plants that opened their doors in 1995 were all located in the Southwest: two in Texas and one in Tom Hoenig's part of New Mexico. Samsung Electronics just announced their plan to open a $1.3 billion semiconductor plant in Austin, with groundbreaking beginning in a couple of months.

A 35 percent real devaluation of the peso turned out to be a drag on the Texas economy but not an anchor. Exports to Mexico are way down over the year, but exports from Texas to other countries have picked up to take up most of the slack. A boom in maquiladora employment along the border has cushioned the blow for border communities like El Paso. However, border retailers were hit hard and they have not yet recovered. Real oil prices are less than half what they were in the early 1980s, but the energy industry has perked up as producers use relatively new technologies, such as horizontal drilling and 3-dimensional seismic technology for offshore drilling in the Gulf of Mexico, to make a profit at prices that would not have been close to profitable in prior years. One anecdote on the new technology is that they are constructing a new Bush library at Texas A&M University, and at the same time they are drilling for oil under it. [Laughter]

Based on our discussions with our directors and Beigebook contacts, the outlook for 1996 seems reasonably good, but we expect growth this year to be somewhat subdued compared to last year. We are already seeing four national trends that are beginning to affect our District adversely. First, there are signs that the expansion has already slowed. In the January Beigebook, Dallas was one of eight Federal Reserve Districts reporting a slowdown in the pace of economic expansion. Our main indicators of a slight slowdown in growth were reports of weak retail sales and somewhat weaker orders for paper, apparel, lumber, and commodity chemicals. Contacts also indicated that semiconductor orders were slightly below their previously very high levels.

The second major trend is that labor market tightness is pushing up wages or restraining the ability of some firms to expand production. Our contacts have mentioned labor market tightness in eight of the last nine Beigebooks, but the problem has been more widespread since September. Contacts and press reports indicate current shortages of electricians, engineers, accountants, truck drivers, software designers and semi-skilled workers. One contact reports that his temporary employment firm formerly pounded the pavement to find more customers, meaning employers, but now they are pounding the pavement to find more employees. Not surprisingly, labor market tightness has translated into higher wages. Real hourly wages for production workers in manufacturing have turned up fairly sharply since midyear. The contacts report that higher wages are squeezing profit margins, but they have not been passed on in the form of higher prices.

The third trend is that retail consolidation has begun in our region and will likely continue. Christmas sales were very disappointing, and our contacts highlighted the Mexican border as one of the worst performing regions. Furthermore, border sales are likely to remain soft for at least the near future, since the purchasing power of the peso has not recovered.

Fourth, the gridlock in Washington is becoming a real problem for District farmers. There may be snow on the ground in the East, but it is almost planting time for farmers in the lower Rio Grande Valley. As Mike Moskow mentioned, the gridlock is interfering with the farmers' ability to make decisions and with banks' willingness to lend to farmers.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. The economy of the Ninth District remains fundamentally healthy, and some parts of the region are very strong. Overall, growth has moderated and there are more crosscurrents than had been the case until recently. One area of the District economy that continues to be relatively soft is manufacturing. For example, the paper industry, which had been very strong, is showing signs of appreciably weakening prices. And that seems likely to continue for some time, given the capacity in that industry which, if anything, is expanding. Retail spending has been lackluster except for the consumer electronics area where sales are quite good. On the more positive side, labor markets remain tight, but there are only scattered signs of more rapid increases in wages. I would say that in general housing activity is good; housing around the District clearly is benefitting from the current level of interest rates.

With regard to the national economy, I find myself in general agreement with the contours of the Greenbook forecast. Because of the inventory situation, I think that the first quarter or perhaps the first half of this year will be on the soft side. I have commented on that before, and I don't see anything that changes my assessment of that situation. Once the economy gets through the inventory adjustment, I don't see any major obstacles to a resumption of growth at a rate in the neighborhood of potential. Tom Melzer made an important point when he talked about staff expectations of future net gains in employment of about 100,000 or a little more per month. The reason I feel that is important is that if we get the projected employment increases, while they may be what we ought to expect, the press is going to play such gains as very disappointing as they did with the December employment report. That may create misleading expectations that we ought to be careful of.

With regard to the risks to the expansion, I think they include the export situation on the down side. I am not persuaded that major foreign economies will live up to even our modest expectations for them. It seems to me that more often than not in recent years we have been disappointed by their performance. As far as the consumer is concerned, I don't see a vulnerability there that in and of itself is going to trigger a disappointing economic performance. If we get some weakening there, it will be endogenous. My reading of consumer incomes, debt burdens, asset distributions, and so forth, is that if some development does trigger a downturn, there probably is some vulnerability in the consumer sector that may add to the downside momentum, but I don't detect a lot of weakness coming from the consumer.

On the up side, one can point to a couple of sectors. The first is housing, which I think will benefit from low interest rates. The other is investment in producers durable equipment; my impression is that such capital investment will turn in another healthy year in 1996 and perhaps in 1997. I noticed when I got to part II of the Greenbook that most of the fundamental determinants of PDE looked positive in historical context. So, we may do a little better than the forecasts in a couple of sectors.

As far as the inflation outlook is concerned, I don't think we will do much worse, and we may come out a little better, than the Greenbook forecast because of some dynamics that seem to be occurring which I don't quite understand. When we look at traditional measures of capacity use and what they ought to mean for wage or price pressures, we just don't seem to be getting that translation in the good old-fashioned way. I think that is actually a plus.

CHAIRMAN GREENSPAN. Vice Chairman McDonough.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The anecdotal evidence in the Second District in recent weeks has been very negative, but that is probably more the mindset of the people in the District than anything else. The broader economic data have been somewhat more positive recently. In the labor markets, private payroll employment rose at an annual rate of 1-1/2 percent in December in New York State and was stable in New Jersey. The monthly unemployment rate rose in December in both states, but we tend to smooth that rate over a quarterly average. On that basis, the unemployment rate in New York State actually declined from 6.7 to 6.2 percent from the third to the fourth quarter and was unchanged in New Jersey. Consumer spending as reflected in retail sales tax collections rose moderately in December in New York, led by strong gains in New York City. Our manufacturing contacts reported that the blizzard had minimal effect on production in the Second District, and that any losses would be quickly made up. In fact, our recent survey of manufacturers, some of which are among the nation's largest employers, was quite fascinating. The majority of them expect unit sales to increase in 1996, but they say that competition will prevent them from raising prices. Wages are expected to rise 3 to 4 percent, and capital spending will be similar to that of 1995. Their most optimistic view of the world is that they think their exports will be growing in the 5 to 10 percent range, about the same as in 1995.

On the national level, assuming that monetary policy remains the same, our forecast is somewhat different from that of the Greenbook. We have real GDP somewhat weaker, growing 1.7 percent in 1996 and dropping off slightly to 1.6 percent in 1997. We have the unemployment rate going up to 5.9 percent in 1996 and 6.2 percent in 1997. We have found the employment picture somewhat confusing, as I think many people have. One of the things we have found difficult to explain is that participation rates in the labor force by women and by teenagers of both sexes are holding relatively steady, but the participation rate by adult males has been coming down over the last few years. I am not certain that anybody has a very good explanation, but it may be that the 5.6 percent unemployment rate is suggesting greater tightness in the labor markets than really exists. That will be one of our research projects.

We have the CPI about the same in 1996 as it came out last year; we have it at 2.8 percent and dropping off to 2.7 percent in 1997. Again, we have trouble, as I think most people do, in anticipating exactly what will happen to prices because neither we nor any other countries that seem to provide a relevant comparison have a whole lot of experience with what happens to prices when the CPI is at the 2.8, 2.9, 3 percent level. We have essentially no experience in estimating the cost of going to price stability, assuming as I do that it is something below 3 percent. But if we want to reduce inflation, it would be nice to know what that will cost, rather than saying it is something that warms the cockles of our theological heart. That again is a major project that we are looking at. Without the knowledge of the cost of lowering inflation further, we are not very content--I am not very content--with our economic forecast. A real GDP growth rate of 1.7 percent this year and 1.6 percent next year, essentially no gain on price stability, and, we think, a rising unemployment rate do not lead us to believe that the basic assumption of unchanged monetary policy has a whole lot going for it. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. The economy of the Atlanta District is still growing at a moderate pace and maintains its advantage over the national growth rate, as best we can tell. But we, too, are seeing signs of deceleration. Nonetheless, while cyclical factors at the national level may be damping growth for our part of the country, the Southeast economy is likely on balance to enjoy moderate growth throughout 1996. The Southeast continues to benefit from some longstanding secular trends: in-migration of population and corporate relocations driven by rapid growth rates and relatively favorable cost factors. We do not see this abating any time soon. This feeds retail trade, services, and construction, all of which are generally healthy in our region at the present time.

Construction is holding firm, and this is not just the Atlanta Olympics effect buttressing the region's overall indicators. The most active component is industrial construction dominated by warehouse and distribution centers. Inventories of unsold houses remain extremely low and multifamily activity remains strong, although vacancy rates recently have begun to rise and we expect to see a slowdown in multifamily construction later this year. As you know, we have a concentration of construction-related manufacturing in the Southeast. So, while industrial production continues to weaken, the slowdown is less pronounced in our region of the country, and it has been cushioned by the continued migration of auto-related production to our southeastern states. This growth has continued even though that in the auto industry as a whole has slowed. Al Broaddus and I are beginning to steal some of your auto jobs, Mike! I don't know if that is for better or for worse, but they continue to move to our part of the country, not only the assembly jobs but all of the support activities. Even so, Sixth District job growth decelerated in the fourth quarter. Weakness in our area is particularly noticeable in the nondurable manufacturing sector. Still, our region's year-over-year job growth outpaced the nation by a considerable margin in 1995. We see no discernible evidence at the present time of acceleration in overall wages or prices. Our manufacturers' survey indicates less price pressure on finished goods but some increase in pressure on input prices.

Turning to the national economy, overall I see the economy continuing to move forward without major impediments, but also without the momentum that we saw earlier. Our outlook has not changed substantively for a number of months. As has been the case recently, the Atlanta forecast and the Greenbook are fairly close. Atlanta has personal consumption growing more slowly than the Greenbook, but we have stronger business fixed investment and net exports. Both forecasts show real GDP growing close to 2 percent over the next two years, and each has inflation continuing at a rate not far from recent experience although we have the CPI on a very slow deceleration course. Neither forecast sees much change in the expected unemployment rate. The difference between our outlook and that of the Board staff is in the interpretation of potential. Our reading of the Greenbook is that it shows an economy expanding near potential and that faster growth will inevitably result in accelerating inflation. We see potential as probably somewhat higher. Importantly, we believe that the current modest and steady inflation environment is a result of 15 years of anti-inflationary monetary policy; it is not some spontaneous reduction in inflation expectations but a rational response to a less inflationary environment. Of course, this is something that I can't demonstrate categorically, but I believe that evidence from both the labor markets and the financial markets tends to support this view.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, as you know the current Greenbook projection is quite similar to, but perhaps a little weaker than, the last several forecasts. The main new weakness is that occurring in this quarter, and that does appear likely to materialize, given what we know now. Thus, I would agree that the Greenbook's assessment of the entire period is probably the best one that we can get. If I could get a guaranteed delivery on that outcome, I would buy it even though it does not project any further improvement in inflation over the projection period. But, of course, there is no guaranteed delivery, and we have to look at where the possible deviations might occur.

First of all on the up side, it seems to me that a breakout, defined as growth well above trend in the near or intermediate term, perhaps should not be taken totally off the table but it appears to have a very low probability. The Greenbook's trend projection goes down the middle and, of course, it does not anticipate any great shock or surprise in either direction. If we don't get any major shock, I think the Greenbook forecast is very, very likely to materialize. It is very attractive. It extends near-trend growth over a substantial period, projects moderate unemployment and a somewhat lower than the generally accepted level for the NAIRU, and it projects relatively low inflation. I would add Al Broaddus's caution that this projection shows some acceleration of wage increases, and I think that is quite likely to be the case later in the period. Unless productivity also increases materially over that period, we may see unit labor cost and production figures in 1996 that could add to inflation in 1997 and beyond. Downside shocks are always possible, and when the economy is operating at a level that is a little weaker than before, it takes somewhat less of a shock or disappointment to knock it off stride. In my mind, the downside risks are somewhat higher than I had earlier thought because the expansion does appear to be slower than I had hoped or expected. Thank you.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. There is more fog than usual in Washington and in the outlook. Some of this uncertainty is caused by the data situation. From the perspective of a rear-view mirror, the data are less reliable than usual due, of course, to delays and revisions and weather disruptions. I suspect that we may not be able to assess fully what has happened in the fourth quarter or even in the first quarter until we are well into the second quarter. The federal budget situation may be a bit clearer in the short run, but it is certainly a lot less clear for the longer term. In the near term, we probably will have some reduction in federal spending either under continuing resolutions or a series of appropriations bills. The range of issues is narrowing, and all sides are focusing on deficit reduction. With respect to the longer term, the delay of a budget agreement means that fundamental policy questions such as the appropriate expenditure levels for Medicare and Medicaid are not going to be answered until after the elections. This is a problem because elections don't always provide very clear mandates, so I think that creates a bit more fog with respect to federal government expenditures in the future.

I think that the best current projection for GDP growth is about 2 percent, or close to potential. There are a number of developments that in my view are consistent with a moderate growth outlook and a reasonably stable employment situation. By that I mean that people are working, though not necessarily at jobs that they prefer, so that a lot of working people would be willing to change jobs. I suspect the 5.6 percent unemployment rate is more flexible than history would suggest. This may be part of the response to Cathy Minehan's question; people are grumpy partly because of job uncertainty. That attitude will be reflected in consumer spending. There is no reason necessarily to see a major decline in consumer spending, and likewise there is not much room for a significant increase. We have worked through the pent-up demand from the early 1990s, but with the increased debt levels that people have assumed, consumption is likely at best to track income growth. As has been mentioned, we have an inventory overhang in some sectors, some of it the result of a disappointing fourth quarter. Hopefully, on the other hand, managers are developing better inventory management techniques. A slowdown in industrial production has been cited, but in spite of that slowdown, we are still seeing corporate profits and cash flows that are better than anticipated. Some of that results from increased investment in machines and equipment to increase capacity and improve productivity. The fundamentals favor continued growth in capital investment, though probably not at the 1994 and 1995 levels. Nevertheless, this sector should continue to support economic growth. The capital markets are not going to be a bottleneck, at least from what we can tell now. The stock markets have been strong; they appear to be supported by earnings. Declines in long-term interest rates should also contribute to keeping the cost of capital down. Credit growth has slowed but credit is still available. So, there are no bottlenecks in the capital markets to prevent business investment.

Turning to inflation, I think that some arguments can be made for a more optimistic projection than the staff forecast of 3 percent. Moderate growth, capacity increases, lower utilization, and international weakness should help to relieve demand pressures on commodity prices. Recent consumer and business behavior, I believe, is consistent with a reduced inflation psychology, but I would certainly grant that there are risks. One of the risks, to which I think we must be particularly alert, is that wage pressures may be reemerging and we are unlikely to get any more gains on the benefits side.

To summarize, a key question for us is the sustainability of moderate growth. I see little chance of a breakout on the up side, and that leads me to conclude that there probably are more risks on the down side. I can't really see any likely sources for a potential breakout on the up side. I suspect that we are going to be getting more pressure for higher growth levels. We are starting to see it even in the business press. Although people around this table think that 2 percent growth with low inflation and a strong dollar is a good situation, the question is whether that will be socially and politically acceptable. The expectations for the U.S. economy are for a boom-and-bust cycle, and I don't know whether people have learned to manage sustainable growth. I think expectations differ from economic reality, which may be another part of the answer to Cathy Minehan's question. I believe that we will start to see pressure build for faster growth.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. As I outlined my thoughts on the national economy in preparation for today's meeting, I realized that I am running the risk of sounding like a broken record by reiterating themes that are completely familiar, given the remarks I have been making during the last several meetings. With respect to inflation, I have not seen any reason to alter my view that it is unlikely to move higher in spite of the fact that the economy is operating with a measured unemployment rate that is a tad below the staff's and most economists' point estimates of the natural rate. In that regard, I think it is important to remember that even if we fully accept the natural rate hypothesis, the natural rate is a parameter that not only changes over time but also is very imprecisely estimated. A recent paper that some of you are familiar with applies every conceivable econometric bell and whistle to compute a confidence interval for the natural rate of unemployment. It is hard to get it down below 2 percentage points for a 95 percent confidence interval. That is disconcertingly wide, and I interpret that as a good measure of our ignorance on this. So, I think it also is worthwhile to look at other measures of inflation pressures--capacity utilization, vendor performance, order backlogs, strike activity, and so forth. Looking at those measures, I see no intensification of underlying inflationary forces at this point. As President Broaddus mentioned, hourly earnings have edged a little higher, and that is something we will have to watch. But in my view, total compensation is what matters, and the ECI does not show upward movement, although it certainly would be nice to have a recent reading. In addition, I see commodity prices and intermediate materials prices as well behaved, and the dollar has appreciated.

With respect to the pace of economic activity, the new chain-weighted GDP figures reveal an economy that grew over the first three quarters of 1995 at a pace a bit shy of the likely growth of potential output, which staff now estimates at 1.9 percent. With the government shutdown and the blizzard, interpretations of the statistics for the fourth quarter of 1995 and the current quarter are obviously quite confusing, but my sense on balance is that growth has weakened a bit and I am becoming--to use the same word that Ed Boehne used--a bit more jittery and marginally more pessimistic about the short-term outlook. Today's report on retail sales coupled with a plunge in the Conference Board's measure of consumer confidence--to which we should not overreact--reinforces my view that there is some downside risk. The level of inventory investment remains above the normal level that would be associated with an economy growing at potential. So, I agree with the Greenbook assessment that declining inventory investment is going to remain a drag on economic activity for a time, and the planned reductions in motor vehicle assemblies that several of you mentioned may indeed have ripple effects throughout the economy. As Mike Prell noted in the Chart Show, the moving average of unemployment claims has edged upward. Unemployment expectations in the Michigan survey, which are significantly related to growth of consumption spending, do appear to be on an uptrend even if one abstracts from a very significant recent run-up in December. One of the facts that always astounds me about the American economy is how a large number of jobs are permanently destroyed in any year, good and bad. Recent estimates place this loss at about 10 percent of all American jobs in any given year, even in good years. Since it is very clear that we are always getting substantial restructuring both within and across industries, we should not be surprised when we hear announcements of layoffs, even significant ones. But having said that, I also sense that the very large and very visible job losses like those that were recently announced by AT&T do attract widespread attention and reinforce what I perceive to be an ongoing sense of apprehension in the workforce about employment prospects, with implications for wages and also potentially for consumer spending.

Ted Truman emphasized that the behavior of the dollar matters to the forecast. The dollar has appreciated about 3 percent on a trade-weighted basis since our last meeting. If we aggregate movements in the dollar together with changes in short-term interest rates into a single index, which is sometimes called the monetary conditions index--if I have done this properly and used a reasonable weight on exchange rate changes of about 1/6 or 1/7--my calculation would be that this appreciation since our last meeting is equivalent to an increase of about 40 basis points in the federal funds rate. The Greenbook certainly recognizes that the appreciation of the dollar will produce a drag on net exports down the road. I also would underscore another point that the Greenbook makes, which is that the market value of the dollar right now is conditioned on an expectation of further Fed easing. If this expectation is frustrated, there may well be further dollar appreciation.

With respect to the intermediate-run forecast through 1997, I emphasized previously my view that the American economic house is fundamentally sound but that there is this little problem of "termites in the basement" or a bias toward below-trend growth, and I have not altered my view on that one iota. I am not going to take the time to reiterate all the reasons I gave last time, but a prominent factor in my own thinking is the behavior of longer-term interest rates. These rates have fallen and are imparting impetus to the economy. I think that impetus will continue for a time, but it is going to ebb eventually and we will be left with a risk of subpar growth over the medium term. I certainly am not envisioning an economy that is heading for an imminent recession, but I think a growth recession with gradually rising unemployment is a distinct risk if we keep the funds rate where it is now. That is roughly the same level in real terms that we reached last February when most of us considered monetary conditions to be quite appropriately somewhat restrictive.

A number of you around the table have emphasized that we need to have a strategy in mind for reducing inflation. I certainly agree with that and in that regard I would endorse the opportunistic strategy that Don described in his sermon last time. I see an opportunistic strategy as one that would not consciously use monetary policy to push the economy below potential in order to achieve a reduction in inflation, unless inflation initially were significantly far from its optimal value. I don't think the current inflation rate represents price stability. I believe the current inflation rate is too high, but it is not vastly too high. I would see an opportunistic strategy as one that would look for gains on the inflation front during periods when negative shocks unavoidably create slack in the economy. Because I hold that view, I regard as quite acceptable for now what I think is currently the most reasonable forecast, namely one where output is expected to continue to grow at a trend rate close to the economy's potential and with no prediction that inflation will decline significantly over the forecast period.

CHAIRMAN GREENSPAN. Thank you. We are running a little late, and we will recess until tomorrow morning at 9:00 a.m.

[Meeting recessed]

January 31, 1996--Morning Session

CHAIRMAN GREENSPAN. Dave Lindsey, would you start us off?

MR. D. LINDSEY. Thank you, Mr. Chairman. I will be referring to the Bluebook, starting with the table on page 11. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Thank you. Questions for Dave?

MR. PARRY. A question about velocity: What do you think the market would assume about our confidence in our forecasts of velocity if we were to raise the targets?

MR. D. LINDSEY. I don't think the market's view is very different from that of the Board staff regarding the reliability of forecasts of velocity. Market participants have not been focusing on the monetary aggregates. They essentially have accepted the FOMC's analysis that in the 1990s there has been a heightened degree of uncertainty regarding velocity behavior. So, I don't think they would change their view of whether velocity was predictable or not if the Committee were to raise the ranges. The wording of the Committee's report and the Chairman's testimony surrounding this decision could attempt to disabuse them of the notion that we felt there was any greater reliability to velocity forecasts than previously. Judging at least from the experience to date for which they have accepted our analysis, we might have a chance of persuading them.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Actually, I think this is pretty much the same question although coming at it from a slightly different direction. What has our track record been at this point during the year, or in June, in terms of actually hitting a forecast for M2 or M3 growth?

MR. D. LINDSEY. It turns out that in 1990, when the process of very slow growth of the broader aggregates began and M2 velocity started on its upward march, we were a bit slow in catching up. But subsequently, despite the uncertainty, we were not too inaccurate. I vividly remember briefing this Committee in May 1993 with a projection of 1-1/4 percent for M2 growth through that year. Perhaps luckily, M2 ended up growing that year at 1-1/4 percent. I also know that last year we were quite--

CHAIRMAN GREENSPAN. I am sorry, who publishes the figures? [Laughter]

MR. D. LINDSEY. The transcript of this will be out in five years and I will be vindicated! [Laughter]

MS. MINEHAN. But it is hard to find the actual figures to compare them to the projections. We tried. It isn't easy to do.

MR. D. LINDSEY. That's right. We are revising M2 and that alters the comparison. For 1995, M2 growth and nominal GDP growth came in almost exactly where we predicted six months ago when the Committee last visited this issue, and that involved a judgmental adjustment on our part to a model forecast that was predicting much slower M2 growth, a forecast that we essentially did not believe. This year we are closer to the model forecast in predicting M2 growth of 5-1/4 percent, but we have been influenced a bit by the slope of the yield curve. In a way, our judgmental forecasts have been better than one might have expected, but I wouldn't say that that would necessarily argue for upgrading the role of money as an intermediate target, or even as an information variable.

MS. MINEHAN. I actually was reacting to the idea that if there is a rather wide range of uncertainty around these projections, though I gather you don't think there is, we may be changing the ranges on the basis of projections that are very uncertain. It seems to me that some of your argument for Alternative II and Alternative III is that they encompass the growth rates that you are projecting.

MR. D. LINDSEY. I wouldn't deny that there is a significant range of uncertainty around our forecast even if the Greenbook gets the pattern of the macroeconomy more or less correct. I wouldn't want to assert that there is not a pretty big range of uncertainty that the Committee ought to take into account. But, as we tried to argue in the Bluebook, it seemed to us that any of the alternative ranges could be justified and a reasonable case constructed even on the assumption that the aggregates were not being upgraded.

CHAIRMAN GREENSPAN. It is certainly true that David's ability and that of others to forecast, say M2, has been quite good in the last few years. But members of the staff are making the forecasts, not a model. The models themselves have been going off considerably because the velocity of M2 has risen rapidly, and since we don't know the cause of that increase, the forecasts have become a judgmental issue. Despite the skill of our colleagues in making those sorts of judgments, it does suggest that the add factors are very important, as they are in all economic forecasts. Those who employ add factors have to be very skillful. No one around this table can be that skillful over time. The worst thing we could do at this stage is to acquiesce in the presumption that because David has been so good for so long, he therefore will be good indefinitely in the future. [Laughter] That would inevitably doom him to failure!

Further questions? It is worthwhile to put on the table some of the issues that members raised back in July when we specified tentative ranges for 1996. We were in an easing mode, short-term, at that time. There was a good deal of academic discussion as to whether it would be appropriate, given the staff GDP forecast then, to move the ranges up to center them around the forecast. No economist would argue that that is an inappropriate thing to do. The rationale that governed us in not moving the M2 range in July was partly that doing so would imply that the aggregates had taken on a greater importance. But, more importantly, it was the presumption that we would be moving away from an M2 range that we considered to be consistent with price stability over time, given a return of M2 velocity to its earlier growth trend. I think the general judgment of this Committee was that it was probably best to allow sleeping dogs to lie. For those of you who address this issue today, I would appreciate that you also indicate whether you think that the views expressed in July are still valid or ought to be altered in light of developments since then. Who would like to start off?

MR. MCTEER. Are we talking about just this issue?

CHAIRMAN GREENSPAN. No, I am sorry. We are talking about the broad question with respect to ranges for the aggregates. If you wish to bring up other issues not related to this, I suggest that you mention them but then set them aside rather than mix everything into this discussion. President Broaddus.

MR. BROADDUS. First on M2, Mr. Chairman, we have a person on our staff named Yash Mehra who is a very good money demand analyst. He has done some work that indicates that the leftward shift in the M2 demand function may be ending in the sense that his equation predicted the actual M2 growth rate in 1995 pretty well. Looking forward, his M2 model projection for 1996 is 4-3/4 percent, which is a little lower than the staff forecast but at least in the same ballpark. I would agree with the staff view in the Bluebook that has already been expressed here this morning. I think it is too early to conclude that any permanent relationship has been reinstated between M2 and nominal GDP. Last year's performance could turn out to be a fluke, and we could see the actual growth rate back down again in 1996 as it returns to the slower growth trend of the early 1990s. In these circumstances I would prefer Alternative I for the reasons that you just suggested, Mr. Chairman. We have been explaining this growth rate range in terms of our longer-term price stability objective and I think it would be appropriate to continue to do that. I would add, however, that if M2 stays on track in 1996, we would need to review it at this time next year. We may then want to consider changing the way we are using M2 and the degree of emphasis we give to it.

I was going to make just a couple of comments about inflation targeting, Mr. Chairman. Should I do that now or would you rather cover that later?

CHAIRMAN GREENSPAN. I would appreciate it if we could wait. There will be other Committee members who will want to raise this issue. So, it may be wise to set that aside unless you believe it is relevant to this particular policy decision.

MR. BROADDUS. I see it as an operational substitute for an M2 range.

CHAIRMAN GREENSPAN. We are legally obligated to make these projections. The drift of our previous discussions on this issue would lead to the conclusion that we want to do something different, but the law has to be changed in order for that to happen. Let us conclude our statutorily required discussion before we move to the broader issues.

MR. BROADDUS. Fine. I prefer Alternative I.

CHAIRMAN GREENSPAN. I was going to say "Professor" Parry. [Laughter]

MR. PARRY. Thank you! Mr. Chairman, I would support Alternative I because I think the considerations you described that motivated our July discussion continue to apply today. It seems to me that we can't forecast velocity reliably. Therefore, I think it would not be advisable to move the ranges annually based on current forecasts. Moreover, raising the ranges at this time in the cycle would, in my view, put greater focus on the aggregates, and I am still not confident that increased focus on the aggregates is warranted. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. In his presentation, Dave Lindsey mentioned the issue of the consistency of the central tendency of the members' GDP projections for 1996 with the alternative ranges for the monetary aggregates and whether we should move away from Alternative I. But even if we were using the aggregates as an indicator variable of the thrust of monetary policy, we would need to know the numbers for 1997 because there would be lags. To be consistent, we would have to say that here is the objective that the Committee is seeking and here is the monetary policy that would produce that result. If you took the Greenbook projection as the appropriate forecast for nominal GDP, then you would have to project velocity and indicate what money growth in 1996 is going to be consistent with your objectives for 1997. I don't think that we know enough to do that. I don't know what the staff's answer to that would be if we asked. I don't believe we need to ask, because I don't think we know enough to say that it should be different from Alternative I. So, the arguments about the merits of using Alternatives II or III simply are not persuasive to me. I also believe that the arguments we used last July were right. Moreover, it would be difficult to tell Senator Mack or anybody else that we need to change the law to focus on objectives and at the same time say to him that, by the way, we are changing the ranges for the monetary aggregates for this or that reason but we don't think the ranges are useful. I don't think it is consistent to say that the ranges are not useful, but the law requires us to set them and we are changing them.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. I prefer Alternative I. I agree with the staff and those members who say it is too early to know where velocity is or what its growth rate will be. I also think that if we change the ranges now, we will have things backwards. If we are changing them because we think the growth rates will be much higher rather than because we want to target what we think should be higher growth rates, knowing what velocity is, we could come up with different answers. I don't think we have enough information in either case, and I don't think that we should signal to anyone that we do.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I prefer Alternative I. I think the arguments that were valid last July are still valid. We really don't have that much confidence in the relationship between money and the economy. Because of that, we are largely dealing with symbolism here. It is important that we use that symbolism to underscore our long-run commitment to price stability. I think that's what the current ranges for the aggregates say, and I think that's the way we ought to keep it.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Alan, I favor Alternative I as well. I have felt strongly for a long time that we really ought to set these ranges on the basis of longer-term relationships and that it would send a bad signal to move them at this point. Let me quickly make a couple of other observations in this regard. First, even though money has not been terribly useful in the short run in terms of gauging the thrust of policy, I don't think we can forget the fact that there has been a relationship in the long run between these broader aggregates and the behavior of inflation. I would hate to think that we are a central bank that doesn't think money matters when we set monetary policy. That would be a scary proposition, frankly, but there is very little mention of money these days. The other thing, and this ties in with what Tom Hoenig said, is that if we start moving the ranges around just because we are expecting different monetary growth, that in effect sends the message that we are going to adjust our monetary targets to accommodate inflation rather than using them as a tool to send a message of where we think long-term money growth has to be to achieve our inflation objective.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I agree with all that has been said so far, which is to let sleeping dogs lie. We would send the wrong signal about our long-run resolve on inflation if we tampered with the ranges now. The projections are too uncertain to be used as a basis for changing the ranges in any event.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. I am afraid I am the odd one out here. I don't think the monetary aggregates should, or do, play an important role in policy. I certainly don't think the Humphrey-Hawkins testimony should focus on the aggregates. I believe we should continue, as we did last July, to downplay the relevance of these ranges to policy. If we are concerned about sending the message that we have a commitment to price stability, we ought to do so in words and, perhaps better than that, we ought to explain in words how we intend to achieve that objective. As I indicated last July when I dissented on this matter, it is important to engage in honest communication with Congress. To me the honest choices are target ranges that are centered on the staff's best guess of where these aggregates will come out given our preferred monetary policy course, which should be related to the economic forecast that we will be presenting in the Humphrey-Hawkins testimony. In my view, the existence of uncertainty does not change this. Yes, velocity is very uncertain, but at a minimum we ought to have ranges that encompass the staff's best guess about what monetary growth we are going to end up with under the preferred policy strategy. I don't want to push the centering issue too hard. My preferred strategy here would be Alternative III, but especially in light of David's argument about opportunistic strategies that I endorse, Alternative II would be acceptable to me. Alternative I, which does not even encompass the staff's point forecast for M2, does not strike me as honest communication. Again, I would say that it's easy to rationalize a change as a technical adjustment. We did this--for M3--in July and it did not appear to create any reaction whatsoever.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I can understand the intellectual attraction of either Alternative II or Alternative III. But I believe the reason the Humphrey-Hawkins legislation requires us to project the M's is that at the time that legislation was enacted, the ranges were expected to be indicators of our intended policy and the future course of the economy. We no longer have the faith that we or the economics profession had in the late 1970s that the M's are directly related to the future growth of the real economy. In that regard, what we now do with the ranges is not governed by forecasts and centered-ranges as much as by communications. Over the years we have moved toward setting these ranges to communicate our long-run goals, and we have been successful in terms of achieving sustainable economic growth at ever lower inflation rates. So, I would view the ranges as a communications vehicle for expressing the goals of monetary policy rather than what they were intended to be when the legislation was enacted. Accordingly, I would prefer Alternative I.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, the idea that these ranges are mainly a communications device is what guides me. Since the Humphrey-Hawkins report and your testimony no doubt will point out that we do not find the monetary aggregates to be a particularly useful policy tool, adopting Alternative I, II, or III would not result in a strong market reaction or great excitement except perhaps in some corners of the academic community. However, at a time when we are still in an easing mode--certainly the last move of the Committee will have been an easing action, whatever we do today--I think using Alternative I would best communicate our long-term goal of price stability. So, that alternative is definitely what I prefer. If the majority of the Committee were to prefer some other alternative, that is not something about which I would get very excited and I certainly would not object by dissenting. But I think Alternative I conveys the message most reliably.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. In his briefing, Dave Lindsey indicated that the M2 range in Alternative I would be the target range that we would have once we reached price stability, assuming that M2 velocity returned to its traditional trend. We don't have either of those conditions. At least we can't be sure about velocity, and we certainly have not reached price stability. None of us to my knowledge put down zero as our estimate for the GDP deflator or more precisely that real GDP growth and nominal GDP growth are the same in any of our forecasts. In fact, I doubt very much whether any of us put down less than 2 percent for our expectation of GDP deflator growth. Given that and given that we are not being asked to provide guidelines for what we would like the M2 range to be in some future time when we reach price stability--clearly that won't happen this year or in 1997--I think the only honest thing to do is to have something like the Alternative II range for M2. At least the staff projection indicates that M2 growth is going to be within that range. For the Committee to say that our range does not encompass expected M2 growth either says that we don't control the aggregates or that the range is not consistent with our policy. So, I think the only honest presentation is Alternative II. I could vote for Alternative III, but

I don't think that alternative is going to be favored by a large number of people.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I favor Alternative I. When we adopted this alternative on a tentative basis back in July, we indicated that the M2 range was going to serve as a benchmark for the rate of M2 growth that would be expected under conditions of reasonable price stability and historical velocity behavior. So, if we repeat that statement or words similar to it, I think we will be communicating honestly to the Congress and telling them what our intention is. To do anything else, no matter how articulate you are in explaining our reasons to Congress, Mr. Chairman, would be read by others as implying that this Committee is placing more weight on the aggregates in our policy decisions. I don't think we are at that point by any means, and I would not want the Congress or the public to think that we are. In my view. a lot of messages would inadvertently be communicated if we were to change these ranges. Clearly, I would favor Alternative I at this point.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I am quite attracted to the arguments that Governors Yellen and Lindsey make and, frankly, it troubles me a little to reject those and go for Alternative I. Nevertheless, I am choosing Alternative I for the simple reason that to change the ranges would involve a certain fine-tuning of the dials that we don't know that we want to do, we don't know that we need to do, and we don't even know that we can do. As a consequence, I will stay with Alternative I.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I will go with Alternative I and associate myself with the comments of President Moskow and Governor Kelley. I will say, however, that I am uncomfortable about not having the staff's expected growth of M2 encompassed by the Alternative I range. As I recall, the staff forecast in July did at least have monetary growth at the upper end of the ranges for last year. If we get to a more normal relationship between GDP and the monetary aggregates, we should take a hard look at changing the ranges. But because changing the ranges at this point would signal more knowledge than we actually have, I think it is best to stay with Alternative I for now.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. I prefer Alternative I as well. I would echo the arguments that have already been made about the danger of sending the wrong signal, particularly the comments of the Vice Chairman about the danger of being misunderstood in the context of our recent easing and the prospect that we may need to ease further in the period ahead. So, I favor Alternative I.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I think most of the relevant points have been made. It seems to me that we can't have it both ways. The issue is what we want to communicate. Do we want to set up ranges consistent with the baseline Greenbook forecast or do we want to set up ranges consistent with our long-run, low inflation objective? I prefer the latter, which is Alternative I. It also seems to me that, putting Dave Lindsey's magic aside, any rigorous confidence interval around a model-based M2 or M3 forecast is going to be quite wide; it probably is going to encompass all of these ranges. So, I don't see it as all that big a deal even statistically.

CHAIRMAN GREENSPAN. The consensus clearly is for Alternative I and I assume that in making that choice, you are accepting 1 to 5 percent on M2, 2 to 6 percent on M3, and 3 to 7 percent on debt. I request that the Secretary call the roll.

MR. BERNARD. The paragraph is on page 23 of the Bluebook: The first sentence is the standard one on the Committee's objectives. "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at this meeting established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1995 to the fourth quarter of 1996. The monitoring range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year." And moving to the last sentence on the page: "The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets."

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Boehne	Yes
President Jordan	Yes
Governor Kelley	Yes
Governor Lindsey	No
President McTeer	Yes
Governor Phillips	Yes
President Stern	Yes
Governor Yellen	No

CHAIRMAN GREENSPAN. Okay, let's now go on to the broader question that a number of you have raised. President Broaddus, would you like to start us on this?

MR. BROADDUS. Thank you, Mr. Chairman. Although retaining the M2 target range of 1 to 5 percent gives a signal of our longer-term objectives, my own view is that we need something more than that to communicate fully to the public and the markets. I think it would be very desirable to supplement our monetary targets with some kind of explicit inflation objective now, and that could be set for any time period that the Committee agreed on. I would suggest that the 1996-1997 two-year period might be the appropriate time frame. I think the current short-term policy situation presents an especially useful opportunity to do this. As we all know, sluggishness in the economy has a lot of folks saying that we should ease our short-term policy stance now. A reasonable case can certainly be made for that. I am not making that case, but it can be made. With the economy operating somewhere in the neighborhood of the NAIRU--even recognizing the uncertainty you mentioned yesterday, Janet--there is a real risk that reducing the funds rate now or in the near future could raise doubts in some corners about the strength of our commitment to our longer-term price stability goals, at least relative to other policy objectives we might have. As I argued last summer, and I recall others did as well, I would certainly hope that Congress at some point will give us an explicit longer-term price stability mandate. The Mack legislation would do that, but it doesn't look as if the Mack Bill is likely to pass the Congress any time in the foreseeable future. With that in mind, I think we should consider confirming our commitment to price stability in some explicit way now. There are a lot of ways that this could be done. Tom Melzer mentioned a couple yesterday.

My own suggestion would be that we include in the Humphrey-Hawkins written report and hopefully in your testimony, Mr. Chairman, a positive statement that the Committee wants and expects the CPI inflation rate to remain below 3 percent on average over the two-year 1996-1997 period and that beyond that we intend to take steps to bring the inflation rate down further over time. We could think of this, and describe this publicly, as a sort of benchmark. That would be the term I would use. Such a benchmark would give the Congress and the public, and for that matter ourselves, something more concrete than we have had in the past to hold ourselves accountable for. It may seem like a small step, but I think this would be a significant departure from what we have done in the past. I believe it would get some attention and hopefully improve our credibility along with our accountability. If we were to agree to do something like this and if it would make the Committee more comfortable, we could add a statement in the report that a benchmark like this would not necessarily constrain us in dealing with short-term ups and downs in the economy. It would not constrain us or prevent us from continuing to take actions that are aimed at stabilizing employment and output in the short run. I think it would make us evaluate such short-term actions against our longer-term price stability objective rather than evaluating efforts to contain inflation against an implicit unemployment objective, which I think has been the case in some past years. Again, this may appear to be a small step, but I think it would be a step in the right direction. It would get some attention, and it would raise the chances that we would ultimately get to where we are trying to go.

CHAIRMAN GREENSPAN. Can I ask you why you believe that the Mack Bill is not going anywhere?

MR. BROADDUS. I am not on top of the latest developments, but in general it seems unlikely to me that the bill is going to pass. From what I understand, there is some chance that it won't pass at all in this Congress. I may be misjudging that.

CHAIRMAN GREENSPAN. I think that's much too premature. The issue has not been joined, and there is a large number of cosponsors on the Republican side. What that all means is hard to say. You may well be right.

MR. BROADDUS. Even if I am wrong on that, Mr. Chairman, I don't think that would change my view about the desirability of doing something like this.

CHAIRMAN GREENSPAN. I think it does in part change the view of where we ought to be moving because I am not certain it is to our advantage to do something in advance of what that bill will do. In other words, that may not help the particular form of the discussions that we are involved in. But I think we will find out within the next two or three weeks because they have to make a move one way or the other in that regard. Well, maybe not in two or three weeks--two or three months may be the more relevant time frame. President Minehan.

MS. MINEHAN. I am attracted to President Broaddus's argument. I think that communication of intent by the central bank does aid in raising its credibility, though I question whether we really have a credibility problem at present. Does anybody really believe the stuff that Don Kohn put in the Bluebook? [Laughter] Moving from 3 percent to 1 percent inflation by the year 2002 results in a full 8 percentage point loss of economic growth in this period. If nobody believes that, that's fine. But if one believes even a portion of that, it strikes me that it's a political decision to give up economic growth to achieve that decline in inflation, and that strikes me as an even greater reason to wait for the Mack Bill.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Al, can a layman ask for some edification here? I think you had in there--

CHAIRMAN GREENSPAN. Al, you are about to be put down! [Laughter]

MR. BROADDUS. I sense that!

MR. KELLEY. I think part of your proposal included a guideline for 1996.

MR. BROADDUS. I was thinking of a two-year period, 1996-97, as a time frame, but the time frame is not a particular issue for me.

MR. KELLEY. My question is, if monetary policy exerts its impact with a lag, whether we are currently in a position to do anything to affect 1996 beyond events that are already in train or policies that have already been implemented.

MR. BROADDUS. A longer time frame would probably be more appropriate given the lags, Mike, and that's why I said 1996-1997. Again, I am not talking about trying to control the inflation rate in any mechanical way; we can't do that. I am simply saying that we would make a statement that we would evaluate all of our short-term policy actions over this period of time--especially those in the near term where the lag is long enough presumably to have some effect on the inflation rate during the two-year period--in a way that would bias the outcome toward this result.

MR. KELLEY. I am going to be very disappointed if we don't achieve your guideline in 1996, and I have some confidence that we will. But I think that will be a result of developments and polices that are already in train.

MR. BROADDUS. Still, making it explicit in this way imposes discipline. It adds a degree of credibility and accountability that I think we don't have now. It would move us a step forward. I don't think it's revolutionary. It will never solve all our problems, put it's a step in the right direction.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. It will be a long time, if ever, before a consensus emerges about the success or failure of monetary targeting over the last 20 years or so. As far as I am aware, of all of the central banks around the world that have experimented with monetary targeting only the Deutsche Bundesbank continues to do so and continues to argue that it has been successful. It does continue to be successful and German economists outside the Bundesbank also argue that way. While this would be considered heresy by some of my professional friends, I think even in the case of the Bundesbank that monetary targeting was neither necessary nor sufficient for achieving the results that they obtained over a period of time. What happened to the Federal Reserve was that monetary targeting was imposed on an unwilling central bank in 1975 and then again in legislation in 1978, whereas the Bundesbank adopted monetary targeting as a means to achieve a very clear, single objective. There was some help for the Bundesbank from enabling legislation. The Federal Reserve did not have that sort of help, nor did the Bank of England, the Bank of Canada, and so on. I think that a central bank that adopts a very clear, single objective for price stability has more freedom to formulate its policy and achieve that objective. On the other hand, one that uses something like monetary aggregates ranges as a monitoring device or as a communications device without a clear objective is going to have political problems and even problems in formulating policy. I think the most important thing is to emphasize clearly the single objective of price stability and to lay that out into the future. It has to be a multiyear objective. I think it's better if it comes from within the organization. Yesterday, Vice Chairman McDonough mentioned the transition cost problems, but we don't know what those transition cost problems are because of the issue of credibility. Nobody else can really estimate them either. With regard to the numbers in the Bluebook to which Cathy referred, Don Kohn is quite clear in saying that they take no account of improving credibility.

MS. MINEHAN. That's right.

MR. JORDAN. If we can enhance our own position, not only with regard to the Congress but with regard to the American public, by very clearly articulating and setting out a time path for achieving price stability and if--a big if--that is credible and people really believe we will deliver on it, we will minimize the transition costs of lost output. As I said last year, I still worry about future Congressional hearings. The very well known, well respected members of our profession will focus more than I would like on the transition cost argument--on lost output and how many people will be thrown out of a job in order to achieve the price stability objective. That will distract from the underlying issue that achieving price stability is growth-enhancing; it raises standards of living. That's why we are trying to do it. I would rather see this Committee say, with or without the Mack legislation, that we have adopted a single objective and that it is a way of achieving the objectives of the Full Employment Act. I am not even sure that requires legislation.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Alan, I have expressed my views on this topic before, and as you know I think we ought to be moving in the direction of setting longer-term inflation targets. I would not disagree with what you said before about the Mack legislation. I do not have any information that would suggest that the prospects for passage of the legislation really have been tested, and I can see the merits of waiting to see what will happen to the legislation. However, if we were to approach the July meeting with nothing happening and our sense was that the legislation was not going anywhere, then I think we ought to be considering what steps we could take on our own without legislation. Their purpose would be to convey more clearly our longer-term objectives and, as Al said, increase our credibility and accountability.

As I mentioned yesterday, one step that could be taken in that regard, short of actually setting a target, would be to extend our horizon with respect to inflation forecasts. It's ironic that the CBO and OMB put out budget projections with inflation assumptions going out five years. They are assuming 3 percent inflation over that horizon. In my view, those projections generally tend to have an impact on longer-term inflation expectations, and the very agency that actually influences inflation over time doesn't have anything to say about it. Obviously, one could take this to the point where a projection becomes a target. There certainly is a relationship. We would have to think very carefully about what we were doing, but I would not see any real problem or any impediment to a decision by this Committee to provide forecasts over a longer time horizon. If we were forecasting inflation two or three years out, people would realize that that is a time horizon over which we could have some influence, and there might be an expectation that we would deliver on that.

To pick up on Cathy's point, and Jerry touched on this a little, I don't put much faith in model projections of inflation. Part of the reason is that they do not take credibility into account. Nonetheless, I found it interesting to look at the model results in the Bluebook. I was fascinated with the examples where it was assumed that shocks raised the equilibrium funds rate by 50 basis points. The conclusion, or the underlying assumption, was that a current and future funds rate of 5-1/2 percent was consistent with 3 percent inflation in the long run. One could argue that easing the funds rate today would be analytically equivalent to the example in the Bluebook of an upward shock in the equilibrium funds rate of, say, 50 basis points. I am not suggesting that anybody who favors some easing has that in mind. What is very interesting, if one believes the model output, is that reducing the funds rate does not really put one in an opportunistic school, which is where I think people who would tend to favor that policy course would be likely to place themselves. Rather, it actually places them in a deliberate camp to raise inflation. The effect in that example, where the real equilibrium funds rate is shocked, is to drive the inflation rate higher; it continues to rise for three years, albeit not by a lot. It does not rise above 4 percent in that particular model.

We have been at 3 percent inflation for roughly the last four years. It is only recently that financial markets have been willing to give us enough credibility so that, in looking at longer-term rates, they build in a premium for inflation and inflation uncertainty that has been reduced to somewhere around the current inflation rate. It has taken us four years to achieve that degree of credibility. So I see a policy easing move in terms of taking an action that is deliberate in the sense of forcing the inflation rate up. I know all things would not be the same, but the Bluebook model suggests that conceivably we could be looking at rising inflation for three years. If we keep inflation at the higher level for a further three years, we will have lost a tremendous amount of time in this process of trying to gain inflation credibility. So, I thought the Bluebook exercise was useful from that perspective, at least for those who would put weight on these models. As I said, I tend not to look at them.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I think credibility is earned by what we do, not what we say. We lost credibility by letting inflation accelerate, and we have regained a lot of credibility by bringing inflation down. Over the last 15 years, we have brought inflation down from double-digit levels. We held inflation to an average of 4 percent during the long expansion of the 1980s. We have held it to 3 percent or under during the fairly lengthy expansion of the 1990s. The actions that we took in 1994, when we tightened in a preemptive way in trying to head off inflationary pressures before they emerged, were worth far more than anything that we might say. I think we really fool ourselves if we think that we can put out statements that will enhance our credibility. What counts is what people do, and there is a lag in market perceptions. We now have inflationary expectations down as low as they have been since the late 1960s, and I think that is based on actions, not words. We have put out words. The Chairman has repeatedly said in his Humphrey-Hawkins testimony and in other speeches that we intend to preserve the gains that we have made on inflation and to extend them over time. If Congress wants to pass the Mack Bill, so be it; that could be helpful. But I don't think we ought to engage in legislation around this table. What we can do and what the legislation gives us the power to do is to act. That is what we ought to do and save the words for the legislature and for other avenues as we have done in the past.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I certainly support the Mack Bill. I think it may increase our credibility, and frankly I think it may have some impact on what we do around this table. In the meantime, having something like the wording that President Broaddus suggested might be useful. One never knows. It might even reduce the probability that we would ease at a time when we as a group expect the economy to grow at a rate in excess of that of potential.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. I would like to associate myself to an absolute degree with Ed Boehne's remarks. I believe that the degree of credibility that we enjoy at the moment has been hard earned, but it is very high. I don't know of anybody--even in the world's capital of cynics, New York City--who really believes that this Committee is not absolutely resolute in the pursuit of price stability. I think that, as Ed suggested, we are better off to continue as a Committee performing with deeds, with good solid, sensible, anticipatory monetary policy. As for words, I for one have been giving a number of speeches recently to groups like the National Mortgage Bankers in which I state as firmly as I can that my whole view of monetary policy is that price stability is the means by which we achieve sustained economic growth. Therefore, I don't really need a change in the Humphrey-Hawkins legislation. To me, that legislation is not in fact contradictory. It says that we want sustained economic growth and we want price stability. I think they are the same goal because sustained economic growth is achieved through price stability. By speaking out publicly, one of the things we can do--and it is a role that I have taken on myself--is to confront the traditional anti-price stability group by reversing their argument. The reason very sensible people have been against price stability is that they believe it is socially and politically harmful to the poor whom they feel they represent. I think they have it absolutely backwards. I believe the best thing for the poor in the South Bronx is price stability. I have argued that, and believe it or not, some of the people who have been most vocal over time as attackers of price stability sort of begrudgingly tell me that I may have it right.

I am very much in favor of a Mack Bill because I think formally establishing price stability as a goal of the Federal Reserve is a major political judgment. Major political judgments should be made by Congress with the agreement of the President. In my view, it would be very much in the national interest to have the Mack Bill or something very much like the Mack Bill enacted into law. So, as an individual and as the President of the Federal Reserve Bank of New York, I have publicly stated that the Mack Bill is a very good idea. I am not endorsing all its details; it's too early for that. But rather I think that legislation establishing a single goal for the Federal Reserve has great merit. That is what the Congress and the President are for, and we would be ill-advised in the meantime, as the Chairman suggested, to preempt that debate and in a way make it unnecessary. The whole history of this country is that the Federal Reserve does its job best when we are carrying out what the American people want us to carry out. Over time we have brought this issue to a point where the American people as represented in the Congress are really in agreement that price stability is what makes sense. We should let that political process take place.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I have some sympathy for Al Broaddus's suggestion. It would be a small step toward helping us achieve our ultimate objective, which I view as maximizing living standards. Price stability is the means that we have at our disposal to achieve that. Having said that, I think Al's suggestion, like a lot of relatively provocative ideas, raises at least as many questions as it addresses. For example, if we were to go down this path, what are the right numbers? Is this going to have any operational significance? If it does, don't we have to worry about instrument instability and maybe economic instability as we start to implement this? So, there are a lot of things we would have to think through in a serious way if we are going to do something like this, at least for me to be comfortable with it.

In terms of trade-offs and loss functions in some of those numbers that are in the Bluebook, I certainly don't take those numbers at face value, but I question how big the credibility effects may be. I think the burden of proof is really on those of us who think that we can make further progress toward price stability without some short-term loss in the rate of economic growth. I say that based on economic history. I am not aware of periods in this country where we have made progress toward price stability without some episodes of subpar growth. One could counter that by asserting that our credibility was relatively low. That may be, but it seems to me the burden of proof, based on history, is still on those who want to argue that we can do this without some short-term loss of growth.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I think most of the people who plan for the future try to do so with a goal in mind. They should state that goal, and I think such a statement can serve very well. I favor the idea of having a price stability goal because price stability does achieve all those objectives that we talk about. Having a stated goal is a form of discipline that is especially useful during difficult times when it is easier to drift away from it. The caveat that I have is similar to Bill McDonough's. I think if we were to do that, it would have to be done very carefully within the context of Humphrey-Hawkins because that's the law of the land. We have to be consistent with that law not only in substance, which we may be able to do by setting the goal, but also in appearance. There is a debate going on in the Congress right now. I would like to get us to the point where we have this goal, but I think we ought to let the debate play out. If we do adopt a goal in the interim, we should couch it in terms that are very clearly consistent with Humphrey-Hawkins.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I, too, believe that deeds are more important than words. However, I also believe that words are very important. Al's proposal has a lot of appeal to me. I would suggest that July might be the right time, though, to consider doing something like that. By waiting until July, we will know more about whether the Mack Bill is being debated, about its chances, and whether we would be making such an announcement in the middle of a recession. Also, doing it in July might mean that we could shift the time frame to something like 1997-1998 and at least partially get around the lag issue that Governor Kelley raised.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. As I have said previously, I am quite sympathetic to the communications goals embodied in the Mack proposal. For the same reasons, I am attracted to many of the arguments that President Broaddus has presented, although I certainly agree with Gary Stern on the issue of credibility. I think we could proceed to communicate more even without legislation. Whatever happens to the Mack Bill, I think it is desirable to work toward that end. In that sense, I agree with Al.

The problem from my standpoint is that before we communicate, we really need more extensive debate and study of exactly what we want to communicate. I do not know precisely what members of this Committee mean when they use the words "price stability." I don't know if they mean literally 0 or 1 percent inflation or a range of 1 to 2 percent. Also, I don't know if we are talking about targeting the price level so that we would expect the level of prices to be the same 100 years from now as it is today. That is a very different thing from targeting zero inflation and then forgiving mistakes. It is very clear that the costs of elevated inflation are high, and, in that case, we need to move inflation down to lower rates, and that a consensus exists to do it. But as we get to lower rates of inflation, we need to think much more carefully about the costs and benefits of moving to still lower rates. There are benefits, but during my time on the Committee, we never really have talked about what the benefits are or attempted to evaluate them concretely. I believe there also are costs of moving to very low inflation rates. I am persuaded that there is at least a significant one-time output loss. There also may be a further permanent loss that occurs because a little inflation, particularly in an economy with slow productivity growth, greases the wheels and makes relative wage adjustments easier and may facilitate intersectoral allocations of labor. This is a subtle point, but I think we never have evaluated or tried to measure it.

So, I think we are not quite ready to proceed without a further discussion. Also, we need to think through what type of strategy is appropriate to reach the target. Al and I have previously debated this. Inflexible inflation targets don't strike me as a good strategy. I think there is a flexible approach that would take account of trade-offs between active stabilization and inflation objectives, but we have never really worked this through as fully as we ought to. So, I believe in communication, but I have some qualms. We need further study. At the end of the day, though, I thoroughly endorse Al's concrete suggestion that we should, at a minimum, be communicating a strong commitment to holding the line on inflation at 3 percent to keep it from rising higher. To me, an opportunistic strategy would do precisely that. It would lean quite hard against any increase in inflation and it would look for opportunities to bring it down.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I, too, think it's important for us to communicate more about the importance of price stability as a goal, and I must say I am sympathetic to Al's proposal. I do have some caveats and concerns about the timing of implementing such a proposal. Like President McTeer and others, I am a little concerned that now may be a bit early. I would like to have the proposal fleshed out a little more before I have to vote on it. Among other things, I think we ought to give more consideration to the appropriate time horizon. The 1996-1997 time frame that Al mentioned makes me a little nervous. I would prefer a longer horizon. President Melzer's suggestion of looking at what inflation might be doing over the next five years would seem to be a useful kind of communication. In sum, while I would like to do something involving more communication, I would like to have proposals like Al's fleshed out a little more and also to have the opportunity to consider some different alternatives as to what we should communicate.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I have been here only a year and five months, but I think we have discussed this question at least four or five times [Laughter] in that period. Some of the discussions have been very good, and this one clearly is in that category. Al's suggestion has some very attractive aspects to it in my view. A number of people have pointed out some implementation problems, potential operational problems, and some measurement issues. What are the costs, what are the benefits and, as Gary Stern mentioned, can we really identify what the benefits of increased credibility would be? Given the discussions of the Mack Bill, I think this clearly would be an inappropriate time for us to do anything on this. But the bigger question is what do we do over the longer term. Like Governor Phillips, I think it would be helpful to have some staff work done to flesh out some of these longer-term issues to see if we can measure in a better way some of the costs and benefits and whether we can get a little more specific about what we are trying to communicate and how that might differ from what we are communicating now. We clearly are doing a lot of communicating now. Some of it, as President McDonough said, is very useful. So, I think it certainly would help us as a Committee to have some focused staff work done on this for our next discussion so that we could understand some of the issues a lot better before we make a decision.

CHAIRMAN GREENSPAN. Let me raise the very specific issue that Governor Yellen mentioned with respect to the possible benefits of a low rate of inflation in terms of "greasing the wheels" to facilitate wage adjustments. As I recall, the staff did some work on that a couple of years ago in which the distribution of wage increases was plotted to see whether the existence of the zero limit significantly constrained the shape of the distribution. As I recall, the results of that study were that it did not. But I also have seen other studies since then that have raised questions about this result. I think that, to a large extent, this sort of thing can be factually evaluated. It would be useful if we had some better insights into it. I am curious: Since that study was made, what has been the specific academic literature regarding the notion of slight levels of inflation greasing the wheels of wage bargaining?

MR. STOCKTON. There have been a few studies in addition to ours. We found some minimal evidence that there was some downward nominal wage rigidity. But the important empirical point we were attempting to make was that it did not appear to be quantitatively very significant. Other researchers using the same data set and other data sets also have found some evidence of downward nominal wage rigidity. Some people put different spins on it in terms of how much or how little, but I don't believe there have been any major breakthroughs. The additional amounts of empirical evidence have been marginal. There is, I think, evidence of some downward nominal wage rigidity. The issue is how quantitatively significant ought that to be in the conduct of monetary policy. In our study, we found that there was still significant downward nominal wage flexibility. There was some evidence that at zero inflation there would be some downward nominal wage rigidity. But the welfare loss of running a low or zero inflation policy that would be associated with that downward nominal wage rigidity was not quantitatively significant.

MR. PRELL. Mr. Chairman, I would like to broaden this a little. We did undertake a Systemwide research effort not very long ago. I don't think there have been major breakthroughs in the economics profession in the last couple of years that would greatly change the picture. The picture was that one could not come up with definitive, compelling evidence that could override people's priors, and their policy judgments in a broader context, about how they should view the value of officially setting our sights on moving the inflation rate down from 3 percent to price stability.

CHAIRMAN GREENSPAN. Where were their priors coming from, evidence or nonevidence?

MR. PRELL. I am not talking about the priors of these researchers, which may have varied. What we found was that it was very hard to pin these things down. It was very hard to get definitive, empirical measures of the costs and benefits of varying inflation between 3 percent and, say, 1 percent as measured by the CPI. So, I don't think we are going to be able to solve the Committee's problem through another intense research effort. You are going to be confronted with what economists normally provide, something that leaves some considerable room to maneuver. You are going to have to confront this issue mainly on other grounds at this point. The profession does not have the tools to ascertain the costs of moving the inflation rate by 2 percentage points.

CHAIRMAN GREENSPAN. You mean economists are truly two-handed! Governor Yellen.

MS. YELLEN. On the question of the greasing-the-wheels argument, I have read the staff paper. It is a very good paper, but I think there are methodological questions that remain open and different ways of approaching it. I understand the empirical findings that you have, and I would not regard them as definitive. This is probably not the right place to get into methodological issues, but if you want just a bit more on this question, I would point to an entirely different type of study that doesn't use longitudinal data sets. Truman Bewley from Yale has spent several years interviewing managers and human resources people at several hundred firms in the New England area to try to understand their wage-setting policies. He is in the process of writing a book summarizing what he found. He gave a seminar here not long ago, and I think it would be fair to say that the bottom line conclusion is that wage rigidity stems from the fact that firms find it extraordinarily difficult to cut wages. This is the unanimous finding of his several years of interviews. That is what people say. It's not that wage cuts never occur, but it is a very serious constraint on what firms feel themselves capable of doing. That is a different kind of evidence on this issue, but it is an empirical question as you have indicated.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Don, your memo about the NBER conference in January referred to the Feldstein paper as indicating that they had identified at least some benefits of going from something like 4 percent inflation to 2 percent inflation. I have not read the paper. Could you comment on whether you find that aspect of it compelling?

MR. KOHN. Although I have read it, I didn't feel qualified to evaluate it. It rested very heavily on the tax system and the interaction of inflation with the way capital income is taxed and the resulting distortions to asset accumulation and savings by households through this. It was a study that was looking at welfare losses characterized by some sort of four-sided figures, trapezoids or something.

MR. LINDSEY. Trapezoids.

MR. KOHN. Right, under the curve. There were a couple of comments at the conference, as I think I indicated in my notes. One of them was by somebody who approached the subject in an entirely different way, with a general equilibrium model, and he found something that was roughly comparable to Feldstein's findings. But that was very theoretical and abstract. Some other people had doubts about the extent of the welfare findings. One commentator, Ben Friedman, noted that the findings of most of the loss of welfare depended on the interest elasticity of saving by households--that is, that the after-tax rate of return really did affect how they accumulated assets. As you know, that is an open question. Judging from what I heard at the conference--Larry Lindsey and Mike Moskow were there as well and I don't know whether they would disagree--it was a suggestive approach but not definitive.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. As I listened to Dave Stockton's remarks about downward wage rigidity, I was struck by how odd that sounds in the context of the last couple of years when people around this table and elsewhere have been puzzling over upward wage rigidity. Why haven't wages been rising more rapidly in the environment that we have been in? The question, which doesn't really need to be answered but needs to be thought about, is whether the rigidity is symmetrical or not. The inference has been that an asymmetry is involved but that is not at all obvious.

On the issue of symmetry and credibility, a simple interpretation of the Bluebook would be that if we were to set an objective of raising the inflation rate to 5 percent, we could increase nominal GDP by 8 percent. If we were to take that proposal up to Capitol Hill, some people there probably would say, "go for it." Does anybody around this table believe that, if we established a policy of raising the inflation rate and announced a policy of raising it to 5 percent, we would increase GDP? Well, of course not. If the rigidity is symmetrical, that also says something about the costs of getting to lower inflation.

CHAIRMAN GREENSPAN. You are raising an interesting issue with respect to the most recent period. If you have downward wage rigidity in a period of falling inflation rates, one would presume that profit margins would be falling. However, profit margins are widening. Average wage increases are admittedly quite small at this stage, and there is evidence of significant downside rigidity on the left side of the distribution curve of wage changes that does not seem to be consistent with the associated distribution of gross profit margins. Were we to look into this issue in some detail, I think it would be incumbent upon us to make a judgment as to what type of underlying process we are dealing with. There are a lot of reasons why wage increases are low. At our last meeting and at previous meetings, I raised the issue of job insecurity and the trade-off of wages against insecurity as an explanation of the low wage gains. We have in that a phenomenon that actually does explain in some detail what is going on. What it does not address, however, is whether in fact there is wage rigidity involved in this. Indeed, if there is rigidity, is that damping the bottom side of the distribution in the sense that with the averages falling, are we in fact getting a narrowing of the distribution that would be consistent with the rigidity argument? The evidence here is that we do not as yet know, but it's not as though those data are not available; they are. It should be a question of whether there is significant flexibility between 0 and 3 percent inflation in the same way that we know there is between 5 and 10 percent. I think the broad macroeconometric evaluations of the sacrifice ratio or related concepts are very interesting, but they are only suggestive. Until we get to the internal structure of the system, I don't think we really will know what the true economic relationships are. Having said that, I am not even sure that one can argue that if we found them that we could therefore stipulate that they are hardened into the system and irrevocably unchangeable in the period ahead. So, even there we are at something of a loss.

MR. LINDSEY. I want to follow up on something else that Jerry Jordan said, which I thought was very good. His example referred to an announcement of an increase in the inflation rate to 5 percent. In fact, I think we went through this exercise about a year ago. The staff model did not have an announcement of an increase in the inflation rate, but it indicated that increased inflation itself would raise real GDP. In fact, higher inflation in the model raises the present value of future GDP. I don't agree with that conclusion, but I have to believe that if we were to announce higher inflation, the increase in GDP would be less than it would be if we slipped higher inflation in there. That has to be true. So, why wouldn't we believe the reverse? Why wouldn't we believe that if inflation were to go down that we wouldn't have the same improvement in the trade-off?

MR. KOHN. I think that's true in concept. The problem, as President Stern and others have noted, is finding it in the real world. That is, when we look at sacrifice ratios across countries that have inflation targets and others that don't, we can't find an improvement there. Now, there are a lot of other things going on in those countries and that doesn't mean that there would not be some improvement in the United States, but researchers also had trouble finding improvements in sacrifice ratios going from the 1970s to the 1980s after the huge disinflation we had and the change in the makeup of the Committee and the objectives of the Committee. So, I agree with the concept, Governor Lindsey. It ought to be there, but it's very hard to find in the data either across time in the United States or across countries.

MR. LINDSEY. Could it be that on the way down we are doing what we are supposed to do and on the way up we are not doing what we are supposed to do?

MR. KOHN. It might be asymmetric.

CHAIRMAN GREENSPAN. When we begin to test the outer limits of these models, I would hesitate to look at the output of our very sophisticated model if we ran a $500 billion deficit through that model. What would happen, I would suggest, is that the model would replicate very poorly what would be likely to occur in the real world. If you don't believe a $500 billion deficit would be enough to produce that result, make it a $1 trillion deficit. The nature of these models is that they are substantially linear in terms of how most of the forecasts and simulations are made. But when we get to the outer limits of policy actions, very significant nonlinearities may exist that are not captured in the first approximations of these models because their simple linear equations really do not reflect what the world is like at those outer limits. An analogy might be that as a particle accelerates toward the speed of light, its physical nature will change only little. As it get close to the speed of light, its nature will be altered very dramatically. I have a suspicion that doing this sort of thing to these models would have a very similar effect, though long before we get to the speed of light. We must seriously question our assumptions about how the sacrifice ratios and other factors are interrelated and not merely presume that we can infer those interrelationships from the types of models that we use. I suspect that those models can lead to misunderstandings that we ought not to entertain for very long. So, I agree with your general focus. There is a serious question here.

This kind of Committee discussion is useful, and it is quite possible that our discussion today has been the best we have had on this issue. If we keep talking, we may find ourselves in agreement on a lot of different questions relating to this issue. As a practical matter, I do think it is worthwhile to wait to see how the basic legislative vehicle evolves. I must say that I agree with both President Boehne and the Vice Chairman with respect to the primary importance of our actions and very specifically with respect to the political questions that are raised when major value trade-offs are apparent. In those cases, we must convince the Congress as to what the real trade-offs would be for economic reasons, and in any event we cannot in our society go against what is fundamentally called for by the law of the land. We may or may not agree with the law of the land, but what makes the country work, what makes it great in fact, is that we all adhere to it. With that, I think it is a good idea to go out for coffee.

[Coffee break]

CHAIRMAN GREENSPAN. I call on Mr. Kohn.

MR. KOHN. To accompany my briefing, I have prepared the material in front of you called "FOMC Monetary Policy Briefing." [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Don? Governor Lindsey.

MR. LINDSEY. Don, you mentioned the fiscal package. If we went from a cumulative deficit of $1 trillion to zero over seven years, how big a shock do you think that would be? How should we compare that to what you have here?

MR. KOHN. There is a footnote in the Bluebook that says that going from a deficit of about 2 percent of GDP, which is approximately where we are, to a balanced budget over seven years would produce a change of about 1 percentage point in the equilibrium rate in our model. Now, that number should be viewed with a huge standard error around it, but that is the order of magnitude.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Don, you referred to the bond market vigilantes who try to correctly anticipate the Committee's actions. One thing they have been able to do is to derive indicators like the Taylor rule that seems to approximate our actions. If we follow an opportunistic strategy, doesn't it imply a much more complicated mathematical expression of our policy processes with lots of nonlinearities? It seems to me that inevitably there would be a loss of understanding on the part of the market about how we react to things.

MR. KOHN. I am not sure, President Parry. I agree that at least in concept putting out a mathematically precise rule would be clearer than something as vague as an opportunistic strategy. But I think that in practice the market has come to understand, as a few members such as President Boehne already have said today, that the Committee has very strongly resisted increases in inflation. The Committee's actions in 1994 were very helpful in that regard. I think the market also believes that the Committee has its eye on a price stability objective over the long run. Market participants do not, as President Melzer pointed out, anticipate that the Committee will deliberately take action to reduce the inflation rate below 3 percent. But I think they actually have developed a rather good understanding of the Committee's intentions and operations by looking at its actions in various contexts. You would have to judge whether acting in the way you think is best as circumstances change over time is better for the economy than putting out some rule that might describe your actions over some period of time. I would think that inevitably you would have to violate that rule sometimes.

MR. PARRY. If I could just have a follow-up question: I assume that under both strategies you have a linear Phillips curve, and therefore the output loss is the same under each. What is different is the time period, or point in history, in which you incur the output loss.

MR. KOHN. For the same set of shocks hitting the economy, the output loss relative to no disinflation is the same.

MR. PARRY. Some people may have gotten the impression that one strategy is less painful than the other. The pain is equal; the question is when you actually sustain it. Is that correct?

MR. KOHN. In a linear world that would be correct, and that is true in this model. I don't think the Committee has behaved that way, and many models suggest that the output loss is not totally linear. In such models, large misses and large variations in output are weighted relatively more heavily than small variations in output. But it is an open question whether minimizing variations in output around the mean, even with the same integral of output losses, is better than having a few big recessions to get to price stability. That is one of the questions that the Committee would need to consider if it were thinking about adopting a time frame for getting to price stability. Should you go there quickly or should you go there slowly? A lot of people think slow is better than fast, but there may be no way to prove that--or at least it would be very hard to prove one way or another.

MR. PARRY. That is what we talked about earlier.

MR. KOHN. Right. It is a question of how the economy adapts and how the institutions in the economy adapt. I think there are reasons to believe that going to price stability slowly and allowing institutions to adapt to lower and lower inflation rates would remove some of the frictions one might worry about, say, in the financial sector. Reality is much more complicated than the models say. I agree with you that these models are very linear, and fast or slow, deliberate or opportunistic will give you the same integral of loss. The output loss of eight percentage points would be the same in the model, but I suspect that it's quite different in real life.

CHAIRMAN GREENSPAN. Further questions for Don? If not, let me start off. I will try not to be as verbose as I was at the last meeting, but I think there are certain points that require some repetition. First, it is hard to find in economic history a recession that began while the stock market was still taking off and earnings expectations were still reasonably good. Indeed, even though there are very significant pockets of weakness, as was discussed around this table, no one is saying that the economy is collapsing and that there is a yawning gap into which we are falling. Nonetheless, I do think there is very clear evidence that the downside risks are significantly larger now than they were earlier. In my judgment, it probably is wise to recognize those risks and raise a serious question as to whether a policy action would provide some appropriate insurance in this context.

In my view real rates are still higher than I feel comfortable with. The analogy that I made at the December meeting, to which Jerry Jordan referred yesterday, about the economy feeling like a car running with its parking brake still engaged, is still clearly appropriate. The actual short-term evidence that we have suggests that the January figures are going to be rather miserable. The weekly data that are available on industrial production, which constitute only a modest part of the industrial production index, contribute something in the area of a .4 percentage point decline in the total index. To be sure, autos are a big factor there. The major problem that concerns me in this context is that we are relatively far along in the economic expansion. We are well beyond the average length of such expansions in the post-World War II period, and indeed, unless my memory fails me, the current expansion is probably already the second longest in that period, excluding the one that was sustained by the Vietnam War.

What tends to happen when an economic expansion gets "long-in-the-tooth" is that a much broader concept of inventories becomes relevant. I would hypothesize that two types of inventories affect economic activity: The first is the standard type of business inventories that are included in the GDP data; the second is the gross stocks that exist both in the household area and in the business area. For example, we tend to look at final sales as though they were consumption. Well, they are not. Consumption basically is the use of a stock, and it is perhaps better reflected in depreciation than it is in purchases. Indeed, in the motor vehicle area, for example, the sluggishness of sales is being caused by the fact that we have had fairly high levels of automotive sales for a considerable period of time. We have built up the stock of vehicles on the road quite extensively, and we have created a large number of second-car and third-car households. We are getting into a situation in which there is, in a sense, another type of inventory out there that is suppressing economic output. We see that in capital goods markets and in a lot of other places. If we were to get a better estimate of what is actually consumed in the economy, I suspect we would probably do something quite similar to certain revisions in the federal and state and local government accounts involving shifts from purchases to consumption. In that context, it probably means that we ought to be substituting depreciation for a lot of the longer-lived assets that are classified under personal consumption expenditures or producers durable equipment. While I have not looked at the data, I suspect that were we to do that--we are, of course, looking at net property account increases--we would probably find that the consolidated inventories situation, including both business and consumer inventories and unsold stocks of homes, is exerting a much more egregious and suppressing effect on economic activity at this stage than so-called business inventories or primary inventories alone would suggest.

The reason I raise this issue is that there is the perennial question of, why do business cycle expansions come to an end? In today's environment, where we presumably curbed the accumulation of business inventories with our preemptive moves in 1994, it is not clear to me how well we have done in the secondary inventory areas. A goodly part of the weakness that we have been seeing probably reflects the fact that there is an ultimate life expectancy to a business cycle in much the same sense that it probably exists in human beings. The expansion cannot go on continuously; something will go wrong. It is hard to know where we stand at this stage. In the past we would have periodic recessions largely because imbalances would emerge, inflation would occur, the Fed would clamp down, and economic activity would decline. That is the classic inventory cycle of the post-World War II period. But our policy has altered that process, and it is not clear what will happen as a consequence or what ultimately will bring this cycle to an end. Do we now have the extraordinary capability needed to fine-tune the system to make a cyclical expansion go on indefinitely? I doubt it, but it is hard for me to judge how long this cyclical advance will continue.

As far as short-term developments are concerned, I think the initial claims figures are showing that the economic expansion is weakening. The production figures are weakening. The purchasing managers' data that we are picking up across the country now suggest that this economy is soft. I don't doubt that weather is a factor here. I don't doubt that weather may be in the consumer confidence numbers we are looking at. I find the Conference Board numbers a little dubious. The sharp decline in those numbers looks exactly like the sharp spike that we had a couple of years ago, for which we could not find an explanation at the time. I don't know whether in fact there are sampling problems in the Conference Board survey. The Michigan Survey has a smaller sample but far better control, which suggests that we probably ought to be looking at that survey.

Nonetheless, commodity prices are weakening. The Journal of Commerce index, which has not been a bad measure of industrial prices, is showing much the same thing. One would not expect that weather per se would tend to have the effects on employment, production, and the like that one would see as a consequence of, say, the Blizzard of 1996.

Not irrelevant to this issue is the fact that economic activity in Europe is stuttering. I am not saying that a huge arbitrage exists between Europe and the United States, but there is some. It's very hard for a major industrial country such as ours to move forward with great alacrity while a significant number of our trading partners are experiencing sluggish or declining growth. Needless to say, neither the Canadian nor the Mexican economies are in great shape. Indeed, the Greenbook projections indicate that they are weaker than in the last Greenbook. And the more we look at what is going on in Europe, the more nervous-making it appears.

Finally, while I would not want to rest policy on this, it is by no means irrelevant that a significant weakening in U.S. economic activity is going to make a very important national policy trend toward budget deficit control more difficult to implement. Ordinarily, I would say that that is their problem and this is ours, but we should have a view that what is in the national interest is not irrelevant to the way we conduct our business.

I come to the bottom line that while I am not of the school that is getting terribly concerned that the economy is about to dip into who knows what, there is an increasing element of downside risks that I think we have to consider. Given what I have described as an overhang of secondary inventories, which I believe is there, the upside risks seem quite minimal. While I don't think the downside risks are all that large, the net downside risks feel high, given the level of real, short-term interest rates. In this type of environment, it would be wise in my judgment for us to move rates down 25 basis points. I have convened a Federal Reserve Board meeting after this meeting is over in which I will recommend that we move the discount rate down. But that is for later, and I would like to propose for your comments a reduction of 25 basis points in the federal funds rate. If the Committee were to accept that proposal, I think that a symmetrical directive probably would be wise. Yes, President Minehan.

MS. MINEHAN. I want to comment at somewhat greater length than usual because I seem to be constantly putting myself in positions that are at odds with one another. I think that 3 percent inflation or lower is a very good long-run target for this group. My operative definition of price stability is stability at low rates. I would take advantage of opportunities when costs seem low to move in the direction of pushing inflation down. That said, I think it's debatable whether there is any specific target below 3 percent that is preferable to staying at 3 percent. In that environment, it seems to me that to be opportunistic and to move against inflation when the costs seem low really involves moving less than might otherwise be required given the economic data, or not moving at all when a small move seems required. Right now, I think the correct course of action seems more murky than usual. There are underlying sources of growth that we talked about yesterday. Labor markets are tight by any traditional definition. There are some reasons to think that housing is not completely dead. I think your inventory stock arguments, Mr. Chairman, are very credible, but there are wealth effects from a booming stock market working in the other direction. Moreover, we have eased 50 basis points over the last six months; we have reversed last February's tightening; and there has not been time for the more recent easing actions to play out fully.

Finally, while we may have more headroom on inflation than traditional calculations would indicate, it is by no means clear that we do. The Greenbook projects some minor pickup in both the core CPI and the ECI. In fact, these upticks may be understated. So, while I do think there are downside risks and the expansion probably has reached a mature stage, if it were up to me I would buy a little insurance now that might enable inflation to move down slowly from 3 percent or at least hold the line at 3 percent through the next cycle. I would buy that insurance in the form of not moving now.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. In our discussions around the table, we talk on occasion about our ignorance, about how little we know about a lot of things such as lags, instrument variables, and so on. But at times I am impressed by the collective judgment of this group in assessing what is going on in the economy and knowing how to make the policy adjustments that are needed. Two years ago we started raising the funds rate well before professional economists in the business community, academia, and Wall Street were saying we should or even before our models and staff projections were indicating the need. Had we listened to some of those Fedwatcher views or looked at Blue Chip or staff projections, we would not have begun to tighten when we did. We tightened because we had information that told us, in the terminology that we use now, that the equilibrium real rate was rising, things were starting to move, and we made an adjustment that was appropriate.

A year ago at this time many of those outside observers were saying that we were going to be pushing the funds rate up to something like 7, 7-1/2, or 8 percent. Again, on the basis of our collective judgment we went to a 6 percent funds rate a year ago, but we said we were getting to the stop-out point. I supported that move with the idea that it was an insurance policy. I was not convinced that it was necessary, but in terms of potential errors it would be the least costly to correct. And given market psychology and other factors at the time, I thought that it was wise to raise the funds rate to the 6 percent level so long as we were willing to retrace that move if that insurance turned out not to be necessary.

So, I view what we did in July and December as simply having cancelled the insurance that we took out a year ago. In the meantime, I have a sense that the equilibrium real rate has moved down from whatever it was a year ago. Your description of household inventories--the stocks of real goods held by consumers--carries a counterpart in terms of attitudes toward financial assets and financial liabilities. If consumers believe they have reached the saturation point for the moment in their stocks of certain consumer durables, the counterpart is that they are going to be trying to reduce their financial liabilities or to increase their financial assets. They are adjusting their net financial positions, which is also consistent with the idea that the equilibrium real rate has moved down.

If I thought that the Greenbook/Bluebook projections were correct about a 5-1/2 percent funds rate producing a 3 percent inflation rate out through 1997, I would have to be arguing for raising the funds rate. The only way I can support reducing the funds rate is to be consistent and say that I don't believe those projections. I have to believe that we are in an environment where the inflation rate will come in lower than is indicated by either the central tendency of the Committee members' forecasts or the Bluebook/Greenbook projections. If that turns out to be wrong, then I will be out in front saying, "Let's get the funds rate back up because we simply were wrong." For now, I am comfortable with the idea that it is appropriate to move the funds rate down and see whether or not inflation in fact comes in at a lower rate.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I support the recommendation of alternative A, symmetric, for the reasons that you gave. I also found Jerry Jordan's intervention just now quite convincing as well.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I would not favor reducing the federal funds rate. I would refer to President Boehne's comment about our deeds speaking more loudly than our words. If you look at the members' economic projections for 1996, we are saying in effect that we are at potential. The midpoint of the central tendency of the Committee members' forecasts indicates that the economy is going to grow 2.1 percent in 1996. The CPI appears to have increased 2.7 percent in 1995, and the central tendency of the members' forecasts has a midpoint of 2.8 percent. The unemployment rate is equal to or slightly below the natural rate and is expected to be there at the end of the year. It seems to me that the Committee's forecasts speak very loudly and are in conflict with reducing rates at this time. I realize that we are in a period where it appears that the economy has some weaknesses. The staff forecast calls for 0.8 percent GDP growth in the current quarter. The question is whether or not that slower rate will be temporary. If it's temporary, then policy ought not be changed. We can't make that determination right now. We are disadvantaged by a whole host of things including a lack of data and insufficient time to model the new information. I see no reason to change now. It would seem to be the prudent thing, in fact the opportune thing, to wait a few weeks before we make a judgment.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I would prefer not to move at this time. We have an economy that is growing at about potential. There are continued inflationary pressures. They are not strong pressures, but I think we will be making little or no progress on inflation. I realize we are long into this expansion, but there is also a lot of noise in our current data. In my view, it would be wise for us to wait and gather more information to help us determine with more assurance where we ought to be and where we will be down the road. So, I think the wiser course would be for us to wait.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. One of the major reasons why monetary policy has been successful in recent years is that it has had a forward-looking approach to it. Forward-looking monetary policy means that we have to peer into the future, and I don't know anybody who can do that with 20/20 vision. There is always some mist out there through which we need to look. As I try to look out through that mist, my sense is that monetary policy is still on the restrictive side and that we are operating with our foot on the brake. And while I don't think this is the time to adopt a stimulative monetary policy and move our foot to the accelerator, I do think it is time to lighten our foot some on the brake in the context of an economy that in my view exhibits some downside risks. So, Mr. Chairman, I support your recommendation of a 25 basis point drop in the federal funds rate.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, the policy call this morning is a very close one. There is certainly a case for easing policy and you have made it. But I come out, probably not surprisingly, much closer to Cathy Minehan and Bob Parry. Cathy in particular expressed very clearly and eloquently in our earlier discussion the kind of thing I had in mind operationally. Beyond what she said, it's not at all clear to me yet how much of a real deceleration in activity is actually occurring. We have bad weather, government shutdowns, and structural changes in the retail sector all fogging up, in my view, the meaning of much of the recent information. Also, we have a lack of headroom in the economy, as I think many would agree, and at least some signs of a firming of wages. All those things incline me to caution. Sometimes I think inertia can be a good thing, and I am feeling the need for a lot of it at this point.

I hear Jerry Jordan's point, but I do think it needs to be said that it may be more difficult this year than in most other years to move the funds rate back up later if things don't go the way we want them to. We are going to get a lot of new information that hopefully will clarify the economic situation in the fairly near future, and I think we ought to look at it before we move.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. The current situation gives me some considerable pause. As I try to look at the real interest rate situation, Charts 4 and 5 in the "Financial Indicators" package don't suggest to me that real rates are particularly high, at least relative to history. There may be an opportunity here, were we to do nothing, to do a bit better on inflation. The mechanism that I have in mind would be through a stronger dollar than we now anticipate and what that would mean for inflation--recognizing, of course, that we can't really forecast exchange rates. They are far more a hope than a certainty. On the other side of this coin, I am certainly convinced that we cannot halt turning points in the economy, or at least I can't. As I said before, I am pretty convinced that the current quarter and perhaps the next quarter will be rather soggy based on inventory considerations and the time it will take to work through the inventory adjustments. Moreover, something that looks soggy could turn out to be something worse. The bottom line is that in this environment, and recognizing that I can't halt turning points, I find your insurance argument persuasive and I would go along with a 1/4 point reduction in the federal funds rate at this time.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. Like others around the table, I would not like to see us step back from our tough, long-term stance against inflation. I would not support a further easing at this time unless the risks were quite clearly on the side of further weakening in economic growth or we judge that we have a much more favorable inflation setting and see an economy that may be growing somewhat below potential. Although most of us see only moderate growth in the period ahead and some recent data suggest the need for added caution about how things may unfold, I do not yet have the sense that we are about to see a major stalling of the expansion, although the risks clearly seem to be greater on the down side. At the same time, I am increasingly convinced that we have achieved a much more favorable inflation environment that gives us some latitude for a modest additional easing without any substantial risk of a prospective deterioration in inflation. As policymakers, we must always try to differentiate between temporary and longer-lasting influences. In my view, there is a good deal of evidence that the favorable changes that we see in inflation expectations and behavior are indeed persisting. On that basis, I would support a modest easing of 25 basis points at this time.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I support an easing of 25 basis points with a symmetric directive. I think it is important to take out some insurance against the downside risks. I am a bit more optimistic than the staff forecast that we can continue to see some progress on inflation. In addition, based on a fairly flat yield curve, I continue to think we are a bit behind in making downward adjustments. So, it would be a good idea in my view to go ahead and ease 25 basis points today.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, last year I was predicting that we would see a very substantial change in the stance of fiscal policy. I was wrong. That has been the big surprise to me since the last meeting. Three weeks ago I was betting that today we would see a long bond rate on the order of 6.50 percent because it seemed to me that the markets also had realized that we were not going to get the fiscal action expected earlier. I was very interested in Don Kohn's estimate that the magnitude of what we are talking about here would be equivalent in this language to a reduction of about 100 basis points in the equilibrium real federal funds rate. So, it seemed about right for bond market rates to back up to 6.50 percent on a realization that the odds of some fiscal restraint agreement had been reduced from, say, 90 percent to 50 percent. The market didn't react that way; the long bond rate stayed around 6 percent. I think the reason for that, I forget if it was the two-step or the three-step--

MS. MINEHAN. The do-si-do!

MR. LINDSEY. Or the do-si-do. I think the market perceived that near-term economic conditions were deteriorating rather dramatically. It is probably true that that is happening. As I have said, conditions in various sectors of the economy are much worse than we thought, and that is what the market was seeing. Hence, what I would normally interpret as a reason at the very least to stop easing and perhaps even a reason to move toward tightening, i.e., the breakdown of the budget negotiations, is overwhelmed by other factors. The failure of bond market rates to move up 50 basis points suggests to me that even a reduction of 25 basis points in the real federal funds rate would still be less of a move than the market is calling for and therefore is consistent with the strategy that Don Kohn outlined in his memo about taking advantage of deflationary situations. Cathy, you raised that in your discussion. I would say that given the failure of the market to act, the funds rate is probably at least 50 basis points too high right now. By splitting the difference at 25, I think we are buying a little insurance on the real side and we are at the same time taking advantage of what might be an opportunity. I hate the term "opportunistic strategy," but I guess that approach is consistent with what is termed an opportunistic strategy to reduce inflation. So, I support your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. The other day Ed Yardini, in one of his newsletters, said that we were going to be cutting interest rates this year--either early in the year to head off a recession or later in the year to try to bring the economy out of one. The first alternative seems much more desirable to me. I believe that the risks are very unbalanced toward the downside, as you have indicated, Mr. Chairman. We do have to be forward-looking and we can't wait to be absolutely sure about how the economy will evolve. Although I am not a global thinker, as Business Week pointed out this week, both the economics and the policy moves abroad make it easier for us to make a modest easing move today without adverse consequences to the dollar. In July and December, we cancelled some insurance against a rise in inflation. Right now, a 1/4 point insurance policy against a recession would be in order. I agree with Larry Lindsey that we probably could justify a greater move and a 1/4 point move now is sort of dragging our feet. It is therefore consistent with opportunism and our long-term inflation objectives. I agree with your proposal.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Where is a vote when you need it? [Laughter]

MS. MINEHAN. I know how you feel, Tom!

MR. MELZER. Like Cathy, I would favor alternative B. I would favor it strongly. One of the factors is the Greenbook forecast of rising inflationary pressures in the consumer price arena and also in labor markets and that is consistent with some of the anecdotal evidence. Nobody has mentioned it, but we have had PPI increases of 0.5 percent in each of the last two months. So, there is some reason to be concerned about inflation even though I have heard very little expression of that concern. There are some straws in the wind with respect to rising inflationary pressures. Secondly, I think it is pretty clear that 3 percent inflation is embedded in long-term expectations, and I think such inflation is too high. Third, I am not at all sure that monetary policy is still in a restrictive posture. Don Kohn has talked about the difficulty of assessing just what the real equilibrium funds rate is. Certainly from the perspective that I have used over time, and this is useful only in longer time frames, the monetary aggregates and the credit markets and so forth are not sending the message that policy is in a restrictive posture. For those who want us to be judged by our actions, I think this action says that we are not interested in lowering inflation and inflation expectations. The ultimate reaction of higher yields in the bond market over time could be disquieting to those who are concerned about the performance of the economy in the short run. I have no way of predicting what is going to happen to long-term interest rates, but it is not outside the realm of reason that over time after markets digest this action we will find that we have not taken a step that will lead toward lower longer-term yields.

Lowering the discount rate makes a bad situation worse by underlining this move. In my view, there is no reason why the funds rate can't be on top of the discount rate or for that matter go through the discount rate. In fact, when one looks at what is going on with these sweep accounts and the way the supply of reserves is shrinking, for us to have a discount rate that creates an incentive to borrow does not make any sense. So, I would not reduce the discount rate. Thank you.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Mr. Chairman, I support your proposal and I agree with your assessment of the risks. As I have argued, I do think some further adjustment is needed to achieve that elusive neutral monetary policy. From my perspective, in spite of the fact that we did make downward adjustments in the funds rate in July and December, all we have done thus far is to offset the decline in inflationary expectations. That leaves the real rate at about its February 1995 level, which was a real funds rate that I think most of us considered to be consistent with braking the economy. History has borne out the fact that we did brake the economy. I agree with the assessment that our foot remains slightly on the brake and we ought to remove it. How much our foot is on the brake is an extremely tricky call from my standpoint. The alternative simulations presented in the Greenbook certainly caution us that we would be running a very significant inflation risk if we were to adopt the easier alternative and cut the funds rate by a cumulative 100 basis points. I absolutely concur with that conclusion. Such a cut would incur a tremendous risk. I would not envision anything of that sort. But is a 25 basis point cut reasonable? It is tremendously hard to gauge whether or not it is reasonable. One thing that I found myself doing to try to get a sense of whether or not this is a move within a reasonable range is to look at that Taylor rule chart in the "Financial Indicators" package. What that shows is that, using Taylor's rule as he proposed it, we are currently at the high end of a reasonable range of values. Looking at our behavior now in terms of our own past behavior, we are well within the ballpark of our past behavior. From that perspective, current policy is not overwhelmingly tight, but certainly a further downward adjustment of 25 basis points would still leave us well within the range of our past behavior. It would not be a major move inconsistent with what we have done before. Again, that would not represent an opportunistic approach, but one designed to bring inflation down. So, I certainly support this move.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I agree with those who feel that the economy is probably all right, but I also think that the downside risks clearly are elevated. I also believe that it is quite likely that the equilibrium federal funds rate is lower than it was earlier. Consequently, a somewhat lower rate is not inconsistent with what the Committee's goals have been all along and will continue to be. With the inflation outlook as good as it is for the near and intermediate terms, all of this leaves us with room to move, and I support your recommendation as an insurance policy.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I would wait. It's interesting that the three M's on this side of the table who voted at the last meeting would all come out the other way this time.

MS. MINEHAN. We used to vote!

MR. MOSKOW. My reason is that we are forecasting the economy to be at potential output. There is a lot of uncertainty. A lot of questions are being raised about the short-term outlook, and we have talked about these. I don't think anyone knows for sure why the expansion has slowed, whether it is the Federal government shutdown or concern about Bosnia or the weather. The business friends that I talk to are all trying to figure out how to operate in this new, low-growth environment. I think Governor Phillips mentioned this factor yesterday. This is a real problem for people trying to operate businesses today because their environment is so competitive. My feeling is that the sogginess we are seeing now in the economy could be a short-term fluctuation that could correct itself. I don't see any urgency to move at this point.

On the opportunistic strategy issue, obviously some of us view this differently in terms of which side of the opportunistic strategy we are looking at. Cathy's presentation was near my view. I would view the current situation as an opportunity to make a little further progress toward price stability at this point, since there is some considerable uncertainty now.

Finally on the discount rate, I think that Tom Melzer had a very interesting suggestion. I remember a footnote in the Bluebook that said there really was no problem in having both the discount rate and the fed funds rate at the same level. So, I too would support that idea. If we are going to lower the fed funds rate, which it seems we are, the Board should give consideration to that idea.

CHAIRMAN GREENSPAN. Let's have a vote on a 25 basis-point reduction, symmetric. Would you read the appropriate language?

MR. BERNARD. With a reference to the discount rate?

CHAIRMAN GREENSPAN. Let's ask the Secretary of this Committee what is appropriate.

MR. BERNARD. This would be adding a reference to the discount rate at the end of the first sentence that would read, "taking account of a possible reduction in the discount rate."

MR. KOHN. I think we have done that before when this situation has arisen.

CHAIRMAN GREENSPAN. We have?

MR. BERNARD. Yes.

CHAIRMAN GREENSPAN. Okay, then do so.

MR. BERNARD. I will be reading from page 24 of the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks to decrease slightly the existing degree of pressure on reserve positions, taking account of a possible reduction in the discount rate. 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. Would you call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Boehne	Yes
President Jordan	Yes
Governor Kelley	Yes
Governor Lindsey	Yes
President McTeer	Yes
Governor Phillips	Yes
President Stern	Yes
Governor Yellen	Yes

CHAIRMAN GREENSPAN. You have until February 7th to submit to Mike Prell any changes you would like in your Humphrey-Hawkins forecasts. Our next meeting is March--

MR. BERNARD. 26th.

CHAIRMAN GREENSPAN. 26th. Luncheon is at 12:30?

MR. BERNARD. 12:30.

CHAIRMAN GREENSPAN. That will be in Dining Room E.

MR. MOSKOW. Mr. Chairman, I had a question. Are you going to share with us the press statement that you will be making?

CHAIRMAN GREENSPAN. I am sorry, yes. Good for you. The relevant paragraph would read: "Moderating economic expansion in recent months has reduced potential inflationary pressures going forward. With price and cost trends already subdued, a slight easing of monetary policy is consistent with contained inflation and sustainable growth." That is followed by the usual boiler plate.

MR. MELZER. Do you care about consistency with the Greenbook forecast with respect to inflation?

CHAIRMAN GREENSPAN. The Greenbook forecast is a forecast of the staff.

MR. MELZER. I understand.

CHAIRMAN GREENSPAN. The Federal Open Market Committee listens to the staff with great reverence, [Laughter] but it then makes its decision.

MR. PARRY. How about the forecasts of the FOMC members?

CHAIRMAN GREENSPAN. The FOMC members' forecasts are estimates of the most likely outcome. Policy is based on the most likely outcome conditioned by a distribution of probabilities. If somebody could guarantee that outcome, I would say that insurance is unnecessary at this stage. I would think that implicit in our decision is the understanding that if the insurance turns out to be inappropriate, as some members have stated, it will get reversed as it should be.

MR. PARRY. So one can accept the forecast, but it's an insurance policy?

CHAIRMAN GREENSPAN. Yes. In other words, I find the forecast not an unreasonable maximum likelihood forecast. That is a factor that is relevant to one's view of the world, but it does not determine what the appropriate policy stance should be.

MS. MINEHAN. People may change their forecast?

CHAIRMAN GREENSPAN. Sure. Some of them might. I know one who will. [Laughter]

MR. KOHN. Mr. Chairman, a reminder: Under our usual procedures our announcement will be made at approximately 2:15 p.m. Particularly since there will be a luncheon before then, we have to be very careful not to allow any inadvertent word of today's policy decision to get out before the announcement. Peter Fisher pointed out to me that last time there was a story on the tape by one of our well-known Fed watchers that suggested that he might have known something. It was ambiguous as to whether he did, but we have to be extremely careful that knowledge of this decision stays with the people in this room until 2:15 p.m.

MR. LINDSEY. What's the time of the release?

MR. KOHN. 2:15 p.m.

MR. LINDSEY. Why don't we do it right now?

MR. PARRY. Why does it have to be at 2:15 p.m.?

MR. KOHN. The Committee would need to make some changes. I think in the past the Committee has wondered whether it wanted to have the market sitting there for hours wondering exactly what time the Committee meeting would be over and speculating, in the event of a delayed release, whether something unusual might be going on. There was some merit in regularizing the time of the release. The Committee could change that.

MR. BOEHNE. If we can't trust ourselves for 2 hours and 15 minutes, we have the wrong people in this room!

MS. MINEHAN. You have been eloquent all day, but that was your finest comment!

END OF MEETING