

Meeting of the Federal Open Market Committee
March 25, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, March 25, 1997, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Gynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

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

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

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

Messrs. Eisenbeis, Goodfriend, Hunter, Lindsey, Mishkin, Siegman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

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

Messrs. Madigan and Simpson, Associate Directors, Divisions of
Monetary Affairs and Research and Statistics respectively,
Board of Governors

Mr. Hooper, Assistant Director, Division of International
Finance, Board of Governors

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

Messrs. Dewald, Hakkio, Lang, Rolnick, and Rosenblum,
Senior Vice Presidents, Federal Reserve Banks of St.
Louis, Kansas City, Philadelphia, Minneapolis, and Dallas
respectively

Messrs. Altig, Bentley, Judd, and Kopcke, Vice Presidents,
Federal Reserve Banks of Cleveland, New York, San
Francisco, and Boston respectively

Transcript of Federal Open Market Committee Meeting of
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CHAIRMAN GREENSPAN. Good morning, everyone. Is Mike Prell coming?

MR. STOCKTON. Mike is arriving for a just-in-time briefing, Mr. Chairman.

[Laughter]

CHAIRMAN GREENSPAN. Would someone like to approve the minutes of the February 4-5 meeting?

SPEAKER(?). So move.

CHAIRMAN GREENSPAN. Without objection. Mr. Fisher, you are on.

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

CHAIRMAN GREENSPAN. Before I ask a question, I have a hypothesis. It is conceivable that the 1982 report on System holdings of individual securities slipped between the drawer and the bottom of somebody's desk and that created a precedent. [Laughter] Therefore, the data were not published in 1982 and it was presumed that they should not be thereafter. I say that only half tongue in cheek.

Questions for Peter? Starting with his second request, is there any objection to including the detailed portfolio information in the annual report? If not, we will assume that it is acceptable, and we need a vote on domestic operations.

VICE CHAIRMAN MCDONOUGH. Move approval, Mr. Chairman.

CHAIRMAN GREENSPAN. Without objection. We also need a vote on the intermeeting leeway.

VICE CHAIRMAN MCDONOUGH. Move approval of the additional leeway to \$12 billion.

CHAIRMAN GREENSPAN. It has been moved. Is there a second?

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. There is a second. Without objection. Thank you all. Let's move on with record speed to Mr. Prell.

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

CHAIRMAN GREENSPAN. Questions for Mike?

MR. PARRY. Mike, I was a little uncertain as to the wealth effects on consumer spending in the Greenbook forecast. I had the impression that there certainly was an impact from higher equity prices in particular, but in the Monday staff briefing to the Board, you seemed to be saying that there was not much of an effect. Would you go into that a little, please?

MR. PRELL. On our interpretation, there probably has been some positive effect on consumption over the past year or so from the increase in financial wealth. Setting aside measurement problems, that effect likely has in reality been offset at least to some degree by an increased propensity to save based on concerns about retirement income and for other precautionary reasons. Going forward, we would interpret our forecast as continuing to incorporate some positive wealth effect, but again with these other factors tending to balance that. Because we have assumed that the stock market tops out as we move into the latter part of this year and then declines noticeably in 1998, the wealth-to-income ratio falls back a considerable distance toward where it was several years ago. That tends to diminish the wealth effect as we move out in 1998. Another factor to keep in mind is that we have had a surge in income growth over the past year or so. It would be natural, given a permanent income view, for spending to lag a bit and for the saving rate, all other things equal, to edge

up a bit. As income decelerates over the next year or so, we might still be getting some adjustment in consumption that would then tend to result in the saving rate edging lower. So, we see a number of counteracting forces that we have tried, at least judgmentally, to balance in a sensible way in the forecast.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I noticed that you built into your forecast for 1998 an increase of 75 to 100 basis points in the federal funds rate.

MR. PRELL. 75 basis points.

MS. MINEHAN. I gather from the wording of the Greenbook and your briefing that that was basically to keep real interest rates stable. But I wondered why you were doing that. At least in my memory, it was a change from earlier Greenbook practices, and I would find it helpful to have your comments on this. Of course, we can see in your alternative projections what the effects are if you do not change the federal funds rate assumption.

MR. PRELL. We felt quite uneasy about what kind of message the forecast would convey had we retained the assumption of a flat nominal funds rate. We perceived that the underlying strength of demand has been greater than we expected. Extrapolating that to some degree, it exacerbates what we already saw as a fundamental instability. I think this was highlighted in some of the longer-run simulations in the last Bluebook, where we stretched the projections out a bit. Perhaps it became clearer to you there that what we foresaw with unchanged nominal interest rates was in essence a path where resource utilization was going to continue to be well above sustainable levels. Following up on that analysis, we thought that the assumed uptilt in the funds rate would be a natural way to

indicate that at some point nominal interest rates probably would have to rise to avoid excessive stimulus. We built in something that is on a par with what is happening to the core CPI and to some of the broader GDP-related price measures.

MS. MINEHAN. I certainly do not object to that approach as a forecast. It clearly is in line with a lot of major forecasts. But I thought the whole point of doing the Greenbook, at least the way we have been doing it, was to have something that shows what happens if we do not change anything.

MR. PRELL. For all practical purposes the assumed rise in the funds rate is tantamount in terms of the economic outcome to your not doing anything over the period 1997 and 1998.

MS. MINEHAN. True.

MR. PRELL. But I thought it might be a useful signal here of what we now perceive to be the longer-term unsustainability of the scenario that we have been drawing in prior Greenbooks.

MS. MINEHAN. Thank you.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I think it was useful to get those alternatives, but which of the alternatives do you think would be most closely aligned with an opportunistic approach?

MR. PRELL. I guess it is a matter of interpretation as to what the opportunistic approach entails. If it entails making sure that the inflation rate does not move above the recent range, then our forecast implies that a policy move is necessary at some point. Whether that means a relatively aggressive approach or something that involves a continued "wait and see" stance and moving later, I don't think we can readily discern. But the fact is

that our forecast does imply that, in an underlying sense, consumer price inflation is moving above the 3 percent mark in 1998. If you view that as a ceiling in the range of acceptable outcomes and the point where you want to apply the brakes, then I suppose you could argue that a more aggressive approach than that associated with our baseline forecast is the one that is consistent with opportunism. But that is in the eye of the beholder. I do not think we can define its application that precisely.

MR. MOSKOW. Mike, if you look back at your forecasts of last summer, you were projecting much lower growth than occurred at the end of 1996 and that you now anticipate through 1997. When you made your comments this morning, I think you used the phrase "entering a boom at this point." I was just wondering if you could step back and explain what has happened here. Why are you now expecting a boom or "maybe" a boom? What has changed in this period?

MR. PRELL. The "maybe" is an important qualifier. That is not our baseline forecast, but again these are matters of definition. We do have a forecast that, given current money market conditions, now sees the most likely outcome as above-trend growth for an extended period and an unemployment rate that falls to 5 percent or less. In some sense, you could regard that as boom conditions even without going to the more dramatic, stronger growth scenario that I suggested was a risk. Why has this occurred? I think we consistently said that we did not see the stimulus that would maintain above-trend growth, so we kept forecasting that growth was going to fall back to something like trend for lack of a compelling reason that it should not.

What has happened? That is very hard to sort out. If we look at consumer behavior, for example, we have not had a drop in the saving rate. It is true that the stock

market has been much stronger than we anticipated. We have had a tremendous increase in financial wealth that either has reflected or supported a tremendous surge in consumer sentiment. We are at very high levels of consumer confidence according to the Michigan or the Conference Board surveys. The current Michigan index is the highest since 1965, and in only a few months in the history of that index have there been numbers this high. I think there is at this point some buoyancy in consumer demand beyond what we would have anticipated. We see very lean inventories. We continue to be surprised on the upside by the strength in computer investment; we have had some very strong numbers. We seem to be getting a more solid performance in nonresidential construction than we anticipated. You will recall that we were somewhat puzzled by weak contracts data through much of last year, but they tended to catch up with an enormous burst in the fourth quarter. All the anecdotal evidence suggests there is more momentum in that sector than was apparent six months ago, and that has multiplier effects. The upside surprise seems to be a collection of things that have supplied a considerable lift to economic activity. At this point, while we are still somewhat in the spirit of saying that economic growth probably will move back toward trend, we see an economy that seems to have considerable momentum, and we are not optimistic that the moderation in growth is going to occur overnight. Basically, one of the things we learned was that financial conditions were not imposing as much restraint on the economy as we thought they would.

CHAIRMAN GREENSPAN. Any further questions for Mike? If not, who would like to start the roundtable? President Broaddus.

MR. BROADDUS. Mr. Chairman, the Fifth District economy continues a healthy advance. Labor markets remain exceedingly tight throughout most of the District, especially

in some of the booming areas of the southern part of the District in the Carolinas along Interstate 85. Wages for skilled labor in that part of our District have been moving up gradually for some time. We now hear more reports of pay increases for unskilled workers. In Charlotte, for example, hourly pay for entry-level unskilled workers has risen about a dollar over the last year to a range of 7 to 8 dollars on average currently. Elsewhere, both residential and commercial real estate and construction activity are rising sharply. On the commercial side in particular, we see very low vacancy rates and rising rents in some areas. That is especially the case in suburban areas, but to some extent we see it in central city areas as well. Most of the other anecdotal information we have received recently is consistent with what appears to be happening in other parts of the country. Consumer spending clearly seems to have accelerated in recent weeks. With respect to prices, although labor and other costs are rising, there is relatively little talk of imminent price increases in most of the comments that we hear. Indeed, at their last meeting, several of our directors went out of their way to say that there was a general absence of pricing power in most markets with which they were familiar.

There are nonetheless a few straws in the wind. One director mentioned that recent increases in trucking fees were beginning to stick for the first time in a while.

who runs a large farm equipment dealership told me that his major supplier, John Deere, is no longer guaranteeing prices for items that will be delivered later in the year. But those types of comments are still the exception rather than the rule.

Turning to the national picture, it is hard, for me at least, not to be impressed by the current across-the-board momentum in the economy. As you already mentioned this

morning, Mike, and as the Greenbook points out, the Michigan Consumer Confidence Index is now at its highest level since 1965. That started me thinking a little about 1965; it was a good year for the economy. At the time, Arthur Okun described the situation as “the promised land of 4 percent unemployment with no compelling evidence of accelerating wages and prices or stress in financial markets.” In hindsight, of course, we know that 1965 was the year in which inflation really began to take off. The inflation rate was below 2 percent in 1965; it rose to over 3 percent in 1966 and subsequently to over 6 percent by the end of the decade.

Obviously, there are significant differences between 1965 and 1997, not the least of which is our greater commitment, I believe, to contain inflation and resist inflationary pressures and the greater credibility that goes along with it. But I think there also are some striking parallels between the situation in 1965, at least early in that year, and what we are facing now. As in 1965, the economy is now operating at a very high level and it strikes me as being quite vulnerable to upside shocks. In the 1960s, of course, the shock ultimately took the form of the Vietnam military buildup. The most likely shock, if that is the right word, in 1997 would be a more subtle process. It would involve a kind of circular process where increased spending generates increases in jobs, which generate increases in income, which encourage further spending, and so forth. I think a key feature of policy in 1965 was that the magnitude of the upside risk was not appreciated by the policymaking establishment as a whole as we went into that year. In the current situation, I worry that the public, as represented by the industrialist who sat next to Mike Prell, does not adequately appreciate the extent of the current upside risk, mainly because of the damping effect of three temporary factors on wage and price behavior. These are: the job insecurity that the Chairman has

emphasized in his recent public comments, increased labor force participation, which always occurs at this point of the cyclical expansion but which I think is greater now than is normally the case, and the strong dollar.

Let me make just a quick comment on each of those. As you said, Mr. Chairman, once the downward adjustment of real wages to the increase in job insecurity is complete, we would expect the usual impact of tight labor markets on wages to reassert itself. Furthermore, if labor markets remain as tight as they are now for any extended period in the future, at some point workers are not going to feel insecure any longer. When that happens, we could see the usual short-run Phillips-curve effect reassert itself just as the restraining impact of job insecurity begins to unwind. We will then have two forces working on the cost side and a considerable upside risk from that direction. Similarly, tight labor markets encourage greater labor force participation because job search costs are lower and wages are higher. Sooner or later, that effect will dissipate even if demand remains strong. Here again, greater labor force participation can only delay the emergence of inflationary pressures, not prevent them. Finally, the restraint from foreign competition on U.S. inflation can work only so long as the dollar remains strong and does not depreciate significantly. This, of course, turns on the ability of the United States to continue to attract capital inflows. I think we have been lucky on this front over the course of the last several quarters in that our economy has been quite strong compared to the economies of other major industrial nations. Obviously, that situation could change. If growth in Japan and Europe were to begin to accelerate, we could have some weakening of the dollar.

The bottom line as I see it, Mr. Chairman, is that I do not think the foundation for our favorable macroeconomic performance is very solid or secure at this stage. We need to

do all we can with monetary policy to reinforce that performance. I think we have been pushing our luck with monetary policy in recent months. We could do this because we had built a lot of credibility in 1994, but I would not want to see us push our luck much further.

CHAIRMAN GREENSPAN. There is a wide range of opinions in the way our society is looking at this inflation phenomenon. I don't remember it ever being so broad. I am not talking about the uninformed; I am talking about people who are participating in the system. President Jordan.

MR. JORDAN. Thank you. Regarding the Cleveland District first, both bankers and a retail executive for a national firm expressed their concerns about the construction of additional retail space. There is already excess space as far as they are concerned. Store closings are starting to occur, yet new construction is being planned and put into place. One of the bankers said that lending standards relating to the construction of commercial real estate have disappeared in the last couple of months. He hears of lending agreements with no takeouts being arranged, no permanent financing being locked up, no tenants being signed, and he is finding it increasingly difficult to rein in his own people and have them turn down applications for such construction loans. Also, he thinks extensions of C&I loans, which have been very strong throughout the region, may be increasing further. Interest margins have continued to erode. On the noninterest expense side, it is a mixed story. Several directors, bankers and non-bankers, talked about how their telephone expense has dropped dramatically. A banker said his overall telephone expense-- --is down 25 percent from a year ago, but his software costs are skyrocketing. On balance, he has not seen much benefit.

from the retail sector said that even though January and February sales came in a lot better than expected both nationally and in the region, he still thinks that growth in retail spending over the next few years is going to average only about 3 percent versus 5 percent so far in the 1990s. So, he is pessimistic regarding the sustainability of the kind of retail spending we have seen. In the steel industry, from a very large company said that he had his people do some research on productivity in 1996 versus 1993. Over the three-year period, they had an increase of 27 percent in productivity, and without that his company would not have been able to sustain its earnings because they have not been able to adjust their prices so far. He said that steel imports were flooding in. In the fourth quarter such imports were 25 percent above a year earlier. He sees downward pressure on steel prices, but then, oddly, he said that he took advantage of a current situation in the marketplace to put in a 3 percent price increase on 30 percent of his volume. I asked if he thought the increase would stick, and he replied that,

he personally did not think it would. Some on his top management team thought that current market conditions presented an opportunity and that he had an obligation to try to find out if the market would support the price increase. I found interesting this shift in attitudes and willingness to test the receptivity of the market to higher prices.

Another interesting development in my view relates to the newsprint side of the newspaper industry. You will recall that a year and a half ago newsprint prices were skyrocketing, and a lot of companies put through price increases for home delivery and at the newsstand. Now, in an environment where newsprint prices are plunging, I asked what newspaper executives were doing about pricing. I was told that the savings were all going to

the advertisers. Price competition there was intense and the volume of ad space was up sharply, but the price of ad space was substantially below where it was a year ago--an indirect effect of how the marketplace works.

On the labor side, construction unions are expecting a 4 percent average yearly increase over the next three years. They think their contract will be agreed to by May and that the increase will be higher than it was in the contract for the three-year period currently ending. An interesting twist in the press about plant closings is that the Ford Motor Company announced that they were going to shut down their Lorain, Ohio, operation and terminate the jobs of some 1,800 people. The news stories have said that these workers were not going to provide much relief to the tight labor markets in the area. That's because these people will collect 95 percent of a very high wage for a year and they have the wrong set of skills for other employers. One press report also said that auto industry workers had the wrong work ethic for what was needed by small manufacturing firms.

Let me turn to the national economy. I want to put a different twist on the notion of an opportunistic policy. We are experiencing a favorable productivity surprise. We do not know its precise dimensions, but a lot of the anecdotal reports that we hear certainly suggest that it is occurring. In some circumstances, we would expect prices to decline. If we were in a stable price environment--whether it is a gold standard environment or a stable fiat currency regime--and we had a favorable productivity surprise, we would expect the benefits of that wealth gain to show up in higher standards of living by way of lower prices. In an inflation-prone environment, we would expect a lower rate of inflation. There is nothing in the mechanism of the way individual firms operate that would by itself suggest to me higher total nominal spending. I think the connection between what we see at the micro level and

the macro level needs unraveling, when we look at projections like those in the Greenbook that show an acceleration in nominal spending growth and in total demand for output.

We would expect a favorable productivity surprise, other things the same, to translate into higher real interest rates. In a stable price environment where there is no discrepancy between nominal interest rates and real interest rates, the level of interest rates would shift up. In a fiat money world, if monetary policy failed to recognize the changes in the equilibrium situation and did not adjust nominal interest rates higher, then effectively, to use the language we normally employ, we would have eased monetary policy even if we maintained the same level of nominal interest rates. In my framework, we would see an acceleration in money growth, and that would accommodate, as in the Greenbook presentation, an acceleration of nominal spending growth. The second difference would go up. But we know that the second difference has to come back down if we are going to prevent an acceleration in the rate of inflation when that favorable productivity surprise begins to dissipate. One thing we do not want to do is to accommodate an acceleration of nominal spending like the one that happened in the 1960s, and I think that was a very large part of the story at the time.

It has been disturbing for me to see that growth in both narrow and broad money measures in virtually every major country in the world has accelerated in the last 4 to 6 months. Growth in some measures, including high-powered money, has risen into the double-digit range. A sharp acceleration has occurred in Japan, Canada, and countries throughout Europe. Now, it may be that the world is experiencing a productivity surprise and a global post-Berlin-Wall marketplace surprise, but overall that should result in higher real interest rates, not in higher rates of inflation. It does seem to me that our economic

analysis would lead us in the direction of saying that we have to guard against passively and unintentionally accommodating an acceleration of nominal income growth.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. The Tenth District economy continues to grow at a robust pace. As reported by our directors and other business contacts, growth is strong across the board in all District states and in just about all industries. Our manufacturing survey suggests that firms continue to project strong production activity as they look forward. For example, one of the high-tech firms, Sun Microsystems, announced plans to build a one million square foot plant in Denver and to add between three and four thousand employees. Reinforcing some of this anecdotal evidence, we know that District employment growth in the last year has been somewhat higher than that for the nation as a whole. We know that bank credit has been growing in our region; it has been down more recently, but that is seasonal. The farm economy and the energy economy in the District are both in good shape for now. One crop, winter wheat, never has been in better shape in most people's memory, so there should be an excellent harvest this year, assuming the weather cooperates. In the drilling area, activity is very high, higher than a year ago, and even though both oil and gas prices have slipped somewhat, our producers remain profitable. Retail prices generally are holding steady, but wage pressures are continuing to rise. Most of our directors and other contacts describe our labor market as tight, and this includes both our smaller manufacturers and some of the larger firms, such as Boeing and Eastman Kodak, that have operations in the District.

Nationally, I think the best way for me to describe our outlook is to say that we are basically in agreement with the direction of the Greenbook forecast, though we do not see as

much strength in some of the components. But in terms of where we see real growth, nominal growth, employment levels, and inflation, we are fundamentally in agreement. I will not comment more specifically other than to note our concerns about the inflation outlook as presented in the Greenbook and in our own projections.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, strong growth has continued in the Twelfth District in recent months following large gains last year. Although severe winter weather slightly disrupted economic activity in January, we have seen indications of a large bounceback since then. In 1996, District payrolls expanded by about 3-1/2 percent. Employment growth in the fastest growing states--Nevada, Arizona, and Utah--currently is averaging between 4-1/2 and 7-1/2 percent. I might note parenthetically that Utah is perhaps the state with the tightest labor conditions in the entire nation; its unemployment rate is 3.2 percent. I would also note that if one wants to find slack labor conditions, I would like to recommend Alaska and Hawaii, which were 49th and 50th in terms of employment growth, and you could also choose a broad spectrum of weather as well. [Laughter]

Revised data indicate that California's recovery accelerated throughout 1996. California payroll employment grew by 3 percent last year, well above the 2.3 percent rate recorded in 1995. The rate of growth picked up in most areas of California last year, and although severe winter weather held down employment in January, the February numbers showed another large job gain. The fastest growing sectors in California are high-tech manufacturing, business services, and engineering management services, although other sectors such as construction, trade, and real estate are growing steadily.

Turning to the national economy, the concerns I had in February about the inflation outlook have been intensified by recent developments. Real GDP growth appears to have turned in another strong performance this quarter following a rapid advance in the fourth quarter. The economy's surge in recent quarters means that it is operating at a noticeably higher level than seemed likely only a few months ago. While judging resource utilization is difficult, the unemployment and the capacity utilization rates as well as estimates of the GDP gap taken together suggest that excess demand pressures most likely are building in the economy. A number of factors, including the high dollar and tight fiscal policy, seem likely to slow growth later this year. However, I do not think the basic problem of excess demand for resources is likely to be solved anytime soon with an unchanged funds rate. Therefore, I see a significant risk of an increase in underlying inflation in the years ahead. I emphasize the word "risk" because we have not actually seen signs of rising inflation in the data. This fact obviously raises uncertainty about the future. For example, it is difficult to judge the magnitude of possible roles for enhanced productivity and for changes in the labor market in holding down inflation. However, given the long lags in monetary policy, we are left, I believe, with little choice but to use forecasts in gauging policy. My best judgment at this point is that even with the measurement improvements being introduced by the BLS, the core CPI would still show a modest upward trend this year and next if monetary policy remains unchanged. Our forecast shows core CPI inflation of around 2-3/4 percent in 1997 and 3 percent in 1998 compared to just 2-1/2 percent last year. I do not think we should risk an upward trend in inflation because, if it becomes established, it would be costly to turn around. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, the Seventh District economy continues to expand at a modest rate that is somewhat slower than the nation's but its growth is consistent with a regional economy that is at full resource utilization. However, activity in a number of sectors has been stronger than expected so far in 1997. For example, both the light vehicle and steel industries have been doing better than anticipated. Production of light vehicles and steel rebounded in the first quarter following declines related to the strike in the fourth quarter. On the demand side, light vehicle sales were stronger than expected in the first quarter, although the Big Three lost market share to foreign nameplates. Orders for steel have remained strong. Incentives have been an important factor supporting light vehicle sales, which appear to be continuing in March at the higher-than-expected rate of 15-1/4 million units that we saw in January and February. In contrast to these price concessions, several steel producers announced price increases, as Jerry Jordan mentioned before. Our contacts are saying that these increases have about a 50/50 chance of sticking at this point. Steel imports remain high and four new domestic plants will come on stream in the next five months. They will add about 3 to 4 percent to steel capacity in the United States this year. Of course, we do not know if any other plants will be closed as these new plants are activated. Adjusting as best we can for the weather, housing activity seems to have been slightly stronger than in the nation. A large national retailer reported that sales in March continued in line with recent gains on a year-over-year basis.

District labor markets are still very tight. The unemployment rate for District states edged lower in January and averaged 4.3 percent in early March. Initial state unemployment insurance claims were still running well below a year ago. Payroll employment growth in our District is lagging the nation, and contacts indicate that labor

shortages are constraining both employment and output growth. Our small business, labor, and agricultural advisory council met last Friday, and the members almost unanimously reaffirmed the difficulty of finding qualified workers. A representative of the temporary help industry mentioned that computer programmers are in extremely short supply, and programmers who know any of the older languages such as COBOL that are needed to deal with the year 2000 conversion problem are receiving significant premiums of up to 50 percent over what programmers would normally be getting. In addition to the usual reasons cited as to why wages more generally have not accelerated significantly, a representative of the United Automobile Workers noted that dramatic increases in gain sharing, tied to either productivity or profits, were significant for her union negotiations.

Turning to agriculture, Taiwan recently announced that they were halting all pork exports because of an outbreak of foot and mouth disease. Some 17 percent of all pork consumed in Japan is imported from Taiwan, and U.S. exporters are now expected to fill a large share of this gap. U.S. hog prices have increased sharply since the Taiwan announcement of the ban last week, and with little or no growth projected in U.S. pork production, this is likely to put more pressure on meat prices this year.

We have received an advance copy of the Chicago Purchasing Manager's survey for March, which is confidential until it is released next Monday, March 31. The overall index for our area shows a slight acceleration in the rate of expansion, up from 56.2 in February to 57.5 in March, with new orders and production both rising more rapidly. The inflation measures were mixed; the prices-paid component moved further above 50, while the supplier-deliveries component dropped sharply to below 50.

Turning to the national outlook, our assessment of the economy has changed somewhat since the February meeting. We still anticipate that real growth will decelerate somewhat by the second half of this year to a pace slightly above trend or at trend. But we no longer believe that current conditions in the economy are such as to guarantee that deceleration. Our growth forecast is now conditioned on a higher funds rate path than it was in February. We continue to see a risk that demand pressures will outstrip the growth of productive capacity. The strength of demand has been surprising most of us since at least last summer. Given the maturity of the expansion, one would not expect demand to be growing so quickly without some stimulus. It is, of course, difficult to know for sure, but that stimulus may stem from a monetary policy that is more expansionary than we had thought. After all, given what we know about the lags associated with monetary policy, the timing of the pickup in demand corresponds roughly to the expected effects of the actions that we took a little over a year ago. Those actions made sense at the time as insurance against what might have been an overly weak trend in demand, but clearly conditions have changed and weak demand is no longer a concern.

Finally, on the puzzle of why we have not yet seen appreciable wage or price pressures, I believe the Chairman's discussion of worker insecurity provides a useful insight. As job insecurity, rising labor force participation rates, and other temporary damping forces wane, the balance of risks tilts more clearly to the upside. In sum, I agree with the overall picture of the economy depicted in the Greenbook.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, the New England economy remains quite healthy. In fact, it is healthier than we thought it was. As I reported before, we had been

tracking regional employment growth at about half the national pace. The spring benchmark revisions to the employment data showed that, in fact, jobs were expanding at just about the national pace or about double the rate that we had been seeing earlier. New Hampshire and Massachusetts are exhibiting the strongest growth; Maine, Vermont, and Rhode Island are on the low side, and even Connecticut is showing surprising strength. The region's jobless rate fell to 4.2 percent in February, more than a percentage point below the national rate. The rates in all six states were below the national average in January, with rates in Vermont and New Hampshire well below in the 3 to 3-1/2 percent range.

The labor market continues to be tight for selected job categories, but the definition of "selected" seems to be broadening a bit. More individual occupations or job types are being mentioned as hard to fill than in previous periods. Some retailers indicate they are experiencing recruiting difficulties even at the low end of the job skills spectrum, and temporary employment firms report both increased difficulty meeting demand and rising wages across the board. Anecdotally, I am told that an employer no longer interviews prospective employees in the data communications field; the prospective employees interview the employer, and some will not even show up in person for an interview unless the answers to their questions over the telephone are responsive to their concerns. Those concerns are not just about money--they include money, to be sure--but more often than not, these technicians want to be assured of being involved in high-tech, cutting-edge projects so that their skills will continue to be marketable. Contacts also note that their firms are using signing bonuses and stock options to attract scarce skilled staff but that those practices are not yet leading to across-the-board wage increases. Rather, employees with specific skills are being paid more, while other employees with less marketable qualifications "enjoy"

much smaller pay increases. Thus, overall wages are rising a bit more slowly in the New England area than in the nation, and we continue to hear that price increases are difficult, if not impossible, to make stick.

I have reported in the past on the pickup in nonresidential construction and the prospects for more nonresidential building, particularly in the eastern Massachusetts area. Housing markets also are enjoying a good bit of strength. Realtors region-wide have said that activity is picking up either in terms of actual home sales or the number of inquiries from potential buyers. Massachusetts stands out with reports that 1996 broke the previous record, set unfortunately in 1987, for the number of residential real estate sales in a calendar year. But contacts say all the New England states are seeing improvement. Prices are rising in response, modestly as yet, and new housing construction has picked up.

Turning to the national scene, we are in general agreement with the Greenbook that the near-term outlook for GDP growth is stronger than we might have expected earlier this year and the risks associated with inflationary growth are a bit higher. Arguably at least, the Greenbook overstates a little the strength of the prospective expansion, and the external sector especially could exert a stronger drag than is projected by the staff. In addition, our estimate of potential is a bit higher, so we do not expect unemployment to drop below 5 percent as does the Greenbook. But all of this falls by and large into the category of "nit picking." The potential for robust, above-potential growth led by consumption seems clear, as are the asymmetric risks that capacity constraints will begin to bind sooner rather than later. Thank you.

CHAIRMAN GREENSPAN. I used to write COBOL. Maybe I could go into business. Perhaps I should make a few telephone calls! [Laughter]

MS. MINEHAN. Right. You have to find all the programs where only two digits are embedded instead of four.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, the Second District economy has shown continued signs of strength in the first quarter. Payroll job creation remains sturdy, and job growth was revised up a bit for 1996 and early 1997. New York State's unemployment rate was stable, while New Jersey's fell to a six-year low. Benchmark revisions to 1996 unemployment rates were minimal, though both civilian employment and labor force participation were revised up substantially. Retail sales generally were above plan, boosted in part by New York State's one-week tax abatement on clothing in January and by unseasonably mild weather in February. Consumer confidence in the Middle Atlantic region surged to a new cyclical high in the first quarter, but it remains below the national average. Residential and commercial real estate markets continued to gain momentum early this year; single-family home sales improved, and permits to build apartments remained on an uptrend. In some of the region's tighter office markets, falling vacancy rates have begun to push up asking rents. Regional surveys of purchasing managers were mixed in February, but they generally signaled improvement in the manufacturing sector. In New York and northeastern New Jersey, consumer price inflation averaged 2.7 percent in the twelve months ending in February, down from 2.9 percent in 1996 and just below the national rate of 3 percent. Local banks have reported little change in loan demand and only a slight rise in consumer delinquency rates.

On the national level, since our last forecast in late January, indicators of domestic demand, labor markets, and production have come in surprisingly strong. However, the

international trade data for January were much weaker than we expected. On balance, we have boosted our growth forecast for this quarter to 2-1/2 percent and for 1997 as a whole to near 2-1/4 percent. We do not have quite the robust growth that the Greenbook does for 1998; we have it at 2 percent, but we do believe that the upside risks are substantial. Under our scenario, the unemployment rate declines to between 5 and 5-1/4 percent by the end of this year and stays around that range for 1998. Despite the continued strength of real economic activity, core consumer price inflation has decelerated further in the current quarter, and the rate of increase in aggregate labor compensation is running well below that predicted by traditional Phillips curve models. Nonetheless, given the current and expected levels of resource utilization, we believe that acceleration of core inflation over the forecast horizon is the most likely outcome. Indeed, while we have pushed the starting point of that acceleration further out in the future, we have raised the rate of core inflation expected to be reached in 1998 to 3.3 percent on a Q4 to Q4 basis.

There are three developments since our last meeting that have raised my staff's and my own concern about inflation considerably above the already increasing level of anxiety that I expressed at our last meeting. First, the levels of consumer spending, consumer confidence, and residential construction are so high that I believe the always hard to predict wealth effect is kicking in and is likely to remain engaged even if there should be a modest stock market correction. Second, business fixed investment seems unusually robust for this late stage of the business cycle, and it shows up in areas such as heavy truck orders and investment in structures that make me believe that the business executive will be joining the consumer in increasing demand. Third, we have benefited for several years from a positive supply shock in the form of slower increases in health benefit costs than in wages that has

produced an acceptable slope to the rise in the ECI. Our sources of expertise--on both the supply and demand sides of health care and for both goods and services--believe that positive period is behind us and that increases in health care costs will track the rise in the CPI in the future. They, and we, are not predicting a negative supply shock but the end of the positive shock. That combination of developments makes me believe that the risk of rising inflation next year and in 1999 has become significantly higher since our last meeting.

CHAIRMAN GREENSPAN. Mr. Guynn.

MR. GUYNN. Thank you, Mr. Chairman. I, too, am an old COBOL programmer. If you go into business, I hope you will give me a call; I would love to be your partner.

CHAIRMAN GREENSPAN. We will increase Federal Reserve earnings!

MR. GUYNN. The economic picture that emerges in the Southeast has many parallels to what is going on nationally. At the same time, as I reported at the last meeting, the overall rate of economic expansion in our region has settled back somewhat from what it was earlier in the expansion. When I talk about some slowing, it is from relatively high rates of economic growth. As elsewhere in the country, retail sales in our area were stronger than expected during the mid-winter period. Retailers are optimistic going forward to Easter, and inventories seem about right to them. We are seeing some signs of a slowdown in real estate, both residential and commercial. Exceptions are in Nashville and Atlanta where, for the first time in this cyclical expansion, a few of my contacts in real estate and banking are expressing some concern about developers who seem to be forgetting the lessons of the 1980s. I will save the stories that go with that observation, but I have heard some very interesting stories that make the point. I certainly will watch that closely. Some bankers in Atlanta also commented recently to me that they think the multifamily market in Atlanta may be close to

being overbuilt. The good news is that they are going to pull back their lending to that sector. Manufacturing, too, seems to have slowed somewhat from earlier in the expansion. Our own survey of manufacturing showed declines in the proportion of firms reporting increases in production, shipments, and new orders. Employment, the average workweek, and the index of expected business activity six months out also declined, and expectations of future capital spending have dropped off some since our previous survey.

As Tom Hoenig mentioned for his area, oil and gas activity is strong--in Louisiana in our case. That activity not only has pushed the rig counts to high levels, but it has brought demand for crew boats and other kinds of support spending to higher levels. We reported at the last meeting on signs that energy prices would decline, and that has happened, as you know. One of our directors who is close to the natural gas business noted that supplies have now been rebuilt after the drain from last year's harsh winter, and that should continue to put downward pressure on energy prices, particularly natural gas, in the period ahead. Shipyards along the Gulf Coast report good orders. One yard in Mobile is particularly excited about getting the first order from Chinese interests; it is for four large container ships.

To be sure, labor markets remain tight in our area, with pressures now evident almost uniformly across our entire region. The extraordinary pressures that we saw in the Tennessee area have lessened somewhat. We still get very few reports of unusually large increases in wages, and we still see almost no signs of cutthroat attempts to steal workers from other companies. We are picking up some reports in our manufacturing survey, and I would underscore "some," of increasing pressures on input prices in the sense that they may be beginning to see some of that also in finished good prices. However, there still is no real change in most retail prices.

Finally at the regional level, we have two new directors this year from the retail automobile industry--one associated with a group of moderate-size dealerships and another who ran the Alamo car rental company until it was recently acquired by one of the new conglomerates. Those directors suggested at our last meeting that we are seeing what they call a "seismic" shift in the retail auto business as the consolidations that are under way continue. They think the consolidations will bring significant efficiencies in operations and an important change in the bargaining power that dealers have with manufacturers, all of which they think should bode well for the prices that consumers will pay for autos down the road.

At the national level, we like almost everyone else have been surprised by the persisting strength in the economy early this year. We continue to expect a slowdown in the expansion later this year and we hope we will not be disappointed. We have not raised our fourth-quarter over fourth-quarter growth forecast appreciably. We expect growth in expenditures on housing and consumer durables to be measurably slower as we move into the rest of the year. We do not expect unemployment to drop quite as low as is indicated in the Greenbook. On the other hand, and probably as a consequence, we also are not quite as pessimistic with respect to inflation, whether measured by the CPI or the deflator. We still see few signs of stress, excesses, or imbalances except for persistent tightness in labor markets. Having said that, it is my judgment that the risks are now somewhat greater on the upside. My view stems mostly from the greater-than-expected consumer spending that we can readily see, fueled by either more borrowing, lower saving rates, or as Mike Prell reminded us again this morning, the possibility that we will see some additional kick to consumer spending from the stock market wealth effect.

One offsetting risk on the downside, as Cathy Minehan also mentioned, is our view that the outlook for exports could change. Should the dollar not fall back or even rise further, and we think that is certainly possible, growth in exports could be less than is currently built into the forecast. There also remains the strong and growing probability of increased wage pressures, although we are less sure than some that those will be fully fed through to price inflation. But again, on balance, I think the risks are considerably greater on the upside. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The Philadelphia District economy is operating at a high level. Intense competition, however, seems to be keeping the lid on wages and prices. Manufacturing is doing well; retail sales are generally good. Commercial real estate is shifting from a buyer's market to a seller's market. Vacancy rates are going down; rents and property values are going up. The incentive to build is picking up, and developers are shopping for land. Competition for bank lending is stiff, with the predictable squeezing of margins and slippage of underwriting standards. The slippage in lending standards is always done by the bank down the street. The problem of one large credit card issuer in the District clearly has had a sobering effect on other issuers, but that occurred too late to avoid varying degrees of hangover for most of them. I think the issuer that received the press attention probably is more prone to problems and not as well managed as some of the others in our District.

Turning to wages and prices, some selected wage hikes are occurring. On the whole, however, the wage/price climate in the District remains subdued. One manufacturing

CEO I recently spoke with, and I think she is representative of manufacturers generally, said emphatically that increases in productivity will continue to absorb wage hikes.

Turning to the nation, the uncomfortable uncertainty that most of us have felt around the table over the last six to nine months is partly explained, I think, by how people look at the economy. Most people we talked with see the economy from their own point of view. They see business rolling in, stiff competition, and productivity going up. They also see some labor shortages, but those are the kinds of problems they like to live with. Now, that view contrasts with the macro framework that I think lays out the prospects for problems down the road. It strikes me that there is a greater divergence between the person-in-the-street view and this macro framework than I have seen in a long time. There is not much appreciation, I think, for that macro framework view. We have to weigh the risks, and my sense is that the national economy has considerable self-feeding momentum. Although inflation is remarkably quiescent for now, I think the risks have shifted fairly substantially toward the upside of too much demand pressing against supply down the road. With the strong demand, I think the current federal funds rate almost surely means that we are pumping too much liquidity into the economy. It is the old pegging problem that we know so well from the past. While patience has been wise, I think some insurance against overheating makes sense now in order to keep the economic expansion on track.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. Most measures of economic activity in the Ninth District remain positive. In particular, labor markets are still tight, and there are widespread labor shortages. But we are at the point that this is so familiar, so much a part of the landscape, that people mentioned it only in passing. Wage pressures are there but they

are scattered and by no means overwhelming. With regard to other District developments, construction activity is positive, the manufacturing sector is doing well, and state tax revenues are running well above what had been anticipated. A major potential negative is the weather. Widespread flooding is anticipated in the spring, but for better or for worse, the snow and ice have not started to melt yet.

As far as the national economy is concerned, I certainly agree with the significant upward revisions in the Greenbook forecast, and I think, if anything, they may be conservative. My sense of the dynamics of the situation is that the economy will probably--and will certainly without a change in policy--grow at the higher pace of the latest forecast or maybe even faster. I would point to a couple of factors. My sense of the inventory situation is that there is considerable room for some significant spending on inventories going forward and that such spending will probably add significantly to aggregate demand.

As I think about financial conditions and the broad range of variables that one might throw into that bucket, it seems to me that financial conditions remain very comfortable whether we look at interest rates, growth in the broad measures of money, equity prices--even though they have waffled a bit recently--or credit availability in general. As I see it, we have financial conditions that are consistent with further substantial expansion in demand.

Finally, as far as inflation is concerned, I agree that a variety of temporary factors has worked so far to restrain inflation to a pace that is certainly lower than I would have expected at this point in the expansion. I think that may continue for some time. In particular, I would point to the state of many of the other major industrial economies around the world where there is considerable slack. In my view, that has been an important factor in

what has been going on here. But having said that, I would emphasize that the factors that have been restraining inflation are certainly temporary and that the inflationary risks are clear.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. We have all been watching this remarkable economy with some puzzlement for the last several months. Until now, the signs of strength in the private domestic economy always seemed to be mixed with some signals that the expansion might be slowing down. What strikes me at this point is that the signs of a slowdown are nearly absent. Virtually all the statistics at the national level point to continued strength. This pattern is reflected almost uniformly in the reports from around the nation, although the report for Atlanta sounds a little different. Labor markets are tight; employment is moving up; labor participation is high; the workweek is longer; initial unemployment claims are down; all these indicators reinforce the good jobs picture. Consumer spending is strong; inventories are lean; business investment, housing, and nonresidential construction, you name it, look good. It just does not look like an economy that is running out of steam.

There are two elements of restraint. One is the federal budget, which is modestly restrictive. I think the outlook for fiscal policy is probably the biggest difference between this year and back in 1965. I remain fairly optimistic that we will get a budget deal, but we probably will not get it until August or September. There is no pressure of an election to keep the Congress from trying hard to finish its work and get home, so the debates will probably string out. But I think the budget deal will get done without a government shutdown and without a continuing resolution, and the agreement is likely to include a modest CPI fix, agreed to very quickly at the very end of the legislative process. In that regard, I think there

was an overreaction to the President's rejection of the commission idea. With all due respect to the Chairman, they do not need a commission; they just need to fix the CPI. My guess is that they will do something.

CHAIRMAN GREENSPAN. Okay, let's do it! [Laughter]

MS. RIVLIN. The long-run effect depends on whether the budget legislation includes significant reductions in the growth of Medicaid and Medicare. I think the chances are quite good that it will. Nevertheless, the effects will be mostly psychological and possibly not particularly strong even there. The real effect of having a deal is not going to be very great in the near term.

The other negative that has been mentioned and is much bigger in its effect is net exports. This clearly is helping restrain the economy at the moment, but it is exacerbating the long-run problem of the current account deficit for which we have no obvious solution at the moment. The case for viewing this economy as just a little too robust to be sustainable is the clearest one that I have seen since I have served on the Board; admittedly that has not been very long. A small move to restrain growth and the future acceleration of inflation that seems increasingly likely could prolong this remarkable expansion, and that seems to me to be what we ought to want to do. I do not see very much downside risk. If we had a sharper, better policy instrument that operated more immediately, we could certainly afford to wait, but unfortunately we do not.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. The Eighth District economy continues to operate at a high level. Contacts report little or no change in the growth rate of economic activity in the past few months and continue to be optimistic about the near term. With unemployment

rates well below the national level, labor markets remain tight in much of the District, especially for construction workers. Payroll employment increased at a 2.3 percent annual rate for the three months ended in January, a rate not seen since October 1995 and well above the 1-1/2 percent average rate posted in 1996. Second-quarter District auto production is expected to be up more than 10 percent from the first-quarter level. Early 1997 sales tax receipts are up substantially in the District from their year-ago levels, suggesting strong economic activity, particularly at the retail level. Residential and commercial construction activity has stayed relatively strong, although January residential permits dropped from their year-ago levels in most District metropolitan areas. About 120 counties in Arkansas, Indiana, Kentucky, and Tennessee have been declared federal disaster areas as a result of the tornadoes, heavy rains, and flooding that occurred in early March. Although reliable estimates of damage are not yet available, federal disaster assistance is expected to lead to new home construction by displaced residents. That was the experience after the major 1993 floods in the Midwest.

At the national level, forecasters see continuing expansion. A burst of consumption growth is expected in the current quarter, which will be the highest quarterly increase in consumption since the end of 1992 if the staff forecast of 5 percent growth at an annual rate is realized. The run-up in stock prices and the high level of confidence reported in consumer surveys as well as early reports on retail sales and residential construction support this conclusion. On the one hand, such an outlook suggests that the downside risks for the economy are limited in the short run. On the other, the longer-run inflation outlook is not so sanguine. Despite moderate decreases in PPI and CPI inflation so far in 1997, there is a heightened concern about an inflationary impulse emanating from observed price increases,

a tight labor market, and a continuing easy credit market. In addition, we have seen anecdotal evidence along the lines of what Bill McDonough mentioned with respect to the apparently shifting pattern of health care cost increases from a declining to a rising trend that will no longer tend to offset at least a portion of the wage increases.

It does not seem to me that the current stance of monetary policy will mitigate the inflation impulse that I outlined. Growth rates in the broad monetary aggregates, which conceivably are back on track, are running at or above our announced targets. The yield curve has steepened further, increasing the likelihood that the federal funds rate target is too low to prevent further acceleration in monetary growth. All told, the longer-term inflation trend may be a lot less favorable than the 3 percent norm of most forecasters. My reading of the economy supports the conclusion that we are at risk of losing the hard-won credibility of our commitment to hold inflation at 3 percent. In the current situation, it is vitally important that we act to preempt prospective further increases in inflation and thereby avoid the substantially higher costs of having to do a lot more policy tightening later.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. The economy in the Eleventh District remains healthy. While data for January showed an actual decline in District employment levels, I am inclined to discount those figures because of weather-related factors and because they are inconsistent with the anecdotal evidence that we have been getting from all our boards of directors and advisory councils. The composition of growth in the Eleventh District has shifted somewhat. Last year's downturn in the computer chip industry seems to be behind us, and the industry is once again announcing expansion plans. Job gains in our District's semiconductor industry are expected to be about 10 percent this year, offsetting the losses of last year.

As both Tom Hoenig and Jack Guynn mentioned for their Districts, oil and gas drilling continues to move forward at all-out, full capacity. The rig count in Texas is 20 percent above a year ago. Shortages of rigs and crews continue to be reported. There is a widespread feeling that the drop in oil prices over the last few months will not result in any drilling slowdown because it is the use of new technology that is making drilling profitable at prices anywhere above \$18. The use of 3-D seismic techniques has drastically reduced the number of dry holes, both on land and at sea, if you can imagine a dry hole at sea.

[Laughter]

The construction sector showed signs of slowing over the last few months in single-family and multifamily homes, industrial and warehouse space, and retail shopping centers. Office construction continues to rebound from fairly low levels, and a large number of medium-size projects have been announced recently, especially in far north Dallas. I might add that when I moved to Dallas six years ago, this was the very region that had the greatest concentration of RTC properties in Texas. Obviously, the glut is over. This has been reflected in rising commercial rents in the suburban areas. There are even scattered reports that prices of prime shopping center property have doubled over the last year or so. We continue to see signs that the Mexican economy is coming back, although there apparently is still more slack in Mexico than in Utah. [Laughter] Warehouse space in Laredo is fully leased, and reports are coming in from both our border and inland cities that Mexican shoppers are returning. However, retail sales to Mexicans remain below pre-devaluation levels, partly because Wal-Mart and other U.S. retailers have opened outlets on the Mexican side of the border.

As for wage and price pressures in the District, it seems like the same song, seventh verse. Wages overall appear to be increasing on a slowly rising gradient, but exceptions to this generalization have been reported with increasing frequency. Still, they are sporadic exceptions against the backdrop of a steady trend. As for pressures on final prices of goods and services, we hear an unending story that competitive pressures negate the ability of business firms to pass cost increases forward.

Turning to the national economy, it is difficult to find signs of weakness or imbalances. The inflation picture in the Eleventh District is a reflection of the trends I see nationally. Consumer and producer price increases have been subdued. The broader inflation measures look even better. As for inflation in the pipeline, gold and commodity prices do not suggest too many reasons to be concerned. M2 growth does, however, remain on the high side, perhaps as a result of the pegging problem that Ed Boehne mentioned earlier.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. I want to focus on two key questions about the outlook that I believe should shape our decision about monetary policy today. First, how does the economic environment, meaning both the recent data and the current forecast, differ today from that prevailing at the July and September FOMC meetings--which in my judgment were the closest calls for a tightening of policy--and more generally from that prevailing for the entire recent period of the asymmetric policy directive? Second, how do today's forecasts for 1997 by members of the FOMC compare to the central tendencies of the forecasts for the year that the members submitted at the February meeting and that were incorporated in the Humphrey-Hawkins report?

This focus presumes that any change in policy we contemplate today would reflect a change in the FOMC members' readings of the fundamentals and risks in the economic outlook. That would be the natural assumption. However, the comments of at least some members at the last meeting could be interpreted as indicating that they already had changed their view about monetary policy but thought that a tightening should be postponed until this meeting to allow an opportunity to prepare the market. And the market certainly has been prepared! [Laughter] For myself, however, some trigger, some change in the fundamentals, is necessary to push me to accept a change in policy. I will focus here on whether or not there has been such a change in fundamentals.

Let me remind you of the basic framework that has underpinned my judgment about monetary policy during this period. I worry about two risks to the inflation outlook: the utilization and the growth risks. The utilization risk refers to the possibility that the prevailing utilization rates may already be so high that inflation will rise over time. The growth risk relates to the possibility that future above-trend growth will raise utilization rates still further, thereby aggravating the risk of higher inflation. Given the uncertainty about how to judge utilization rates, we have tempered our inclination to be forward-looking in our policy actions and have given added weight to recent data on inflation and labor costs. There is, nevertheless, a causal chain that I believe we have been relying on--from growth relative to trend, to utilization rates, to wage changes, and finally to inflation. There are, to be sure, complications associated with changing profit margins, possible change in the productivity trend, favorable or unfavorable supply shocks, and change in threshold levels of utilization rates. But this causal chain is and must be at the heart of preemptive policy.

Policy could be said to be more forward-looking or preemptive the more willing we are to act earlier in this causal chain. The importance I attach to this causal chain necessitates a response to the flurry of disclaimers around this table at the last meeting about the usefulness of NAIRU. I intended to respond then but, frankly, I somehow got distracted. [Laughter] As the most enthusiastic champion of the NAIRU concept around this table, let me briefly respond now because I think that concept is relevant to our decision today.

The concept fundamentally involves three principles. First, a major proximate source of higher inflation is excess demand in the labor and/or product markets. Second, the causal chain is most likely to proceed from excess demand in the labor market, to wage changes and hence labor costs, and finally to price inflation. Third, as long as the excess demand prevails, inflation continues to rise progressively and indefinitely over time. I frankly would be shocked if most of us around this table did not believe in these principles. To be sure, applying them has become more difficult of late because the implied relationships have not been nearly as tight as had been the case earlier. There are data that suggest some decline in the NAIRU. Nevertheless, these principles must in my view be the framework for conducting a disciplined monetary policy, and I believe that is central to any decision to tighten today.

Now back to the outlook: What is different today in the data and/or the forecast compared to what we had at FOMC meetings during the period of asymmetric directives? To set up my later discussion of my position on monetary policy, I will organize the discussion from the perspective of the Taylor Rule. A rough summary is that current utilization rates are about the same and core inflation is lower. Unlike at earlier meetings, the forecast now shows continued above-trend growth immediately ahead and, as a result,

higher utilization rates over the next year or two. The current Greenbook projection of a decline in the unemployment rate is not much different from what was projected at the last meeting, though I would argue that this forecast is more believable now for many of us. At the February meeting, both the Greenbook and FOMC members were projecting near-trend growth over 1997, but the FOMC members were forecasting stable unemployment rates in contrast to the decline projected in the Greenbook. The current data on utilization rates and core inflation are no more alarming now than earlier, and perhaps less so. So, if we want to justify action today, we have to look at an earlier stage of the causal chain.

In his recent testimony, the Chairman has focused on labor market indicators as being of special importance in reaching a decision for a preemptive move, and I agree. Let us take stock here. The data on compensation are somewhat mixed, but they suggest some acceleration on balance. The latest 12-month increase in average hourly earnings is 1/4 to 1/2 percentage point higher than had prevailed at the time of the July and September meetings. On the other hand, the increases in average hourly earnings were rather tame in the last couple of months. There is certainly a hint here but hardly a smoking gun. On the other hand, virtually all other indicators of labor market tightness are at more elevated levels today: help wanted ads are up, initial claims for unemployment insurance are down, the index of hard-to-get jobs is down, and consumer sentiment about jobs being plentiful is up. But the key to our decision today is the change in the forecast.

I'll focus now on the Greenbook forecast, which may be more aggressive in certain respects than some of our own forecasts. This will effectively serve to make more dramatic the point I want to make. There is a significant change in the current Greenbook forecast for 1997 from the forecasts prepared for the July and September meetings and even that for the

February meeting. Compared to the earlier meetings, the Greenbook now projects a 2-3/4 percent rate of growth over 1997 in contrast to just above 2 percent at the July and September meetings and 2-1/4 percent at the February meeting. This follows an unexpectedly strong second half of 1996. To be sure, as is almost always the case in such projections, growth slows to trend over the forecast period. But the combination of a stronger second half of 1996 and an upward revised forecast for 1997 translates into an increase in the level of output and hence utilization rates in 1997 and 1998. At the July and September meetings, the unemployment rate was expected to stabilize near 5-1/2 percent for 1997. Now it is expected to decline to 5 percent this year and below 5 percent in 1998. Just to underline the difficulty in making and selling any policy change, the other important difference in the Greenbook forecast is that inflation for 1997 has been revised downward relative to the July and September meetings.

To repeat the second question, how did we FOMC members change our forecasts for growth over 1997 and the unemployment rate at the end of this year compared to the central tendencies of the forecasts that we submitted for incorporation in the Humphrey-Hawkins report? For my part, I see the economy as having more near-term momentum than I did at the last meeting, and therefore I now expect the unemployment rate to be lower in the second half of the year and into 1998. As a result, I have revised upward my expectations for inflation over 1998.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. For a number of meetings now, the economy has seemed to be déjà vu. For some time, we have felt that we were looking at a fully utilized economy, one with tight and tightening labor markets that seemed likely to

begin to show escalating labor costs and from there escalating inflation--in short, an overheating economy. But that has not happened so far. In fact, inflation is flat to down according to many statistical series. Our expectation has been that the expansion would slow to growth at about trend and that this might allow us to experience a quiescent inflation rate for some period of time or indefinitely. This is a very rosy scenario. It certainly has seemed quite plausible, and it has been working for a long time. Our policy has been to stay alert, stay asymmetric, but basically to wait and see. While I have never been very comfortable with it, I certainly have been solidly in that camp.

But now I think the very strong first quarter that we seem to be experiencing calls into question the continued viability of that scenario. Growth for the past four quarters including this one is going to be somewhere in excess of 3-1/2 percent. That is certainly well beyond anybody's estimate of potential in an economy whose resources already seem to be fully utilized. And it now seems that there is very little that is likely to slow that growth materially. We talked about all the factors this morning: job formation and the purchasing power that it creates, surprisingly strong construction, both residential and nonresidential, sky-high consumer confidence with jobs plentiful, and supportive wealth effects. If consumer spending should slow in the near future, I think we probably would get an inventory pop that would keep things going. Certainly, there is a potential for slower growth if we were to get a stronger dollar or a bear stock market. There are other potential shocks I am sure, but they seem to have a considerably lower probability.

The very strong and persistent job formation that we have seen is very likely in my view to start to take its toll on costs. The unemployment rate has been held up as high as it is by the fact that the labor force has been growing at an unexpectedly high rate. The labor

force participation rate is now at a record high, I believe, or very close to it. If the rapid growth of the labor force were to slow, the unemployment rate would probably go down substantially and costs would probably and perhaps inevitably rise. But if that labor force growth somehow continues, we will have to wonder about the quality of the new labor and what is going to happen to productivity and costs as a result. Certainly, there is some other combination of potential developments in the labor market. Some employers who are not chasing their firm's stock price will simply restrain production, slow growth down rather than allow their costs to rise. I am sure that many will be able to keep their productivity growing. There are employers who are causing jobs to migrate to lower cost areas, though it looks as if Utah is off the list. [Laughter] Many are going offshore. That is happening, but we have to wonder whether there is likely to be enough of that to affect aggregate indicators of economic performance. There certainly are a lot of things or combinations of things that could stretch out the benign era that we are in. But given what we see happening in the economy right now, what we know about the utilization rate of economic resources, and what seem to me to be the highest probabilities in coming quarters, it may soon be time for us to consider pulling up stakes and moving the camp to higher ground. [Laughter]

CHAIRMAN GREENSPAN. Is that the result of the floods?

MR. KELLEY. I started to say something like that, Mr. Chairman, but I thought that was just taking it too far.

CHAIRMAN GREENSPAN. I am glad you restrained yourself from referring to the notion of excess liquidity. [Laughter]

MR. KELLEY. I would not want to see us get under water. [Laughter]

CHAIRMAN GREENSPAN. Governor Phillips, I think you better talk now.

MS. PHILLIPS. My goodness. Well, I guess I am batting cleanup here. Last month we were trying to determine whether the returns for the fourth quarter of 1996 and early 1997 constituted a temporary burst of energy and the economy was about to settle down to the proverbial sustainable growth trend or whether those developments marked the beginning of a stronger growth path. It does appear that we have a bit more confirmation in the direction of the latter than last time. In addition, as Governor Meyer mentioned, we have come out of 1996 with an economy that is operating at a higher level. So, additional growth could put significant strain on our product and labor markets.

The areas of economic strength that have been confirmed since our last meeting include consumer spending, which is supported by increases in income from a strong labor market and perhaps even by stock market wealth effects. Housing activity appeared to slow in the fourth quarter, but it is now showing signs of reviving or at least continuing to operate at a relatively high level. In the business sector, we have persisting strength in profits and cash flows, restructured balance sheets, and reasonably priced capital. I see no reason to expect a slowdown in expenditures for equipment or structures. With demand holding up and space shortages developing, we may continue to see strength in construction expenditures with follow-along equipment purchases. If anything, inventories are lean, so the goods-producing industrial sector should be able to maintain its momentum. This rosy scenario does not mean that the business cycle is dead, just that it is a long cycle.

Some of the stories that we see concerning the industrial sector are in a sense showing a little more creativity. I would point to the Business Week article this week that indicated the technology industry is about to "tank." I must say that I have a hard time swallowing that story. Granted the technology industry is competitive and some fallout is

likely to occur among producers, the fundamentals for continued demand for information and communications technology are not going to disappear.

The monetary aggregates, although we have not been talking much about them recently, are confirming the economic strength. I believe that the industrial sector is aware that it is about time for us to remove the punch bowl.

The only area of weakness in the economy that has been confirmed since the last meeting is net exports. Although this sector is somewhat of a drag on U.S. growth, strength in the domestic economy significantly mitigates the effect. Another area, which Governor Rivlin mentioned, is the fiscal situation. In a sense, stronger economic growth is improving the chances of a successful budget deal.

Turning to inflation, although ostensibly it appears fairly benign, I would argue that there are growing signs of latent or pipeline pressures. I would point to average hourly earnings of non-supervisory production workers. The anecdotal stories of labor shortages and wage pressures are increasing, and employers certainly are getting more creative. I hope that productivity improvements will contain labor cost pressures, but it seems to me that there are some limits to this process. Governor Kelley referred to that issue. There are some commodity price pressures showing up: President Moskow mentioned hogs, certainly a prime commodity to which attention should be paid; other commodity price pressures may be seen in metals, lumber, and coffee. There also seems to be a lot of testing of the sustainability of price increases. With energy prices easing off, it is hard to know exactly how quickly any of these pipeline pressures will show through to the CPI, but it seems to me that we have moved further into the inflation alert zone.

CHAIRMAN GREENSPAN. I assume that the Beigebook did pass through the group around this table before it got out to the public. I would suggest that you all go back and read it. It really is quite interesting to see the difference between what is in that document and what was said around this table today. Shall we go to coffee?

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

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

CHAIRMAN GREENSPAN. Questions for Don? If not, let me start off. It is quite evident that we have come to a point, as we suggested we might at the last meeting, where as Don put it--how did you put it?

MR. KOHN. "Deliver."

CHAIRMAN GREENSPAN. We have to "deliver." Let me, however, review the various aspects of what is going on and try to put them into a policy context, which I think we need to fashion fairly carefully. Let me start with something that has not been discussed very much around the table this morning. The proposition that inflation has stopped falling is not readily provable. That may seem to be a rather ridiculous statement, but if we look at the data, what we see is that the rate of inflation, no matter how we look at it, has been edging lower with some bumps here and there. Even if we add back the BLS adjustments, that conclusion is not changed significantly; it certainly is not changed with respect to the GDP chain-weighted index and the like. The reason is very clearly that productivity is badly underestimated and indeed may actually be accelerating. If we start with the proposition that price levels are moving up very modestly, that domestic operating profit margins are stable or maybe slightly improved, and that consolidated nonlabor costs in the nonfinancial

corporate sector are going nowhere, we necessarily end up with the conclusion that on a consolidated basis unit labor costs in the nonfinancial corporate sector, as I mentioned at the last meeting, are not moving very much, if at all. Since we know what compensation per hour is doing, it necessarily follows that productivity has to be rising almost as much as the compensation numbers. Indeed, all the anecdotal stories that we hear tend to confirm that. This suggests, as Mike Prell pointed out, that we may finally be getting the productivity gains that many have anticipated from the synergies created by the rapidly developing computer technology information structure. The gains surely seem to be showing up in a lot of areas, and it is very difficult to understand the profitability numbers we are looking at without some reference to significant improvements in productivity. The reported per share profit figures, I should add, are stronger than domestic operating earnings despite the fact that the dollar has been firming. That's because the earnings of foreign affiliates, which are a significant portion of both the S&P 500 index and the NIPA data, have been rising rather strongly and indeed have been an increasing share of total profits over the last couple of years. So, we have to discount the reported profits at least slightly. But even after doing that, we still get a sense that the rate of increase in operating profits of domestic firms probably implies modestly accelerating productivity.

The reason why manufacturers in particular and business people more generally have the view that inflation is dead and the economy is in a new era is that that is the way it feels to them. In other words, if we examine individual company accounts, we find that business firms are offsetting their cost increases fairly aggressively and quite successfully. They are not able to raise prices. Pricing power is gone, and the reason it is gone, as we have discussed previously, is that competitors have sufficiently high rates of return to enable them

to undercut price increases and go for market share, should some firm try to raise its prices. This also implies that a degree of slack still exists in the system that all these business people can see. You can speak to any of the most sophisticated corporate managers, and you will get exactly the same story. The answer, of course, is that as sophisticated and farseeing as they may be, their time frame is too short for the purposes of monetary policy. Indeed, as we might put it in a macro sense, there are certain realities that are consistent with perceptions of the individual companies but inconsistent with the macro data.

First of all, it is pretty clear at this stage that the tightness in labor markets is increasing. Initial claims for insured unemployment continue at a very low level, showing no signs of turning up. Insured unemployment data have moved off the previous track and have gone down. Help-wanted advertising, which admittedly is not the world's most reliable statistic, has suddenly perked up in recent months in a way that we have not seen for a number of years. Most importantly, as a number of you have pointed out, labor force participation now seems to be rising after being stagnant. And if we look at the internal structure of the workforce, we see that employers are hiring marginal workers. The first sign of some labor market pressure is that new workers are recruited from outside the labor force. The problem is that there is no way to increase the working age population, which means that we can expand our labor resources only up to a point. We then run out of qualified people to hire. The numbers in this regard look quite impressive. We also are seeing that average weekly hours are moving up, and in a sense we are running out of space to expand, at least in terms of labor market resources. The reason I emphasize this is that it is far simpler to evaluate capacity use in the labor market than capacity use of other producer resources, and since either labor or capital utilization limits can restrain economic growth, we

need not argue that both constraints are in place. All we need is for one to be exerting a constraining effect and labor supply clearly is.

It is very difficult to see the emergence of resource constraints in the nonlabor structure. The reason, of course, is that advancing technology has created a degree of flexibility that we never had before. Not only can business firms now produce customized products in small batches through computerized and rationalized production techniques that they did not have previously, but they can also add features or take them away--do whatever they want--in a way they never had the flexibility to do before. This means that the concept of capacity is far more flexible than ever. The only way that we can detect obvious difficulties or pressures is by watching such things as lead times on deliveries, overtime hours, or other measures of tightness that are symptoms of the difficulty of using the existing state of technology to adapt capacity and facilities to unanticipated developments. One way business firms have accomplished all of that is by moving to a quite remarkable just-in-time inventory system. They have tightened the production system to a point where, as part of its flexibility, they have the capability of essentially not having inventories other than work in process. Indeed, part of the improvement in productivity has resulted from squeezing down the way businesses use resources. As a consequence, inventories measured in terms of days' supply at factory value are now at very low levels.

The reason I raise the issue of factory value is that when we are looking at a demand system, the markup of inventories in the distribution channels is not a truly relevant consideration. We are interested in the number of shoes in the distribution channel if we are calculating production; we are not interested in the constant dollar value of those inventories because that will change depending on where they are in the production and distribution

process. While I may exaggerate when I say that the markup for the inventories is not all that important, it nonetheless is not as valuable in measuring the tightness of supply and demand as the factory value numbers. For purposes of measuring GDP, the markup obviously increases value added, which is why we calculate it, but it does not give us information about the supply of shoes. It just tells us what the value added has been in the distribution process.

One problem with just-in-time inventory systems is that resource use is very tight. Consequently, if anything abnormal emerges, there is a marked rise in delivery lead times or bottlenecks. All of a sudden people who think just-in-time inventory management is terrific find that they now need to add some safety stocks. What happens is that the inventory pattern then begins to turn around even though days' supply may not go up very much.

In the current situation, since inventory-sales ratios at factory value have been coming down in general, inventory investment could go up quite abruptly. As a consequence of such a development, there is a very clear underlying tightness in the current inventory situation that is creating significantly more risk on the upside than we had earlier, certainly more than in the summer of 1996 when inventories had backed up and there was a degree of slack in the system. That slack has essentially been pulled out of the system at this stage.

It is very hard to believe that personal consumption expenditures are not significantly affected by the wealth effect. Leaving aside the econometrics, I think that whenever we get as huge an increase in financial market wealth as we have gotten, people at some point begin to believe that it is permanent. They start thinking that it is not going to disappear right away and that they are now in a sense richer. That attitude begins to have an impact on consumption expenditures. Indeed, if we look at the decline in risk premiums

and/or the cost of capital, what that means essentially is that we are progressively discounting the future less. If we examine the normal processes by which time-dependent investments are made, as the risk premiums and the discount factors fall, we see that production is brought up front from the future. Capital assets are produced today on the basis of expected returns much further in the future than was true in the previous periods. As the risk premiums fall, the time preference moves into the future and picks up additional current demand. I think we are seeing that in consumption expenditures and in home sales.

Let me just add parenthetically that awhile back I discussed the discrepancy between the level of home sales and the levels of housing starts and permits. What we were observing was that the level of starts was being supported by declines in permit backlogs and the level of permits was being held down by sales drawn out of housing inventories. I am talking about single-family homes. We now are seeing for the first time at least some pickup in the permit backlogs. This indicates that sales of single-family homes out of existing stocks finally are beginning to induce builders to take out more permits for new home construction. While I certainly grant that the February data were an aberration, they do tend to suggest that housing activity may not be moderating.

Certainly, plant and equipment expenditures are crucially related to this time preference issue and are undoubtedly being affected by the evidently continuing rise in the prices of commercial real estate and the quite pronounced decline in vacancies, especially in suburban areas. We are beginning to see some upward movement in commercial rents.

Having said all of that, we are not at this stage moving into what I would describe as an overheated boom. We are short of that. For example, it is certainly the case that homebuilding is at a relatively high level, but it is not accelerating. Motor vehicle sales, I

think, are a little softer than Mike Moskow was suggesting. Our reading of the same people he spoke to a week ago comes out with a slightly smaller number. Chain store sales have tended to flatten out. In other words, this economy is not running away to a degree that would suggest we have to hold everything in place. What we have at this stage is a situation that is clearly evolving over time. In fact, as I said at the beginning of my comments, we still do not have concrete evidence to suggest that the inflation rate has stopped going down. In this situation, we can allow ourselves a fairly considerable amount of time to act. Therefore, I do not think that there is any particular urgency to move in a very aggressive way. I do think we have to move, but I don't think that we have to be concerned about being behind the curve in any measurable way.

Certainly, there are some principles that clearly need to be kept in mind here. One is that recent experience tends to reinforce our view that low inflation is very positive to economic growth, to employment, to stability, to all the good things we talk about with respect to the economy. Therefore, it is crucial to keep inflation low. The argument that we can wait until we see signs of inflation before taking action fails to take account of how important this low inflation environment apparently has been in enhancing the recent performance of the economy. It strikes me that whatever we do, we need above all to make certain that we keep inflation low, risk premiums low, and the cost of capital low. We recognize that that can create unusual problems within balance sheets and the like, and members have expressed some concerns regarding those problems of late. Nonetheless, if we are talking about long-term equilibrium, high market values are better than low market values. What we are trying to avoid is bubbles that break, volatility, and the like, but we are

not opposed to the implications of low inflation, which include relatively low risk premiums and fairly strong economic activity.

I conclude that what we clearly need at this stage is finally to move off the dime. I think that 25 basis points is enough for now; indeed, I will argue against 50 basis points in a minute. It is conceivable that economic growth may slow, and it is possible to interpret the data we have seen as suggesting that backlogs, new orders, and sales are beginning to turn sluggish outside the high-tech area. As far as the high-tech sector is concerned, we have seen a very strong acceleration over the last two or three years that is numerically unsustainable because if that rate of growth were to continue, the high-tech area would soon account for 120 percent of GDP! That clearly is not going to happen. I think the stock market is telling us that the growth projections implicit in some of those earnings forecasts for high-tech industries are unrealistic, and there is some evidence that this sector is beginning to flatten out. One of the reasons why I suspect that Microsoft is not moving terribly fast in coming out with a Windows 97 is the fact that they are getting some resistance to all these technological changes. There is a physical incapability of putting in one software revision after the other, and this reaction could very well be in the process of occurring.

I would not rule out as a significant probability, perhaps not a high probability, that the current economic expansion is on the verge of some slowing. If that does happen, 25 basis points is not going to be a major inhibiting factor, but 50 basis points, which the market is not expecting, could be very jolting indeed.

I want to recall a conversation we had when we last decided to move up the federal funds rate after a long period of no change. That was in February 1994. We had a lengthy discussion as to whether we would move 50 basis points or 25 basis points. We did 25 basis

points and the market almost fell apart, but not because they did not expect us to move. As you all know, I had been out there in the immediately preceding weeks in effect waving a red flag saying we were about to do something. We did it and somebody asked, "Why didn't you tell us?"

At this stage, the market is expecting 25 basis points. It has discounted such a move, frankly, but it has done so in a positive way, not a negative way. The stock markets are up this morning; the bond market is up. I think that if we were to move 50 basis points today after a long period of doing nothing, though being vigilant if you like, we suddenly would shock the market into thinking that we must feel that we are behind the curve. We are not behind the curve, and we have a lot of time to take various actions as we perceive the need to take them.

I think the odds are better than 50/50 that the move we are considering will not be our last tightening move. We are very likely to have to move again, though I see a low probability of a very considerable near-term acceleration that would raise inflationary pressures and require us to move before our May meeting, which you will remember is two months away. I think we would have to have a telephone conference to consider such a move partly because the views regarding the risks of rising inflation among our constituents, especially the business community, deviate so far from where we are that it is very important for us not only to move appropriately but also to make certain that people understand why we are doing it. You may recall that there was a fairly broad consensus at our last meeting that we ought to condition the markets in the Humphrey-Hawkins testimony to the likelihood that we were finally going to move. I think that was a desirable thing for us to do. I would say that the stage is set for us to take action, and I would argue that we should do only 25 basis

points. I must say that it definitely would be better to do 25 basis points than to do nothing. I believe a failure to act would be a major mistake, given what we see out there in the economy.

I would prefer symmetry at this stage if for no other reason than our having been asymmetric for so long I am worried about devaluing the currency so to speak. I do not think that symmetry or asymmetry will affect our actions one way or the other, and I must tell you that I do not feel strongly about my preference. If we were to move further before the next meeting, we would do so with a preceding telephone conference, so as a practical matter the symmetry or asymmetry doesn't mean anything in this situation. It does, however, establish a presumption that we probably would move again in May. The issue is basically whether we want to convey that notion in advance, because having asymmetry and then not moving again is something that I think we ought not to get involved with. In sum, my view on the symmetry/asymmetry issue is more a mechanical than a policy matter. Governor Rivlin.

MS. RIVLIN. I would strongly support this set of moves--the 25 basis points and a symmetric directive. I think what we say about our action is terribly important, not just in the announcement but what we all say about it over the next few days. I believe the key words should be that we want to sustain the growth of the economy and to sustain our ability to have tight labor markets. There is an enormous benefit, which we are seeing, in having tight labor markets, and I think we ought to say that sustaining them is our goal. I also would support a symmetric directive because I think there is significant uncertainty about whether we will want to move again in May. We do not want to stack the deck.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. I strongly support your recommendation for a 25 basis point increase in the funds rate, and I can accept your recommendation for a symmetric directive though I could have been persuaded to go for an asymmetric one. I will come back to that later. I want to focus my remarks, though, on an analytical framework for supporting this kind of a move. First, I want to consider the implications of the Taylor Rule and talk about the importance of a flexible approach to interest rates in response to economic developments. I also want to explain why we should not leave the task of countercyclical policy to the bond market and present an interpretation of tightening in terms of what I will call the maxi/min solution.

The Taylor Rule, as Don Kohn noted in his presentation, would suggest no move at this meeting because utilization rates are about the same as they have been and core inflation is actually lower. While the Taylor Rule does not provide support for an action today, it would suggest that, if the Greenbook forecast proves to be correct, we will want to tighten later. There is, however, an alternative specification of the Taylor Rule that would, in my view, support a tightening of policy today. I will call it the forward-looking Taylor Rule. To be sure, the standard rule is forward-looking to a degree in relation to inflation because it includes current utilization rates. But in the forward-looking Taylor Rule, actual values of inflation and utilization rates are replaced by forecasts. There is a growing literature on forward-looking policy reaction functions. An early paper was done by Steve McNees at the Federal Reserve Bank of Boston in the mid-1980s and updated in the early 1990s. Over the last year, in fact, there has been a flurry of additional work along this avenue, including work in progress at the Board, which finds that policymaking has tended to evolve over the last 15 years from reliance on incoming data to gradual responses to forecasts. However, these

papers are an exercise in description and what we really need is a normative analysis to confirm that moving in response to forecasts, given the accuracy of forecasts, would produce better results than responding to actual data.

Would such a forward-looking reaction function provide support for moving today when we did not choose to move at earlier meetings? In terms of thinking about raising interest rates today, we might interpret the recent strengthening as a shift in the IS curve and ask whether monetary policy should impose a horizontal LM curve that would resist the natural tendency for stronger growth to push up interest rates. Alternatively, should monetary policy enforce an upward sloping LM curve that allows a stabilizing response to cyclical strength? In fact, there has been a lot of discussion or implicit commentary around the table about the old pegging strategy, the mistakes of the 1960s, and also more discussion of M2 than at any of the previous FOMC meetings that I have attended. One of the implications of imposing that horizontal LM curve is allowing an acceleration of M2 growth in response to a shift in the IS curve.

Some might argue that because long-term interest rates already have risen along with the dollar, the economy is moving along an upward-sloping LM curve. I do not believe, however, that we should leave monetary policy to the bond market. The question is whether we should be validating or resisting the recent move in long-term rates. That move after all reflected to a significant degree the bond markets' expectation of a shift in monetary policy, particularly as a result of the Chairman's recent testimony combined with the recent strength in the data. Let's pat the bond markets on the back and tell them that we appreciate their effort but also let them know that they should not have to do all the work.

Finally, let me discuss the maxi/min solution. Here I compare the consequences of two types of mistakes we could make today: not tightening when that would have been appropriate versus tightening when it was not needed. In this approach, a decision today can be interpreted as selecting the best of the worst possible outcomes. First, consider what would happen if we tighten when that turns out to be unnecessary, NAIRU could turn out to be lower than anticipated, productivity growth higher than projected, or demand unexpectedly weaker. The unemployment rate could then be higher than would have been desirable and inflation lower than otherwise. In this case, the unemployment rate would still be at a historically low level and inflation would be moving toward our long-run objective, not a really bad outcome. Indeed, that would be a preferred outcome for some on this Committee.

On the other hand, if we failed to tighten when it would have been appropriate to do so, the excess demand gap would open or widen and inflation could increase. We would then face the Taylor Rule's triple whammy on the funds rate. We would have to raise the funds rate to prevent the real rate from declining, to counter the rise in output relative to potential, and to combat the increase in inflation relative to our target. This is usually an ugly affair. It does not end well for the economy.

Mr. Chairman, because I am guided by a forward-looking specification of the Taylor Rule, because I believe we should be flexible in adjusting interest rates to changing economic developments, because I think we should enforce an upward-sloping LM curve in response to shifts in the IS curve, and because it is a maxi/min solution, I support your recommendation for tightening monetary policy. Because containing a threat to higher inflation is likely to require some further increase in short-term rates beyond the small

change contemplated today, I could have accepted a call for an asymmetric directive. I think that is particularly true given that your comments raised the possibility, if not the likelihood, of a move between now and the next meeting. That sounds like an asymmetric directive to me. But I do not see that as a very important point, and I can certainly accept your scenario.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. I think that the best thing to concentrate on at the moment, or at least what I find myself concentrating on, is what we do not know. Even though we have had a lot of rather good albeit partial explanations, I think we are not, and certainly I am not, altogether sure why inflation and the cost-push causes of inflation have been so benevolent. We are tightening now largely because we as a group have decided--and certainly I believe--that the risks of waiting further have become excessive and therefore unacceptable. Then the question arises as to how much we should tighten. I think 25 basis points does two things. It indicates our concern, especially given the fact that a shift in policy direction is involved, but it does not pretend that we know more than we know. I, at least, am not so sure that the benign performance of growth and inflation, which we have found acceptable since last July, is going to end soon. Therefore, I think it is appropriate that our response be moderate and in that sense a 25 basis point increase is enough. I believe a 50 basis point move would indicate a far greater assurance regarding the end of the benign period--that it is more highly predictable and will occur sooner--than I feel intellectually or in any other way.

The asymmetric directive--I think I have become almost the resident theologian on what asymmetry means--is inappropriate now. I believe that the combination of a move with asymmetry would cause us to fall into the same trap of assuming something that we do

not know. If, as is possible and not absolutely a no-brainer, we decide that we have to increase the fed funds rate again either before the next meeting or at the next meeting, the lack of asymmetry when we announce it in releasing the minutes the Thursday after the May meeting will not be very important to anybody. Consequently, I think the 25 basis point increase and a symmetric directive are most consistent with what we know and maybe more importantly with what we do not know.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I support your recommendation on the federal funds rate. Though I might prefer asymmetry, given your comments I would also support symmetry.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, I can accept your recommendation. On balance, I think the case for a larger move is stronger than indicated by others who have spoken to this point. But I am satisfied with 1/4 point. It is a way of getting back into the ballgame, so to speak, and reaffirming our longer-term commitment to price stability. I do think, as you suggested, that this move very likely will not be our last and that we will have to tighten further. And I see a good chance that the tightening may happen sooner rather than later, perhaps before the May meeting. I hope we will move promptly if we need to do so. In that context, I would prefer an asymmetric directive because I think the situation even after a 1/4 point increase is still going to be asymmetric. The issue is not a deal breaker for me, but I have more than a marginal preference for asymmetry.

If I could add one other hopefully preemptive point: In this situation, I think there is some possibility the dollar could strengthen. I am not predicting that, but I think it is

possible. If it should, I hope we will resist the temptation to engage in any foreign exchange market intervention because I think that would dilute the signal we want to send with this move.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I should mention that the estimated Taylor Rule, which we use as a policy reaction function in our forecasting model and which I think is preferable to the original Taylor formulation, suggests a gradual rise in the funds rate totaling about 100 basis points, with the increases beginning in the second quarter and continuing through the end of this year. The degree of tightening is very similar to the one assumed in the tighter policy simulation in the Greenbook. According to our analysis, a path like this for the funds rate appears necessary just to hold the line at around 3 percent on core CPI inflation. It certainly is time to take an initial step in tightening policy. While I think the case for a 50 basis point increase is stronger than you do, Mr. Chairman, I would support a 25 basis point increase to 5-1/2 percent. I also would strongly prefer to have language in the directive that is asymmetric toward further tightening since I think that course of action is likely to be appropriate in the future. It seems to me that there was very little, if any, discussion around the table that would be consistent with a symmetric directive. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, as we all have said, we need to be forward-looking in our policy, and I think a rate of inflation as high as the forecast we have seen today is clearly unacceptable. Just looking at the Greenbook forecast of a core inflation rate of 3.2 percent by 1998, that rate would increase to 3.6 percent if we added back the BLS methodological changes. Although this forecast has not changed since our last meeting, I

think we are more confident about the forecast today than we were then because of the persisting strength in the economy and because of other changes in the forecast, as Larry Meyer pointed out in his comments. Therefore, I clearly support your recommendation for the 25 basis point increase, and I prefer 25 basis points to 50 basis points for the reasons that you explained. I would prefer an asymmetrical directive, but I do not feel strongly enough about it to dissent on that issue.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, I fully support your recommendation for both the 25 basis points and the symmetric directive. I, like many others, could support an asymmetric directive as well, but I think your wisdom in this case is good as usual.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support a 25 basis point increase. We ought to explain this tightening action by indicating that we think we will increase the chances of prolonging the expansion by moving now. We central bankers ought to like job creation; we ought to like growth; we ought to like prosperity, and I think we ought to explain our actions in the context of favoring those things. Indeed, if we have learned anything, it is that low inflation is pro-growth rather than anti-growth. With regard to the symmetry issue, I think the choice of symmetry or asymmetry is based on a flexible theology. It seems to play different roles at different meetings, and I do not have strong feelings one way or the other. But I think your rationale is as good as any, Mr. Chairman, so I would vote for symmetry.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I am generally comfortable with your recommendation, Mr. Chairman. I do not want to dwell on too many nuances, but let me just make a couple of

additional comments. Like President Broaddus, if I interpreted him correctly, I guess I am somewhat less confident than you that we are not behind the curve. My concern is that there seems to be a lot of momentum to demand in the economy, and that momentum could translate into rising inflationary pressures. While I agree with your assessment that we probably have been underestimating productivity growth for some time, I wonder how widespread that mismeasurement is and what the prospects for productivity are going forward. Mike Prell's report on the dichotomy between the views of the banker and the industrialist is perhaps a little indicative. There is no doubt that the productivity increases have been substantial in manufacturing, but people in the financial services industry at least implicitly suggest that they have not achieved the same kind of gains. I think that is one of the reasons they have not quite bought into the "new era" story the way others have.

Having said that, I think that when we make policy adjustments like this, it pays to be cautious. We are uncertain about the outlook; we are uncertain about the effectiveness of policy; and because of those uncertainties, I think we ought to be cautious. As I said, I am comfortable with your recommendation.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. I, too, am comfortable with your recommendation, Mr. Chairman. I came to this meeting with a preference for an asymmetrical directive, and even after the discussion, I still have a slight preference for that. But you and others have argued very persuasively that it is not a big deal in present circumstances, so I am comfortable with a symmetrical directive.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I support your recommendation to tighten 25 basis points. I am not sure how much tightening ultimately is going to be needed, but caution seems appropriate when we change the direction of policy. I support a 25 basis point move. At 5-1/2 percent, we may not be that far out of alignment, so symmetry seems like the right message to me.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Alan, I agree with what you said in terms of the likelihood of more tightening down the road. I think we will need to do more, and I might be inclined to do more at this point, but I can accept your recommendation.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I support the 25 basis points and I support the symmetrical directive on its merits.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. We are now entering the seventh year of the expansion as dated by the National Bureau. For the most part, it has been an extraordinary expansion in that not only has inflation been contained, but more importantly it has tended to drift down through this expansion period, which is remarkable. Last summer when Fed watchers--Wall Street types especially--were certain that we were not only going to raise rates then but that a tighter policy was needed, I was comfortable in not supporting that view. I felt from a forward-looking perspective that we would continue to get productivity increases, downward pressure on inflation, and a concurrent decline in the unemployment rate. People's perception about capacity and how much slack existed would be changing, which allowed us the luxury of leaving the nominal funds rate where it was and not incurring any trouble. But I also was counting on not having an acceleration in the growth of nominal final demand.

For quite a while we had been in a period where the successive Greenbook surprises were in the direction of lower nominal spending growth than previously forecast. Not only was inflation lower, but nominal spending growth and domestic final demand growth were lower. Even as recently as the December Greenbook--a week or two away from the end of the quarter--we were looking at a fairly modest growth rate of nominal spending of under 5 percent for the fourth quarter.

Of course, it did not turn out that way. It came in much, much stronger. But then in the February Greenbook we still were looking at the reported strength in the fourth quarter as having been a one-time occurrence associated with such things as seasonals, weather, and the trade sector. Now we are looking at a situation where nominal spending growth accelerated very sharply in the final two quarters of the sixth year of this expansion and, more important in some ways, where the domestic component of final demand accelerated in those two quarters. All of that may turn out to have been a one-time thing, and spending growth may decelerate significantly from these levels. But when we look at virtually every measure of money and credit, the monetary base, M1, MZM, and so on, not only for this country but around the world, we find that such money growth rates have accelerated sharply. That says to me that the world's central banks are financing an acceleration in final demand and that monetary policy could very quickly come to be viewed as being behind the curve and require a lot of adjustment to make sure that money growth does not start sprouting out in higher inflation.

CHAIRMAN GREENSPAN. We have acceptance of 25 basis points and--I'm sorry. President McTeer.

MR. MCTEER. Ditto. [Laughter]

CHAIRMAN GREENSPAN. Ditto what?

MR. MCTEER. I agree with your recommendation, and I also agree with Governor Rivlin and Ed Boehne on the pro-growth rhetoric.

CHAIRMAN GREENSPAN. I knew I was missing an important voice.

MR. MCTEER. If you want, I will tell you an Aggie joke! [Laughter]

MS. MINEHAN. We don't have time for that!

CHAIRMAN GREENSPAN. There is a marginal consensus toward symmetry as the first choice. Therefore, I will ask your vote on 25 basis points with symmetry.

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

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Broaddus	Yes
President Gynn	Yes
Governor Kelley	Yes
Governor Meyer	Yes
President Moskow	Yes
President Parry	Yes
Governor Phillips	Yes
Governor Rivlin	Yes

CHAIRMAN GREENSPAN. Given the possibility that we would do this, I already have a draft of what we may want to announce. I will read the whole draft announcement.

“The Federal Open Market Committee decided today to tighten money market conditions slightly, expecting the federal funds rate to rise about 1/4 percentage point to around 5-1/2 percent.

This action was taken in light of persisting strength in demand, which has progressively increased the risk of inflationary imbalances developing that would eventually undermine the long expansion.

In these circumstances, the slight firming of monetary conditions is viewed as a prudent step that affords greater assurance of continuing the current low inflation environment for the rest of this year and next and prolonging the economic expansion. The experience of the last several years has reinforced the conviction that low inflation is essential to realizing the economy’s fullest growth potential.

No change was made in the Federal Reserve discount rate, which remains at 5 percent.”

Is that acceptable to everybody? I would put it out in the name of the Committee because this is such an important document. I hope you do not mind in this context.

MR. KELLEY. Mr. Chairman, one suggestion for your consideration.

CHAIRMAN GREENSPAN. Sure.

MR. KELLEY. About two sentences from the bottom, you list inflation first and growth second. I would suggest reversing the order in which you say those two things.

CHAIRMAN GREENSPAN. Let me think about whether the grammar holds.

MR. KELLEY. We have to do that for sure.

MS. RIVLIN. I had the same reaction. It was a little heavy on inflation, and since we do not have any, I don't think we want to be stressing that quite so much.

CHAIRMAN GREENSPAN. You favor reversing the order in that sentence?

MS. RIVLIN. Yes, or some other verbal means of emphasizing growth a little more, inflation a little less.

CHAIRMAN GREENSPAN. That is the reason the previous sentence says in part "and prolonging the economic expansion." It was meant to capture that thought.

MS. RIVLIN. It is there.

CHAIRMAN GREENSPAN. Let me see if it creates grammatical monstrosities to reverse the sequence in the last sentence.

Let me remind everybody that we are going to lunch to say our best departing words to Janet Yellen, and a lot of people will be there who do not have access to what we have done. The announcement will not be released until 2:15 p.m. Please be particularly careful in observing this central bank confidence. It may or may not be crucial, but it would be awful to find that somebody picked up something and it got out prior to the 2:15 p.m. release to the press. Also, as Joe Coyne will tell you, we have a rule about not commenting about what we have done during the next week. I merely emphasize that.

We have no further business except to note that our next meeting is on May 20. See you all at lunch. Lunch is at 1:00 p.m.?

MR. BERNARD. At 1:00 p.m.

END OF MEETING