Meeting of the Federal Open Market Committee
November 13, 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 Wednesday, November 13, 1996, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Jordan
Mr. Kelley
Mr. Lindsey
Mr. McTeer
Mr. Meyer
Ms. Phillips
Ms. Rivlin
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. 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, 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
Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, 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. Moore, First Vice President, Federal Reserve Bank of San Francisco

Ms. Browne, Messrs. Davis, Dewald, Eisenbeis, Goodfriend, and Hunter, Senior Vice Presidents, Federal Reserve Banks of Boston, Kansas City, St. Louis, Atlanta, Richmond, and Chicago respectively

Messrs. Cox and Judd, Vice Presidents, Federal Reserve Banks of Dallas and San Francisco, respectively

Ms. Perelmuter, Assistant Vice President, Federal Reserve Bank of New York

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CHAIRMAN GREENSPAN. Good morning, everyone. The first item of business is to welcome John Moore, who as you know is First Vice President of the San Francisco Bank and is attending his first meeting. It means that Peter Fisher has to be on his best behavior!

MR. FISHER. Why me? [Laughter]

CHAIRMAN GREENSPAN. But before he exhibits that good behavior, I would like somebody to move approval of the minutes for the meeting of September 24.

MR. KELLEY. I move it, Mr. Chairman.

CHAIRMAN GREENSPAN. Without objection. Now, Mr. Fisher.

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

CHAIRMAN GREENSPAN. Questions for Peter on either subject?

MR. MCTEER. I would like to congratulate Peter on his record period of nonintervention.

MR. BROADDUS. I would like to second that. [Laughter]

MR. TRUMAN. Congratulate the Chairman

MR. FISHER. Yes, I think congratulations are due at the other end of the table, but since I get beat up occasionally down here, I will take what I can get!

CHAIRMAN GREENSPAN. If you had not run the Desk as well as you did, we would not have had a choice up here. If there are no questions on either subject, would somebody like to move the renewal of the reciprocal currency arrangements, which expire during December, and ratification of the domestic transactions? We will vote separately on each of them. Peter, how do you want to define the motion on renewing the swap lines?

MR. FISHER. The Committee would be giving me the authority to negotiate their renewal.

VICE CHAIRMAN MCDONOUGH. So move, Mr. Chairman.

CHAIRMAN GREENSPAN. Is there a second?

MR. BOEHNE. Second.

CHAIRMAN GREENSPAN. All in favor of the authority to renew the swap lines say "aye."

SEVERAL. Aye.

CHAIRMAN GREENSPAN. Any opposed?

CHAIRMAN GREENSPAN. Hearing none, they are approved. The second motion--

MR. FISHER. To ratify our domestic operations.

CHAIRMAN GREENSPAN. All in favor say "aye."

SEVERAL. Aye.

CHAIRMAN GREENSPAN. Opposed? The Secretary will note that both motions passed unanimously. Would you like to move to our domestic discussion? [Laughter] Wait a second! Have we ratified the domestic market transactions?

SEVERAL. Yes, we did.

CHAIRMAN GREENSPAN. Oh, that was the second vote!

MR. PRELL. We are just moving too fast!

CHAIRMAN GREENSPAN. No, the trouble is jet lag, and even though Peter and I were on the same plane, his jet lag is different from mine. [Laughter] Slowing things down, we move to Mike Prell.

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

CHAIRMAN GREENSPAN. Mike, granted all the problems with the data, there seems to be a gradual uptrend in the last two or three years in the measured personal saving rate in the context of a very rapid rise in household wealth. If we were to take the published personal saving rate and adjust it for the econometric evidence of the impact of changes in household wealth on that statistic, is there any question as to whether we would be looking at a secular updrift?

MR. PRELL. I think there always is a question about the behavior of the saving rate, particularly when we are estimating it ahead of the annual revisions of the NIPAs. We have seen saving rate trajectories altered considerably by those statistical revisions. Given that we feel that GDP growth may have been underestimated, it is not inconceivable that a part of those revenues could be in consumption expenditures. I do not have any particular insight on that, but that may be one aspect of the situation that should make one cautious about jumping to conclusions. But on the face of it--

CHAIRMAN GREENSPAN. Is there any correlation between the saving rate and the statistical discrepancy?

MR. PRELL. I cannot give you an answer to that off the top of my head.

CHAIRMAN GREENSPAN. I would assume that Commerce would be doing that sort of analysis in looking for the causes of the statistical discrepancy and presumably making adjustments where they could.

MR. PRELL. Obviously, each time they do their quarterly estimate, they try to reconcile the income and product sides. If they find income is stronger, they are presumably going to look for opportunities to find product and add it in. But I think they are limited by their source data. And now they are running behind on the updating of the benchmarking to Census surveys and so on because they were unable to do their regular annual revisions. That said, and recognizing that the data may be throwing us a curve, one would have anticipated over the past couple of years, all other things equal, that the saving rate would have declined appreciably in light of that increase in wealth. The saving rate might have been depressed by 1/2 to 3/4 percentage point this year relative to a path that would be consistent with a stable wealth-to-income ratio, say, since the end of 1994. The apparent updrift that we have seen creates a considerable differential from that, and so we look to other possible factors. One of them, as we have noted for some time, may be the fact that the wealth gains are not evenly distributed across the population. A considerable number of households that have built up debts may now be restricting their spending. The tightening of credit availability has contributed something, even if it has not been very great to this point. Earlier we were seeing a liberalization of credit availability and that could have been enhancing consumption growth; now the credit effect presumably is moving in the other direction. We also have offered a laundry list of other rumored factors that may be affecting the saving rate such as greater concerns about retirement security, particularly in light of the perception that Social Security may not be there fully for people now in the workforce; Medicare and Medicaid issues that might suggest less security about medical coverage later on; and the general notion of job insecurity. While we do not see clear evidence that by historical standards people are unusually uncertain at this point about job prospects, there remains some general sense that all is not well and that jobs are not secure, so there could be some rise in precautionary saving levels.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mike, one interesting aspect of the forecast is the strength of consumption. PCE goes up 2.7 percent in 1997. I assume that one of the reasons is the strong growth of income--you have a strong 2.7 percent increase in real disposable income. A bit of a puzzle to me is why there is such a difference between the growth of real disposable income and that of real GDP. The 0.5 percent difference is greater than anything we have seen in the 1990s, and I do not know how far back one would have to go to see that kind of difference in the growth of those two measures.

MR. PRELL. We do have some increase in real wages. We have diminishing profit shares. So, some shift is occurring in income shares.

CHAIRMAN GREENSPAN. There is also the CPI-product price.

MR. STOCKTON. Consumer energy prices, in particular, rose quite rapidly this year and are expected to be flat next year. The swing we get there acts to boost growth of disposable income.

MR. PARRY. They push up real disposable income?

MR. STOCKTON. Yes. Because we are a net importer of oil, declines in crude oil prices obviously are going to be one thing that helps push up disposable income.

MR. PARRY. So maybe what one is using for the deflator shows up in disposable income versus GDP?

MR. STOCKTON. That is consistent with the historical evidence.

MR. PARRY. Okay.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mike, I am particularly interested in these methodological changes that BLS is making in the calculation of the CPI. You have a table on page 15 of Part I of the Greenbook that shows how these affect the CPI going out through 1998. Could you tell us more about this? I have a couple of questions. Is the BLS planning other changes going forward? To what extent have the changes made so far chipped away at the 1/2 to 1-1/2 percent estimate we indicated before in testimony about how much the CPI actually overstates the true underlying inflation rate?

MR. PRELL. I should defer to our foremost authority on this, Mr. Stockton.

MR. STOCKTON. At this point, President Moskow, I think what we have built into the forecast through 1998 is all that the BLS has officially announced in terms of planned changes. If we pressed them, I am sure they would say that they have an ongoing program for improvement and there will be further changes down the road. Thus far, we think the changes they have made have reduced the CPI by roughly .2 percentage point in 1996 relative to the 12-month change we would have looked at using the 1994 methodology. So, we already have .2 percent built into the data to date, and we are expecting another .3 percent downward correction going forward between 1996 and 1998.

In terms of how that affects our current estimates of the bias, according to a paper published earlier this year by my colleague, David Wilcox, the estimated bias is .6 to 1.5 percentage points. That estimated bias incorporated a number of the improvements that we expected the BLS would be making. What we had not anticipated was the change that the BLS will be making in January to the measurement of medical care prices, which we think is going to reduce the CPI by .1 percentage point. I guess we would adjust that range of .6 to 1.5 percent by lowering it by .1 percentage point, but that is all. So, we would say a range roughly of 1/2 to 1-1/2 percent is still a reasonable estimate for the measurement bias.

MR. PRELL. I should note that our estimates of the effects of these changes in method, or the market basket change in 1998, are somewhat conjectural. It is not a simple, mechanical arithmetic story, and that is truer in some cases than in others. But these are estimates; they are not engraved in stone. I would remind the Committee that the Boskin Group is slated to come out with their final report on the bias by December. I do not think we have any inside information on whether they will be revising their estimates up or down, but there certainly will be considerable focus on the issue at that time.

MR. MOSKOW. But if it were not for these methodological changes, you would see a gradual updrift in the core rate of CPI inflation?

MR. PRELL. That is right, yes.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I have a question on the material you sent us last night. On the basis of the inventory data that were released last week, I see that you reduced your estimate of third-quarter GDP growth to a rate of 1.9 percent and traded that off with an uptick in fourth-quarter growth. How sure are we of third-quarter final sales?

MR. PRELL. Well, final sales for the quarter could be changed at least noticeably, maybe not importantly, by a possible revision to September retail sales to be published tomorrow. Moreover, we have yet to receive the net exports data for September, which are always a wild card. At least some modest change in that number is possible, but at this point we would not expect a major change in the PCE estimate based on retail sales. We are talking mainly about September. In effect, enough of the quarter is known at this point that there is not going to be a big surprise. In addition, there is only one more month of trade data. So, we know it was a weak quarter for final sales.

The inventory situation is harder to gauge at this point. Built into the estimate that we gave you is the BEA assumption about retail inventory investment. It is a moderate number. We did not see any reason to quarrel with it, but the translation of these data into real inventory change is difficult. There is a further wild card here in that a lot of the surprise in the wholesale trade inventory numbers was in food products. There is some question about whether BEA might decide that, if it did not show up in those numbers, the food was still on the farm and maybe some adjustment should be made in farm inventories. Nothing that we have been able to glean from discussions with BEA or from their previous behavior would lead us to assign a high probability of their making some ad hoc adjustment here, but it is a possibility.

MS. MINEHAN. So you are still quite confident that the low level of consumption recorded in the third quarter, despite changes in inventories, is pretty much baked in the cake?

MR. PRELL. I think the numbers will probably hold up fairly well. As I said, they may not be accurate numbers, but we have no basis for gauging a bias one way or the other. We do not perceive that the trend in the growth of consumption has moderated to the degree that those third-quarter numbers might suggest.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. My question actually was the same as Cathy's. It was about the GDP estimate.

MR. PRELL. If I'm asked again, I might give a different answer!

MS. PHILLIPS. Well, actually I was going to put it slightly differently. How confident are you about the 1.9 percent growth rate?

MR. PRELL. Not highly confident, given the statistical uncertainties that I indicated. We can imagine a number a little lower; we can imagine a number a little higher. You will recall that one of the fundamental factors in our thinking about the third quarter was that the labor input was quite ample, and the income side would suggest there was room for considerably more growth. On the other hand, when we looked at the first half of this year or the second quarter, we did not always see these things tracking perfectly; there was some averaging out. The basic trend of growth in the mid-two's for this year seems fairly reasonable relative to the behavior of the unemployment rate, to other measures of labor input, and to our general sense that things had picked up and were running somewhat above the long-term trend.

CHAIRMAN GREENSPAN. Any further questions for Mike?

MR. LINDSEY. When you estimate a consumption function, do you divide the population into subsets?

MR. PRELL. We have some notional views about proportions of the population that might be liquidity constrained or not liquidity constrained. So, embedded in some models is a perspective on that. But in preparing our forecast, we are not thinking of this on a disaggregated basis.

MR. STOCKTON. We also try to take account of the distribution of income. For example, there is a much higher propensity to consume out of transfer payments than there is out of labor income.

MR. PRELL. Transfer income has been relatively strong, and to an extent that might lead one to have expected fairly firm consumption relative to aggregate income.

MR. LINDSEY. It would seem that the potentially liquidity-constrained or debt-constrained population would be different from the people who have had stock market wealth gains. I would think that the key to sorting the two out is to try to disaggregate the trends. This is just a suggestion for future research.

MR. STOCKTON. As you know, Governor Lindsey, there are not a lot of disaggregated time series data on consumption and saving.

CHAIRMAN GREENSPAN. Any further questions? If not, who would like to start the Committee's discussion?

MR. PARRY. Mr. Chairman, the Twelfth District economy expanded briskly in the first half of 1996, and it remained on track during the third quarter. Growth in total payroll employment slowed only slightly between the second and third quarters, from 3.6 to 3.3 percent at an annual rate. The District's performance this year is attributable largely to a strengthening in the State of California. For example, growth in construction employment in that state has accelerated substantially since the first quarter. The overall expansion has been stronger in northern California than in other parts of the state. The northern region has benefitted from low unemployment and a substantial recovery in housing values, factors that gradually are spreading to southern California. The Washington State economy continues to benefit from stepped up production at Boeing. Twelve-month gains in total employment in the state have increased from 1 percent at the start of the year to 3.1 percent in September. Increased demand for manufactured products related to aircraft production also spilled over to Oregon and added to a third-quarter surge there. The intermountain states--Arizona, Idaho, Nevada, and Utah--continued to post large year-over-year employment gains. About the only weak part of the District is Hawaii, which showed a decline in jobs during the third quarter.

Turning to the national economy, data released since we met in September caused us to lower our projections for near-term real GDP and, to a lesser extent, inflation in 1997. We now expect real GDP growth to fall below its 2 percent trend this quarter, in part because inventory investment should drop off following its strong increase in the third quarter. At the same time, inflation in the ECI and the GDP-based price measures all came in below expectations. Over a longer horizon, underlying inflation has shown a slight downward trend according to most measures despite the low unemployment rate.

We have updated some earlier work that looked at conventional inflation equations incorporating historical relations among unemployment, inflation, and other variables. These equations over-predicted inflation by a wide margin in the third quarter, and this noticeably intensified the more moderate pattern of overprediction that we have seen for some time. As a result, we have lowered our forecast for CPI inflation in 1997 to just under 3 percent, in effect putting somewhat less weight on upward pressure from labor markets. However, I still consider the risks for inflation to be on the up side because it is quite possible that the historical relationship with labor market conditions will begin to reassert itself. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, the Seventh District economy continues to expand at a moderate pace. It appears that price pressures may have eased somewhat.

Overall construction activity remains strong, with recent slowing on the residential side being offset by a pickup in nonresidential activity, both public and private. Retail sales improved moderately in both September and October, and the sales gains in the District generally have matched or slightly exceeded the national averages. One of our directors characterized the recent pickup as representing steady gains rather than indicating a new trend. Sales of apparel and other soft goods have been strong, while sales of big-ticket items such as appliances and, especially, electronic goods have been soft. District retailers generally expect a reasonably healthy holiday sales season, and the shorter sales period this year is not expected to be a serious constraint. As we had expected, auto and light truck sales recently have been running slightly below a 15-million-unit annual pace. October sales were not significantly affected by the various strikes against GM, but November and possibly December sales could be. According to GM management, downtime from their new model changeovers presents a significant production challenge in the fourth quarter. The new GM-UAW contract increased compensation costs by just under 5 percent per year and followed a pattern that already had been set with Ford and Chrysler.

Manufacturing activity in the District generally remains somewhat stronger than nationally, although conditions vary by industry. Purchasing managers' surveys from around our District indicated continued expansion in October at a pace that was somewhat faster than for the nation as a whole. We are hearing about strength in the farm equipment industry, while producers of heavy trucks and paper are not reporting improvement. Growth in manufacturing employment has slowed in District states, but the number of factory jobs in September was the same as last year. This represents a better performance than the rest of the nation.

For employment conditions generally, the news is still the same. Labor markets remain tight in many parts of the District. While we continue to have reports of upward pressure on wages in some sectors, the ECI for the Midwest, like that for the nation, did not indicate a significant acceleration in total compensation costs. Confidential information we received from Manpower Incorporated regarding their recent survey indicates that hiring plans for the first quarter of 1997 are slightly more upbeat than normal. I would caution everyone that this information will not be publicly released until Monday, November 25.

On the price front, most firms continue to report that competitive pressures make raising prices extremely difficult. In fact, many of our contacts are quite adamant on this point. I get the sense from people I have talked to recently that materials costs are coming down rather than rising. Steel prices, for example, are down and supplies have increased, in part because of imports. One sign of the impact of imports is that at least two domestic steel companies recently have filed anti-dumping charges under our trade laws.

Our latest reports on livestock and crop conditions generally point to larger supplies ahead than were previously expected, and this will result in less upward pressures on retail food prices in 1997 than were previously expected. Our latest quarterly survey of agricultural banks indicates that District farmers are in very good financial condition, and we see no signs of ag loan problems in our District.

Turning to the national outlook, it seems clear that the long awaited slowing in the growth of aggregate demand has arrived. We have no quarrels with the broad outlines of the Greenbook's outlook for 1997, but we expect that real growth and employment gains may be slightly higher in 1997 than the Greenbook forecast. I think it is fair to say that the risks to the outlook are more nearly balanced than at our last meeting, but I believe that the upside risks remain more serious. The inflation forecasts concern me. As the Greenbook notes, the NAIRU may have fallen to 5.6 percent. Still, this is an economy where resource utilization rates are high and slack is limited. The outlook is for higher core inflation, as we discussed before, when we adjust for the BLS's methodological changes to the CPI. Obviously, there is a good deal of uncertainty about these adjustments in the inflation forecasts, but I think it is important that we avoid getting into the position of validating an incremental upward creep in inflation.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, New England remains on a solid growth path. Job growth on average has been slower than for the nation, but this is traditional for New England. The unemployment rates for the region as a whole and for each state remain below that for the nation. Employment in our region is still below its prerecession level, but the slow, steady job growth that we have been experiencing is expected to continue for the rest of the decade and to bring employment back to the prerecession level by the end of 1998.

Just to touch on some of the bright spots: Manufacturing job losses are continuing but at a slower rate. We see this especially in the defense industry where downsizing is abating, and we are beginning to see signs that defense-oriented firms are becoming successful in nondefense lines of business. Real estate vacancy rates are down everywhere, especially in Boston. A director on our New England Advisory Council heads up the building trades in Boston, and he reports that new buildings are actively on the drawing boards, including six new hotels and a couple of new office complexes. When I arrived in Boston five years ago, that was not expected to happen in anyone's lifetime. Despite low rates of unemployment, anecdotal reports of labor shortages, except for specific technical skills, appear to have abated in the last couple of months. There is some sense that the New England labor force may be growing. There is less net outmigration and perhaps greater labor force participation by previously discouraged workers, especially older workers. Wage increases are expected to be in the area of 2 to 5 percent, probably centering around 3 percent, but pressures on overall prices are considered to be low. Business people firmly believe, along the lines that Mike Prell reported for the nation, that they cannot raise prices. Some are going to try, but overall the expectation is that whatever happens on the wage side, businesses will somehow accommodate to it within their overall cost structure and not raise prices.

Consumer sentiment and business sentiment are extremely upbeat, even in such formerly depressed areas as Connecticut. We have had people from Connecticut talking to us about business conditions looking brighter. The stories in the newspapers are more optimistic, and that is not because they just opened a new Indian-run casino in Connecticut! I think the better sentiment has its roots in the opening of a lot of small new businesses.

On the national scene, we do not have any essential disagreement with the Greenbook. Certainly, the risks that growth will get out of hand seem to have abated since our last meeting. The slower growth in consumer spending in the third quarter, a slight cooling of housing markets, and a bigger drag--bigger than we expected anyway--from the trade deficit all point to a moderate fourth quarter, even assuming a fairly good bounceback in consumer spending. The risks to the forecast for growth also seem fairly balanced, at least for the coming year, again as compared with our expectations at the time of the last Greenbook. However, there are continued upside risks to inflation. The Greenbook may be overly optimistic about the unemployment rate. It could very well drift slightly downward, at least in our view, and we do not have a whole lot of wiggle room here. The NAIRU probably is lower than we expected earlier, either permanently or cyclically, but it certainly is not centered around 5.2

percent. The Greenbook inflation trend is up, even though that gets masked a bit by measurement adjustments and so forth. But if we were able to make all of those adjustments going backward, we would still expect to see a small uptick in the rate of inflation going forward. The key question here is whether that expected upward tick in inflation is acceptable, and if it is not, when we should move to address it even in the presence of moderating economic growth.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, activity at the regional level in our District, as elsewhere in the country, has decelerated pretty much across the board. In particular, residential construction recently has softened noticeably. Our most recent monthly surveys, though, do suggest a bit of a rebound lately in both the service and the manufacturing sectors. It is our sense that despite the deceleration, these sectors are still relatively firm overall, with a few exceptions like textiles and apparel. In addition, labor markets in our region remain tight according to the information that we have, and wage pressures are still evident in at least some local markets, although here as elsewhere these conditions have produced only scattered increases in prices at this point.

In general, I think it is fair to say that households and businesses in our region remain reasonably confident that the expansion is going to continue for the foreseeable future. One manifestation of this is continued, quite marked strength in commercial real estate along the lines of Cathy Minehan's comments. Mike Moskow mentioned that as well. As we pointed out in our Beigebook report, vacancy rates have fallen and rental rates have risen in many parts of the District, and we see at least some new construction activity. In Charlotte and northern Virginia particularly, we see a lot of strength in the commercial real estate sector.

Turning to the national picture, I think the third-quarter GDP report and the recent monthly data are quite encouraging on balance because they suggest that the economy is now moving back to a more sustainable growth path. At a minimum, it seems clear that the very rapid and obviously unsustainable growth rate in the second quarter is not going to persist. Moreover, and for me this is probably the single most encouraging development, the recent drop in long-term interest rates suggests that inflation expectations have diminished in a material way at least for now.

Finally, employment growth has moved back closer to the trend growth in the labor force, and while labor markets remain tight, they may not be tightening further at present. All in all, I think it is a considerably improved and encouraging picture. As you know, I was not at all confident that we would get this kind of outcome without some additional restraint before now on our part. I am happy that things have worked out this way, at least for the time being.

Looking ahead, as others already have noted, the risks of error in the staff's projections are more balanced now than they were. I did not think that there was any significant downside risk until recently, but final demand especially for households was very weak in the third quarter. I don't think we understand this weakness or the related increase in the saving rate very clearly at this point. It may just be noise, and that is my guess, but we cannot rule out the possibility that something more is going on, and we need to be sensitive to that possibility.

Having said all this, I do believe, like Mike Moskow, that the balance of risks is still skewed to the up side on both growth and inflation, if somewhat less dramatically than earlier. It is certainly possible that we could experience a poor holiday selling season and that consumer demand could remain weak going forward. But this outcome seems unlikely to me given what we know about the solid growth in jobs and incomes, continued high consumer confidence, and the behavior of the stock market. Also, the overall level of activity seems to remain high. According to all of the information that I see, labor markets are still quite tight. The Greenbook, after all, is still projecting a modest but steady increase in the ECI over the projection period and also in the core CPI, especially abstracting from the reweighting of the index. So, again, I think the risks remain weighted to the up side. Also, even though the upside risk seems to be diminishing somewhat, as I see it there is precious little margin for error in that direction. We are still at a very high level of activity, and if we see any significant increase in aggregate demand in the near term, that could get us back into trouble in a hurry. So, bottom line, we need to remain vigilant.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Economic activity in the Philadelphia District continues to expand, although the pace of growth has slackened some since the summer. Manufacturing overall reflects this trend. Some industries like rubber, plastics, chemicals, primary metals, and machinery are relatively stronger than textiles and furniture. Retailers are having a better year to date than last year, though there has been some slowing so far this fall compared to the summer. A number of retailers have told us that sales volumes hold up only when prices are cut. Construction activity generally has edged down, with nonresidential construction well under the levels of a year ago and housing permits somewhat above. Labor markets remain mixed, with some areas very tight and others reporting slack. In general, employers report increased difficulty in finding qualified entry-level workers. A major reason is that some minimal level of computer skills is required for many entry-level jobs, especially for clerical workers. There is also a shortage of truck drivers and of skilled tradesmen in construction. In the job categories where shortages exist, there are notable upward wage pressures. Generally, however, wage increases are in the 3 to 4 percent range.

On the national front, the economy is performing according to a script of more moderate, sustainable growth and subdued inflation. The best-bet outlook is for more of the same, though something can always go wrong. There are always uncertainties, and there is always room for improvement. At the same time, the macro economy is performing rather well, and monetary tinkering at this point would be likely to do more harm than good.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, many of us indicated at the last FOMC meeting that we were still waiting for the forecasted and hoped-for slowdown in the economy, but as of that time there were only a few scattered signs of a slowdown. I do not think that is the case any longer. Indeed, while the Sixth District does not exactly mirror the national economy, many of the same trends that we are seeing within the District are now appearing in the national economy as well. Our District economy continues to grow at a moderate pace, although I no longer would suggest that it is leading the nation. Signs of a slowdown are beginning to appear, particularly in residential construction and manufacturing. Tourism, a mainstay for our District, particularly in Georgia and Florida, continues to be extremely strong. Retail sales exceed year-ago levels, and retailers we talk to are optimistic about the upcoming holidays. Our real estate contacts report that the single-family market has begun to slow, albeit from an historically high level, as both sales and construction activity flattened in October. At the same time, multifamily and commercial construction continue strong. Loan demand remains steady, with consumer loan demand described as flat and commercial as mixed. Banks in our region tell us they are beginning to pay closer attention to credit quality.

On the labor market front, we continue to get reports of localized shortages, which are in fact becoming more and more common across the District. At the same time, we are hearing of only scattered wage pressures and, as Mike Moskow and Cathy Minehan indicated for their Districts, there are almost no signs that this tightness is being passed through to consumers in the form of higher prices. We get few reports that there will be any direct impact from the increase in the minimum wage, but some of our business contacts indicate that certain wage contracts are indexed to the minimum wage and hence we will be watchful on that front.

Our outlook for the District calls for moderate-to-strong growth well into next year. We look for some signs of possible slowing due to diminished demand. Although consumer confidence remains strong, we see a slight drop in the willingness to buy big-ticket items. And the regional decline in loan quality suggests the possibility of tighter loan standards and weaker loan demand in the future. Similarly, regional capital investment may slacken unless manufacturers stop revising their capital expenditure plans downward.

On the national front, we see things about the same as everyone else does. The reported drop in third-quarter GDP growth and other more recent monthly data seem to be signalling the slackening that we were looking for, especially in light of the evidence that growth in consumer spending and business investment may be slowing. Despite the evidence of some slowing in the expansion, we still expect forward momentum to continue at a good level, with most of the economy's fundamentals remaining essentially healthy.

We see three key question marks for the forecast, essentially the same as those discussed in the Greenbook. The first concerns consumer demand and specifically when it will pick up and by how much. We think there are some upside risks here. As Al Broaddus just noted, personal income has been up, savings have been up, debt burdens were reduced slightly in October, and the run-up in the stock market has given consumers' holdings of financial wealth an added boost. The second question relates to inventories, which we have already talked about. Looking at the data closely, we feel that a large part of the increase in inventories was not a result of an unanticipated drop in sales but rather stemmed in most cases from attempts to replenish stocks. Inventory-sales ratios remain moderate to low by almost any standard. Of course, the third factor is the labor markets. How long can we continue to have the current job growth and unemployment environment without the resulting tightness beginning to put upward pressure on prices? We think we have been fortunate with developments in this area for some while now, but it is not likely that reduced increases in benefits can continue to offset wage increases indefinitely. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. The expansion of the Eleventh District economy has slowed a little from its rapid pace earlier, but it is still fairly strong. The strengths certainly outweigh the weaknesses. On the up side, higher oil and gas prices are a positive for us at least, boosting activity in the energy industry in the Southwest. The Mexican economy is rebounding, adding to the demand for District goods and services. Nonhousing construction activity is strong in the District, particularly office buildings, warehouses, and industrial space. Call centers are hiring all the people they can get, and there are many reports of labor market tightness. On the down side, the electronics industry is weaker than a year ago. We have seen about a 3 percent decline in electronics-related jobs as compared with 5 percent growth over the previous two years. Homebuilding has dropped off a bit. Employment in motor vehicles manufacturing is down and more layoffs are expected in coming months. On the whole, it is fairly clear that growth remains strong in the District, though it is moderating a little from its earlier pace.

Turning to the question of upward price pressures, the bottom line, as other people also have indicated, is that we do not see much evidence of such pressures yet. There has been a lot of evidence both statistical and anecdotal that the labor market is tight in our part of the country. On the other hand, there is little evidence that the tightness is translating into upward pressures on prices. The labor picture is interesting. I have heard a lot of stories recently and have seen some of the problems that companies increasingly are experiencing in their efforts to find enough help at the lower end of the wage spectrum. We hear of restaurants offering signing bonuses for new employees. People are going into 7-Elevens and getting a job offer when they are not even looking for work. [Laughter]

CHAIRMAN GREENSPAN. Did they think you were worth the minimum wage? [Laughter]

MR. MCTEER. Well, I am not getting any respect as a result of that offer! [Laughter] My own evidence of the tightness in the labor markets came just before the elections. For the first time in my life, I was polled about my political views, and the interviewer had trouble reading the questions to me. She never could pronounce the word "conservative."

MS. MINEHAN. She was from Texas!

MR. MCTEER. I don't know where she was from.

SPEAKER(?). Massachusetts! [Laughter]

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. As far as the District economy is concerned, there is little to report because the very healthy trends continue, as has been the case for a long time. Labor markets remain very tight, and I have no doubt that there are outright labor shortages that are restraining activity and expansion in some parts of the District. Anecdotes of wage pressure have increased and while we are hearing more about that, the pressure does not appear to be showing up in any of the broad measures of wages. I am not in a position to reconcile the anecdotes in one direction and the data in the other. Part of the explanation would appear to be a greater reliance on variable pay, which seems to be both larger and going deeper into organizations than we earlier thought. But the evidence in support of that explanation still is very fragmentary at this point, and I would not put a lot of emphasis on it. Whatever one might say about wages and wage pressures, business people remain adamant, as a number of people have already commented, that they cannot raise prices and that inflation is not something they are confronted with or that they contemplate.

As far as the national economy is concerned, I would characterize developments in recent months as generally pleasant surprises. Inflation has turned out to be less of a problem than I feared earlier, and demand does seem to be slowing along the lines that we anticipated. I am not particularly worried about the third-quarter slowdown in consumer spending. That story looks to me like the dog that does not bark or did not bark. What I mean is that retailers are prone to complain and in fact do complain almost no matter how good things are. The fact that I do not hear them complaining suggests to me that sales remain satisfactory.

I clearly do not understand some of the dynamics in the labor market. If we work our way through the data, there are some signs of an upward creep in the rate of wage increases. But given that we probably have been underestimating the rate of growth of productivity, it may be that cost pressures have been offset to this point. Having said that, we know that businesses are relying increasingly on less skilled, less experienced workers because they are the only ones available to fill vacancies, and we may be at the point where we are about to run through the good news as far as being able to offset somewhat higher wages with productivity improvements. That is, we may start to see real increases in labor costs and the pressures that follow from that. I do not know how much to make of that at this point because, as I said earlier, it seems to me that most of the surprises in recent months have been pleasant.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, the economy in the Kansas City District continues to grow moderately and consistently. Our directors and other business contacts generally report healthy economic conditions throughout the District. Retail trade appears to be holding up well across all seven District states. A recent survey of District manufacturers conducted by our Bank found that moderate expansion of production schedules is in place at this time. Despite some generally favorable anecdotal reports, employment has leveled off in recent months. It was unchanged in September and up just a little in August. Improved conditions in our agricultural sector have raised income levels somewhat, and we are seeing some drilling activity in our energy sector as well. Overall consumer and wholesale prices now appear to be rising slowly but consistently across our District. Labor markets are indeed tight, and we are hearing more frequent reports of wage pressures for our manufacturers as well as for our retail and service industries.

For the national outlook, our projections are very similar to those of the Board staff. Over the next several quarters, I look for real GDP to advance at around the trend rate of 2 to 2-1/4 percent. There remains, as others have mentioned, some uncertainty about consumption, but we believe that the underlying fundamentals are good. Looking at other sectors of the economy, it appears that we can expect solid economic growth in the fourth quarter. For example, the industrial sector continues to expand, and housing activity should remain healthy, given the declines we have seen in long-term interest rates. While we have a CPI inflation rate that is now reported to be running around 3 percent, allowing for the methodological adjustments being made to this measure, that still reflects an upward move in the inflation rate. I think this has been noticeable over the last 18 months. As it has in the past, the rise in inflation continues to concern me. Thank you.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. Eighth District economic conditions continue to be very good. Sales increases, employment gains, and plant expansions are reported far more often than declines and closures. Firms recently announcing plans for new facilities include some in the poultry processing, paper products, and package delivery businesses. Most firms report inventories at or slightly below desired levels. Construction permits for new homes were up recently in more than half of the District's 12 metropolitan areas. Two District auto manufacturers, Chrysler and Ford, plan to produce 334,000 cars and light trucks in the fourth quarter, an increase of 15.2 percent from third-quarter levels. Current plans call for first-quarter 1997 production to exceed first-quarter 1996 production by about 2.7 percent. Also, farm income is strong because of generally high prices and good yields.

With respect to labor markets, unemployment in several Eighth District states remains near 20-year lows. In Missouri, for example, the September unemployment rate was 3.9 percent, well below the national average and the state's unemployment rate one year ago. District payroll employment growth on the other hand was 1-1/2 percent at an annual rate from June through September, somewhat below the national average of 2-1/2 percent. Given other developments, this may reflect a shortage of qualified workers to fill positions rather than weak labor demand relative to the nation. District labor markets are tight.

The national jobs picture is similar. For 1996, the average gain in nonfarm payroll employment has been about 209,000 per month or 2.1 percent at an annual rate, well above the Board staff's longer-run trend in labor force growth of about 130,000 workers per month. The national unemployment rate, as we all know, was 5.2 percent for October. All in all, labor markets remain robust. There has been some moderate wage pressure associated with these tight labor markets. The Greenbook notes that the employment cost index increased at 2.9 percent in the third quarter, up from 2.6 percent in the third quarter of 1995. Unit labor costs increased at a 4 percent annual rate in the third quarter, about double the rate in the first half of the year.

Financial markets have concluded that the slowdown in real GDP growth has reduced the urgency for immediate action by this Committee. That may be correct, but the facts are that in each of the last three years, we have managed to achieve fourth-quarter-to-fourth-quarter CPI inflation rates a few tenths under 3 percent. This year, on the other hand, CPI inflation will move higher to an estimated 3.2 percent. And forecasts for next year on a consistent basis are higher still, as was mentioned earlier.

In short, we are in the process of violating an implicit upper bound on acceptable inflation, which may cause some to conclude that the Committee's tolerance for inflation is rising. Furthermore, the current inflation rate is too high in my opinion to allow for maximum efficiency in the U.S. economy. But because markets believe we are focused solely on short-run developments in the real economy, there is apparently no rationale for tightening unless inflation moves up markedly, which of course we all know is too late once it occurs. In my view, the Committee should develop a plan to move inflation lower and publicize that plan through an announcement of multi-year inflation targets. Lack of transparency in policymaking is preventing the Committee from gaining full credibility and is causing market participants to demand compensation for possible inflation surprises in the future. While current long-term interest rates on U.S. Treasury debt seem low, they could be lower still if market participants were less worried about inflation making a comeback. A clear statement of our objectives and actions consistent with those objectives could help in this regard.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, the economy of the Second District advanced at a slow but steady pace in recent weeks. Private payrolls rose at an annual rate of 1.2 percent in New York and 1 percent in New Jersey in September. Job growth kept pace with labor force growth, and unemployment rates therefore were essentially unchanged. Consumer spending was moderately strong. Retail sales growth remained in its recent range of 4 to 5 percent. Sales in the existing home market softened a bit but from near-record highs that characterized recent months. Housing demand remained strong and price increases were reportedly in the range of 5 to 6 percent. Builders tell us that construction of single-family units declined sharply but that construction of 2- to 4-family condominiums was robust. The vacancy rates for prime commercial office space declined in most metropolitan areas throughout the Second District, while rental rates continued to firm throughout the dominant Manhattan market. The consumer price index for the New York/northeastern New Jersey region ticked up to 3.1 percent on a year-over-year basis. Leaving aside monthly gyrations, the CPI in our area has averaged 2.8 percent over the last two quarters. That is about on a par with the national gain of 2.9 percent.

On the national level, our forecast is rather consistent with the views that have been expressed here, at least those of the Greenbook and of the members who are generally sympathetic with that forecast. The concern we have been spending a good deal of our time looking into is whether the tightness that all of us perceive in labor markets is something that is likely to plague us soon and, if so, how. Most economic theory says that if compensation growth does accelerate, it will be passed on to higher prices if labor's share of costs, labor productivity, and the profit margin are all constant. But according to the research that has been done throughout the country, the linkage between the cost of labor and the price level varies from very weak to reasonably strong. In fact, the research that was conducted recently at the New York Fed suggests the strongest link. But generally speaking, the research indicates that the link is not particularly strong, and we have been looking for the reason why that might be so. One possible explanation we have come up with in work that is still very much in progress is that expenditure categories accounting for about half the CPI do not indicate that changes in labor costs have a significant direct effect on prices. That is because either the labor costs represent a negligible fraction of total costs--for example, in existing housing, food that is consumed at home, or in energy--or because of the government's role in price setting as in medical care, tobacco, alcoholic beverages, utilities, and public transportation. That seems to us to leave the remaining half of the CPI as the place to look for a stronger link between compensation and finished prices.

We find that labor costs matter in two areas, but a good deal more in one of the two. We find the linkage quite weak in the area involving the production of goods and the prices of the goods. I think that is the area about which we hear so many anecdotes saying that the labor market is very tight, but even if labor costs go up businesses say they cannot pass them on to prices. The competitive marketplace makes that very difficult. But there is another area, namely, labor-intensive services that account for about 23 percent of the CPI, where there is not so much discipline on pricing, at least not any that is close to being comparable to that of the goods producing area. So we have been looking at the linkage between that portion of the ECI attributable to people who produce services and the cost of services. There the linkage is quite clear. That is, if we look back over almost any period of time we see that as costs go up in that area, prices follow rather quickly. That is the area that we think we have to concentrate on most. But even in that area, the related portion of the ECI has not been moving up. Therefore, that particular alarm bell, which we think is the first one that really indicates approaching problems, is not yet ringing. We have not been able to find any convincing reason to think that productivity improvements have been absorbing increases in labor costs. We are all aware, of course, that the productivity numbers are not very good, but we do not think that that is an area where we can place a lot of confidence, at least not yet.

The other area that we in New York and most of us around the table have been talking about relates to whether the share of corporate profits in national income has been producing something of a buffer. One would think that is true for the first two quarters of this year. As the data keep coming in on the third quarter and we start getting into the fourth quarter, we are rather inclined to believe that that may be behind us. Corporate profitability is in fact beginning to turn down a bit and, therefore, the notion that increases in compensation will be absorbed by lowering the profitability level is probably not a very good bet to make.

Our conclusion from all of this is that we understand better why there has been better price performance than a lot of people thought there would be but that the labor market still is tight. That portion of it in the service area seems to be tight. Therefore, there is still reason to be cautious. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. In the relatively long interval since our last meeting, gave us two reports from an area we had not heard much about. He said it appeared that the had gotten itself in a bit of a jam, but they were going to try to preserve as many jobs as they could. [Laughter] Listening to directors on a recent conference call reminded me of how important it is to listen very carefully. One of them very forcefully stated that he had seen very strong evidence of weakening demand for steel. He indicated that domestic demand was flat, and he thought it would actually be down in 1997 compared with 1996. Imports would continue to be a problem, and the new capacity he has been telling us about for the last couple of years was already coming into production and capacity would increase further in 1997. He said the new mills were the price leaders. The productivity of these new mills was so much greater than that of the preexisting capacity that he saw substantial downward pressure on prices and some very difficult times ahead for the older mills.

Another report from that I found very interesting in terms of new developments came from a company in Columbus, Ohio, It is like a Mrs. Fields but very diversified. The official from that firm said that the fastest growing segments of her business are catalog orders, as she calls them, that come in over 800 numbers and increasingly this year over the Internet. and I asked her what would happen if she came into the office on a Friday morning and found a message from Osaka ordering pastries for a Monday morning meeting. She said that her firm gets such orders all the time because there are so many Japanese associated with Honda and other firms in Ohio. They learn about the gift box that her firm sells and their orders then start to come in over the Internet. When I asked about the cost, she said that for a group of 15 people her firm would arrange for delivery on that Friday afternoon. The package would arrive in Osaka on Sunday, and it would be delivered on Monday for about $100, including transportation. She said that was less than they would pay to buy the pastries locally. I asked if she ever thought of herself as being in the export business. She said, No, and she didn't care. What difference did it make? She may be right about that, too.

We also met in recent weeks with a lot of bankers in western Pennsylvania, West Virginia, and all over Ohio. Especially with the community bankers, the consistent story in meeting after meeting was about the quality of consumer credit. One banker would get started on that subject and then everybody would tell stories not only about rising delinquencies and increasingly slow payments, but the phenomenon that most worried them was that of people who had never been late in making their payments unexpectedly walking into the bank and declaring themselves bankrupt. Basically, these were stories about the pyramiding of credit card debts through transfers of debt balances from old cards to new cards until the borrowers ran out the string and their incomes simply could no longer service the debts. So, they declared bankruptcy. The bankers said that the charge-offs could be very high for this quarter, but there was a difference of opinion about the future. Some said that they thought they had tightened up enough that this would be the worst quarter; others believed that 1997 was going to be much worse. We met with the senior credit officers of about a dozen of the larger banks, and they all said that charge-offs would be much greater in 1997. They are very concerned about the credit quality of their loans on the consumer side, though increasingly they seem to be concerned about the commercial side, too. They all believed that their own exposure to commercial real estate in the form of shopping center stores--they call them boxes--and hotels that they have financed is going to be a problem in 1997.

I asked them about their earnings projections. They were all budgeting for double-digit loan volume growth in 1997. I asked them to square that with the nominal GDP growth of about 4 to 4-1/2 percent, and of course they said they were going to take it from their competition. [Laughter] They all confessed concern about margins next year and said that they simply would not be able to sustain their current earnings levels without the loan volume they had built into their budgets. So, 1997 is going to be an interesting year in terms of bank earnings.

On the national economy, the Board staff has revised down its third-quarter GDP numbers from those shown in the Greenbook. Based on the latest GDP numbers and until we get new data, I assume that means the productivity growth number was close to zero in the third quarter, which defies belief. We can talk all we want about whether the productivity number is bigger or smaller, but it is wrong. It is simply inconceivable that there was no productivity growth at all in the third quarter. In fact, the productivity numbers for this whole year are just not believable.

What I am encouraged about is the Board's staff projection of the nominal GDP trend. I was very concerned in March of this year when the staff first made a substantial upward revision in its projection of nominal GDP for this year and out into 1997. I was even more concerned in August when that projection was notched up further, but since then the upward adjustment has all been taken away. The staff now has its lowest nominal income growth projections through 1997 since around 1995, including a growth rate of around 4 percent or a little more as we finish the year, about the same as it appears to have grown in the third quarter. I do not know precisely what the growth of nominal GDP was for the third quarter; it was probably below 4 percent. The staff has raised its growth projection for the first quarter of 1997, but that is strictly on the basis of an assumed rebound in auto sales. If we take that rebound out of the projection, nominal GDP growth is still flat at about 4 percent. So, out through

1998 the expansion of nominal GDP in this projection is still running at a rate of around 4 or 4-1/4 percent. These numbers are well below the central tendency of the nominal GDP forecasts that the Committee members provided in July for the year 1997, and they are below our own forecast in Cleveland, which was at the lower end of that central tendency.

The question, then, is how can we get an acceleration of inflation? It has to result from an acceleration in final demand, and we are no longer seeing that. In fact, each successive revision of the nominal spending forecast has been in a downward direction. Conceivably, if one were to believe such a forecast, higher inflation could result with such nominal GDP growth if real output were to drop further to little or no growth. As a practical matter, I do not see how the Board staff could be wrong on the low side of its nominal spending forecast unless I am given different assumptions than I have seen so far about money growth, which has continued to come in below the earlier assumptions, or I am told it has something to do with velocity. But such a velocity story would not be consistent with the interest rates we are seeing. In fact, the story goes in the opposite direction. The way I use MZM, as I have tried to describe before, is as a contemporaneous monitoring device of what is happening to nominal spending with a consistent set of assumptions about interest rates and money growth. That tells me we are more likely to see weaker rather than stronger final demand in the period ahead. I think that the risks are growing on the down side, not on the up side. That view was reinforced by these stories that bankers tell about their consumer credit portfolios.

I have one last comment on labor-intensive services that Bill McDonough was just talking about. I think there is a very interesting issue in the linkage here that deserves some further research. If one thinks about a self-employed person in business services, the price of the service is, of course, going to be equal to the person's compensation because output in this case is defined as the labor input of one person. That cannot change. There is no productivity in the calculation. So, any increase in compensation would be all inflation simply by definition.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. The data available since the last meeting confirmed that the economy has slowed to trend growth. They suggested that an unfavorable mix between final sales and inventory investment in the last quarter weighs heavily against a rebound to above-trend growth in the period immediately ahead. The data also indicated that the acceleration of wage and compensation costs that is under way is somewhat more modest than previously anticipated. And despite the stabilization of the unemployment rate at a level that may yet prove to be below NAIRU, inflation remains remarkedly well contained. On balance the data, if not precisely consistent with every aspect of that forecast, at least matched our fondest hopes and rewarded our patience.

The prevailing economic environment, however, is not without risk going forward. The main challenge in my view lies in the suspicion of many of us, precisely as set out in the staff forecast, that trend growth at the prevailing unemployment rate will ultimately prove to be inconsistent with stable inflation going forward. Nevertheless, in the near term there may be more downside than upside risk with respect to GDP growth, particularly given the absence so far of any clear evidence that the collapse of final sales in the third quarter has been reversed and given the restraint to production in the period immediately ahead from the projected slowing in inventory investment.

Over the more important intermediate-term horizon of the staff forecast, on the other hand, favorable underlying fundamentals do I think support expectations of growth near trend. Such growth might be incompatible with stable inflation, given the current low unemployment rate. Still, this outcome is far from preordained. Given the current federal funds rate setting, growth could easily be below trend, especially in the near term but even over the forecast horizon. The unemployment rate could gradually increase to NAIRU before the building wage pressures are passed through to higher inflation. If this sounds too good to be true, one should note that this is essentially the Blue Chip consensus forecast. The Blue Chip panel projects 2 percent GDP growth over 1997, measured on a fourth-quarter-to-fourth-quarter basis. While this is just below the 2.2 percent rate of the Greenbook forecast, it is enough to produce a modest but sustained increase in the unemployment rate. The latter reaches 5-1/2 percent by the end of 1997, a level almost identical to the downward revised estimate of NAIRU in the staff forecast. As a result, inflation stabilizes at 2-1/2 percent for the GDP deflator and 3 percent for the CPI. Even if the staff forecast proves to be correct, a more likely prospect in my own mind, the projected acceleration in labor costs over the forecast horizon is modest, thereby containing the threat to our long-term price stability objective over the time period required for a tightening of policy to reverse the rise in inflation.

For the moment, a continuation of remarkably subdued price inflation gives us the luxury of waiting for the data to clarify whether growth will remain at or above trend and whether the unemployment rate will begin to rise while we continue to monitor wage pressures and benefit costs. We should not, however, be lulled into believing on the basis of the most recent data on wages and compensation that the acceleration in wages that we have been monitoring and worrying about at recent meetings has abated. In particular, I find the third-quarter employment cost report literally too good to be true. Rather than taking at face value the deceleration in wage costs from a 4.3 percent annual rate in the first quarter to a 2-1/2 percent rate in the third quarter, I believe it is prudent to focus on the gradual but unmistakable uptrend in the four-quarter growth rate to 3.3 percent in the third quarter from 2.8 percent a year ago. Part of the explanation for this surprising pattern of deceleration in the quarterly wage data may be the volatility of quarterly wage changes for sales workers associated with their commissions. Leaving out sales workers, the uptrend in annual wage increases is both more consistent and steeper; it rises from 2.7 percent a year ago to 3.4 percent in the year ended in September. For the moment, the slower acceleration in benefit costs has damped the effect on labor costs of the rebound in wage changes. In addition, the effect of higher compensation costs on prices may be damped for a time by declines in markups, especially in light of the widespread expression by firms of the lack of pricing leverage. Nevertheless, if benefit costs accelerate toward the rate of increase in wages, we will move very quickly toward the staff forecast of an increase in compensation per hour near 3-1/2 percent. At some point, firms will exhaust their willingness to accept compression in their markups. We may therefore be living on borrowed time, but given the slowdown in growth and the recent pattern of price inflation, we still have time to make sure.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. Once again we find ourselves in a very good situation and one that is remarkably uniform, as the stories around the table suggest. Tight labor markets, which have a potential for making a considerable contribution to the long-run efficiency of this economy, provide an opportunity for people of modest skills to increase those skills and move up to jobs that provide moderate increases in income. If the shortages of people with computer skills result in more people obtaining computer skills, we will be a lot better off going forward. If Bob McTeer's young interviewer learns to pronounce "conservative," she may well get a better job, and all of this is to the good.

At the same time, we have the slowing in the expansion that we predicted and little evidence of rising inflation. The economy is generating the kind of mixed signals that we really like to have, although they make us a little uncomfortable as forecasters because it is more difficult to tell what will happen next. I could build a case, and I think we all could, for the expectation that the economy will rebound more rapidly than we would like it to and that the mystifyingly proper behavior of inflation, as several members have suggested, may be only temporary. The consumer may come roaring back during the holidays and beyond. I could also build a case for excessive slowing, and some have suggested that. The consumer may remain cautious in the face of rising debt, and the clearly overvalued stock market might head down, perhaps sharply. Much depends on post-election political developments. If we get strong evidence, which we might get fairly quickly, of a bipartisan will to continue the deficit reduction process, that could reassure both consumers and the financial markets and give us lower long-term rates as a solid basis for the continuation of moderate growth. That would be the best gift that the newly elected candidates in both the White House and the Congress could deliver. But it will not be easy. It will be a lot harder to make further progress on the deficit than it was in the last several years.

In sum, the Greenbook forecast looks as good as any to me. The risks, as several people have pointed out, seem a lot more symmetrical now than at the time of the last meeting, but I would expect to be back in a month looking at very much the same problem.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Thank you, Mr. Chairman. Since Thanksgiving is almost upon us, it seems appropriate to count our blessings, which are numerous. Economic performance with respect to both job creation and inflation has been excellent, and developments during the intermeeting period have enhanced the prospect that these favorable trends will persist. In the first place, it now seems probable that spending growth will moderate quickly enough to avoid placing additional strains on the labor market. Second, inflation remains well contained. In fact, the data on broad measures of inflation in Part II of the Greenbook suggest that inflation performance has been better than merely well contained since, as Bob Parry mentioned, every broad measure of inflation other than the total CPI has been trending downward since 1993.

With respect to inflationary pressures in the pipeline, the third-quarter ECI report failed to confirm our collective fear that labor market pressures would translate into an accelerating compensation trend. I was quite pleased to see that with the passage of yet an additional quarter in which compensation ran at such a moderate pace, the staff has finally revised down their estimate of NAIRU to 5.6 percent. I consider this a sensible response to roughly two years of evidence that the dynamics of inflation have changed a bit. Additional good news from an inflation perspective is that prices of commodities and intermediate goods have turned down since our last meeting. The outlook for food prices has improved, and even the outlook for energy prices is more favorable. In contrast to pressures in the labor market, pressures on capacity do not seem intense at this point, and investment in plant and equipment is still rapid enough in the staff forecast to mitigate capacity pressures even further over the forecast period.

Finally, there are hints that firms may be stepping up the less visible investments that they make in their workers to create through training the skills they require in their workforce but find in short supply in the labor market. I would agree with Governor Rivlin's comments in this regard. In particular, I was struck by a recent Business Week article that detailed myriad ways in which the Marriott hotel chain and several other large corporations are working with unskilled, disadvantaged workers to inculcate good work habits and in particular to teach English as a second language to improve basic literacy and create opportunities for eventual promotions into more responsible positions. These investments are on the flip side of the hysteresis process that is believed by many observers to have raised NAIRUs in European countries; that occurred as young people unable to find jobs experienced deterioration in their skills and lost attachment to the world of work. So, I would agree with the view that there are benefits as well as costs to tight labor markets.

In spite of all that is going right in the American economy, I too remain concerned about the outlook. My first worry relates to the Greenbook's assessment. I agree with the staff that we may well be living on borrowed time and that inflation will eventually accelerate if the unemployment rate remains at its current level, as in the Greenbook forecast. Although I believe there is strong evidence that NAIRU has declined below 6 percent, it seems difficult to use the data in hand at this point to defend the proposition that it is as low as 5.2 percent.

My second worry relates to the behavior of aggregate demand. Here I have no quarrel with the staff's estimate of moderation in growth to a shade above trend in 1997 and 1998, but I am concerned about the risks. With drags on growth stemming from government spending, residential spending, and trade, and with reduced impetus to growth from investment spending, the behavior of consumption, as Mike

Prell emphasized, is critical to the outlook. The Greenbook assumes that consumption will quickly rebound and then grow in line with disposable income. As Mike noted, consumers have greater income and wealth and their confidence is high, so it is perfectly reasonable to assume that the third-quarter spending lull was temporary and a statistical aberration. Indeed, I think one could easily justify a much stronger consumption forecast than in the Greenbook, given the enormous gains in stock market wealth and the huge increase in household net worth that we have seen in spite of the buildup in consumer debt. On the other hand, I am equally concerned about the downside risk to consumption because at this stage a rebound in consumption spending is a forecast and not yet a fact. During the third quarter, it seems that three things occurred simultaneously: consumer spending stalled, the growth of consumer credit plummeted, and lending standards tightened. I do not know just what caused what, but with household debt burdens--if one includes leasing payments as Governor Lindsey likes to do--approaching all time highs and with bankruptcies surging and consumer credit charge-offs running well above expectations, it is not very surprising that lenders would tighten standards. It seems perfectly possible to me that the consequence could be weaker spending by liquidity-constrained households than the Greenbook assumes. I also would agree that a significant stock market correction, which cannot be ruled out, adds downside risk.

Well, where does that leave me? It leaves me thinking that it is certainly within the realm of possibilities that growth may slow enough over the forecast period to bring the economy back toward NAIRU under the Greenbook assumption concerning monetary policy.

CHAIRMAN GREENSPAN. Thank you. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. I think this Committee is going to be facing some difficult issues in the years ahead. As if we don't have enough to worry about, I want to throw one other issue on the table and explain why I think it is more important than what we have been talking about. Mr. Chairman, you were the one who put me in this pickle. You had to go to another meeting, and so I had to talk to a group after you walked around the table, shook all their hands, went out the door, and there I was! [Laughter] Interestingly, it was a group of Dutch visitors, but there also were Japanese in the audience. One of them said that 15 years ago when he was stationed in New York the Dow was at 1,000 and now it is at 6,000. He asked me how I explained that. Well, that is a sure way to get oneself in trouble, so I did some quick, fancy math and explained how 6,000 was a perfectly reasonable number. Throw in nominal GDP growth and profit share growth and, voila, we were pretty much there. In fact, I got the Dow up to 6,600 [laughter], and then I stopped and just breathed a sigh of relief. I had other things in the background in case I did not make it!

But here is the problem. Let's take a shorter period, 1992 to 1996. The S&P index has gone up about 69 percent and corporate profits have gone up 63 percent. That sounds pretty reasonable. The catch here, of course, is that if the markets are at all forward-looking, they are presumably buying the next five years' profits, not the last five years' profits. It is not clear all mutual fund buyers know that, but that is what they should be looking at. At the beginning of an expansion when you are about to face five years of 13 percent growth in profits, you can put a higher evaluation on stock prices. Implicitly, therefore, the fact that stock prices have risen as fast as profits implies an expectation of another five years of 13 percent growth in profits. But that would be inconsistent with the numbers in the Greenbook, and that gets to the root of our problem. I think that because of our success people have now pushed the perceived risk of a recession so low that they are putting valuations on financial assets and--God forbid, they are erecting buildings in Boston again--on real assets that pose a problem for the future. I think Governor Meyer was exactly on target in quoting the Blue Chip as an indicator of where people think we are heading. The consensus now is that inflation is permanently under control and that we will have continued moderate growth, probably permanently, though with some down quarters and some up quarters. As a result of our great success here, we have low and stable interest rates. I would suggest that our recent well-intentioned silence may actually be leading to even more of a sense of security, which may be good in the short run but is probably not good in the long run. In addition, we have world peace. The only remaining risk in the forecast is political risk, and the market says that we have taken care of that by electing a divided government.

So what is there to worry about? Well, I have a little list and I am going to go over it in reverse order. One is the oil sector which I think is probably riskier than is perceived in the Greenbook, particularly when one looks at the situation in the House of Saud and places like that. That is a low probability risk. Then we come to the consumer debt slowdown. Here I think we really have a two- to three-quarter story at most, unless either we or the banks mess it up, and I do not promise that. Back when I first commented on consumer debt at the beginning of 1995, I was looking at 1994 numbers. I estimated that to get out of the consumer debt hole, the personal saving rate had to rise by about 1-1/2 points from what it was then, about 3.8 percent in 1994. We are up to almost 5 percent now; a little more and we will be there. There is nothing really to worry about. A couple more quarters of drag on consumption growth and we will be fine. But I think there is the possibility that we as regulators and the banks will make things worse, particularly if Jerry Jordan's story is true about what to expect in 1997. I have learned in this job that bankers are very predictable and regulators are very predictable as a result. We have to be very, very careful in making sure that we do not have a consumer recession that we create by regulatory decree. But basically I do not think there is that much of a risk if we leave well enough alone.

There is also a political risk. At our last FOMC meeting, I said that if we got a narrow election result, which is what the markets wanted, the result was going to be a lack of political courage. The new Congressional leadership has signaled that they are going to sit back and wait six months for the President to come up with a budget. The President has signaled that he is going to support a balanced budget amendment, which he is going to be stuck with anyway. So, we have nobody taking action except to push through something that will save us from ourselves. That sounds a lot like what I hear in Europe, which is that Brussels is going to save the politicians from themselves in each of the countries. I think that, when the markets recognize that we are trying to postpone severe fiscal problems by finding commissions or balanced budget amendments to deal with them, there is a potential risk for the bond market and for the economy in the years ahead.

The biggest risk relates to the current stock market valuation based on 13 percent growth in profits. It comes back to simple math. Nominal GDP growth in the last four quarters has been 4.2 percent. As Jerry Jordan pointed out, if we look at the money growth numbers, there is absolutely no reason to expect such GDP growth to accelerate. I admit that we do not know a lot about money growth, but everything we do know suggests that nominal GDP growth is not going to accelerate. How we are going to get 13 percent growth in corporate profits, or 11 percent growth or anything like that, to validate these levels of the stock market I am not sure. If we have a problem there, either the market will stop rising or we will have to decide whether we are going to make it stop by injecting a little risk into the process. And, frankly, I think that call is going to be our toughest decision in the years ahead.

CHAIRMAN GREENSPAN. Thank you. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. The economy currently seems to be in a fairly wide holding pattern. The anticipated second-half slowdown is under way, although we do not know its extent. As always when we are trying to look forward, it is hard to know whether we are going to circle for a while longer, come in for another soft landing, crash land, or resume higher altitudes. At least for the near term, it seems to me that the holding pattern is the most likely scenario. The slowdown in the third quarter now appears to have been more pronounced than was earlier thought, given the recent inventory numbers. But low inventory levels should make the fourth quarter of 1996 and early 1997 look a bit stronger, leaving the outlook on balance for the second half of this year at the proverbial sustainable level. Although we are beginning to hear some arguments about weaker demand, I think the arguments that the economy may be slipping into a recession are fairly weak. They depend on continued weakness in consumer demand and housing, and associated slowing in the manufacturing or industrial sector. It seems to me that most of the recent economic indicators are pointing to a bit more strength, or at least to a soft landing, and there may be some tail winds for higher altitudes.

With respect to the spending situation, there will be some propensity for consumers to spend as long as we continue to have a strong labor market and people are making money. That view is supported by some of the recent consumer confidence numbers that may in turn be fueled by the wealth effects of the strong stock market. The retail surveys are pointing to a reasonably strong holiday season. It is even feasible that we could see some tail wind action from lower interest rates; the housing market feasibly could get a modest boost. Business fixed investment, including nonresidential construction, has been holding up better than most forecasts. Financing is generally available. At least for now, we are seeing continued internal financing available as business profits have held up. Maybe, as Governor Lindsey says, that will not continue. Even so, if profits start to get pressured, the cost of external capital is low as a result of low interest rates and the rise in stock prices. Banks are continuing to provide financing. Foreign investment is another source of strength. There is evidence that businesses are issuing new debt and equity and utilizing increased bank financing. Maybe they are putting all of it under a mattress, but productive activity is more likely.

On the inflation front, we may also be in a holding pattern. We are in the middle of a period of gathering the most current data, and what we have, I think, is relatively encouraging--the core PPI data that came out this morning, lower commodity prices, better-than-expected crops, and a fairly benign third-quarter GDP deflator and other PCE deflators. The recent ECI numbers were surprisingly benign.

There are some uncertainties in this scenario. Will consumer debt, in fact, damp spending or will some of the labor market uncertainties in the era of downsizing damp consumer enthusiasm? If there is a stock market correction, it is hard to know how that is going to play out. It depends obviously on how deep a correction we have.

Fiscal policy has been a bit on the back burner at our last couple of meetings. But with the elections over and Congress coming back, we are starting to hear discussions of another budget deal. Depending on how it is structured or how contentious the budget negotiations get, this issue may throw some uncertainty into the financial markets or cause some uncertainty among consumers.

Turning to productivity, the numbers do not provide much support for increased or continued progress on inflation. Given current wage pressures and low unemployment, we should either be seeing lower profits or price increases or improved productivity. We are not seeing any of those. So, I continue to be skeptical of the productivity numbers, but we really do not know the full story.

In sum, I think that the picture that we painted at the September meeting is playing out much as expected. The slowdown is confirmed. And while there are risks, I think that on balance the best guess going forward is continued growth.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. I would like to say first of all that comments around the table at these meetings are always insightful and very interesting, but I have found that to be particularly true this morning and I greatly appreciate it. It also would appear that the discussion is moving along rather smartly today; we may get coffee at a more reasonable hour than we sometimes do! By my calculation, I am the clean-up hitter and I have very little to add to what has been said.

Let me just summarize very briefly. I share the strong general concern around the table that the tight labor markets and the attendant rise in wages could very well lead to price increases. That still could very well happen, but we see very little evidence of such a development so far, and we will just have to watch that very closely. The one big thing that is new this time, as we had hoped and expected, is that we now have confirmation that the expansion has slowed. Looking ahead, our attention obviously must shift to whether the expansion is in line for a reacceleration with the dangers that would be attendant to that, whether it will rock along near trend, plus or minus a bit, or whether indeed the economy may be in the early stages of a somewhat more serious slowdown. The point has been made, and I share it, that as time goes on and events unfold, the risks are becoming more symmetric. We cannot tell yet, and I am not prepared to adopt a symmetric point of view at this juncture, but it may be that we will be thinking quite soon of returning to a symmetric directive. For now, it would certainly appear that the remarkable economic performance that we have seen for some time is continuing. We should watch it closely and continue to let it run. Thank you.

MR. LINDSEY. There is a question at this time regarding the availability of coffee.

CHAIRMAN GREENSPAN. We will adjourn for coffee, whether it is there or not. [Laughter]

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Lindsey.

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

CHAIRMAN GREENSPAN. Thank you very much. Any questions for David?

MR. JORDAN. I had a question all ready, David, about trying to square the Bluebook with the Greenbook, but your last remarks about the aggregates go in the same direction. That's because you anticipate M2 growth of 4 percent for the year, and that means there will have been essentially no increase or a very small increase in M2 velocity this year. As I noted earlier, the Greenbook has a nominal GDP growth forecast of 4-1/4 percent or so. I track nominal GDP on a four-quarter moving-average and an eight-quarter moving-average basis, and that, of course, produces a growth pattern that has been trending down over the last several years. Now, if I run that trend out through the end of 1998 using the Greenbook's forecast of essentially 4 to 4-1/4 percent nominal GDP growth, such growth must accelerate beyond the Greenbook horizon to validate the staff statements about inflation and a policy stance involving a 5-1/4 percent funds rate. The staff forecast is getting close to the point where the CPI is growing at the same rate as nominal GDP. That does not compute. That means we have to have nominal GDP growth accelerating beyond the forecast horizon, and I do not see the mechanism by which a sustained 5-1/4 percent funds rate produces the needed increase in the growth of aggregate demand.

MR. D. LINDSEY. I will turn to Mike Prell for answers to some of your questions about the forecast. As I look at the nominal GDP numbers on a four-quarter basis starting this year, I don't see much change in the annual growth rates, which go from 4.7 percent this year to 4.5 percent in 1997 and 4.4 percent in 1998--actually a little deceleration. I do think, though, that the question of the CPI versus the broader measures of prices is something I should probably pass on to my R&S colleagues.

MR. PRELL. Thank you. [Laughter] Let me just say once again that our forecast is not based on the monetary aggregates. Rather, we derive what we would expect in terms of monetary aggregate growth through our assessment of likely patterns of money demand consistent with the interest rates and economic activity we are forecasting. That is a different framework than I think you are suggesting for thinking about the outlook for nominal GDP. As we look ahead, we see an economy that is operating above potential and a gradual acceleration of inflation. In such an economy, the growth of real output tends to erode gradually over time. We anticipate some gradual deceleration in real output growth from 1996 to 1997 and 1998. I think there is a coherence to this, and nominal GDP is just a summation of these forces as we see the picture. I do not have a particular view about 1999, but certainly we are coming out of 1998 in no better position with respect to the alleviation of inflationary pressures in the labor markets. So, we would anticipate at this point an extrapolation of that gradual acceleration of inflation.

CHAIRMAN GREENSPAN. Any further questions for David? If not, let me get started. As far as I can see, the outlook is very little changed from what it was at the time of the last meeting. The outlook may have shifted toward slightly slower growth, but only at the margin and within the expected range of statistical error.

The data are difficult to read, but labor markets unquestionably are still quite tight. My suspicion is that our measures of labor costs may be biased downward in the third quarter. This is my impression for reasons other than those that have been raised around the table.

First, I don't think we have enough data to verify this hypothesis on a national level, but it clearly shows up at a micro level in the sense that, when we have a very tight labor market, some of the wage increases take the form of promotions. Consequently, we get a grade updrift that does not show up fully in the wage structure, which is essentially what the ECI represents. Compensation data do suggest that some of the grade drift may be in addition to the real drift toward truly higher skilled workers.

There is also a question about the average hourly earnings for October, which as we know came in at zero. But I think the staff has also demonstrated quite credibly that the industry-by-industry correlation between average hourly earnings and average hours is significant. This implies that there is an overtime component in these data. There was a significant decline in average weekly hours in October, and adjusting for that would raise the October average hourly earnings number by something like .2 percent. That is not a big change, but I think the data are giving us a more benign look at the wage structure than probably exists.

There also is the issue on the other side as to whether the acceleration in entry-level jobs suggested by anecdotal reports is being offset by an increase in the number of people leaving the labor force, largely through retirement. I am not sure whether the wage rates of retirees are rising, but because the wage rates of these older workers are higher than average, the ratio does not have to rise. The rate of retirements just has to be high enough to overcome the general aging of the remainder of the workforce to allow us readily to reconcile higher entry-level wages with a still sluggish structure of wages overall.

Another issue is the variable pay question that was raised earlier by Gary Stern. The surveys are beginning to show that for a proportion of the workforce, which is still relatively small, wages are significantly related to profitability or other company results. This means that the issue applies to a much broader group than sales workers. It is an important issue because to the extent that we have big wage increases as a consequence of, or tied to, profitability, such increases are not necessarily inflationary. That is true because as costs go up in relation to prices, profit margins are squeezed and those wages automatically start to adjust down. So, while it may be true that the wages of commission sales workers have been slipping relative to the average, which is the reason why the numbers for non-sales workers have gone up somewhat more, that may be partially offset by the higher wages of the increasing proportion of workers who have their salaries tied more closely to profitability.

What I see as the bottom line of all this is that the wage structure is extraordinarily dynamic and not easy to read. The only thing we know for sure--or more precisely for which our information is fairly accurate--is total wages and salaries, and probably average hourly wages and salaries as well if one is prepared to argue that the data on hours worked are not all that bad. But any effort to isolate in that structure such things as misplaced merit increases or compa ratios and that kind of thing, all of which are important to an understanding of where the wage increases are stemming from, is really difficult. Therefore, I think we have to be quite careful. We also have to be careful about our productivity data, not only for the reasons that I have been mentioning in previous meetings relative to the bias in price indexes and the like, but also because there are significant changes in the quality of the hours worked that we do not adjust for. Our deficient understanding of the true structure of costs, benefits, and the like should create a degree of humbleness on our part that we have not yet achieved. [Laughter] I merely suggest that we have to work harder.

The evidence that there is a significant shortfall in measured wages from the predictions of our wage-NAIRU econometric relationships is pretty clear. It is also clear from the reports all of you are getting that wage increases, no matter how we measure them, are falling short of those estimated from our equations. They are falling short in a way that largely mirrors the rise in operating profit margins. It is difficult to get an exact relationship, but it is rather obvious that we can explain a very significant part of this wage/price inflation nexus by a clear downshift in the tradeoff between wage gains and job security or some other factor for which job security stands as a proxy. This, as we have discussed over the last two years, is clearly a transitory phenomenon. Nonetheless, the evidence suggests that the third-quarter operating profit margins are holding up. They may be revised down when we have more complete data for the quarter, but they clearly will not be down by very much, and they surely will not be down by anywhere near what is implied by holding the statistical discrepancy of the GDP accounts constant.

The importance of all of this is that if we are still seeing evidence that the broader indexes of price inflation are easing, the rate of inflation is falling or at worst stabilizing, and profit margins are holding up, then the productivity/wage relationship suggests that whatever is happening is not happening very fast. And, as I argued at the last meeting, irrespective of how badly we underestimate what productivity may or may not be doing, it is still the case that if wages begin to accelerate relative to whatever the growth of productivity may be, then we will begin to see wage/price pressures, which we very strongly wish to avoid. Nonetheless, I think we have been very fortunate in that there is no credible evidence that such a process is in train.

If we reduce the size of the add-factors in our various equations that relate wage change to unemployment or any measure of labor tightness, we will get an acceleration of inflation; that is what the algebra requires. But we do not know that we have turned the corner. As far as I can see, it is not self-evident that we have add-factors that have stabilized and are closing. They are not. If we wanted to become real deflationists, we could argue that we are halfway through the process and we have not seen anything yet. I do not believe that myself, but it is not outside the purview of our evaluation. The Greenbook requires a certain add-factor forecast that presupposes the current transitional phase is in the process of coming to an end. I think the process is coming to an end, but I do not wish to bet the ranch that that is in fact the case. So, however one evaluates this, it is clear that whatever is occurring is not occurring rapidly.

When we look at the inflationary pressures that are currently built into the economy as a result of the tight level of labor utilization, the question is really one of whether the economy will ease off before a process of inflationary pressures emerges or whether there has been some longer-term change in the structure that, as some people in the business community argue, has essentially killed the inflation expectations bugaboo. I think there is no evidence of such a change. There is, however, some question as to whether in fact this expansion can slow sufficiently to take pressures off the labor market, ease everything up, and make the issue of inflationary pressures moot. It is much too early to say that that will happen. My own judgment is that the evidence is very mixed and highly unlikely to be in that direction in the short run.

It is nonetheless the case that less final demand is being generated now by a net increase in the stock of motor vehicles or the stock of plant and equipment. That is the saturation argument. One should remember that the net increase in property accounts plus the net increase in the stock of consumer durables--that is, after depreciation--is the private capital account component of GDP. We can compare it with GDP to get a judgment as to the extent that the element of saturation is adding to or subtracting from GDP. It is the issue that I raised when I said there were two types of inventories: the stock of capital and business inventories. The growth in the stock of capital moderated in the third quarter, as best we can judge, putting downward pressure on GDP and on final demand.

I think the regular inventory data are interesting, especially in the context of their being historically low by any measure. But the level of inventories is not relevant in the short run for the GDP forecast. It is the rate of change that is relevant, and a change clearly can occur at any level irrespective of where the inventory-sales ratios may be. While I think there is some reasonable argument to be made that a goodly part of the inventory accumulation we are seeing is voluntary--in the sense that all the surveys we monitor do not point to particular problems--we do have to account for the fact that the underlying prices of commodities and materials have taken a big turn to the south. Steel scrap prices have fallen off a ledge. I think the reason in part is competition from imports. It may also be increased capacity. As I am sure Messrs. Jordan and Moskow are both picking up in order books into the first quarter of next year are coming in below expectations. If that continues, it may reflect some weakening in the consumption of domestic steel or it may be that imports are really becoming an issue that is going to be something for the steel industry to be concerned about. In addition, aluminum prices are under significant downward pressure. They obviously are more subject to international pressures than steel prices in the United States, certainly more so than steel scrap prices. Copper is weak. All the industrial prices are getting soft. These are not the types of numbers we usually see when there is a big voluntary inventory surge. So, the inventory issue is by no means clear.

I think all of you have argued quite correctly that the retail market--and personal consumption expenditures more broadly--is the key to the outlook for economic activity. I did have somebody on the Board's staff look at the historical relationships and try to re-work the consumer credit data to put them back into gross extensions minus repayments, equalling the change in consumer credit, as we in fact used to do. We have some unpublished information that probably gives us a leg up on it. It shows, as you might well imagine, a very sharp decline in gross extensions. When we get, as hopefully we will shortly, the ratios of gross extensions to retail sales for certain groups, we will have a better view as to whether there is anything to the argument that particular groups are being liquidity constrained. I am not saying this information will tell us a great deal, but it may add something to our understanding of this puzzling third quarter. We have been through a lot of periods in which consumer expenditures have slowed and then picked up again. Unless the business cycle is dead, however, there will be a point at which that pickup will not occur. The question is when, and perhaps these consumer credit numbers will tell us something in this regard. I have been concerned about the level of consumer debt, as you know, since the beginning of the year. I have taken over from Governor Lindsey, who has thrown me a lateral, and I am running with it for a while anyway. I gave him the worry about the stock market. [Laughter] This division of labor is probably worthwhile.

It is too soon to tell what is happening to Christmas sales, but remember that we do not get much of the fourth-quarter personal consumption expenditures from the October data. The real action is in November and December, and the monthly seasonals are not one-third, one-third, one-third. They clearly are biased significantly toward the November data, which we do not have.

I think one of the more interesting unanswered questions gets down to the housing industry. As Mike Prell pointed out, it is weakening but there are two fascinating trends. One is home sales, which as you know have gone straight up. The other is single-family permits net of cancellations, which are essentially single-family housing starts plus the change in the permits backlog, and that number has gone straight down. It is at its lowest level in more than a year. If we look at a chart, the sales figures go up like that and the net permits figures go down, with the starts in the middle. If we reconcile them statistically, what we find is that not only does the permits backlog drop very sharply but so does the inventory of new homes. The changes in those two inventories essentially account for the different trends in sales and permits. This raises an interesting issue. Have the homebuilders decided that the markets are weakening, which is what is reflected in their reports to the National Association of Homebuilders, and are they therefore trying to reduce their advance commitments and inventories by pushing the excess supply out into the market? That would not be inconsistent with the relatively soft prices of new home sales. Or is the demand for new homes really much stronger than they have committed to and consumers are pulling out what the builders have been putting into the pipeline much faster than they expected so that they will be forced very shortly to pick up their permits activity and their starts activity? My guess is that the odds are still in the direction of the first scenario. But unless October home sales are down, which I think is very likely, we have a very interesting dilemma about what is going on in this market. And since this is such a big cyclical component in the current, immediate context, it along with personal consumption expenditures will be a key player in determining where this economy is going.

For the moment, I would say from a policy point of view that these developments leave us just about where we have been recently. I think it would be premature to pull back on the asymmetry. As long as the labor markets remain as tight as they are, inflation can turn up on a dime. Were we to go back to symmetry and then suddenly have to tighten, I think that would put us in an awkward position. So I think we ought to stay where we are, at least through the December meeting. I would recommend "B" asymmetric. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. I favor "B" asymmetric, Mr. Chairman.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, formulating policy under present circumstances obviously requires finding the right balance between likely future outcomes in the economy and recent developments. Labor market conditions, as you have indicated, appear to be on the tight side. Even if the natural rate of unemployment has decreased a bit, that tightness would suggest a moderate uptrend for inflation in the future. And as I said earlier, we could see a substantial rise in inflation if the normal historical relationship between unemployment and inflation were to reassert itself. These considerations make it likely that we will need to tighten policy in the future. However, recent inflationary developments have been surprisingly favorable, and economic growth slowed in the third quarter and may slow further this quarter. These developments suggest that it might be prudent to wait a while to see how things unfold before tightening policy. On balance, therefore, I would prefer to leave the federal funds rate unchanged for the time being, and I support your recommendation for alternative "B" and asymmetric language.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, it is obvious from the discussion around the table today, the latest economic data, and I think particularly the behavior of bond rates that the risk of a pronounced near-term increase in inflation pressures has diminished. So, I no longer think that we need a 50 basis point increase in the federal funds rate. But I still think it is more likely than not that somewhat greater restraint is going to be needed at some point in the relatively near future if we are going to contain inflation over the longer haul. Beyond this, the Greenbook's projections for the core CPI over the next couple of years suggest that at best we are going to hold the line on inflation, and that is only with the help of the reweighting of the index. The projections do not show any further progress toward our basic longer-term price stability goal. And if that were the actual outcome over the next couple of years, the credibility of our longer-term strategy could be reduced, at least to some degree.

For all these reasons, Mr. Chairman, I would still favor a 1/4 point increase in the funds rate today. Any tightening now obviously would surprise the markets. I recognize that that could have near-term consequences, but I think it could well help us over the longer run. In particular, I worry about the possibility of a scenario developing next year where we finally begin to see some discernible upward drift in the inflation rate at a time when the unemployment rate may be moving up to a more sustainable, longer-term level. In that circumstance, I think it would be quite difficult to make a move toward restraint. I feel a modest move now could help keep us out of that trap.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. When people use the word "inflation," I always translate that as something having to do with the purchasing power of the dollar. I can't get away from that notion. So, if people say inflation is going to be higher, I ask what is it that is going to cause the purchasing power of the dollar to erode at a faster rate in the future than it has in the past. I wind up thinking in terms of an excess demand kind of framework and so on. I do not believe that we are in an environment where the purchasing power of the dollar will be eroding at a faster rate for the next year or two. If I thought that, I would of course conclude that we have to adjust policy. I have not seen the evidence for that, and I still do not see the mechanism that is going to produce greater inflation from this point. In these circumstances, if we had not already adopted asymmetry at the last two meetings, I certainly would not want to go asymmetric toward restraint at this time. I wish we were not already there, but since we are, I can see the wisdom of not moving to symmetry and running the risk of having to return to asymmetry. So, I will support asymmetry toward tightening but only because we used it in the directives for the previous two meetings.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. I support "B" asymmetric, but like President Jordan I do not feel nearly as "asymmetric" as I did at the time of the last meeting, and if we were not already there, I think moving to it would be questionable. But since we are and we have a winning formula, let's stick with it.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Central bankers worry a lot. That is a requirement for the job. But difficult as it is for us, I believe we ought to take good news when it comes. Therefore, I think staying where we are with an asymmetric directive is more than desirable at this point.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. I do not want to talk about symmetry, so I am going to advocate a modest increase in the funds rate. I would be where Al Broaddus came out, a 25 basis point increase. My view is basically that CPI inflation has been trending up, that 3 percent inflation is too high, and that the risks are in the direction of higher inflation, at least if it is measured on a consistent basis. We should lean against this, and we should do so in the context of making clear our long-term intentions. I also think that we should not lull ourselves into thinking that we can in fact predict short-term developments in the real economy and count on these developments to do our job for us, at least on a temporary basis. I also agree with what Al Broaddus said about some of the risks down the road. Another risk is one that Governor Lindsey pointed to; it relates to evidence of some speculative excesses in financial markets. By moving now we might be able to avoid a bigger accident in those markets later.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Things have changed, at least from my perspective, since the last meeting. I see a bit more balance in the factors bearing on the prospects for growth going forward. At the last meeting, I saw all the risks on the side of faster economic expansion, but I now see some counterbalancing developments. Factors that in my view inject some negative prospects into the growth picture include consumer debt, the trade deficit, and some cooling in housing markets. There are still many sources of strength in the economy, and I tend to feel as do Al Broaddus and Tom Melzer that there are considerable risks on the inflation side. But I think the perhaps temporary abatement in economic growth and the injection of some negative aspects to the growth outlook have given us a little breathing room. However, I want to associate myself to some extent with what Governor Lindsey has said and what Tom Melzer just said. The financial markets are acting as if interest rates only go in one direction, and with that attitude there are undoubtedly bets being made that are unwise now and will grow to be more unwise as time goes by. We are risking a major asset price bubble unless some sense of caution, some sense of reality is injected into these financial markets at some point, and I think that injection needs to be made relatively soon. All of that said, I could go with a 25 basis point increase at this point, but I can also support your recommendation, Mr. Chairman. We have some breathing room, but I think we need to retain an asymmetric directive. So, I would agree with you.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I support your recommendation for an unchanged and asymmetrical directive. In fact, I think the asymmetrical directive that we have had in place, and would retain, sends a very important signal of this Committee's intention not to let inflation creep higher. I only hope that we are prepared to move if in fact the upside risks that we have talked about materialize.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I support the recommendation for "B" asymmetric. I think it is important, echoing what some other people have said here, that we not lull ourselves into a sense of complacency. If we believe the Greenbook forecast, the core CPI, abstracting from improvements in methodology by the Bureau of Labor Statistics will move up during this forecast period. That clearly is not acceptable. However, we recognize that there is a lot of uncertainty in the data, and we have not seen signs of compensation increases or of price increases in the latest data. The key in terms of the strength of the economy, as you point out Mr. Chairman, is the level of consumer spending going forward. So, at this point I support the recommendation.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. As I commented earlier, recent developments have been favorable, and I believe there is something to Ed Boehne's observation that we ought to take the good news when we can get it. However, it still seems to me that the principal risk that we face is that of more inflation than we have forecast. I laid out my basic concerns having to do with taut labor markets, and we may be at the point where we are starting to run out of good news on productivity, if we can in fact accurately measure it or observe it. But having said all that, I do think that the risk of a meaningful acceleration of inflation has in fact diminished. It looks to me as if expectations of future inflation also have diminished among market participants, judging by what has been happening in the bond market. If that is right, then for a given nominal short-term interest rate, a given funds rate, the real short-term interest rate is at least a bit higher today than it was earlier.

In sum, I believe that at least for now the risk of an acceleration of inflation has been addressed, hopefully adequately, by higher real short-term interest rates, and I am prepared to support your recommendation.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I continue to have two concerns. One is that the risks of inflation remain on the up side, as depicted in the projections that both the Greenbook and our staff have laid out. In that kind of atmosphere and related attitudes going forward, I am concerned about signs of a potential financial bubble. Having said that, what you have defined is an environment involving a fair amount of uncertainty about activity in the real economy, where that may be going, and some uncertainty in the outlook for inflation. So, I would be inclined to move now, but I could accept your recommendation of "B" asymmetric.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Mr. Chairman, I support your recommendation for no change, and I can vote for your recommendation to stay with asymmetry toward tightening. It would be embarrassing to go to a symmetric directive and then rapidly have to go back to asymmetry. On the other hand, if the economy weakens further and more sharply than we expect, it could also be embarrassing to go into a downturn with a tilt toward tightening. So, like Governor Rivlin, I do not feel nearly as "asymmetric" as I did at the last two or three meetings.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. I support your recommendation, Mr. Chairman, and I also support the sentiments regarding symmetry expressed by Governor Rivlin and President McTeer.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Mr.Chairman, I support your recommendation of "B" asymmetric. We should not be changing course now, particularly when we are in the middle of getting more current inflation data.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Mr. Chairman, I support your recommendation. I think that an asymmetric directive is warranted for all of the reasons enunciated in the Greenbook. I believe the inflation risk definitely remains asymmetric. I also share Governor Lindsey's and President Minehan's concern about euphoria in asset markets. On balance, though, it seems to me that the incremental data since our last meeting point toward more moderate growth than last time as well as a better inflation performance. I would consider it perfectly possible for demand to end up moderating more than the Greenbook assumes, eliminating the excess pressure in the labor market and any need for additional monetary tightening. So, for now I am certainly comfortable with more watchful waiting.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, I support your recommendation. I think it is important when we think about symmetry and asymmetry that we not focus too much on conditions in the current quarter or even the next quarter. When we have unemployment of 5.2 percent, we can tolerate a substantial short-term weakening of the economy and still want to be poised on the asymmetric side toward tightening. It would take, for example, two to three quarters of growth in the 1-1/2 to 2 percent range just to get the unemployment rate moving back toward 5-1/2 percent, which arguably means no more acceleration in pressures on resources and inflation. So, I think that being asymmetric is exactly the right thing to do, and frankly I think we are going to be there for quite a while because I do not see any signs that we are going to be removing inflation pressures in the economy very quickly.

CHAIRMAN GREENSPAN. Finally, Governor Meyer.

MR. MEYER. Mr. Chairman, I support your recommendation for no change in policy. Indeed, given that the recent data suggest that the risks have become more balanced, I am more comfortable supporting a proposal of unchanged policy than I was at the last meeting. I still think the major risk is that inflation will begin to rise over the next year. An asymmetric directive reminds us of the importance of remaining vigilant in the face of this risk, and I therefore support your proposal to retain the current policy posture.

CHAIRMAN GREENSPAN. Thank you. Would you read the directive which encompasses that?

MR. BERNARD. I will be reading from page 12 in the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and relatively strong expansion in M3 over coming months."

CHAIRMAN GREENSPAN. 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 Meyer	Yes
Governor Phillips	Yes
Governor Rivlin	Yes
President Stern	Yes
Governor Yellen	Yes

CHAIRMAN GREENSPAN. Thank you all. I would just remind you that the next meeting is on December 17. We adjourn for lunch.

END OF MEETING