Meeting of the Federal Open Market Committee
March 26, 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, March 26, 1996 beginning at 8:00 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 and 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. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Lang, Mishkin, Promisel, Rolnick, Rosenblum, Siegman, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Mr. Reinhart, Assistant Director, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Stone, First Vice President, Federal Reserve Bank of Philadelphia
Messrs. Davis, Dewald, Goodfriend, and Hunter, Senior Vice Presidents, Federal Reserve Banks of Kansas City, St. Louis, Richmond, and Chicago respectively
Mr. Judd, Ms. Rosenbaum, and Mr. Rosengren, Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, and Boston, respectively
Mr. Bentley, Assistant Vice President, Federal Reserve Bank of New York

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CHAIRMAN GREENSPAN. Good morning, everybody. Some of us are slightly blurry-eyed, which is understandable. I appreciate your coming somewhat earlier. Would somebody like to move the minutes of the January 30-31 meeting?

SPEAKER(?). Move approval.

CHAIRMAN GREENSPAN. Without objection. Mr. Fisher.

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

CHAIRMAN GREENSPAN. Questions for Peter? If not, would somebody like to move to ratify his transactions since the last meeting?

VICE CHAIRMAN MCDONOUGH. I move approval of the domestic operations.

MR. LINDSEY. Second.

CHAIRMAN GREENSPAN. Without objection, thank you. Mr. Prell.

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

CHAIRMAN GREENSPAN. With respect to your last remark, has the decline in cattle prices been, as best you can judge, essentially a reaction to the increased feed costs that have crushed margins or is there a broader cattle supply cycle involved here? Do we know the answer to that?

MR. PRELL. I take it you are not referring to yesterday's--

CHAIRMAN GREENSPAN. No, I am referring to the fact that cattle prices have been falling in the face of rapidly rising corn and soybean meal costs, for example, and ranch margins have been coming down quite appreciably. The question I am trying to get at is whether the weakness in cattle prices is the result of premature unloading of herds, which in the past has often been the determining factor in such price declines.

MR. PRELL. I don't have a good answer. My sense is that a reduction in herd size probably has not begun in any significant way. That remains one of the uncertainties. It could be that the markets anticipate that such a development will occur in the not too distant future.

CHAIRMAN GREENSPAN. So a pickup in meat prices, should it occur, is still quite some time away?

MR. PRELL. Yes. We see that as more of a risk as we move out into 1997.

MR. HOENIG. Mr. Chairman, I think that is accurate. We think the depletion of herd inventories has just begun, at most, and meat prices probably reflect that expectation in the context of rising grain costs. The dominant factor is a strong supply of red meat that has not been liquidated yet.

CHAIRMAN GREENSPAN. Do you have any mad cows in your District?

MR. HOENIG. A lot of mad ranchers, but no mad cows! [Laughter]

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mike, you talked a little about PCs, and the Greenbook indicated that in recent history we have all underestimated the amount of investment in that area. I also saw The Wall Street Journal article on Monday. Is your reasoning as to why such investment is going to be weaker in the future similar to that in the article, or are there different reasons that lead you to that conclusion?

MR. PRELL. The article did echo a couple of the reasons that we stated in the Greenbook. Admittedly, we stated those reasons only very briefly.

MR. PARRY. Yes.

MR. PRELL. One was the remark about replacement demand. I certainly have heard this from people in the industry. They feel that in many cases businesses have acquired about all the computers they need. The question is how fast they are going to replace those computers, given the changes in technology. That was a central theme of yesterday's article. It also is clear that businesses confront an ongoing decision about whether to buy or to wait for the next round of technology. This is not something we really went into in the Greenbook, but it is one of the uncertainties in the forecast. We have gone through a number of product cycles. At times this has been a significant feature in our thinking--that perhaps people would hold off buying until the Pentium chip became available or some earlier version. In this case, the P6 chip that is just coming out might lead to another issue of timing. Basically, though, the industry seems to be mature enough at this stage--its penetration of the business market, in particular, seems great enough--that the movements in investment more generally are going to show through in computer purchases. If we are in a phase when the accelerator effects are no longer a big plus, we would expect that to show through more in the computer sector than it might have earlier when computers were still increasing dramatically their penetration in the business sector.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Mike, when you first gave us the projections for 1997 in the September Greenbook, the nominal GDP growth in that initial projection was a very hopeful path to me because it had nominal GDP growing just under 4 percent for the full year. That seemed about right to me. But in this Greenbook, your upward revision of nominal GDP by a full percentage point for 1997 jumped out at me. You now have it rising just under 5 percent, and I know your real output numbers have not changed that much. Even the CPI is only about 0.1 percent higher than you had it before. As I look at this puzzle and ask where the change is coming from, of course, it is all in the deflator. What changed your thinking so that you now have nominal GDP growing a percentage point faster in 1997 than you were projecting six months, or even four months, ago?

MR. PRELL. President Jordan, that's a good question. I do not have a ready answer for you. Obviously, the deflator has shifted more than the other price indexes.

MR. JORDAN. By a full percentage point.

MR. PRELL. That suggests an element of mix change here. It is conceivable that, on further investigation, we shall find that there is something we are not entirely comfortable with in these numbers. So, I shall take that question as something for us to investigate before the next round.

MR. STOCKTON. This does not answer the question either, but one of the reasons why the deflator is higher now than it was back in September is the shift to the updated base year. That has the effect of tending to raise the deflator and to lower GDP growth. That does not explain why nominal GDP is a percentage point higher than it was before, but it does explain why the deflator might be a bit higher.

MR. PRELL. I should have noted that. Because the nominal GDP is higher, there is a bit of a mystery here for us.

MR. LINDSEY. I'm glad Jerry pointed that out. When you construct the forecast, do you start with the nominal GDP forecast and work back?

MR. PRELL. No, but in the course of a forecast where one needs to align both the income and the product sides of the accounts, the nominal totals are relevant. We should not end up with numbers that don't make sense.

MR. LINDSEY. Right. I am fairly startled at your answer. That is why I am asking the question as to how the nominal falls out. I would think that you would start with a monetary policy forecast that would determine a nominal GDP--Don is shaking his head, so I have it wrong. Tell me exactly.

CHAIRMAN GREENSPAN. It is a simultaneously determined system.

MR. LINDSEY. But you have a full percentage point change in nominal GDP--

CHAIRMAN GREENSPAN. It means that somebody's "add factor" changed very substantially.

MR. LINDSEY. Well, all right, this burst of nominal GDP was the way of reconciling things that did not add up in the model.

MR. PRELL. Let me remind you that the observation was about a forecast made last September. That September forecast was put together prior to a total revision of the national income accounts. Some of those revisions did affect nominal GDP going back historically. I don't want to go too far here. I am not certain.

CHAIRMAN GREENSPAN. But they did. There were significant changes in nominal GDP.

MR. PRELL. Right. But the fact is that the largest change in these nominal GDP forecasts for 1997 was between September and November. There has been a further upward creep that accumulates to a significant difference from September to now. But if one looked at the changes just over the past couple of months, one would see a pretty small creep and it would not be quite so shocking. We have to go back and look at this in light of the fact that, as Dave Stockton pointed out, we really did have a total change in the accounts in this period, both in terms of data whose history was revised and concepts that have changed.

CHAIRMAN GREENSPAN. Any further questions?

MR. JORDAN. Can I just follow up on that as regards further work? Mike, had you said in response to my initial question that you had been assuming a monetary policy indexed by a 6 percent funds rate --or, I guess, it was 5-3/4 percent at that time--and that the 1/2 percentage point drop since then is what did it, then we could have talked about that, or a change in fiscal thrust, or something. Or, coming at it from a different framework, if you had said that monetary growth is now producing much more total spending, then we could have talked about that change. So, the underlying question that has to be embodied in your answer once you come back to this is that at the end of the day we are still trying to decide whether a 5-1/4 percent funds rate is too high, too low, or just right.

MR. PRELL. You are getting into a fundamental question about the whole forecast, and I am focusing more on the fact that, in particular, our consumer price forecast looking out into 1997 did not change a great deal. Our real GDP forecast has not changed much either, but we have switched from 1987 dollars to chain-indexed 1992 dollars. Allowing for that, our real GDP forecast for 1997 is stronger than it was back in September. You have just pointed to a couple of factors that would be relevant to thinking about that: one, we have a lower funds rate path than we anticipated at that time; two, we have removed some of the fiscal restraint that was in the forecast looking out through 1997. So, there is a consistency in that respect. I was focusing more on this narrower technical question and this relative movement in our price measures. That raises an interesting question.

CHAIRMAN GREENSPAN. Any further questions? If not, would somebody like to start the roundtable? President Parry.

MR. PARRY. Mr. Chairman, economic growth in the Twelfth District has picked up after a brief lull at the end of last year. Over the past 12 months, growth in the District has been substantially more rapid than in the nation according to recently revised employment figures. The increased pace of activity largely reflects a pickup in

California, where job growth also has exceeded the national figure over the past year. It is encouraging that as the economy in California has improved, job growth has become more broadly based. During the early stages of the state's recovery, job growth was concentrated in several sectors that were growing even more rapidly nationwide, such as business services. During 1995, these sectors continued to grow rapidly but accounted for a smaller share of state job growth. Several key durable manufacturing sectors, primarily electronics, outstripped the rest of the country.

In the rest of the District, employment has been very robust in Nevada, Utah, Oregon, and Arizona, which continue to be among the five fastest growing states. Washington's economy slowed over the past year, but the state's outlook for the rest of 1996 appears stronger in part because of increased orders at Boeing. District employment has been particularly strong in the services, trade, and construction sectors. Manufacturing employment in the District has expanded by just over 1 percent over the past 12 months. This compares favorably, of course, with declining manufacturing employment at the national level. However, declining semiconductor demand may slow District manufacturing growth in the near term.

Turning to the national economy, as Mike Prell stated, the substantial amount of economic news released since our last meeting has taken us on a bit of a roller coaster ride. Nonetheless, it probably has had little net effect on the outlook for this year. Assuming a constant funds rate at the current level, I would expect to see real GDP growth perhaps slightly above its 2 percent potential rate in 1996. Of course, the GM strike will have some near-term effect on GDP volatility. What I find most striking about the current situation is the consistency of many inflation indicators. They all seem to be pointing toward core CPI inflation remaining around 3 percent, roughly the same rate as in the past 3 years. For example, both the unemployment and the capacity utilization rates are near common estimates of their natural rates. Also, the employment cost index rose by nearly 3 percent in 1995; this would be consistent with about the same increase in the CPI if experience over the past 15 years is a guide. Finally, inflation expectations as measured by Ed Boehne's survey are around 3 percent. This isn't surprising given the inflation indicators I have mentioned as well as experience with inflation in recent years. So, if we maintain the current stance of policy, it appears that conditions in the economy are likely to maintain roughly the status quo when it comes to inflation over the next two years. Moreover, if we do end up seeing a change in inflation, it is more likely to be on the up side since measures of unemployment and unused capacity appear to be slightly on the low side of their natural rates. Thank you.

CHAIRMAN GREENSPAN. Thank you. President Broaddus.

MR. BROADDUS. Mr. Chairman, the information we are getting from our regional contacts has been decidedly more upbeat in recent weeks. Both our latest District manufacturing survey and our retail service sector survey showed broad-based increases in activity for the first time in about five months. Some of this news obviously reflects the rebound that occurred in February from the weather-related weakness in January, but not all of it was a rebound. We have made some inquiries beyond our normal survey questions, and it seems likely that at least some of the increase in the activity that we saw in February reflects a more fundamental strengthening of aggregate demand in our area. This apparent firming also is evident in what I would describe as the noticeably more optimistic tone of the comments at our board meeting a couple weeks ago and at our Small Business and Agricultural Advisory Council meeting last week. For example, who is on the boards of a couple of large retail chains including one national retail chain, has been generally pessimistic about the outlook for this sector ever since the beginning of last year. a couple weeks ago, though, she said she was guardedly optimistic about the prospects for the retail sector. That really got our attention since it was at variance with what she had been saying until now. who runs a multi-state building materials chain supported her assessment. In fact, most with only one exception reported greater optimism in the retail sector at that meeting. Elsewhere, real estate activity has been rising noticeably in most of the major urban areas of our District. The housing market in Richmond is said to be the strongest in five years.

Turning to the national picture, we would agree with the Greenbook's increased emphasis on the upside risk in the current outlook. Obviously, we would not want to put too much store in one or two monthly economic reports. The February employment report, in particular, could easily be revised downward somewhat. But even if it is, I think the current situation is striking in that that report and most of the other recent monthly reports on industrial production, car sales, and other retail sales are stronger than we had anticipated. That is, they are all speaking with one voice. Although I would agree that we don't yet have unambiguous evidence that aggregate demand is now growing more rapidly than potential output, I think it is clear that we don't have a lot of upside headroom. By all accounts, the economy has been operating for a while now somewhere in the neighborhood of nonaccelerating inflation capacity or whatever you want to call it.

With respect to inflation, I am not unduly concerned yet about the uptick in the core CPI that we have seen so far this year, since it may reflect continuing seasonal adjustment problems that we have had with that series in the early months of several recent years. Nor would I want to give too much weight to the recent increases in some measures of labor compensation, which were mentioned in the Greenbook. But as Bob Parry just pointed out, these indicators are generally moving in the same direction. That makes me nervous, especially against the background of the recent acceleration in money growth and even more especially against the background of the really spectacular rise in both intermediate- and long-term interest rates since the beginning of the year including, of course, the extraordinary 25 basis point jump in the 30-year bond rate on the day that the February employment report was released. Of course, until we have an inflation-indexed bond, we are never going to know for sure, when we get a runup in rates like this, what part of it is real and what part is an increase in the inflation premium. But with the economy currently operating near full capacity, that may well be a distinction without a practical difference because even if all or most of the increase were in real rates, if the economy is strong enough to push real long-term interest rates up this sharply in this brief period of time, it may not be long before that strength presses on capacity with longer-term inflation consequences. Indeed, if one were a pessimist on this, one could actually read the recent data as suggesting that something like this scenario may already be playing itself out. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Thank you, Mr. Chairman. What is remarkable about the economy in recent months is its resiliency. Despite government shutdowns, severe weather, and strikes, the national economy is still on track for moderate growth and low inflation. The economy is also experiencing what could turn out to be its greatest restructuring since the Industrial Revolution, with all the attendant insecurity that comes at the personal level from change of this magnitude. That, I think, makes this resiliency all the more remarkable. My sense is that the upside and downside risks are about evenly balanced for the period immediately ahead. The inventory correction appears to be well along. The consumer, while somewhat stretched in terms of debt, still appears to have ample purchasing power for sustainable spending growth. And the strengthening in residential construction reflects positive consumer sentiment. One major builder told me, for example, that some of his strongest sales are in areas heavily impacted by the layoffs at AT&T.

On the wage/price front, I think we need to be watchful, but we also need to keep in context where we are. We are more than five years into an economic expansion. We have seen little if any acceleration in inflation. I must say as I look back through the pipeline, there really are few signs of an acceleration of inflation at this point. The positive aspect of this expansion is that after more than five years we have not had any acceleration of inflation. My sense is that we are not at the point where that is likely; I think inflation will continue to be subdued for the period ahead.

Turning to the region, the Philadelphia District economy continues to lag the nation. Pennsylvania in particular is a major laggard. New Jersey growth rates are more promising, and I think the outlook there is brighter. Delaware continues to be the little jewel that it is in the regional economy. What has impressed me most in recent weeks is the surge in new housing sales in the District. For the better builders, this surge has been apparent for a couple of months. Even in the dead of winter, the traffic into showrooms was very high, and people were more than looking; they were signing contracts. Now, if you talk to the builders who are not the most competitive or the leading builders, they also are feeling the upturn in activity. It is difficult to find a builder in the District who is not feeling that. I think low mortgage rates and the perception that mortgage rates have bottomed out have been a stimulus. But at least for the Philadelphia District, with existing home sales much slower than new home sales and population growth slow in the mid-Atlantic region, I think one has to be skeptical about the sustainability of the rapid increase in new home sales. Nonetheless, for a District that has been rather sluggish for a long time, a spur in residential construction is welcome at this point.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, the economy in the Kansas City District continues to grow at a fairly strong pace, with recent developments pointing to greater strength now than I reported at the last meeting. Recent revisions to our state employment statistics showed stronger job gains in the Tenth District in 1995 than previously thought, running at a year-over-year rate of about 2.7 percent. Moreover, all seven states in the District added jobs at a fairly robust pace in January. Principal sources of our strength are in the manufacturing and construction sectors. District manufacturing continues to operate at high levels of capacity, and our general aviation industry is doing very well right now. Our survey of factories throughout the region also indicates considerable optimism about the next six months. In addition, our directors are reporting continued strength in commercial construction and some expansion in housing activity. As reported to us, loans are readily available at our banks to both commercial and other borrowers.

Although District activity is generally strong, there are a couple of weak spots. The region's energy industry remains lackluster despite some higher oil and natural gas prices in recent months. Another weak area is agriculture, where a continued slump in cattle prices and continued dry weather are hurting the income prospects for many in that sector. However, those farmers who do harvest a crop should do well in light of the high grain prices right now.

Wage and price pressures still remain modest in the District, although labor markets appear to continue to get tighter. More of our directors are reporting tight labor markets for entry-level and some skilled jobs as well. Prices of raw materials are showing some increases.

On the national front, I think that the fundamentals remain strong, and we expect, as the Greenbook does, growth at about the potential rate of 2 percent. With the capacity in the economy being used at its current level, the rise in core inflation from 1994 through 1995 probably will continue, and I think that is a risk we have to keep in mind as I have said before. That concludes my comments.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. For the most part, the Eleventh District's economy is showing reasonably healthy overall growth, but as always there are a few pockets of weakness. In the last ten days, we have met with our board of directors, our Financial Institutions Advisory Council, and our Small Business and Agriculture Advisory Council. The messages we got are pretty much the same. Our urban areas--particularly Dallas, Houston, and Austin--are doing quite well, but the rural areas are hurting. Cattle ranchers and cattle feeders are having a disastrous year so far. Conditions are expected to get worse, and the fallout is affecting our smaller communities.

Once we get to the rest of the economy, conditions look a lot brighter. The stabilization of the Mexican economy has given an additional boost to our export demand. Retail sales along the border area have improved a little lately. Demand for computer chips and semiconductors remains strong, and five out of the six large chip plants under construction in the Eleventh District will produce customized chips. Whether we are in the early stages of an overexpansion and excess capacity remains an open question, but more and more people are beginning to express the view that when the next big shoe drops and affects the economy, it will be a boot filled with computer chips.

Our construction sector is quite strong and some markets are beginning to heat up, particularly the industrial warehouse market where there is talk of 6 million square feet of speculative warehouse space coming on line in Dallas alone. We also are hearing discussions indicating that the office market is back to where money is chasing office buildings. While this may be a little exaggeration, we have been hearing for nearly a year that the office market has changed from a tenants' market to a landlords' market.

The picture for the energy industry has been mixed. Oil and gas extraction continues its downward trend in spite of the high-tech drilling activity that I referred to at the last meeting. But the oil field machinery industry is expanding thanks to drilling demand. The petrochemical industry has been adding to capacity in spite of recent soft demand and low prices. Labor shortages continue to be mentioned as a constraint on further growth in a few industries. Wage and price pressures seem to be contained. Overall, the District shows moderate growth that probably is well above national growth rates.

On the national economy, it seems that we are getting the soft landing we have been striving for, though perhaps the runway may be a little shorter than we like. The risks seem reasonably well balanced, but that would not have been the case in my opinion had we not reduced the fed funds rate at our last meeting. With respect to the Greenbook, I remain somewhat more optimistic than the staff with regard to the outlook for both real growth and inflation.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, the New England economy is looking more and more like the national economy, even better in a couple of respects. The small revision in how we are looking at things comes about as a result of changes in the benchmarks for payroll data, which other people have commented on. The changes have shown New England's rate of growth over the past year to have been about the same as that for the nation. Before that, we thought our regional economy was lagging. The picture may change a bit when the national figures are revised this summer, and New England still has not recovered all the jobs it lost during the recession. Nonetheless, the latter episode is beginning to look more and more like a rather severe, one-time negative shock rather than the beginning of a new, slow-growth regime. New England's recent growth, while modest, reflects a continuation of longer-term trends in each of the states. New Hampshire is enjoying the strongest growth. Connecticut continues to lag behind the region while Rhode Island--the basket case as I have referred to it in a couple of presentations over the last several months--now appears to have been holding its own at least with regard to job formation over the past year. Unemployment in the region is low, only 5 percent for the region as a whole, with New Hampshire now down to 3 percent.

Surprisingly, in view of the low unemployment, hourly earnings are increasing at an annual rate of only about 2 percent compared to 3 percent for the country as a whole. Anecdotally, however, our contacts indicate that there is a little more wage pressure than these numbers would suggest. Most of them are planning wage increases in the 3 to 5 percent range, where in prior months they had been contemplating 2 to 4 percent. One contact observed that people are no longer comfortable with wage increases covering inflation, and several others have commented on their difficulty in finding highly skilled computer workers and especially software engineers, for which there is a crying need. Unfortunately, laid-off defense workers are not always seen as suitable for seemingly comparable civilian openings.

Defense cuts continue to be a drag on the New England economy, with the region experiencing larger cuts in defense-related employment than the country as a whole. The pace of these cuts is slowing, however, and over the next several years we believe the fallout in defense employment should be mild in the region. Despite defense cutbacks, total manufacturing employment has fallen less in New England in the past year than in the nation. No areas of strength stand out. Rather, employment seems to be increasing slightly in a variety of traditional industries such as lumber, metals, food, and paper and to be stabilizing in nondefense high-tech industries. Moreover, conversations with a variety of manufacturers suggest that 1996 is likely to be similar to 1995. Business is not great, but a number of contacts describe new orders as pretty good or decent. Indeed, some companies that pared employment in 1995 are now planning modest increases in staff, and several contacts report efforts to increase prices of final goods.

Retailers continue to worry about competitive pressures and consumer anxieties. However, several contacts with stores in other regions observed that their 1996 results have been better in New England. Moreover, some of those who complained most bitterly in the past now report that their 1995 profits were up rather substantially rather than down as they had suspected.

Turning to the national scene, we agree with the Greenbook's assessment that the likely outcome for the next year or so is GDP growth at a rate near potential, with unemployment relatively unchanged, and some rather modest upward pressure on wages and prices. While I agree that the risks to this forecast seem balanced right now, there may be some reasons to believe that it is marginally subject to surprise on the down side. That is especially because it includes very optimistic projections for both residential investment and consumer durables, at least when compared with several other forecasts, and because of the upward trend in interest rates, particularly since the employment report released in early March. I would view the possibility that the interest-sensitive sectors may be weaker as a potentially moderating influence on the upward tick, albeit small, in inflation that is incorporated in the forecast. If in fact we do see a March employment report that is anywhere close to being as strong as the numbers we saw for February, I think we would have to take rather decisive steps at that point to keep the expected uptick in inflation from becoming a surge.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, economic activity in the Midwest remains at high levels, with some sectors relatively strong and others showing signs of moderate weakening. In general, housing and retail sales continue to perform well; manufacturing is growing slowly; and labor markets remain tight. A major concern has been the Dayton brake plant strike against General Motors. The strike has had a disproportionately large impact on the Seventh District where half of GM's laid-off assembly workers in the United States are located. Moreover, reports have been increasing of related layoffs at District suppliers of auto parts such as engines, transmissions, brake systems, exhaust systems, and electrical systems. Steel workers in Wisconsin and Indiana also have been affected. First-quarter production has, of course, been depressed by the strike and the layoffs. While some of the lost production will be made up now that the strike has been settled, GM will use the strike to reduce inventories of 1996 model cars and may wait for their new 1997 models to rebuild their car stocks. For light trucks, GM plants were already running at close to capacity, so it is not clear that light truck production in the second quarter will be much higher than it otherwise would have been. The strike does not appear to have affected sales of light vehicles because inventories of most GM car models were above what the industry considers desirable, and we understand that light truck dealers in the District have already sold out their first-quarter allotment. Preliminary reports indicate that sales of light vehicles so far this month are running at about a 15 million unit annual pace or a bit better, which implies a 14.9 or 15 million unit rate for the first quarter, slightly above the latest 12-month moving average.

District retailers indicate that sales have improved from the weak results reported for January. Sales in February were somewhat stronger than in January but the bounceback was not as noticeable as it appears to have been elsewhere in the nation. I would note that the Midwest was hit by bad weather in February rather than January and that was a factor. Retailers report that sales so far in March show about the same increases from last year as they had in February. Contacts said it was too early to discern any noticeable impact on sales in communities with a large GM presence and actually none was expected. Reports indicate that Midwest consumers are less in debt and delinquency rates are generally lower than those in other parts of the country. Therefore, consumers are better able to take on additional debt.

On balance, it appears that the level of housing activity is still fairly strong in most parts of the District. Housing starts in the Midwest fell in February, but that appears primarily to reflect colder-than-usual weather. Permits have held up and homebuilders remain optimistic. The District does not seem to have an overabundance of either new or existing homes for sale.

In labor markets, the issue of job security continues to be a factor mentioned whenever we try to reconcile reports of tight labor markets with continued subdued upward pressure on wages. Labor markets remain tight throughout the District, and the unemployment rate in our states is still averaging about 1 full percentage point below the national average. Both total and manufacturing payroll employment increased in January, in contrast to what was posted nationally for that month. Reports indicate that the use of temporary workers by manufacturing firms has picked up since the end of 1995 as well.

After taking weather differences into account, it appears that manufacturing activity in the District continues to do better than in the nation as a whole, although less so than in the past as we observe Midwest manufacturing activity converging to the national experience. For many of our major durable goods producers, activity has been flattening or edging down from the record or near-record levels of last year. Purchasing managers' surveys from Detroit and Milwaukee indicated expanding activity in both January and February. However, the Chicago survey moved from indicating expansion in January to contraction in February. Confidential information we have received indicates that the Chicago Purchasing Managers' report to be released this Friday, March 29, will show the index increasing from 44.9 in February to 47.3 in March, suggesting that manufacturing activity has continued to contract in March but at a somewhat reduced pace. The weakness evident in the Chicago report for March does not appear related to the GM strike because relatively few workers were laid off in Illinois and the survey was taken before the strike had gained much momentum.

Farmers in the Midwest are gearing for a sizable increase in spring plantings, especially corn. Analysts expect combined corn and soybean acreage to be the largest in over a decade, up 7 to 8 percent from last year. Crop input prices are up, especially for fertilizers, but supplies are reported to be adequate to accommodate the increased acreage. More generally, however, most reports on prices still seem to point to little upward pressure or declines for a broad range of items such as aluminum, copper, paper, steel scrap, and steel mill products. The price component of the Chicago Purchasing Managers' survey for March continued on a downward trend and actually indicated declining rather than moderating increases in prices for the second straight month.

Turning to the national picture, we do not have any serious disagreements with the Greenbook, although we still are slightly more optimistic on inflation. One reason for our marginally greater optimism is that real GDP is estimated to have grown only 1.4 percent last year. Obviously, there is a lot of uncertainty surrounding that estimate, but our analysis indicates that the output gap was about nil prior to 1995 and if our estimate of potential output is accurate, some slack has built up in the aggregate economy, which should reduce the likelihood that inflation will accelerate this year.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. Looking through the anomalies of the last several months, it appears to us that the Sixth District continues to grow at a moderate pace. The bad weather is likely simply to have increased the amplitude of the seasonal pattern in activity rather than to have exerted some lasting effect on overall performance. When we look beyond these distractions, we think that the Southeast will continue to outperform the rest of the nation, but probably by a smaller margin than has been the case in past years. As before, this improved performance is based on continued migration of both businesses and people into our region.

Retail sales grew very unevenly in the District during the first three months of the year, with a notably slow start early in the year, especially in the northern part of the region where weather was clearly a factor. More recently, sales of many goods, particularly apparel and autos, appear to be much improved.

Home sales in our area have been particularly brisk in early 1996 after a slow fourth quarter. Much of the acceleration is reported to be in starter homes at the low end of the market. Both residential and nonresidential activity remained surprisingly resilient throughout the bad weather period. Commercial real estate markets continue strong throughout our region. Outside of Atlanta, the industrial market is the most active, with lots of construction of warehouse and distribution facilities. The retail construction component finally seems to be slowing in some areas that have reached saturation, and that is something we have been anticipating for some time. In Atlanta as you might expect, Olympic activity has kept construction at a very high plateau, starting last year. The entire town is a mess. Bulldozers and paving equipment have the right-of-way over cars and people. We promise to be ready when the time for the Olympics comes, but if you can avoid it, please don't visit us until later in the summer.

According to our regional survey of manufacturers, manufacturing activity actually eased off a bit in February, but at the same time expectations for the next six months are reportedly improved. In our District, the strongest sector is durables, while nondurables, especially paper, are lagging, and the apparel industry continues to shrink. In fact, the apparel industry is in secular decline and has lost almost 35,000 jobs nationwide over the last year. We don't expect those jobs to come back any time soon.

Payroll employment expanded moderately in January following three months of only modest growth. But for the last 12 months ending in January, payroll growth in our region was 3.4 percent, more than double that of the nation. There continue to be scattered reports of wage pressures and labor shortages, and those are in isolated pockets in our District. At the same time, both our manufacturing survey and business contacts report minimal price increases in both raw materials and finished goods.

As far as the national outlook is concerned, the unusual circumstances of late 1995 and early 1996 certainly have muddied the waters considerably and left us with more uncertainty than would usually be the case. On balance, however, I believe the economy has been relatively resilient after taking account of those special factors early in the year. So, our forecast of continued moderate growth and moderating inflation is essentially unchanged. From where I stand, I see pretty solid underpinnings for moderate growth in household spending and investment, a return to inventory balance, and good export demand.

Except in the details, our outlook is very similar to that of the Greenbook. After a modest first quarter followed by a bounceback, I would expect a resumption of moderate growth in the 2 percent range. I still think that 2 percent is probably a little less than potential, so it may not come as a surprise that I am more optimistic than some with regard to inflation. In fact, I think there is a reasonable prospect that inflation could moderate over the next two years. It is unlikely that the moderation will be particularly dramatic or smooth, but I think there is a reasonable chance that the CPI could move closer to the 2-1/2 percent level rather than the 3 percent level that some seem to expect. I continue to believe that our policies and other factors have combined to create a more favorable price-setting environment that is both genuine and persistent. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. Our District economy has outperformed the national economy for a number of years, but I do not have the impression that that is continuing. If anything, District growth certainly has been less than that of the national economy in recent months. The principal areas of concern are the manufacturing and cattle industries. All the cattle producers with whom I have talked describe their industry as an unmitigated disaster. Having said that, I think the District economy in general is still fundamentally sound. Part of the reason for the slowing growth is a factor that I have mentioned before, namely, labor supply constraints. Labor markets remain very tight. There are a few more, but still scattered, indications of increasing wage pressures and a somewhat more aggressive attitude on the part of labor. In addition, I would say that consumer spending on both goods and houses has been healthy in the last couple of months.

With regard to the national economy, as has been the case for some time, I remain generally comfortable with the contours of the Greenbook forecast. I do think that the risks to the outlook may have shifted a bit recently, and I say this because as I look at the real side of the economy today, it strikes me as being in better shape than I had earlier expected it to be at this point. Therefore, I think there is probably less risk of prolonged weakness or even prolonged stagnation on the real side. By the same token, as I look at some of the potential indicators of rising inflation and in particular think about conditions in labor markets and labor attitudes, I sense that the risk of somewhat more inflation than at least I had earlier anticipated may also have increased.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. The Eighth District economy continues to expand. A few contacts noted some softening at the beginning of the year, but many expect a pickup as we move into the second quarter. Unemployment rates in District states tended to jump early in the year for weather-related reasons, but Missouri was a notable exception; the state enjoyed a very low unemployment rate of 3.4 percent in January. About 3,400 District workers were laid off because of recent strike activity against General Motors, and unofficially about 800 workers in related industries were affected. But looking forward, District auto production at Ford and Chrysler plants is expected to rise 4.7 percent in the second quarter. Loan demand, especially for commercial loans, is still strong in most parts of the District. Unseasonably cold weather produced significant damage to winter wheat in southern Illinois and catfish in the Mississippi portion of the District in February. [Laughter] It's a big industry!

Nationally, the economy is displaying some underlying strength. The February employment report was more than a simple rebound from a weak January. The pace of net job creation was averaging somewhat better than 100,000 per month over the last nine months of 1995. It seems plausible that the January data were depressed by about 300,000. Even if we count 300,000 of the February total as a rebound and add 100,000 for trend growth, the 705,000 February number still looks like a significant upside surprise of about 300,000 jobs. Maybe some of that increase will be revised away. Retail sales, factory orders, and housing starts also indicate underlying strength.

For those who look at the latest developments in the real economy as a trigger for monetary policy actions, I think it is clear that we moved last time without much new data; and when the data came in, they were contrary to what was expected. Some here referred to our lowering the federal funds target as buying insurance, but this was not a hedge in any usual sense. In fact, we were making a speculative bet on the nature of the incoming data. It is a bet that we likely lost now that the economy looks a lot more resilient and also a lot more inflation prone.

The press release accompanying the last move compounded the problem in my view by suggesting that the FOMC is complacent about longer-term inflation objectives. It read a bit like a victory statement saying in part, "with price and cost trends already subdued" when in fact we are still a long way from price stability and Q4/Q4 CPI is projected to rise in 1996. Furthermore, as others have mentioned, some recent data are worrisome, including the employment cost index for total compensation of private industry workers as well as benefits costs, which were discussed at some length in the Greenbook. The long-bond yield, as others have mentioned, also has increased more than 50 basis points since the last meeting. An important component of that yield, namely, longer-term inflation expectations, is a matter of concern for this Committee. As I have stressed before, despite FOMC pronouncements of a commitment to stable prices, market participants and professional economic forecasters do not expect lower inflation in the foreseeable future. These expectations are a large part of what is standing in the way of further progress toward price stability. The way to influence those expectations is for this Committee to announce a target path for inflation over the next several years that contemplates a reduction from the current 3 percent level. In addition, of course, we must take actions consistent with that path. An opportunistic approach will buy us no credibility whatsoever nor market behavior that reinforces our efforts to achieve our objectives. Thank you.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The economy of the Second District continues to underperform the nation as it lumbers along on its slow growth path. Recently, retail contacts reported that February sales rebounded to plan levels following the very disappointing January and the record blizzard. Senior loan officers at small- and medium-sized banks reported that demand for nearly all types of loans has strengthened over the last two months, with the largest increase developing in the consumer loan segment. Of course, we all know that the consumer loan debt level is a bit higher than we might wish. In the securities industry, a major investment bank reported a three-fold increase in pretax profits for the fiscal quarter ending in February compared to the same period a year ago, and our market soundings indicate that its competitors also seem to be having a robust quarter. The profits in that industry are an important contributor to income growth in New York State. Overall, the District's housing industry has remained weak in February and early March, but we have a glimmer of hope in the commercial real estate market, with continued improvement in the vacancy rates in midtown Manhattan. We continue to be concerned about the District and why it underperforms the nation. We are going to be moving even more of our research capabilities into that area and look forward to having a couple of meetings toward the end of the year: one consisting of economists will try to identify the problems and the other of policymakers will discuss what might be done to get the area growing a bit faster.

At the national level, our forecast is very similar to that of the Greenbook. The Greenbook, as you know, has growth at just about 2 percent in 1997, and we have it somewhat below that. Not surprisingly, therefore, our CPI forecast is more attractive, at 2.8 percent this year and 2.7 percent in 1997. We have the unemployment rate moving up some, in fact to about 6.2 percent next year. That is to some degree related to our view that the participation rate, especially by adult males, has been unusually low, and there might be some rebound in labor participation that would raise the unemployment rate. So, with the favorable data recently on employment, consumer sentiment, auto sales, retail sales, housing starts, and net exports, the major shift that we have made in our forecast is that we think that the risks to the forecast are now quite well balanced. At the previous meeting, we were concerned about the risks on the down side and therefore thought that the "insurance" easing, as the Chairman described it at the last meeting, was appropriate. Now we think that the forecast looks rather good and that the risks are quite well balanced.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. It seems to me that economic activity is tracking along the Greenbook path about as we had expected and hoped. I want to associate myself particularly with Ed Boehne's comment that the remarkable resilience of this economy has been the most interesting development recently. This certainly is not surprising, but it is highly gratifying. Perhaps the only surprise is the very early and rather strong reemergence of strength in the economy, and along with that a more credible upside risk and its mirror image, a little alleviation of the downside risk going forward. This seems to leave us with a high likelihood of a quite satisfactory economic performance in the period ahead. I agree with Vice Chairman McDonough that the risks appear to be symmetric, perhaps not terribly strong at this point, but it seems to me that they are moving in the upside direction. My main concern at the moment is that all of this looks just a little too neat and too pat. I can't quite trust it. We know that challenges are going to emerge, and I suspect they probably will arise somewhat sooner rather than later. We will just have to be alert to what those challenges turn out to be and when they are going to appear.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Thank you, Mr. Chairman. The progress of the economy over the last several months has been reminiscent of "the perils of Pauline," with blizzards, government shutdowns, threats of default on the national debt, strikes, and a frightening albeit brief dive in the stock market threatening the progress of our heroine. Nevertheless, the single most probable outcome at this stage is that this economy will survive its treacherous adventure and ultimately attain trend growth with stable inflation. I agree with the Greenbook assessment that the stage appears to be set for a rather sharp rebound in economic growth from the average pace in the fourth and first quarters. Considerable progress appears to have been made in reducing inventory overhangs, so there is a reasonable prospect that inventories will become a neutral factor in the economy in the not too distant future. Meanwhile, demand has held up surprisingly well in the face of a rather large inventory adjustment in the fourth quarter.

Over the longer term, a projection of near-trend growth through 1997 with roughly stable inflation strikes me as a plausible scenario, although there are some risks. On the negative side, I am particularly concerned at this stage about the possibility of a significant stock market correction. The current level of stock prices is not impossible, but it is increasingly difficult to justify in terms of fundamentals. Disappointing earnings reports could easily set off a correction. I am also concerned about the likely negative, albeit lagged, impact on housing and consumer durable spending of the very substantial increases in interest rates since our last meeting. I find the longer-term Greenbook projection of housing starts particularly optimistic in light of these increases. On balance, with intermediate- and long-term interest rates at their current levels, I feel less certain than the staff that trend growth is possible as we go out in the forecast period. But there are also some risks on the inflation front. While recent readings on average hourly earnings provide reassurance that wages are not accelerating, the jump in health insurance costs evident in the fourth-quarter employment cost index creates the worrisome prospect that these benefit cost increases may be poised to rise further. I don't think we should overinterpret one single report, but I do agree with the Greenbook's assessment that this is one of the risks going forward.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. The fog has lifted somewhat since our January FOMC meeting, and perhaps we are now operating only in patches of fog. I continue to believe that it will be well into the second quarter before we have a clear picture of what happened even in the fourth quarter, let alone the first quarter of this year. We will continue to hear arguments about whether the government shutdown obscured the sampling periods and so on. There will be arguments about the effects of the weather--whether or not firms will make up their losses and whether or not needed inventory adjustments have occurred. I also think that the new data calculation methods will continue to challenge us to become comfortable with the notion that 2 percent real GDP growth is in fact what we should be striving for.

Obviously, the past is behind us, but a clear picture of the near past or even what is in the proverbial "rear view mirror" can help us understand whether or not the economy is going up, down, or has just rounded a corner. This uncertainty about the near past certainly has been reflected in the markets. There is sensitivity to almost every piece of economic news that is released, and we seem to be having a considerable reaction, perhaps even overreaction, to unanticipated economic news.

I was struck by the sizable swings in the GDP estimates in the Greenbook since the last meeting. There is quite a change in the fourth-quarter, the first-quarter, and the second-quarter estimates for GDP. Most of it is explained by the inventory correction, which has shifted some of the growth from the fourth quarter to the first quarter. That improves the outlook so that the second-quarter estimate is considerably higher. The net effect is a forecast that is a bit brighter. Going forward, I quite agree that the best estimate is for continued moderate growth. The employment report that we got for February probably was on the high side and may well be revised. Even so, it is a relatively strong report. Industrial production has been stronger. Housing may slow a bit due to the backup in interest rates, but the recent data have been surprisingly strong, and the fundamentals for continued activity in housing remain pretty good. In addition, my brother just sold his house. [Laughter] This is a sign of considerable strength in the housing sector--in the Fifth District, I might add. [Laughter]

With respect to business fixed investment, I think it is pretty unlikely that we will see growth continue at the same pace as in 1994 and 1995. By the same token, I don't think there is any major reason for a big pullback. The cost of capital is still fairly low, and if we are correct in forecasting that aggregate spending will hold up and that businesses have a continuing commitment to holding costs down, profits and cash flows should be reasonably strong. Nevertheless, business firms already have added a good deal of capacity, so we probably will see less growth in spending on industrial production facilities. As has already been mentioned, the outlook for spending on computers is not as strong as it has been, and such spending has explained a lot of the growth in business fixed investment. So, I think we probably will not experience quite as much strength in business fixed investment as we have seen recently.

Again going forward, I don't think that the usual bottlenecks that one might see in a mature expansion are present. We seem to have plenty of credit availability. The banks and the markets are still reasonably well positioned to support expansion. We are not seeing as much in the way of balance sheet adjustments. There are some but not enough for us to find ourselves in a windshear situation. I think household spending is likely to keep pace with income. This is a little less optimistic than the Greenbook, but I think that some of the hypotheses relating to household spending suggested in the Greenbook are very interesting. These include job anxiety and perceptions of the shakiness of Medicare/Medicaid. Perhaps people are being attracted to high stock prices. I hope this is going to mean some improvement in saving, and maybe people are hitting their borrowing limits. So, while moderate growth is a probable forecast on balance, I think there are risks to the outlook.

One of the big risks that several people around the table have mentioned is on the inflation side. While I believe it is possible to make some progress on the inflation front given reduced capacity pressures, labor market uncertainty, and cautious consumers, I do think that some of the inflation risks have increased since the last FOMC meeting. The increase in oil prices is an example. Another year of bad crops could cause prices to ratchet up. Wage increases could finally be heading up. Also, prospects for major gains in terms of deficit reduction have diminished considerably even since the last FOMC meeting.

In sum, I think the economy is in a more balanced situation than it was in late January and we can look forward to moderate economic growth with a bit less uncertainty than we were feeling in January. But I do think that the inflation outlook is less favorable.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. The Fourth District is in between Ed Boehne's and Mike Moskow's Districts, but so much for geography. It is hard to get a reading not only on what is actually happening but on what is expected in our area for this year and the year ahead--the time horizon that is relevant for policy discussions--especially when the national statistics are so troublesome. An optimistic note for the longer term from one of our directors--he called it an optimistic note anyway--was his report that applications for admission to law school this fall are down 20 percent. In trying to filter all the anecdotal information, the Beigebook report for our District was definitely more upbeat than the previous couple of Beigebooks. One director who has lived in the area all his life noted that this change in mood happens every spring. Sometimes it is a reflection of how bad the winter was. Since this was the second worst winter of the century, a rebound may not be too surprising. That also may explain some of the resiliency of the national economy that both Governor Kelley and Ed Boehne noted, and I will come back to that in a moment.

You may have seen the other front page article in yesterday's Wall Street Journal that covered the export industries, including those in Ohio, and indicated how that sector of the economy has served as an underpinning to overall economic activity to an extent that may not have received the attention it deserves. Another issue that we have been looking into is retail sales. Our region of the country is incredibly strong in retailing companies, companies that operate not only nationally but even globally. There are consistent reports of much stronger catalog sales; their mail order sales are continuing to rise very sharply as a percent of their totals, often at double-digit rates. This raises questions about how much of that is domestic and how much of it is what we would call exports, whether it gets reported that way or not. A new phenomenon that people are citing, though it is hard to quantify, is Internet sales, ordering from these companies through the Internet for shipments abroad and bypassing the usual retail distribution problems that exist in Japan in particular but also in other places around the world. The Commerce Department says that at this point they don't have a good handle on either the magnitude of this or what it is contributing to total sales. They are pretty certain that they are underestimating total sales, but they can't quantify it.

Because of the difficulty of interpreting the numbers, I made a special effort yesterday to get the first-quarter report of the National Federation of Independent Businesses that will be released in a few days. Not unlike the comments around the table this morning, the report will be fairly mixed. Employment plans are down somewhat from the earlier report while capital spending plans are up, which is contrary to the commentary in the Wall Street Journal column and the general concerns about capital spending. Small businesses indicate that they will increase such spending this year to what would be a record level in the index.

The inflation news is fairly good. Fewer firms are now planning to increase their prices this year than in previous reports. This still raises in my mind some very fundamental questions about the process by which an inflationary phenomenon is created. I don't think of inflation as being rising prices. In one sense, I am very encouraged as regards the national economy. It is one of those stories about the water glass being half full or half empty. Compared to a year ago, inflation psychology seems to have improved by about 1/2 percentage point. A year ago at this time, the general forecast was that inflation would rise to about 3-1/2 percent. The current expansion has now lasted several years and every year the forecast has been that inflation would go up. Finally, we are at a point where the forecast is that inflation is going to remain the same this year. It may be too much for us to expect people to say that inflation will go down next year. So, we have to go through a transition period of at least no longer forecasting rising inflation to get comfortable with the idea that, even as we head into the sixth year of the expansion, inflation is going to remain the same. The next step is for people to adjust psychologically to that, and in the future inflation actually will go down.

I am trying to interpret what has been going on in asset markets and separate the real from the inflation components. We have to be very careful in what we think we know about that. What has been encouraging about all the commentary this morning and the reports we have seen about the resiliency of the economy is that no one is saying that this is a result of good old-fashioned, pump-priming monetary and fiscal stimulus, but rather it is what markets do. When depressants are absent, markets tend to create a process by which an economy expands. If that is a valid interpretation of the dynamics at work out there, then I don't think we have to be nearly as concerned about an increase in inflation as we would if we were concluding that either monetary or fiscal policy was pumping up aggregate demand. That relates to my earlier concern when I asked Mike Prell about the Greenbook, but we will have to discuss that another time. I am still not comfortable with the Greenbook projection of inflation for 1997; I would like to see it lower. If I firmly believed that the Greenbook was correct and we would have yet another year of about 3 percent inflation, I would find that unacceptable. So, I have to conclude by simply hoping that they are wrong.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I think the change in the data, the closing of the government, and the snow have allowed us to forget there are still three unresolved issues in the economy. The first I would call the labor market/household sector issue. I think the story is that we can't go on like this, but I do not know how it will change. The anecdotal comments around the table universally have referred to tight labor markets. That is what I hear anecdotally as well. I was in Indianapolis two weeks ago and, as they phrased it there, "you can't hire people at any wage." I won't comment on their economic logic, but no one was raising wages at the time they were saying they could not hire people at any wage! We have had very low increases in nominal and real wages. That is inconsistent with reported labor market conditions. In addition, household spending has been growing substantially faster than wage income, and the gap has been financed by higher debt levels. This situation is going to be resolved either through greater wage claims in a more militant labor market, which could be financed incidentally by foregoing any further increases in the share of profits but would require at least a stabilization in the profit share, or through curtailed spending at some point.

The second unresolved issue is fiscal policy. We thought we were going to begin to see it get resolved, but the fact is that we still have unsustainable entitlement policies in place. The entitlements will have to be cut at some point. The market has decided that that decision will probably be delayed until after November. Of course, the election results in November may well serve to defer the decision still further.

If that is the case, I think it will lead to what I see as a third unresolved issue, the level of prices in capital markets. That level is one of the reasons why we have been enjoying an investment boom; in fact, the investment boom and rising prices in the equity markets have been feeding on one another. A booming capital market has made equity capital very cheap and has allowed the double-digit rate of growth that has occurred in gross private domestic investment. Focusing on the computer issue, when we have a deflator that is actually deflating, the effective hurdle rate of return needed to justify a purchase becomes quite high. That's because the nominal price of the good is going down, and in addition we need a positive nominal return on the capital. To justify buying a computer now, we have to add the 12 percent decline in the deflator to a 6 or 7 percent rate of return on the cost of capital, a total return of 18 or 19 percent. There just are not many investments in that sector that can be justified on that basis, and at some point such investment is going to end. It will end more quickly if in fact the cost of capital rises at the same time. That in turn will depend on how the labor market and fiscal policy issues are resolved. If we end up with greater wage claims or if we end up with a decision to defer the entitlements reform, we will see a substantial further increase in intermediate and long rates, and that will precipitate a market adjustment. On the other hand, if we see curtailed spending by both the household sector and the public sector, we probably will see a decline in the share of profits and a decline in investment as a result.

I think that the weather hiatus has allowed us to forget that we still have some fundamental unresolved issues. The Greenbook is forecasting a sustained middle course on how the economy will resolve those issues. The risks around that middle course are probably balanced at this point, but I think those risks are growing. In fact, especially in the sixth and seventh year of an economic expansion, there is an increasing probability that the expansion will not be able to stay on the middle course but will fall to one side or the other.

CHAIRMAN GREENSPAN. Thank you. Coffee should be out there. Would someone take a quick look and see whether it is there?

MR. LINDSEY. We really just finished breakfast!

MR. KELLEY. We must be in great shape if we are having a break at 9:30 a.m.!

MR. PARRY. They are setting up, but it will take a few more minutes.

CHAIRMAN GREENSPAN. Corporate planning is less than adequate. [Laughter] Don Kohn.

MR. KOHN. We will have a race between my briefing and the setup for the coffee. I'll talk fast and maybe I can win! As background for your policy discussion, I thought it might be useful to take a closer look at a key development in financial markets over the intermeeting period, the rise in long-term interest rates that a number of you have mentioned. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Thank you. Why don't we break for coffee?

[Coffee break]

CHAIRMAN GREENSPAN. Let me get started. In a period like this, it may be a good idea to review history to see how we got to where we are. At the moment, the economy might be described by an electrocardiogram that does not say the economy is dead but indicates it is functioning in a way that suggests something is going to move--as a number of you, including Governors Kelley and Lindsey, have stated. The one thing that is reasonably certain is that the outlook depicted by the electrocardiogram in the Greenbook is very unlikely to prevail. The key questions are: In which direction is the economy going and how is it going to get there? A critical element in this outlook is the interplay of asset values, specifically bond and stock values, and inventory changes. What is really quite extraordinary about this period is that despite what we continue to envisage as an increasingly service-related economy and one where business firms are increasingly getting control over their inventories, inventory investment has been the most volatile element and the greatest determinant of economic change in the last two or three years.

In the early part of the 1990s, as firms finally were technologically capable of moving toward just-in-time inventory management, inventory-sales ratios moved down precipitously. You may recall that in the latter part of 1993 one of the reasons we began to get a little concerned about the upturn and potential strength of the economic recovery was that inventory-sales ratios were getting to a point that seemed to be close to bottom. Obviously, the arithmetic of a change from a declining inventory-sales ratio to a flat ratio is a "pop" in inventory investment. Indeed, it "popped" more than I believe we had expected, creating a significant surge in economic activity throughout 1994. Presumably through the normal multiplier mechanisms, the pickup in inventory investment induced enough income and PCE to create fairly strong economic growth. A big pickup in profit margins was superimposed on that, which in turn fostered growth in the capital goods markets until we ran into the wall in early 1995 when voluntary inventory accumulation temporarily turned involuntary. Final demand slowed appreciably, and you may recall that in June, or maybe slightly earlier, we were terribly concerned about whether the economy was on the edge of a recession. The economy worked its way through that, but inventory investment continued to fall throughout 1995 as business firms endeavored to restore some degree of normality.

In the early months of 1996, were it not for the weather problems that dominated a substantial part of our economy, estimated at as much as one-third, plus the government shutdowns, we probably would have begun to see some economic strength after the retardation in economic growth that the inventory adjustment engendered all through 1995. The experience of California, where weather was not much of a problem, suggests that quite possibly the turn occurred at the beginning of the year rather than in February as shows up in a lot of our data. At the moment, we can look back and ask ourselves why the economy held up, or as Ed Boehne put it, was so resilient through all of this period. I think the answer is largely that we had a very substantial increase in stock and bond market prices. There has clearly been a wealth effect here. As in previous periods, it was quite likely that the turn in inventory investment could have tilted the economy into a recession, considering that the expansion is more than five years "long in the tooth" so to speak. I think the equity and bond markets were especially helpful in creating a degree of resilience that has carried the expansion into 1996.

The economy is likely to be stronger rather than weaker in the period immediately ahead if for no other reason than that it will be getting some stimulus from the GM strike. The strike in retrospect may turn out to be somewhat fortuitous in that the bulk of excess motor vehicle inventories was held by General Motors. While I don't know the configuration of the inventory decline in terms of particular models, because invariably such declines are not uniform nor are they the same as a voluntary decline, clearly there has been some significant pressure on the economy that will be reversed as we move into April and May. The comments around this table suggest that the members regard the risks to the economy as being as close to balance as one has seen for quite a while. In looking back at the performance of the economy in this period, I must say it was the most probable result that we could have anticipated, but attaining that outcome was fraught with potential uncertainties.

I disagree with Tom Melzer's characterization of what taking out monetary policy insurance means. As I see it, taking out insurance means that we are adjusting policy on the basis of a risk to the forecast that has a low probability of occurring. In fact, that is the basis for all insurance. We take out fire insurance because we forecast that there is some small probability of fire. I don't think we take out monetary policy insurance when we think that the economic trend has changed fundamentally. A fundamental change in our forecast calls for a policy response in the appropriate direction, whereas I think an insurance takeout is done largely on the basis of a forecast of something that we do not expect to occur. The fact that it did not happen in this case, or at least it has not happened yet, is a desirable outcome. I would be very much disturbed if it were the other way around. You can look at insurance any way you want. I like to take out insurance. I have a lot of personal insurance. I have never collected on any of it, and I must say that I am delighted. [Laughter] And I hope that that is exactly what we will say later with respect to what we have been doing.

MR. MELZER. The premium isn't fixed in this case; that is the difference.

CHAIRMAN GREENSPAN. Let's not get into insurance policies! [Laughter] More generally, to confront the problems that we face, we have to ask ourselves what can change. Two issues have surfaced in the discussion around this table that, I think, are quite to the point. One is whether we are going to be looking at increased labor militancy. The answer is that increased militancy is more likely than not, if for no other reason than that we cannot expect the current situation to continue. As I indicated maybe 6 or 9 months ago when I hypothesized that job insecurity was an explanation for why wage inflation has been subdued, there is a limit to this process at which point it begins to go back to normal. It may well be that political issues that have been raised during the presidential primary campaign plus the General Motors' strike are the first signs that the limit has been reached. It is too early to say, and I don't think we have any definitive data to suggest, that the wage-job security tradeoff has changed, but I believe we are getting the first indications that it may.

The second and more disturbing issue is the question of the stock market. The market is probably high by any objective measure that we can find. We need a lot of different assumptions to argue that it will stay there. It is being driven largely by long-term interest rates, but there is more to it than that. Earnings are still coming in above expectations. This is the Wall Street evaluation. It's what a series of analysts expect earnings to be company-by-company. Those numbers have been coming in better than expected for quite a while, although the margin is now changing very materially. There is increasing evidence that profit margins, after showing some significant strength, are finally beginning to soften somewhat, as Mike Prell indicated with his markup ratio analysis. This obviously has significant implications for the capital goods markets at some point and far more impact with respect to the question of what stock prices are going to do.

What I find particularly bothersome is that history suggests more often than not that stock prices remain high for a protracted period of time when they should not; stock prices may just be waiting for us to move rates up before they go down. We probably are going to find ourselves in that position one way or another at some point. But I do think we have to be aware of the fact that this may be unlike 1987 when the stock market decline essentially took out virtually all of the overheat, if I may put it that way, in the economy, increased the saving rate about a full percentage point, and barely affected economic growth. In a sense, it went through fat and never quite hit muscle. There is very little fat left in the economic system at this stage. If we get a very significant contraction in stock prices, I think it will have a quite measurable wealth effect. Therefore, it is very difficult to look into the future and merely presume that 1996 and 1997 will produce a flat electrocardiogram. It is probably the best forecast and the most likely outlook simply because it is difficult to figure out where the extremes are. But one thing that we can forecast is that we probably are going to be surprised by more rather than less volatility in the economy. I do not know in which direction the economy will be going, though ultimately it will go down. It will go down basically because if we seriously believe, as I think every one of us has said around this table, that the business cycle is not dead, recession is going to look us in the eye at some point. We do not know when, but I think one of the most extraordinarily difficult periods for monetary policy lies somewhere ahead.

For the moment, listening to the consensus on the economic outlook and the balance of risks, I would subscribe, and I hope the rest of you will also, to doing nothing today. This is what the market largely expects because they are looking at the same data that we are. Thank you.

VICE CHAIRMAN MCDONOUGH. Symmetry?

CHAIRMAN GREENSPAN. An obvious symmetry. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I support the "B" symmetric proposal. I agree that the most likely forecast is the one that we all agreed on, and I think it also is highly unlikely that it will materialize. We will have to adjust one way or the other and stay extremely wary and ready to move in the interim. But certainly for now, the "B" symmetric proposal is the right one.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, much of the evidence that we have received since the last meeting suggests that economic activity has strengthened, as the gains in February have more than made up for the weakness in January. Even with the GM strike this month, it now appears that there will be a marked pickup in real growth in the current quarter as a whole. At the present time, there appears to be little upward or downward pressure on inflation, although I do think that the inflation risks are on the up side. Accordingly, I would agree with your recommendation that we make no change in policy at this time. It seems to me that further easing would be inappropriate, given the increasing strength of the economy and the risks that this could lead to higher inflation in the future. It would also seem prudent to me to wait for more information before we decide on our next action. If economic activity continues to pick up, it might soon be appropriate to increase the funds rate. Thank you.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Alan, I agree with your recommendation. I have some concerns, obviously, based on what I have said before. It is difficult to evaluate the stance of policy, but I am concerned that it may not even be neutral at this stage--just based on what is happening, for example, with monetary growth rates and some of the factors that Don mentioned. I think the current policy stance is inappropriate given the 3 percent inflation expectations. In my view, we ought to be in a somewhat restrictive policy stance and be working the rate of inflation down in some orderly fashion. But having said that, I don't think it is appropriate for policy to go in one direction at one meeting and in the other direction at the next, certainly under the circumstances we have described today. We are where we are, and we should stay there for a while and watch. But we need to be vigilant so that--I am going to stick with this insurance analogy a little longer--the premium on last meeting's insurance policy in terms of higher inflation expectations does not become onerous. That is what I meant before when I said that, in effect, the premium is not fixed. There is a cost to it.

One other point I wanted to make quickly refers to Don's briefing. Don, you made a statement, if I heard it correctly, about the Committee's opportunistic inflation strategy, which implied that the Committee had actually adopted that. By default, that may be where we are, but I don't think we ever consciously made a decision about what our inflation strategy ought to be, whether it is deliberate, opportunistic, or whatever. I just wanted to make that comment.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, as others have said, we often evaluate the economy and the outlook in terms of risks and how they are balanced. It would certainly seem that there has been some change in the balance of risks away from the downside risks toward upside risks. I don't know whether we want to call it insurance or whatever, but at the last meeting I think there was a perception that the risks were more heavily balanced or tilted toward the down side than they are now. That balance seems to have changed. On those grounds I think we have to contemplate the possibility that we may need to reverse the move we made last month at some point in the not too distant future. I certainly would not recommend doing that now. I would agree with your proposal. But if the data for the month of March that we will get at the beginning of next month--for example, retail sales or unemployment--show continuing strength, I think we will need to consider seriously the possibility of reversing our policy course at a fairly early date. In that regard, I would point out that we have a long interval before the next FOMC meeting, which is on May 21. If we begin to get these numbers for March early in April and it appears that they are signaling continued strength, I would hope that we might have a conference call to consider how we might want to react to them.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I agree with your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I also agree with your recommendation, Mr. Chairman. I would like to reflect a little on your comments about reaching the end of the business cycle expansion sooner or later. Obviously, that will happen. The concern I would have is that we might experience a pattern somewhat like the late 1980s when prior to the end of the expansion phase of the business cycle, we had a surge in inflation that we had to tamp down, thus feeding into the end of the business expansion and adding to the depth of the recession. I am a little nervous about that possibility at this point and concerned that we should, on assessing the data as we go forward, be vigilant on the side of keeping interest rates and monetary policy restrictive enough to prevent a surge in inflation that ultimately would tend to shorten rather than extend the growth phase of the business cycle.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I agree with your recommendation.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I, too, support your recommendation.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I agree with your recommendation.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. I agree with your recommendation.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I agree with leaving the federal funds rate at 5-1/4 percent at the present time. But in the context of Al Broaddus's suggestion about monitoring the incoming information and deciding what to do in the future, I think we need to think more about what the yield curve is telling us and try to reach some consensus about it. In his remarks, Don traced what was happening in the forward and futures markets. I was on the Morning Call during this period and paid more than usual attention to daily movements in interest rates. The yield curve at the end of January and in early February was priced off a 4-1/2 to 4-3/4 percent funds rate. The only thing that was at 5-1/4 percent was the overnight federal funds rate. The rest of the yield curve--3-month bills on out to the 30-year bond --was priced to be at least 50 basis points lower by Labor Day. I don't know what people have in mind in the way of a transmission mechanism of monetary policy to real economic activity, but I thought that the markets simply were well ahead of us for whatever reason: perceptions of a weak economy, inflation expectations, or whatever. They simply readjusted to economic developments and that had to happen. In that sense, we had a relative movement toward less stimulus even though the funds rate did not change, and it should not change for the time being. But as we interpret numbers in the future and decide how to react to them, I think we need to be very, very careful about whether the market is ahead of us, behind us, or whatever.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I agree with your suggestion. It seems to me that the need for additional insurance is less pronounced. The cost is now simply too high relative to the risk. The economy is moving forward, and it does not appear to need our help at this time. I can well imagine that our next move could be either up or down.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Mr. Chairman, I agree with your proposal and I also agree with your assessment of the key risks.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. I concur with your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. I concur with your recommendation as well.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. I agree with your recommendation.

CHAIRMAN GREENSPAN. Would you read the symmetric directive?

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

CHAIRMAN GREENSPAN. 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. The next meeting is on May 21. We took out an hour's worth of insurance this morning. [Laughter] It turned out that we did not need it. I don't know whether you consider that too high or too low a price. [Laughter]

MR. BROADDUS. The risks were definitely up.

CHAIRMAN GREENSPAN. Thank you all for trying to confine your remarks to a shorter time frame than usual. We probably will be going up to the Hill in about an hour and we'll see what happens there. In the interim, we have lunch scheduled at 11:30. Joe Coyne is going to announce at 11:30, 11:45, or something like that we have nothing to announce. Obviously, until then our decision is not public information.

END OF MEETING