

Meeting of the Federal Open Market Committee
August 18, 1998

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, August 18, 1998, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Poole
Ms. Rivlin

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

Messrs. Guynn and Parry, Presidents of the Federal Reserve Banks
of Atlanta and San Francisco respectively

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

Messrs. Cecchetti, Dewald, Hakkio, Lindsey, Simpson, Sniderman,
and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

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

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

Mr. Hooper and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Struckmeyer, Assistant Director, Division of Research and Statistics, Board of Governors

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

Ms. Strand and Mr. Varvel, First Vice Presidents, Federal Reserve Banks of Minneapolis and Richmond respectively

Messrs. Beebe, Goodfriend, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Richmond, and Dallas respectively

Messrs. Bolwell, King, Kopcke, Meyer, and Sullivan, Vice Presidents, Federal Reserve Banks of New York, Atlanta, Boston, Philadelphia, and Chicago respectively

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

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CHAIRMAN GREENSPAN. I just read on the Dow Jones tape that this meeting was going to begin at 9:00 a.m. as scheduled. It is now 8:58:25 a.m. Does anybody object to moving up this schedule?

MR. HOENIG. I move that we start the meeting.

CHAIRMAN GREENSPAN. Without objection.

MS. MINEHAN. Don't tell Dow Jones!

CHAIRMAN GREENSPAN. Who would like to move the minutes of our previous meeting?

VICE CHAIRMAN MCDONOUGH. Move approval.

MS. MINEHAN. Second.

CHAIRMAN GREENSPAN. Without objection. Peter Fisher, would you start us off?

MR. FISHER. Thank you, Mr. Chairman. I will be referring to the package of color charts, which should be on the table in front of you. 1/

The first page as usual shows the 3-month deposit rates: current, 3-month forward, and 9-month forward. Since your last meeting, there have been small but noteworthy changes in interest rate expectations. In the United States, the top panel in red, you can see that the 9-month forward 3-month rate has slipped below the current 3-month rate. Even though this negative gap is small--a dozen basis points or so--it is the widest on the chart since the January period. I think it reflects a growing chorus of voices in the market, particularly in the last 10 days, who are increasingly confident that the Committee's next move will be an easing action.

In the middle panel, as you can see, the German 9-month forward 3-month rate also has crept a little lower in recent weeks. I think it still reflects the anticipation of an increase in European rates sometime over the coming months. I believe it is particularly noteworthy that the 9-month forward 3-month rate is actually trading around levels just above 3.8 percent where most people just a month ago were expecting the European Central Bank's 1-month policy rate to be set next January. So, that reflects quite a reduction in expectations over the last couple of months.

1/ Copies of the charts used by Mr. Fisher are appended to the transcript. (See Appendix)

In the bottom panel in green, you can see that both the 3- and 9-month forward 3-month rates in Japan dropped distinctly below the current 3-month rate following the selection of the new LDP leadership team, but those rates recently have bounced back up a bit.

As I look at the last 14 months of interest rate expectations in the leading industrial nations, two things strike me. First, the current trepidation in global capital markets is not a consequence of the perception that the leading central banks are about to do anything. There is no such expectation. Secondly, it strikes me how far markets have come over the last 12 months in giving weight to the risks of deflation, however they imagine them to be. A year ago at your August meeting, I introduced my four characters in pursuit of a return, the old and the new paradigm pessimists and optimists. At the time I introduced the new paradigm pessimist who was anxious about deflation and global capacity glut leading to competitive devaluations, I think only Governor Kelley had a kind word to say about the new paradigm pessimist who he thought should not be overlooked.

MS. RIVLIN. He is always nice. [Laughter]

MR. FISHER. Today, at least as the market sees it, the nation with the second largest economy in the world, Japan, and the nation with the largest share of the world's potential labor supply, China, are both experiencing distinctly falling prices. Moreover, the premier of China is no longer worrying about maintaining the pace of investment in order to prevent inflationary bottlenecks. Instead, he is now talking about how China is trying to invest its way out of deflation. It is this context that I think we should keep in mind in our effort to understand how the markets are looking at the question of whether China will devalue its currency. I think that implicitly this question is seen, rightly or wrongly, as representing something of a turning point for the markets--from a world they are familiar with to one they are less familiar with, that is, a deflationary world.

Turning to the second page of charts, on the left side are three panels showing foreign equity prices, German and U.S. equity prices, and German and U.S. 10- year yields over the period from last July to the present. On the right hand side are three panels depicting the same market movements since the beginning of July this year. Markets have gotten a little ahead of me since I prepared this chart, but let me focus on the right hand side first and make a point. I think we can see in retrospect that the combination of the Chairman's Humphrey-Hawkins testimony this July and Mr. Obuchi's selection to lead the LDP were turning points for global market expectations. Now, I want to be very clear. In both cases, the outcomes were as the market expected but not as the market hoped. Market participants were engaging, I believe, in some wishful thinking, hoping to be pleasantly surprised.

With respect to the Humphrey-Hawkins testimony, the market was hoping that the Chairman would say something rather kind and benevolent. Instead, they heard him say exactly what he said in June at his JEC testimony, namely that he was more concerned about the risks of inflation than those of deflation, and they heard him testify with what might be characterized as a "make no mistake about it" delivery. With respect to the selection of the LDP leadership and the new Japanese government, again the market was hoping to be pleasantly surprised, thinking that perhaps the Japanese could find their own FDR. So far, it does not appear that they have. Thus, looking back, I think the market's two self-generated disappointments can be seen as the last sneezes on which the start of the recent equity market declines might be blamed.

I do not have charts depicting some of the market movements in the last two days that reflect the Russian devaluation. Let me just note that on Friday both the German bund market and our Treasury market experienced some extraordinary inflows. There is still a flight to quality into both core Europe and the United States. The details are still coming out for the Russian devaluation and debt restructuring announced yesterday. Market assessments are that the Russian program is better, at least insofar as can be judged in the first day or so, than they might have feared. However, I think there is also a great deal of anxiety about how trades will be settled, and this is causing considerable market commotion. The ruble was fixed today at 6.8 to the dollar, but it is trading around 7, at least in the interbank market. But according to the reports that we have, the ruble is already trading around 9 in the black market. I do not pretend to understand, and therefore I am not comfortable explaining, how it is that the Dow thinks this is great news while the Bolsa and other emerging equity markets think it is bad news. I think we will have to wait a few days to see how this plays out.

I would note that the devaluation of the Thai baht had looked pretty good on day 2 also. I think we have quite a few risks ahead of us particularly in the days ahead when the collateral that has underpinned much of the leverage in the Russian financial markets starts to be liquidated as counterparties figure out what trades are being settled and what trades are not. There is still a great deal of uncertainty there, but I cannot pretend to be up to the minute on these developments.

Turning to the third page, you will see three different charts that depict changes in dollar exchange rates since July 1997. In the top panel dollar exchange rates, indexed to last July, are shown against a number of currencies as well as the Bank of England's trade-weighted dollar. In the middle panel dollar movements are shown against the yen and the mark. The changes are comparably scaled in the middle panel. That is, given percentage changes for dollar/mark and dollar/yen are the same on the chart and permit a comparison of how the dollar has moved against the yen vis-à-vis its movements against the mark. The bottom panel, again comparably scaled, shows the movements of the yen against the mark since the beginning of July 1997.

Given the dollar's movements indicated in the top panel, my point, Mr. Chairman, is that we are quite fortunate in my view that the world is not talking about too strong a dollar but rather is focusing its attention on too weak a yen. There are some reasons for our good fortune. Not the least is the fact that policy inertia is most evident in Japan and that the yen is weak against both the dollar and the mark, as you can see in the bottom panels. The fact that the yen is weak against both currencies has translated into a remarkably stable dollar-European currencies relationship over the last year and a half as evidenced by the green line in the middle panel for dollar/mark. As I noted a moment ago, investments both in the last few days and over the last few months have been pouring out of emerging markets into core markets. This flight to quality is what has made our 30-year yields so low and has reduced German 10-year yields to below 4½ percent. Because Europeans historically have been the loudest to complain about too strong or too weak a dollar, I think the relative stability of dollar/mark is obscuring the public's appreciation of the dollar's strength against a lot of other currencies. For example, we passed through new highs against the Mexican peso and the Canadian dollar.

Another way to think about the strength of the dollar is to look at how stable the dollar/mark relationship has been and to realize that we are in the middle of the period in which, as I would have expected and we hear anecdotally, there are significant flows into Europe in anticipation of the creation of the euro. Those flows are not going to occur in January after the euro is a fact, but people are trying to position themselves in anticipation of its creation. Again, with bund yields at 4½ percent, we see that the bund seems to be the happy place to invest in anticipation of a successful launch of the euro and also to hedge against its failure.

Turning to the fourth page of charts, you can see in the top panel the September Eurodollar futures contract as it has traded from May to the present and the November fed funds futures contract. I want to make two points here. First, you can see the slight decline in yields in the last few days as expectations of an ease in policy, not immediately but in the future, have come into the market. What I think is much more noticeable in the top panel is how flat and boring these movements have become since your July meeting compared with what they were earlier in the spring. There is much less a sense of "push me/pull you" in the interest rate markets and expectations have gone very flat without a lot of rate movement.

The bottom two panels show something that I depicted several meetings ago, which is the positive carry of on-the-run Treasury issues. The on-the-run Treasury yields are shown in the red dots and the blue dots represent the term-to-date financing for each of the on-the-run issues. The gap between the two gives some sense of the positive carry that the dealer community and leverage participants are still experiencing in pricing on-the-run Treasury issues. I want to make clear that the general collateral rate that applies to most Treasury securities is still close to the funds rate, and therefore there is not as much positive carry for most off-the-run

issues. However, the price discovery process is dictated by the on-the-run issues where there is depth, liquidity, and trading volume. Even as the yield curve has been squeezed to below the funds rate, you still can see the very modest positive carry in the on the-run issues.

Turning to open market operations on the next page, activity in the federal funds market has been mostly uneventful since your last meeting. Funds traded at very elevated rates on one day when wire transfer problems bottled up a very large amount of funds at a major money center bank. That bank sold funds in the market after the wire was extended. Given the very firm rates we saw around the turn from June to July, we tried to anticipate similar pressures at the latest month-end turn from July to August, and we laid in some repos in advance. We seem to have succeeded more or less in calming the market in this case. Yesterday, we had quite an elevated funds rate, which is not depicted in this chart. August 14, the last date shown in the chart, was on Friday, and the somewhat higher range of trading on that day occurred in anticipation of market pressures associated with the settlement of the Treasury's refunding yesterday. There was in fact a great deal of pressure in the market yesterday, but that seems to be behind us. We made an outright purchase of \$1 billion of securities on August 3, and we will be looking for opportunities to make additional permanent injections of reserves in the coming days.

One final point, Mr. Chairman: On the last page of my handout is a list of primary dealers. A number of Committee members and others in the System have asked me how many dealers there are. You need a scorecard to know the players at present. In the top half of the page, you can see the 26 dealers whose status has not changed in the last year. On the left side of the bottom half of the page, you can see the list of dealers 27 through 39 as of August 1997. At the bottom, you can see the three withdrawals that have occurred since then: Yamaichi, Eastbridge, and Sanwa. Sanwa was the most recent firm to withdraw from dealer status. They were aware that we thought of them as one of our weaker counterparties, but their decision to close their operations was unlike that of Yamaichi and Eastbridge: It was not forced on them by the market or other events but reflected a business judgment on their part. A dealer operation was not in the mix of activities that they thought would be profitable for them in New York.

In the middle column for August 1998, we have listed the mergers that have been effected to date. On the right side, you can see that we expect a couple more mergers to take place and have two pending applications for dealer status. I want to make clear that we do not have the "aspiring dealer" category, but it still takes some time to work things out with a firm that has approached us to become a dealer.

Mr. Chairman, we did not conduct any foreign exchange intervention operations during the intermeeting period. I will need the Committee's ratification of the Desk's domestic open market operations, and I will be happy to answer any questions.

CHAIRMAN GREENSPAN. The black market ruble is selling at 9 and the fix was around 7. What are the mechanics that allow that to happen, and secondly, which of the two rates filters into the price inflation structure? In other words, which rate affects import pricing?

MR. FISHER. The right answer is that I do not know.

CHAIRMAN GREENSPAN. That is the wrong answer! [Laughter]

MR. FISHER. It is the only correct answer that I am able to give. I think the most important point is to be very skeptical about the interbank fixing at 6.8 or 7 rubles to the dollar. It is best to assume that that is a number that someone in the central bank or a couple of banks have decided to post on the screen. I don't know whether there is any volume behind it at all.

CHAIRMAN GREENSPAN. Is there a measure of volume in the black market?

MR. FISHER. By definition, we don't know how to measure that. We don't even know whether the black market is experiencing a deep day or a thin day.

CHAIRMAN GREENSPAN. Some black markets are blacker than others.

MR. FISHER. Yes. I'm afraid I cannot help you there, Mr. Chairman.

MR. TRUMAN. I don't know either, but my guess would be that the fixing rate is a rate at which people have agreed ex ante to settle certain contracts. Ultimately, it should provide some guidance, but it doesn't necessarily provide any in the short run. The black market rate presumably depends a bit on where you are and who you are and which black market you are talking about--the foreign exchange kiosks outside the railway station or the large transactions. I think there is a big difference between those. Over time, we could see a black market in Russia that was very important in terms of its effects on import pricing and the inflation structure or one that was of only minor significance because it would be the place where one might go to take

\$100, not \$100 million, out of the country. The Russians have essentially brought their foreign exchange and financial markets to a halt. In time, as they announce what they are doing with the GKO's and what they are doing with the 90-day suspension of debt repayments, one would think that these things will come together. For a while, though, I would assume there will be a number of different rates depending on the nature of the underlying transactions. I guess that's as far as I would go, which is more words but less substance probably than Peter Fisher conveyed.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. This is an easy question.

MR. TRUMAN. Good!

MS. MINEHAN. What exactly did the Russians do?

MR. FISHER. That is not an easy question!

MR. TRUMAN. They floated their exchange rate.

MS. MINEHAN. To a band?

MR. TRUMAN. They had a band before, but they were really operating with a heavily guided, narrow interbank band. However, they floated the ruble in a wide enough band that it is trading, at least for the moment, within that band; it is not yet at the lower limit. They announced that they were going to restructure their internal official debt in the form of the GKO's, which are obligations with maturities of less than one year, and their OFZs, their more than 1-year obligations. They announced a debt moratorium or suspension of controlled payments, and they clarified that announcement slightly this morning to say what was included and what was not. They excluded debt to the EBRD, state and local debt, and some other categories.

MS. MINEHAN. So they excluded foreign official types of debt?

MR. TRUMAN. They have excluded foreign official obligations.

MS. MINEHAN. What about private-sector debt?

MR. TRUMAN. Private-sector debt is subject to a form of temporary capital control.

MS. MINEHAN. Just the external private-sector debt--debt to foreign lenders as opposed to debt within the country?

MR. TRUMAN. Yes, debt owed to foreign lenders. The trouble is that the linkages are quite high. It is a little odd to read in the wires that Russian banks have borrowed abroad in order to invest in GKO's, which are obligations denominated in rubles. That is not exactly what one normally would think would be the way so-called financial institutions should operate. That has led to a lot of problems and, of course, there has been a lot of financial engineering going on relating to those transactions. That has created a lawyers' paradise.

MS. MINEHAN. Yes, with no laws.

MR. TRUMAN. Well, lots of laws, maybe no justice! [Laughter]

MS. MINEHAN. Just a small follow-up question, which may be harder. Why? Were they really broke?

MR. TRUMAN. I think the answer to that question is "yes." They had lost about \$5 billion in reserves, most of it in the last couple of weeks since their program was put in place. It was quite clear that the new program approved by the IMF on July 20 had not stabilized confidence. They were facing an external and internal financial crisis. The only difference is that they did it with \$10 billion of actual foreign exchange reserves still in the bank rather than zero. One might argue that it is better to take such actions sooner rather than later.

MS. MINEHAN. So, you think they really did have the \$10 billion?

MR. TRUMAN. Yes. Their dwindling reserves combined with the momentum in the market last week did not, I think, give them much choice on Monday. Both of their actions are regrettable, as has been amply highlighted. Abandoning the peg means, at least for the moment, that they put in jeopardy the one success they have had on domestic inflation. With regard to what might be viewed as their internal defaults, I think that will be mostly a matter of restructuring and refinancing their internal debts, though that process gives rise to some trepidation. It is hoped that there will not be a confiscatory refinancing in real terms, and in that sense one might argue that they will just be leveling the playing field that is particularly oriented toward the domestic fiscal problem. Even making relatively modest assumptions about how much they have achieved on the fiscal side, they have a primary surplus. Their problem relates to the fact that they have accumulated a lot of debt recently, and they have very high interest rates.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Peter, at the beginning of your remarks you made reference to market concerns about Japan in two ways, deflation and weakness of the yen. This may sound like a continuation of a similar discussion about Japan at the last meeting or some of the previous meetings. What adjustment process do people really think needs to take place in Japan? When markets are unfettered by various kinds of intrusions, prices provide information. We have seen numerous examples in the last couple of decades of governments, central banks, and regimes of one type or another--in the former Soviet Union, Latin America, and elsewhere--that have dismantled various barriers to the free flow of goods such as tariff and non tariff barriers, the movement of products if not labor, and obstacles to financial flows such as capital and other controls. We have seen as a result that the law of one price takes over and the economies in question move toward equilibrium in global markets--those for goods as well as assets. If we start

from where Japan was some years back and if--maybe a big "if"--Japan is in the process of gradually transforming itself into something that is more like a market economy, they will have to have either deflation or devaluation. They cannot get from current domestic yen prices to world market prices without one of those two things happening. Now, the world does not want them to have deflation and does not want them to devalue their currency. What do they want them to do, impose controls?

MR. FISHER. I don't think the world or market participants disagree with your analysis. I believe the dominant view is that the yen will grind lower from its current level. That is the market consensus forecast for exactly the reasons you described. Now, the market has gotten itself into a bit of a loop by becoming persuaded that a depreciating yen will force the devaluation of the Chinese yuan. I don't think that follows from a macroeconomic perspective. It is the absence of Japanese demand that is affecting the rest of Asia, not the behavior of the yen per se, even if that makes things worse. But there is a deeply imbedded expectation in the market that further yen weakness will lead to a devaluation of the yuan and the Hong Kong dollar. That is where the market gets itself into a tizzy and thinks that such an outcome will be the end of the world as they know it. I am impressed by the number of unabashed dollar bulls I talk to who say that if the Japanese do the right things, if they suddenly find their FDR and start to clean up their banking sector, the yen will continue to weaken. But if they don't get their act together and they continue to dawdle and delay, the yen is still going to weaken. The result would be positive for the dollar in either case. The dollar bulls are unabashed in asserting that view, essentially along the lines that you outlined. It is the Chinese connection that I think causes the anxiety.

CHAIRMAN GREENSPAN. What about the differential between tradable goods prices in Japan and the average general price level, which is really a crucial difference there relative to the rest of the world? What do the markets think about that resolution?

MR. FISHER. How is it going to be resolved?

CHAIRMAN GREENSPAN. In other words, how do the traders view a continuing weakening in the yen and Japan's ever increasing trade surplus?

MR. FISHER. I think they recognize a certain tension there. That is true even of those who assert that the best probabilistic forecast of dollar/yen is that it will go through 150 and keep going. If we ask the same people who make that forecast when they plan to start to "bottom fish" and buy cheap Japanese assets, the quick response is that the time to start cost-averaging in is now. They do not see any contradiction there. I think that is the traders' answer to your question. They are in effect acknowledging that the turn may occur sooner than they are forecasting, which itself is ironic.

VICE CHAIRMAN MCDONOUGH. If their position does not appear altogether logical, it is not.

CHAIRMAN GREENSPAN. I appreciate that, Vice Chair. [Laughter] President Hoenig.

MR. HOENIG. Peter, I think you just answered this question, but given the confusion in the market, I will ask it again. When you made your earlier comments, you indicated that the market has suddenly begun to think about deflation though it is uncertain about that prospect. How is that reflecting itself in the market? In other words, how is this new attention to deflation manifesting itself in the market's actions?

MR. FISHER. One thing I alluded to is the continuing demand for bunds and Treasuries, which is indicative of uncertainty. The reason for the uncertainty is that investors do not understand the deflationary world, and the result is a flight of capital. The flight is not motivated so much by a search for quality as it is for certainty, to something investors think they know how to price. As I have said a few times before, 18 months ago I could not find anyone in Germany who thought Germans would hold 10-year bunds at a yield under 6 percent. They saw that rate as a rigid floor. Now the yield is below 4½ percent. Something affecting global investor sentiment has changed. That is how I would put it. Now, that is not an entire explanation, but it's the best that I have.

MR. HOENIG. Better than mine!

CHAIRMAN GREENSPAN. How do you read the rise in risk spreads in the last three or four months--junk bonds vis-à-vis Treasuries, BAA's versus single A's, that sort of spread? They are not huge by any means, but they sure are consistently higher.

MR. FISHER. I may be too much of an optimist here, but I think there is a growing appreciation that credit quality may matter some day.

CHAIRMAN GREENSPAN. That is also a deflationary indicator.

MR. FISHER. Absolutely. In a deflationary world, lenders and investors had better start figuring out who is going to remain in business because not everyone is going to make it.

CHAIRMAN GREENSPAN. Any further questions for Peter? If not, would somebody move approval of the Desk's operations?

VICE CHAIRMAN MCDONOUGH. Move approval of the domestic operations, Mr. Chairman.

CHAIRMAN GREENSPAN. Thank you. Without objection. We now turn to Messrs.

Prell and Truman.

MR. TRUMAN. Let me start with a few words about the June trade data that were released this morning. The deficit was \$14.2 billion compared with a downward revised \$15.5 billion in May. As readers of the footnotes in the Greenbook know, we put down an estimate for the June deficit that was somewhat larger than the one that was implicit in BEA's preliminary estimate of second-quarter GDP. We had weaker exports of goods and services, stronger imports, and a deficit of \$16 billion. That deficit was similar to one of the consensus market reports and a bit higher than another, though both were above the BEA estimate. In fact, exports declined further in June by about the magnitude that BEA assumed but by less than we had estimated. The decline in imports was more than BEA assumed and substantially more than we estimated, suggesting perhaps a bit less strength in underlying domestic demand than we might have thought. Despite this positive surprise, the effects of the Asian crisis on our trade balance are not over. Our bilateral trade deficits with the Asian economies, including Japan, widened further in the second quarter. Moreover, we had a decline in real exports of goods and services for a rare second quarter in a row. The differences between the staff and BEA estimates for real net exports in Q2 from the now-published data merely reduce the deterioration from almost \$60 billion--measured in chained 1992 dollars--to slightly less than \$50 billion at an annual rate. Our quick look at these data suggests that, taken alone, they would imply an upward revision of about half a percentage point to second-quarter growth. However, there is likely to be a substantial offset in producers' durable equipment.

To state the obvious, the June trade data do not alter the contour of our outlook for the external sector from the one we have presented for the last seven meetings: continuing restraint on aggregate demand in the United States associated with very weak growth on average abroad and a strong dollar. But we see some diminution in these trends. Though it is difficult to imagine at times, growth abroad will eventually return to trend. In our outlook, growth picks up next year, but it remains extraordinarily weak. We believe that the modest pickup in foreign growth on average--with perhaps some associated modest uptick in interest rates abroad--the success of the euro's introduction, the stabilization of the Asian crisis, including importantly the situation in Japan, and the widening U.S. current account deficit will be enough to bring about some decline in the dollar next year.

As I am sure you can appreciate and as was amply demonstrated in Peter Fisher's report and by the discussion that followed it, we once again had to assemble a forecast against the background of substantial turbulence in global financial markets that has been associated with considerable uncertainty about

the course of policies and other developments in much of the rest of the world. While most of the major industrial countries seem to be on solid growth paths, Japan is a glaring exception. In fact, one might argue that the uncertainty about its prospects are indicative of the risks in the entire external forecast.

So, let me say a few words about our outlook for Japan while staying away from the deflation debate. I proceed from the assumption that Japan's downward spiral eventually will come to an end. We have a bottom built into the forecast but not much of a recovery. Four consecutive quarters of negative growth are projected to end this quarter. For the remainder of the forecast period, Japanese growth averages less than one percent at an annual rate. While net exports impart a small positive contribution to Japanese growth throughout the forecast period, that growth is driven almost entirely by government spending. We have a swing in the structural budget deficit of $\frac{3}{4}$ percentage point this year and a bit more than 1 percentage point next year, including a large dose of permanent personal and corporate tax cuts and some additional spending that is not yet on the plate of the Diet. However, private domestic demand contracts through the middle of next year and is flat thereafter, even with substantial tax cuts. Thus, we have at best the hint of a turnaround in Japan based on the assumption that the Japanese authorities will continue gradually to get their collective act together on fixing the banking system and the macro economy.

For the developing countries in Asia, we have five quarters of negative growth extending into early 1999 and a modest recovery thereafter. Our basic story is that external and internal financial conditions stabilize, recovery begins in the traded goods sector, confidence improves, and investment begins to pull out of its deep swoon, financed primarily from internal sources of funds--not by domestic banks.

Outside of Asia, we have weakness in Latin America owing to the spillovers from Asia that add to investor caution and boost interest rates. With slowing growth in Canada and the United Kingdom because of the rise in real interest rates in both countries, there is not enough growth in Euroland to provide much impetus to aggregate foreign growth.

Weighted by U.S. nonagricultural exports, the four-quarter growth of foreign GDP was less than 2 percent in the second quarter of this year and will have remained below that rate for six consecutive quarters ending in the third quarter of next year. The only comparable period over the past thirty years was in 1982-83. By this metric, the Asian crisis and its surrounding events and aftermath are now projected to match the scale of the Latin American crisis in the early 1980s. To review a bit of history, in that case the dollar continued to rise through early 1985--albeit with a different U.S. fiscal-monetary mix--and our current account deficit peaked at 3.6 percent of GDP in 1987, the year in which our net international investment position turned negative. In contrast, we

project that the current account deficit as a share of GDP will exceed the previous peak by early next year and that our net international investment position will be an estimated minus 20 percent of GDP.

There are still considerable downside risks to the outlook, as illustrated by the material on the possible implications of recent Russian events that was circulated to the Committee late yesterday by Peter Hooper. At the same time, there are some upside risks as well. Without spelling them all out, let me just say that at some point our outlook for the external sector will be seen in hindsight to have been too pessimistic.

Nevertheless, I suspect that the next cycle of external excitement will focus on our external position and the dollar. The reason is that unless growth in the rest of the world comes roaring back, we are likely to see a continuing erosion of our external position from what is already a rather low base, and investors will see dollar depreciation as the only way to narrow the gap. Moreover, we don't know how much of the recent strength of the dollar has been driven by safe-haven or risk-aversion considerations. It is suggestive, I think, that the dollar did not rise against either the DM or the yen yesterday following the Russian announcements. Once Japan and the rest of Asia stabilize, the air could come out of the dollar's balloon in a rush, and I could find myself in another location drafting vacuous statements about the excessive and unjustified weakness in the dollar.

Mike Prell will now add his own perspective on the outlook.

MR. PRELL. Frankly, I'm hard pressed to see where I can add much of value to what you already have heard this morning or read in the Greenbook. Much of the drama during the intermeeting period was on the international side, which Ted has just covered. The domestic development that has attracted the most attention, the decline of the stock market, has been pretty much of the dimension we predicted last time and for the reason we gave--namely, disappointing corporate earnings.

Looking ahead, our forecast has been altered only a little, mainly to incorporate the more negative outlook for the external sector and to deal with the additional short-run gyrations associated with the longer-than-anticipated GM strike. The basic story, however, remains one of a deceleration in economic activity and some worsening of inflation.

Perhaps the interesting point is that we appear to be predicting a considerably weaker expansion of aggregate demand than are the majority of forecasters. For example, the latest Blue Chip consensus shows nominal GDP growing around 4¼ percent over the six quarters of our projection period--the

better part of a percentage point above the Greenbook prediction--even though their short-term interest rates are, like ours, flat.

I can't tell you for sure why our forecast differs from the average view of the several dozen Blue Chippers, but the available detail on their forecasts contains one compelling clue: Only two members of the Blue Chip panel have real net exports in 1999 as low as the Greenbook forecast, and the consensus view is that the trade gap will widen only around \$25 billion over the next six quarters, versus more than \$100 billion in our forecast. Even allowing for the endogeneities that President Poole emphasized at a prior meeting, I feel quite comfortable in asserting that this difference is a key factor in our more subdued outlook. While I can't prove who is right on this, I will note--because humility would prevent Ted from doing so--that in the past couple of years he and his colleagues have been much more on track than the private analysts with regard to the deterioration in our trade position.

Of course, even if we don't seem to be at odds with the Blue Chip panel with respect to the tenor of the domestic demand outlook, that doesn't mean we're right on that side. Expectations of a slackening of demand have repeatedly been disappointed in the past couple of years, and there is no assurance that it will materialize this time. We continue to think that the performance of the stock market has been, and will be, a key factor. The revisions to the national income accounts have done nothing to diminish our belief in the significance of the "wealth effect." Although the recent slide in equity prices has erased only a modest portion of the gains that had accrued to investors, the mere cessation of wealth increases relative to income would remove an impetus to household demand. And this, in turn, would prompt businesses to curtail the growth of their inventories and fixed capital.

This is, of course, the scenario that we have described in our forecast. We have the Wilshire 5000 running at a level around 10,000 through next year; it closed less than one percent above that level yesterday after exceeding 11,000 a few weeks ago. As we noted in the Greenbook, even with that correction, shares still seem to be very generously valued, given what we see as the plausible scope for corporate earnings growth from the high levels already attained. But, while some hints of rationality perhaps have crept into the market, one still hears people saying that there is no other good place to put investible funds. A sure return of 5 or 6 percent on a fixed-income investment doesn't provide much competition for equities that, as surveys have repeatedly shown, people expect to yield double-digit returns over the coming years. To be sure, there were signs of some hesitation in flows into equity funds during the recent market downdraft, but we've seen such episodes before in this long bull market. It seemingly takes merely a whiff of favorable-news oxygen to get the bulls running again. In fact, yesterday they even rallied the market on what might have been construed as bad

news. Under the circumstances, we've thought it wiser for now to treat a deeper market decline as an explicit risk rather than as part of our baseline projection.

Let me turn, then, to the inflation side of the ledger. Given our softer real outlook, it probably isn't surprising that we also have a more moderate inflation forecast than the Blue Chip. Again, without knowing their perspective about such things as the dollar, oil prices, and crop prospects, it's difficult to pinpoint the sources of the difference in forecasts. I think we've given due emphasis in the Greenbook and in yesterday's Board briefing to the uncertainties that attend the price outlook. The trimming of our core inflation forecast since the last meeting represents in large measure a fairly straightforward reaction to the slightly weaker outlook for aggregate demand and the lower import prices that now appear likely. But, at the margin, we've also been moved by some of the recent economic data to give a little more weight to the stories we've been telling all along for why inflation should be slow to pick up even with such tight labor markets. Those data have included a smidge lower readings on wages and prices recently than we had predicted. Given that the July CPI was to be released this morning, just before my briefing, moving our forecast farther below the consensus obviously was risking some immediate embarrassment. But the Fates have been kind, with the two-tenths increases in the overall and core indexes being in line with our expectations.

The bottom line of the inflation story is that, although labor markets are tight, experience suggests that prices respond only slowly to such pressures. And, in the recent period, and for a while longer, the underlying tendency for inflation to pick up in response to those pressures is being offset by favorable shocks with respect to the terms of trade and supplies of food and energy--not to mention an ample amount of unutilized factory capacity. Some of the favorable shocks are expected to turn around next year but not with sufficient force to do much damage within our projection period. We'll be extending our Greenbook forecast through 2000 next month, and I hesitate to venture now beyond our current horizon. However, recognizing that the lags in the effects of policy on inflation are long, I probably should offer the observation that, with a stable funds rate, there's nothing in the direction of our present forecast that points to a take-off in wages and prices in 2000. Of course, with things as unsettled in some important areas as they are now, we'll have to take a further close look at this over the coming weeks. That concludes my prepared remarks, Mr. Chairman.

CHAIRMAN GREENSPAN. With regard to the year 2000 problem, I noticed that the Greenbook forecast does not have any acceleration in nonfarm inventory investment for the fourth quarter of 1999. I have no doubt that as we move toward an unknown Y2K phenomenon, just-in-time inventories will get a little disrupted and concerns are going to arise that will create

some inclination to put a few extra goods on the shelves, so to speak. Has anyone thought about that as a potential cyclical event? My question is whether the numbers that are involved are so small that they are not even remotely of an order of magnitude to show up in forecasts such as these.

MR. PRELL. We have not anticipated that prospect in our forecast, as our numbers might suggest. The one thing that we have anticipated is a pattern of earlier than usual acquisitions and installations of computer equipment over the next few quarters in an effort to avoid doing a lot of that in late 1999. But I take your point; what you describe is possible. Certainly a lot of people may consider stockpiling some cash over that weekend. That is an entirely different issue.

MR. KELLEY. That inventory will be up! [Laughter]

MR. PRELL. Obviously, we will have to confront this question more concretely when we write down year 2000 numbers in our Greenbook forecast for the next meeting. We will do that with some trepidation. I don't recall hearing anything from business firms that suggests they have focused very much attention on this matter thus far. In fact, even in talking to some of the computer firms, we find that they sometimes seem surprised when we raise the question about business strategies with respect to equipment purchases toward the end of next year. It is a bit puzzling that people seemingly have not given more attention to that question, but there is, I think, plenty of time for them to undertake that kind of stockpiling.

CHAIRMAN GREENSPAN. Let me put it this way. The one forecast that I will make unequivocally--with almost the same amount of fervor as Governor Kelley displayed in his forecast of currency inventories--is the media's response to this. From their perspective this is the equivalent of an asteroid hitting the earth at 12:01 a.m on January 1, 2000. The one thing we can

be certain about is the extent to which this Y2K issue will be unbelievable grist for the media. Two days before the start of the year 2000, that is all that is going to be in the newspapers. Two months before, there will be enough of it to really attract people's attention because there is no way that anyone can guarantee that the event has a zero probability of being disruptive. So, it will get everybody's attention and it is going to affect business behavior. People make decisions in the context of relative degrees of certainty, and this will be a major uncertainty without historic precedents. No one has a clue about what will happen under these conditions.

MR. PRELL. Obviously, firms that provide goods that their customers might want to add to stocks will have to decide whether to increase production or just let their shelves be depleted and then not have to reverse an increase in production. With the just-in-time production chains, there may have to be some producer responses.

CHAIRMAN GREENSPAN. What happens is that business firms that fail to meet the demand of their customers lose market share. Customers are going to build inventories, and the only question is to what extent. If company A does not supply a product, company B will. This is going to be a very interesting forecasting exercise. You did say that you're going to extend your forecast to include the year 2000 in the Greenbook for the next meeting?

MR. PRELL. We're looking forward to it! [Laughter]

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I have two questions. Ted, when I went to Asia in June one of the comments that I heard, particularly in Korea, was that a lot of exporters were facing tremendous difficulties in getting financing to support their businesses. More recently, there have been discussions about a shortage of shipping containers and the need actually to build them in Asia. The reason I guess is that most of the containers are in the United States at this point. Do

you think these developments are major factors affecting Asian exports to the United States? If these two problems were to be dealt with, would that lead to a significant increase in our imports from Asia?

MR. TRUMAN. I would say a couple of things. I think your sign is probably right. I believe the problems are still there; we still hear these reports. The question is one of magnitude. It is fair to say that our imports have not increased as much as one might have thought as a result of this crisis. But we have to be a little careful about that conclusion because those imports have held up in nominal terms and their prices clearly are down. So, in real terms there has been an increase in imports from Asia, though perhaps not as much as certain incentives would suggest there could have been. Therefore, it would seem to me that in time, one way or another, if the incentive is there and remains, people will find a way around the obstacles and there will be some upward impact on our imports. On the other hand, to the extent that the growth of the U.S. market slows, not all of the higher Asian exports may be coming to the United States. I find it is quite interesting that the one area where we seem to have been about right in our forecasts is the extent to which the swing in the trade position of the developing Asian countries has been shared among importing countries. Some considerable fraction has gone to Japan, notwithstanding its own situation, and a considerable fraction to Europe as well. Indeed, in line with some comments at recent meetings, European domestic demand has been much stronger than we expected before the crisis, and European net exports have been much weaker. Thus, there has been a parallelism in this situation.

MR. PARRY. Thank you. Mike, I thought the staff survey on recent trends in compensation practices produced some interesting results, as did the related discussion of the ECI. One thing that struck me is that variable compensation practices clearly have become much

more significant for many firms in different industries. In the past, at least when we had an economic slowdown, sticky wages were an important automatic stabilizer. Have you done any analysis that can give us some insight into how the more flexible compensation practices will in fact affect total compensation when the U.S. economy goes into a slowdown and what the effects on spending might be? I ask because it appears that we will be facing a different situation from what we have experienced in the past.

MR. PRELL. We are engaged in a multifaceted research effort on that issue. In a sense, the work that the Reserve Banks were kind enough to do for us in conducting the survey is a small component of that research. We have been talking to firms, interviewing them in some depth, and we are going to be doing more of that. Our contacts emphasize that this is a new labor compensation regime and that flexible compensation practices will enable them to cut back on labor costs if the economy and their fortunes deteriorate. That outcome is untested and time will tell. We also are doing some statistical work at a micro level, using employment cost index data from the Bureau of Labor Statistics, to try to estimate at the firm level how businesses are managing in this new regime, perhaps by trading off various components of their compensation packages and so on. We hope to have some additional insights on this in the next several months, but I think this is something that ultimately will have to be tested in the real world by a real change in the cyclical situation. We will only be in the conjecture phase on this for now, but I think that too is a potentially meaningful exercise.

I would stress that our projection of the ECI does not assume a major change in compensation behavior. Some of these compensation elements do not even show up in the ECI. That is another factor we need to take into account in thinking about cost pressures in the economy and how those may wax or wane. Basically, the most important element going forward is the

potential role of the continuing low inflation that we are experiencing in damping nominal wage increases. On that basis, models embodying that mechanism suggest that there is considerable potential for deceleration in compensation increases over the coming quarters. As the pressures in the labor markets abate in our forecast, these factors combine going out through 1999 to produce what I think is likely to be some moderation in spending.

MR. STOCKTON. One factor in thinking about the spending outlook is that it is conceivable that as variable pay becomes more important, profits will become less variable and labor income more variable. That is, when there is a slowdown in the expansion, more of it will show up in the form of a slowdown in labor income than in capital income. Past estimates typically have indicated higher marginal propensities to consume out of labor income than out of capital income than had previously been the case. If those propensities were to remain the same, the implication would be that consumer spending could be more cyclically sensitive. Arguing from first principles, however, one might think that those marginal propensities to consume would change if in fact people began to recognize that their labor income was indeed more variable now than in the past. In essence, the marginal propensity to consume out of labor income should shrink somewhat as consumers perceive that any movements in their labor income may now be more transitory than was the case earlier. Those are just some conjectures about how changing compensation practices could affect spending. Consumer income might become more variable and spending more sensitive to income changes if people continued to consume out of permanent income as they have in the past. That effect might be muted to the extent that their behavior actually changes when they recognize that the sensitivity of their labor incomes to changing economic conditions has increased.

MR. PARRY. There certainly are a lot of studies that suggest that the marginal propensity to consume would be lower if variable incomes were expected to regress to Friedman's original permanent income levels.

MR. STOCKTON. Right.

MR. PRELL. That might be true at least for those people who are not living essentially from hand to mouth. I think a lot of these flexible pay schemes tend to affect people who are in the upper income brackets and have no liquidity constraints.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. Payments that are directly related to labor recruitment and paid to outside agencies in one form or another obviously are not included in measures of compensation per hour. But am I correct in assuming that such payments are of an order of magnitude that suggests we should be adjusting compensation per hour to include them as costs in our models that interrelate market tightness with wage change?

MR. PRELL. Maybe not with wage change, but with total labor costs in some way.

CHAIRMAN GREENSPAN. I meant compensation.

MR. PRELL. Theoretically you might want to include those payments as your argument suggests, but I don't think we have any data that quantify them. I suspect that they are not a huge element in the picture. On top of that, we have payments that actually go to employees that are not counted in the ECI. The reason is that they are regarded by the definitions used in the ECI as out of scope because they are recruiting expenses.

CHAIRMAN GREENSPAN. Shouldn't the value added of personal service or help service groups like Manpower all be directly related to this?

MR. PRELL. Yes, except to the extent that in a sense they also are substitutes for the internal management of labor resources.

CHAIRMAN GREENSPAN. That is true.

MR. PRELL. If you eliminate a janitorial function and outsource it to another firm, that firm is taking over various fixed administrative-type costs. The analysis gets complicated.

CHAIRMAN GREENSPAN. In that sense, there is an argument for including internal costs of employment administration in those data as well.

MR. PRELL. Obviously this is an incredibly complex matter. As I said, I hope that we are going to make some headway in our effort to discern the effects that some of these changing practices have on the cyclical variability of spending.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I want to go back to your previous comments about folding in expectations about Y2K problems into the forecasts. In looking through a number of forecasts for this meeting, I noted that DRI seems to be the only one that explicitly deals with the year 2000 problem. However, it does so only in the context of a boom/bust scenario and not in their alternative scenarios--the baseline and the pessimistic scenarios as they call them. The scenario that they have had for some time puts us behind the curve in 1999, has us increasing fed funds rates to catch up with inflation at that point, and has the boom/bust scenario aggravated by an inventory accumulation related to the year 2000 problems. I had a feeling that their model results were rather marginal with regard to that inventory swing, at least insofar as they see the data. They already have a swing taking place in the boom/bust scenario and inventories feed into it in the same direction. Otherwise, inventories do not seem to have much of an impact on their overall statistical analysis, at least as yet.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. First, on Cathy's point, I would think that even people who believe that there is not going to be a significant problem because of the century date change will find it prudent to stock up before the hoarders get all of the supply.

MS. MINEHAN. Only those who read or work on the Internet!

MR. JORDAN. I have a couple of questions that relate to the staff presentations. The first is directed to Ted Truman on imports. I don't know anything about the mechanics of putting the import data together, but it would seem to me that in times like this, unraveling the crosscurrents between volume effects and price effects is very complicated. A dollar today buys boatloads more of Indonesian goods than it did before. I do not know what is happening to the rupiah prices of goods, especially the costs of exportable goods. We have a retailer on our board who reports that he is importing a lot more from Asia, and his import bill has gone down. That says the volume effects did not swamp the price effects. How should we think about these import numbers, given this exchange rate and pricing problem?

MR. TRUMAN. The answer to the first part of your question is that we have aggregate price and aggregate quantity numbers. The aggregate price numbers basically come from the BLS survey of import prices. There are problems with those import prices, and what we do is to take a nominal total and deflate by an index at various levels of detail to get real figures. The quality of the price data is substantially better than it was 20 years ago. We used to have something called "the unit value," which really would have led you to ask this question. On the other hand, it also is not clear what we are now getting with the price data or what question they are answering. That's because it is unclear what the relationship is between the price that is quoted on an invoice and

included in the index and the price at which the sale actually is made and embodied in aggregate demand.

The other point is exactly what I was trying to say in response to Bob Parry's question. We do have disaggregated price indices by area, and we can see what has happened to the price index for the Asian countries. That has declined dramatically. You may then say that the nominal amounts of our imports from them have been flat, so the increase in real imports has been substantial. I think the only point that we can make here is that we have a J-curve effect. We might have expected that J-curve effect to have run its course earlier. I have not been able to look at the detail of the numbers that came out today, but there have been stories, for example, relating to some industrial supplies. You probably have heard additional stories about iron and steel, for example, some involving Korea. The trouble is that we have a third factor, which is the general weakness of commodity prices. In fact, one of the surprises in the data that came in today was that June exports and imports of industrial supplies were much less than we had anticipated. I asked the same question you are asking, is this shortfall nominal or is it real? The answer may be some of both. A lot of it may well be nominal, in which case real would be less. The analysis is very complicated. The other thing you want to remember is that although conceptually we think about exports and imports as being final demand, they are not. Very few imports go directly from the ship or the plane to the supermarket shelf. As a result, the way they get imbedded in the production and therefore the price structure is very complicated, and it probably has become more complicated in recent years. Just-in-time inventories, reduced transportation costs, and the reduced weight in GDP which the Chairman likes to cite mean that the way these things get integrated accounts for much less of GDP. That is probably one of the reasons why simple rules of thumb for exchange rate depreciation or exchange rate changes and inflation have tended to

break down. Another reason may be that we are not talking about just two countries. We are talking about the increasing number of sources of imports to be traded, as in the Indonesia point that you raised.

MR. JORDAN. Thank you. I also have a question about the Greenbook's outlook for the U.S. economy and the emphasis on wealth effects. Following up on your response to Bob Parry, it seems on the surface that there might be some logic and even some indirect empirical evidence in support of these wealth effects. People are behaving in recent months and quarters as though their permanent income is either above or has risen relative to their measured income. The indirect evidence of that shows up in measures such as the personal saving rate and so on. I do not know how much weight to give to all of that. But suppose the central bank does give significant weight to that kind of phenomenon, how do we then avoid incorporating views about equity markets in the formulation of monetary policy? We would run into the problem we have discussed before about somehow using the level of the stock market or changes in the stock market perhaps not as an indicator but almost as an objective of policy.

MR. PRELL. I do not think that you need to go that extra step. The stock market is in effect one of the financial market channels through which the impulses that the Committee generates through open market operations create a financial environment that influences the growth of aggregate demand. Exchange rates are another channel. We also would include the bond market and the shape of the yield curve. We can think about what the consequences of the Committee's actions might be with respect to the bond market if we were to change money market conditions. We also need to consider the effects on the stock market in that context, which may be harder, though I am not sure, than anticipating the effects on these other financial markets.

In any event, the whole complex of financial variables does influence spending decisions. I don't think you can avoid that conclusion.

MR. JORDAN. That is the reason I asked the question. As I read the Greenbook and I think about the outlook for the balance of this year and next year and the emphasis you put on the wealth effects, I cannot help but think that my comfort level with that forecast depends on what I think about the outlook for the stock market. If the Dow Jones Industrials were to soar to 10,000 by year-end, how do I avoid that?

MR. PRELL. If you felt that the market was likely to start to rally again, even against the fundamentals, and to spur aggregate demand in a way that you felt excessive in terms of the inflation prospects that would go with that, I think that would argue at the margin for considering a tightening of policy that you would not otherwise have wanted to institute were it not for that expectation. Now, what I think I heard from many people around the table is that they want to remain humble about their ability to anticipate movements in the stock market, especially nonfundamental movements. So, that might cause you to be reluctant to move with great force on a hunch about which way the market would go. But I think you have to have one. It is manifest in the behavior of the economy in the last couple of years that the stock market's movements are of considerable importance. You need to take a position on this.

Mr. Chairman, I might just add one small fact. I can't say for sure that we have this nailed down, but I am told that our first look at the trade data suggests that about $\frac{3}{4}$ of the imports of capital goods would be offsets to PDE. So, we would have weaker producers durable equipment expenditures than is written down in the Greenbook. However, the GDP effects are trivial. That is a tentative conclusion.

CHAIRMAN GREENSPAN. Any further questions? If not, who would like to start?

President McTeer.

MR. MCTEER. The Eleventh District economy has continued to grow at a healthy but steadily moderating pace. The summer's heat and drought combined with the unending financial and economic troubles in Asia are the two most important factors contributing to the slower expansion of the Texas economy. Unless the weather changes soon, this year's drought losses could exceed the \$5 billion of agriculture-related losses that occurred in Texas in 1996. Cotton is the number one cash crop in Texas, and cotton farmers' losses currently are greater than during the 1996 drought. The impact of the drought also has been severe on the corn crop and on cattle ranchers. Although the drought is causing enormous financial strains on the agricultural sector, its effect on the Texas economy is fairly modest because agriculture is less than 1½ percent of gross state product.

The impact of the worsening Asian situation is being seen in the Eleventh District through reduced demand for semiconductors, lower energy prices, the stronger dollar, and growing strains in Mexico. Worldwide chip sales have continued to decline. As a result, a couple of manufacturers have shut down their factories three times this summer to ease the glut of memory chips. Sales of more sophisticated chips, such as digital signal processors, have been hurt to a much lesser extent by the situation in Asia. In spite of all this, we are seeing a considerable expansion of the resources going into the research and design of new chip technologies, particularly in Austin and Dallas.

Oil and gas prices are very weak and my industry contacts expect them to remain so. A lot of new supply from non-OPEC producers is scheduled to come on stream in the near term. With the expectation that low oil prices are here to stay, a number of companies, particularly in

Houston, are beginning to announce layoffs and other belt-tightening measures. As the dollar has strengthened, it has made energy cheaper in dollar terms but increasingly expensive in currencies that have weakened relative to the dollar. This currency value effect has reinforced the downward price effect from weaker Asian demand. Low oil prices continue to adversely affect the Mexican economy, and if this situation were to continue, it would place considerable financial strain on Mexico.

The construction and service sectors remain strong in our region. Residential construction, especially apartment construction, has been robust. A shortage of labor seems to be as important or more important than the shortage of concrete, which I have mentioned before, in limiting the supply of new housing units. Office vacancy rates have begun to edge up slightly and rent increases have slowed. Employment gains in the private service sector remain strong, and wage pressures, if anything, have increased slightly.

Turning to the national economy, the Greenbook is full of crosscurrents and, like the Bible, can support many different points of view. [Laughter] Real GDP growth slowed dramatically in the second quarter, but inventories were largely responsible. Wage inflation has picked up, but price inflation has not. Money growth has been excessive by historical standards, but market measures of monetary policy reflect a restrictive stance. Perhaps we should back away from the trees and try to see the forest the way historians might do so several years from now. What historians are likely to focus on looking back to 1997 and 1998 is the international crisis that began in Asia last summer and spread to several countries. Currencies and stock markets collapsed in one country after another. Financial conditions appeared to be stabilizing for a while, but they subsequently relapsed and a second round of turmoil ensued that included additional countries. During this period of growing deflationary pressures, with gold and oil and other

commodity prices falling in dollar terms, the dollar rising against most currencies, the yield curve flattening, import prices falling, and most measures of price inflation declining, the FOMC adopted and then in my opinion held on too long to a bias toward tightening monetary policy whose implementation would have exacerbated these trends. In my opinion, the risks were pretty well balanced at our last meeting, and in my opinion the downside risks are greater today and the consequences of policy mistakes are greater as well. In terms of the global context and our nation's position in the world, I think it is time to talk about getting ahead of the curve by easing monetary policy.

MR. PRELL. Mr. Chairman, I just want to make clear that while we were praying that we would not be humiliated by incoming information, there was no divine guidance when we drafted the Greenbook.

MR. MCTEER. We never really suspected it! [Laughter]

CHAIRMAN GREENSPAN. I did! [Laughter] President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. The Seventh District economy suffered a minor fender bender in June and July. The setback was only temporary, and we are back on the moderate expansion road now that the GM strikes have been settled and recalled employees are working overtime. It will take a few months before the inventory pipeline is completely filled, so light vehicle sales in August may still be affected by inventory shortages, as was the case in July when reduced incentives also depressed sales. Demand apparently remains solid as automakers indicate that light vehicle sales in August remain slightly ahead of expectations of about 14½ million units at an annual rate.

Abstracting from GM strike effects, it does appear that activity in some manufacturing industries has slowed over the past few months. In particular, Asian developments have adversely

affected producers of paper, chemicals, food equipment, agricultural equipment, and some other heavy equipment. For most of these industries, however, strength in other export markets has offset at least part of the weakness in Asian demand. I spoke to a group of steel executives earlier this month and, as Ted Truman anticipated, they were quick to express their concerns about steel imports from Asia and declining prices for steel products.

In our District, however, almost all of the recent weakness in steel output has been related to the GM strikes. We have seen some slowing in a few construction-related industries such as cement and gypsum wallboard. Housing activity remains at very high levels, but we are observing smaller increases than elsewhere in the country and smaller than we experienced earlier in the year during our unusually mild winter. Retailers indicate that consumer spending continues to surprise them on the upside and recent reports suggest no pullback in consumer demand.

Labor markets remain very tight, and the Manpower survey to be released next week will show strong hiring plans continuing through the fourth quarter, with both the national and Midwest results after seasonal adjustment at the highest levels in the survey's 22-year history. The only weakness is in durable goods manufacturing where hiring plans have fallen for the second consecutive quarter. The Manpower survey results should be treated as confidential until they are released next Monday, August 24. Increasingly, we are seeing entire communities becoming involved in the search for qualified workers. For example, 2500 workers are needed for a new shopping mall opening up this November in a Detroit suburb. Recruiting is going on at high schools, colleges, senior centers, and social agencies like Goodwill industries. In addition, job fairs started to be held in June and will include one at the Pontiac Silver Dome this October. Significantly, the city of Pontiac is adding a bus line to the new shopping center and efforts are under way to get similar public transportation to and from Detroit.

Business contacts in the manufacturing sectors continue to say that competition constrains their ability to raise prices. Furthermore, many of our farmers are caught between a rock and a hard place as weak Asian demand combines with expected record soybean and near-record corn harvests to push grain prices lower. But we have sighted some upward price pressures outside of agriculture. In the trucking industry, shipping costs are being affected as empty trucks head to the West Coast to bring back full loads of Asian imports. We were told that several consumer products firms are planning to increase prices this fall. One retailer noted that although prices for new inventory are lower, they plan to raise prices to consumers by 3 to 5 percent largely to offset labor cost increases of 4 to 6 percent.

Turning to the national outlook, at our last meeting I indicated that I thought the risks for the economy had increased both on the upside and the downside. News since that meeting has convinced me that while the international situation has worsened, domestic demand continues to grow strongly. On the one hand, second-quarter export figures reveal a deterioration in the international situation, which continues to be a substantial risk to the U.S. and the world economies. Although I am a bit more optimistic than the Greenbook about the outlook for foreign GDP and its effect on our exports, this sector continues to represent a big downside risk. On the other hand, domestic demand continues to grow strongly. Consumer confidence is at a high level, and employment and income gains remain substantial. Economic fundamentals for the consumption and investment sectors continue to look strong. We see real GDP growth for 1998 in the 3 percent range. Looking to 1999, there is a great deal of uncertainty, but we expect real GDP growth to decelerate to the 2 to 2½ percent range. The 1999 projection gives a good deal of weight to the deteriorating international situation and that may be overly pessimistic.

Consequently, I continue to think the risks are tilted to the upside. In any event, they are large on both sides.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the Twelfth District economy expanded at a strong pace during the first half of 1998. Payroll employment grew by 2.9 percent at an annual rate, noticeably above the pace of growth in the rest of the United States. Among District states, growth has been most rapid in Arizona, Nevada, and Washington during recent months. Vigorous construction and real estate market activity has helped to maintain the District's expansion. Construction jobs have grown at a sizzling pace in California and Nevada this year, and construction activity remains at high levels in most parts of the District. Although District growth has outpaced the nation's this year, it has been slower than in 1997. Oregon, Utah, and Idaho have cooled the most, and employment was flat or down slightly in the second quarter in those states. Employment growth also is moderating in California this year. Among sectors, slower growth has been most evident in durables manufacturing.

This slowing is consistent with what might be expected from the restraining effects of the East Asian financial and economic problems. Data for the first five months of 1998 compared with the same period in 1997 show that growth in total District exports has fallen essentially to zero following substantial growth in previous years. This slowdown appears to be almost entirely attributable to East Asia. For example, in the first quarter of this year, California's exports to key East Asian countries were down about 13 percent compared to a year earlier. Exports have slowed substantially throughout the District, and Hawaii's struggling economy has been hit hard by additional losses in their Asian tourist business this year. Although these effects may grow as the year progresses, the problems in East Asia have not derailed the District's expansion so far.

Turning to the nation, it remains to be seen whether the long awaited slowdown will be sustained during the second half because a good deal of the slowdown was due to temporary factors. Despite these doubts, I think that the most likely outcome is moderate growth of around 2 percent through the end of next year, with activity being restrained by problems in East Asian economies, the high dollar, restrictive fiscal policy, and relatively high real short-term interest rates. The recent drop in our stock market adds another potentially moderating factor.

The news on inflation certainly continues to be outstanding. The GDP price index came in under 1 percent for the second straight quarter and, as we all know, inflation as measured by that index has averaged only 1 percent over the past year. In our Bank forecast, the unemployment rate does not quite reach 5 percent by the end of 1999. This low rate perpetuates the acceleration in the ECI that we have seen over the past year. However, I expect this pressure on price inflation to be offset by diminished inflation expectations, the higher value of the dollar, ample industrial capacity, falling commodity prices, and somewhat higher trend productivity growth. As a consequence, our forecast shows CPI inflation staying between 2 and 2¼ percent for the remainder of this year and next. Thank you.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. The Tenth District economy continues to do relatively well. Year-over-year employment growth as of June was better than 2 percent, slightly below the national average. Consumers are still buying at a fairly brisk pace. Manufacturing for the most part remains strong, although in some areas, especially in Colorado, our contacts have seen some effects from the fallout of the Asian crisis. Construction remains high for the District as a whole; we are experiencing a modest slowdown but from extremely high levels. Our agricultural sector is an area of weakness. Like the Seventh District, we are

experiencing very large grain harvests and large supplies of meat, both beef and pork. That is having a depressing effect on farm prices and farm income. Labor markets remain very tight in the District. We are receiving more reports of wage pressures going forward.

Perhaps the most interesting change that is occurring, though very preliminarily, is in the area of psychology. We hear more negative talk even though we are enjoying a very strong economy. People talk about the good times, but they are more concerned about whether the latter can continue. Some of that concern relates to the outlook for energy. I think it is important for us to try to keep tabs on such attitudes as we go forward.

Turning to the nation, I think our District largely reflects national economic trends. Our projections point to strong domestic demand that is being offset to an important extent by the external sector. We also do not rule out some possible retarding effects from the stock market correction. We continue to have supply shocks that are having favorable effects on prices. As I add all that up, I see a fairly tame projection for inflation going forward. I cannot help but wonder, given Peter Fisher's earlier comments on the markets' efforts to assess the outlook for inflation and the risks of deflation, whether we are not seeing some of this negative psychology and uncertainty spreading a little more widely. I think that bears watching as we go forward.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. District economic conditions remain positive, but they are perhaps a bit more mixed than they were formerly. I previously have talked a little about the emergence of a two-tiered economy in our District, and the gap between the urban economy and the rural economy appears to be widening.

On the positive side, consumer spending remains strong. Real estate markets are healthy. Construction activity is buoyant. Most recently, markets for rental apartments have

become very, very tight in the urban areas of the District. Rents are moving up significantly. Construction will undoubtedly follow once labor becomes available. Labor markets are tight. Just one anecdote on that issue: The Minnesota State Fair, which is a major activity in our part of the country as you might imagine, gets under way in about 10 days. They are short about 600 or 700 temporary workers that they need to hire to open the Fair. There is, I would say, widespread upward pressure on compensation, and I think it is fair to say that labor is becoming more militant, at least in our area.

On the other hand, in the rural parts of the District the problems in agriculture are serious, as Tom Hoenig just mentioned. Mining activity is softening. Energy exploration is slowing. Some executives from the paper industry told me recently that their industry is not doing well. They are talking a lot about the trade situation and the need in their judgment for a lower dollar.

As far as the national economy is concerned, I have talked before about what I perceive as the tension between the pace at which domestic aggregate demand is growing versus the growth in aggregate supply and how the two might ultimately be reconciled. At the moment, it looks as if the reconciliation is occurring through the serious and sustained weakness in Asia and the squeeze on domestic profit margins, with their attendant effects on equity prices and ultimately their wealth effects on the economy. If those trends remain in place, I think the Greenbook forecast is more likely to materialize than I thought formerly. I also think that however this plays out, the risks look to me to be very large. The Greenbook forecast may be a good central tendency, but the risks that I see on both sides are significant.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. Because the Sixth District economy is little changed since our last meeting, I will try to keep my remarks shorter than usual this morning. Over the summer, the Sixth District has continued its steady but modest expansion. Retailers expect sales growth to persist, and a significant number of new plant announcements bode well for capital spending. There have been some recent signs of slowing in our regional manufacturing sector. They showed up in the decline in our latest index of manufacturing activity and in, as expected, the export orders component. This information, which came in after the Beigebook was prepared, is supported by anecdotal evidence. However, the overall prospects going forward are for the Southeast economy to continue to operate at a high level. I see the outlook for growth in our area as only slightly less positive than at the time of the last FOMC meeting.

A number of special negative factors in the District have received a lot of nationwide publicity, but in fact they have had no appreciable impact on the overall level of regional economic activity. It is true that the drought has caused substantial losses in farm receipts in our District, but our agriculture sector has become a much less important part of our regional economy, the sort of development that Bob McTeer indicated also has occurred in Texas. The fires in Florida caused a temporary slowdown in the state's important tourism industry. However, the losses from postponing the Daytona 400 stock car race because of smoke from fires are greater than all the other losses due to drought and fires in the region. The only other noteworthy intelligence, and this also has been commented on by Bob McTeer and Gary Stern, is that we are receiving an increasing number of reports of significant increases in wages and benefits. However, there is still no indication that companies are able to pass those higher costs on to their customers.

On the national front, it seems to me that the overall risks to the forecast have increased, as almost everyone has commented. The uncertainties relating to the net drag from the international sector, particularly Asia and Russia, are being realized and are proving to be more negative than expected. However, and again I join others in making this comment, the strength of domestic demand based on continued strong growth of income and employment and what now appears to be considerable momentum in domestic consumption and investment are important sources of upside risk to the inflation picture.

The recently released revisions to GDP by BEA have impacted our forecast to a greater extent than recent market developments. They have caused us to raise slightly our forecasts of sustainable economic growth, personal consumption, and investment, and they leave me marginally less concerned that the past pattern of growth in the monetary aggregates will be translated into future inflation. Our real GDP growth forecast for the rest of this year is slightly more optimistic than that in the Greenbook. Furthermore, there are other differences in the forecast. They relate to the extent to which the hypothetical risks that I mentioned previously will be realized. In that regard, they are mainly that we see less of a decline in business investment and consumer demand than the Greenbook. As a consequence, we are slightly more pessimistic about the inflation outlook.

Finally, I continue to believe that policy is not seriously out of line, nor is it allowing inflation to accelerate though we are predicting a slightly worse inflation performance over the second half of 1998 and into 1999. Most of the price acceleration that we project reflects the expected reversal in the previously favorable behavior of energy prices. Having said that, however, I do believe that the overall inflation risks continue to be slightly more on the upside and that now is not the time for us to relax or to let the depressing effects of the international sector

divert our attention from the projected strength in the domestic economy or our ultimate goal of a stable, low inflation environment. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. The New England economy remains strong, but weakness related to Asia and the GM strike and increased labor and real estate market pressures are evident. Unemployment rates for the region's states were a full percentage point below that for the nation in July, and job growth was a full percentage point above the region's long-term trend. Part of the region's labor market tightness is due to sluggish or even negative labor force growth in the various New England states in recent months. Job growth varies from state to state; it is virtually flat in Connecticut, Maine, and New Hampshire and up about 3 percent in Massachusetts.

The Asian flu has hit New England manufacturing, with exports to South Korea and Taiwan dropping about one-third and exports to Japan off almost 10 percent. Manufacturing jobs declined in July for the fourth month in a row, largely due to Asia. Business confidence, as measured by one of the surveys in Massachusetts, fell sharply in June and then again in July; manufacturers were the main contributors to this fall. This survey, Beigebook contacts, and anecdotal reports all suggest that about half the manufacturers in New England have experienced undesired inventory buildups and layoffs, again with much of this attributed to the impact of Asia.

At the same time, labor markets remain extremely tight. Regional consumer prices are thought to be rising slightly faster than the average for the nation. Construction, tourism, and service jobs are expanding rapidly. Real estate markets, especially in Boston though elsewhere as well, are tighter and commercial vacancy rates are lower. Technical engineering workers are hard to find, even for manufacturing jobs, as are workers in the tourism industry where raiding workers

from competitors is becoming commonplace. Large and small employers report being forced to grant broad wage increases to existing staff when new employees are hired at higher salaries, especially in technical areas. Hiring bonuses are commonplace even for fairly low-level jobs such as restaurant positions and telemarketing.

Commercial and industrial lending at the District's large banks grew at rates about double that of the nation as a whole, and competition among lenders reportedly remains intense. However, _____ of a large national insurance company, reports that they see some widening of spreads related to credit quality and the beginnings of some slight restraint in credit markets. That view is reflected a bit in the data, but unfortunately it seems at odds with the System's survey of senior loan officers.

On the national scene, we agree with the projection in the Greenbook of a slowing in the pace of GDP growth from the first half of 1998 to 1999. However, without a tightening in interest rates, our estimates suggest somewhat stronger growth averaging above 2½ percent over the period. We do see consumers and businesses affected by Asia, by rising labor costs that are putting a squeeze on profits, and by a sideways if not slightly lower stock market, all of which dampens consumer enthusiasm and reins in business spending. However, we do not see unemployment rising to 5 percent nor inflation remaining as quiescent as in the Greenbook forecast. These differences partly reflect different estimates of the economy's potential. Ours is a bit lower than the Board staff's. We also assume a somewhat slower rise in unemployment when GDP is growing at rates below potential. This reflects, I think, a greater agnosticism on our part as to whether the higher rates of productivity growth we have seen are cyclical or more structural in nature. Thus, we do not see unemployment rising above the upper four percent range, and our estimate of inflation rises to just about 3 percent by the fourth quarter of 1999. Clearly, the data in

our projections suggest a good deal more upside risk on the inflation side than that expected by the Greenbook, but I would confess to some humility about these projections as well.

With that in mind, my concerns at prior meetings about the stance of monetary policy and the risks associated with the current economic situation have revolved around two issues. The first is that the risk of rising inflation, given tight labor markets, is considerable though hard to see as yet except in the form of wage increases. The second is that financial markets were fueling speculation that, even in the absence of inflation, could present real risks. The inflation risks remain, and I think the recent data on the domestic side suggest that they are at least as strong as they were at the time of the last meeting. But it seems to me that financial markets, both nationally and especially internationally, have interjected real notes of caution.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Thank you, Mr. Chairman. I, too, will try to be brief. Not a lot has changed in the Philadelphia District. The region generally remains strong, although growth has slowed. This is showing up in manufacturing where the effects of Asia are apparent, particularly with producers of building materials, chemicals, and machinery. The same phenomenon of a high level of sales but slowing growth is apparent in retailing. Although the national news reports have spotlighted the weakness in autos, sales of automotive products apart from GM products generally have been strong in our area. Construction is robust, both residential and commercial. There may be some slowing of construction activity in our District. The reason is not so much because of a lack of demand but I think because of some bottlenecks related to the shortage of machinery and labor. A number of people around the table have commented on the problems in agriculture, and they certainly are severe, but I would like to add a footnote to that. Apparently, "fat is back" and the dairy farmers in my District are pleased about that. People want some taste back in their

food. Milk fat prices are up and milk now joins red wine, martinis, and eggs in making a comeback. I have heard complaints from dairy farmers for years, and it is nice now and then to hear something positive from them. Labor markets remain tight in our District, although wage increases are generally moderate and the phenomenon of not being able to raise prices is still heard among businesses around the District.

As far as the nation goes, I think the biggest change since we last met is that the problems in Asia and their spillover effects appear to be more severe or at least make me feel as though the global economy is in a more precarious situation. U.S. inflation remains subdued, and in my estimation the threat of a breakout on the upside has lessened. So, whereas the risks in recent months were thought to be more pronounced on the side of greater inflation, they now seem to me to be more balanced.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The Second District's economy has continued to expand at a strong pace since our last report, led by real estate and construction. Job growth moderated a little in June, but it was brisk in the second quarter overall. Retailers report continued very good sales in July, notably of home durables. Retail prices were steady last month and inventories remained at satisfactory levels. Tight real estate markets persisted in the second quarter. Office rents surged at a 27 percent annual rate in Manhattan but leveled off in the suburbs, and vacancy rates generally were steady.

On the national economy, our forecast is somewhat more optimistic on growth and, not surprisingly, we have the CPI rising a bit more between now and the end of 1999 than does the Greenbook. But by and large, we are in sympathy with the Greenbook forecast. What I think has changed since our last meeting is the balance of risks. The risks have moved from a higher

likelihood of rising inflation to a situation in which that possibility still exists but is at least counterbalanced by the possibility that both the American consumer and the American business executive will become more cautious, with the result that growth could be reduced to below our New York forecast or that of the Greenbook. I am not suggesting that we fear a recession but rather quite weak growth.

The international situation appears to me to be worse. Japan's new government is doing virtually nothing, and the political opposition has announced its unwillingness to support the already inadequate banking reform legislation that the government has proposed. The recession in Japan, in my view, is at least as likely to persist--with continuing chilling effects on the rest of Asia and the rest of the world--as to bottom out and improve. A weak Asia, a seriously troubled Russia, and weakness showing up in Latin America all raise the likelihood that the flow of capital to the safe havens of the United States and core Europe will not slow down but rather will continue, making those currencies stronger than they otherwise should be. I believe that will lead to a political furor both in continental Europe and in the United States, especially as people become, probably appropriately, unhappy with helping Japan solve its problems, to the degree it is solving them, by drawing in exports from that country.

I do not recall a time when there has been more uncertainty in financial markets. Although there has been heavy trading volume in the U.S. equity markets in recent days, that seems to be concentrated among speculative investors. In many other markets, there is considerably less liquidity as large financial institutions, both observably and from what they tell us, react to the uncertainty by reducing their trading positions. That strategy makes an immense amount of sense at the level of the firm, but it increases market volatility because of a lack of liquidity.

I have felt for many months that watchful waiting is appropriate for this Committee but with a view that the risks were in the direction of rising inflation. Now I think that the risks are greater still but much more fully balanced, given the perceptible shift in the direction of the risks toward inadequate growth. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. The autoworkers in our part of the country have ended their very welcome summer break and have gone back to productive activities, giving the theme parks and other tourist attractions a little relief. They are looking forward to the start of school so that they can get a little more relief. Everybody is reporting record tourism traffic of all types throughout the region.

Construction projects continue to be announced at a rapid pace. I view it as a "tyranny-of-small-decisions" effect. Some people might call it an aggregation problem because virtually every metropolitan area in the region is announcing new construction projects on the assumption that they will be able to import the needed construction workers from someplace else; the local construction workers are all fully employed. A director of a construction trades union said that the union halls were empty, so they are now providing training to prisoners and parolees as well as lobbying for increased immigration of construction workers, as I have mentioned before. This is quite a dramatic change in the attitude of unions that are trying to satisfy the demand for labor as they see it out into the future. Nevertheless, Pittsburgh announced that it is going to spend \$1 billion to construct two new stadiums and a convention center over the next few years. Apparently, Pittsburgh is trying to outdo Cincinnati, which is building two new stadium projects if they can find the needed workers. Both cities are trying to keep up with Cleveland, which is completing a new stadium as well as a large assortment of infrastructure projects

downtown. Like every other region of the country, billions of federal tax dollars are now going to become available to add to local spending for roads, bridges, tunnels, and rapid transit systems--again if the necessary construction workers can be found. Our banking directors and advisory council members cite examples of what they view as the overbuilding of hotels, motels, and retail space. They report that the deals are being done at ever thinner margins, longer terms, less collateral, or no collateral.

I was interested in the Board staff's report on rents for commercial space relative to prices of commercial structures. Mike Kelley was at our board meeting last week, and one of our directors, the chairman of National City Bank, said he had read in a newspaper that National City Tower had been sold again. His bank occupies 90 percent of the building and has fixed rents for seven years. The building sold two years ago for \$60 million, eight months ago for \$80 million, and last week for over \$100 million. Public works infrastructure projects are being announced all over the District every week. Tax collections continue to be very strong throughout the area. Residential construction also is very strong. Some counties report that permits are up over 50 percent from a year ago. The only area of softness in construction is industrial structures where there has been a slowing in new contract awards.

Overall, the labor markets are reported to be very tight. Turnover continues to increase and the quality of entry-level applicants is reported to continue to deteriorate. Retail sales were reported to be surprisingly strong right through the GM strike period. Retailers now are concerned that they will enter the fourth quarter without adequate inventories of the right products to satisfy what they see as very strong consumer demand. Apparel and specialty stores have experienced very strong sales and their earnings should be at record levels this year. Last week the Cleveland purchasing managers reported the first increase in new orders in several months.

Business confidence levels, one director said, are more shaken by what they read about Asia than by what they see in the order books. Our steel industry sources say that consumption levels are excellent, perhaps a record, but surging imports have put downward pressure on steel prices. So, the domestic steel producers are going to start filing dumping charges very soon and join textile producers in seeking some protection from cheap imports.

Turning to the national economy, much like Bob McTeer I think that the time is growing nearer when we will have to contemplate an easing of our policy stance, but my reasons are quite different from his. That's mainly because I think it will become increasingly apparent that we first will have to tighten monetary policy to deal with the speculative imbalances and excesses that are accumulating across the country. Subsequently, we will have to be flexible enough to respond promptly once we get to the other side of this problem. Over the last year we have seen final demand persistently exceed our expectations in the context of the rise in equity markets, related wealth effects, and other developments, but we still found reasons not to act. I think that once we finally do act, we will have to be prompt in reading errors on the other side in the expectation that we subsequently will have to back off a bit.

Even though we and everyone else are happy about the low inflation, the low unemployment, and the good income gains that we are seeing in the nation, it would be very hard to call this a well balanced expansion at the present time. We can put a favorable spin on the past year by saying that in view of the very strong domestic demand, we are fortunate that the Asian economies fell apart at just the right time, that their exports were available to meet our surging consumption, and that their reduced demand for our exports liberated some domestic industrial capacity so that the domestic economy did not spill over into rising inflation. Or we could turn things completely around the other way and say that in view of the Asian crisis, it is really a good

thing that the United States was enjoying a spending boom so that we could play locomotive to the rest of the world and lessen the adverse effect on people in those countries. But the distortions in our economy are becoming ever more obvious. Manufacturing has been hit hard while construction soars to unsustainable levels. Goods prices are falling while service prices are accelerating. Returns to capital have risen to historic levels as a share of total income in the economy, while returns to labor appear to have declined as a share of the total.

I will now commit a little heresy in the minds of some folks. In current circumstances, the absence of consumer price inflation is not a sufficient condition for financial stability in my view. It is ultimately financial stability, as we have seen in our own history and in other economies around the world that is the key to maximum sustainable growth. When there is a favorable productivity surprise, it brings with it an acceleration of the growth of business earnings and in equity prices. It is a normal cyclical phenomenon in any case, but it is accentuated when we have a favorable productivity surprise. That in turn translates into increased credit demands. So, we see both bank and nonbank lenders face outward shifts in the demand for loanable funds and investment capital, and then an increase in the derived demand for bank liabilities. But if those demands for credit and investment capital are accommodated by an acceleration of money growth, there will be an acceleration of nominal spending growth that manifests itself in excessive capital accumulation, inventory accumulation, and even employment in some sectors of the economy.

I have avoided talking about the stock market because I do not want to make the same mistake that Irving Fisher made weeks before the crash of 1929. But there was another economist of the period, a New Zealand economist, Allan Fisher, who wrote an analysis of the boom-bust cycles of the time. He was following Dennis Robertson, Ralph Hawtrey, and some other

economists who dissected the period of the 1920s and the 1930s. Fisher argued that sustained periods of very favorable developments in productivity led to an exaggeration of what he called false profit signals or returns to capital. If capital investments were financed through an intermediary banking process, with or without moral hazard problems, there would be set in motion dynamics that ultimately would result in an economic decline. He, of course, was writing in a period of the gold standard and arguing that the price level should be allowed to decline in order to avoid the imbalances resulting from these dynamic forces. Speaking of gold, it is intriguing that the ratio of gold prices in dollars relative to oil prices is about the same today as it was 30 years ago. In all of the intervening years, the ratios stayed in a fairly narrow range expressed as a multiple of gold in dollar terms to oil in dollar terms. That is because both are internationally traded commodities. They do not look quite the same in yen or rupiah or other currencies that have been weak relative to the United States dollar.

In the end, shifting the supply schedule of bank credit or other forms of intermediary credit by increasing the monetary base in a passive way by pegging an overnight interest rate in the face of a shift in the demand for loanable funds is not the right thing to do. We ought to be allowing a move up on a relatively fixed credit supply schedule and let a rationing process take place. I still am concerned that the growth of the monetary base and the monetary aggregates this year is fostering too much demand, and we are going to pay a price for correcting it.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Conditions in the Eighth District are substantially the same as they have been in recent months. Labor markets remain tight. Labor shortages are abundant, particularly in professional areas. Builders are unable to satisfy demand in some markets. The agricultural economy in the Eighth District is in fairly good shape. There are some areas that have had too

much rain and some too little, but on the whole crops are going to be satisfactory. In sum, economic conditions are about unchanged in the Eighth District, but there is an ever so slightly easier or less buoyant feel to these District conditions.

I want to concentrate my comments on the national economy. I also want to talk about Asia from that perspective, but I will begin by talking about the balance between aggregate supply and demand, putting Asia aside. On the aggregate supply side, I think that we probably have overshot full employment and are seeing evidence of that in the upcreep of wages and in the labor shortages that are widely reported. My casual impression is that we have rising numbers of labor disputes and time lost through labor disputes. There have been a number of strikes. That is a standard feature of labor markets that are overstressed. Almost independently of what happens to aggregate demand, I think we can anticipate slower growth of employment than we have had as we move toward a closer equilibrium of supply and demand in the labor market.

On the aggregate demand side, domestic final sales remain strong, and that was true in the second quarter as well. Money growth, whether we use M2 or a narrower measure--I prefer MZM because I think it avoids the problem with sweeps--is up substantially over the last year in terms of both measures. It has tapered down a little most recently, but I see no signs of a real turn.

Now, how big is the impact from Asia? Has that slowed aggregate demand sufficiently to put us on a reasonable track for the near future? Asia accounts for roughly 25 percent of the world economy. If 25 percent of the world's economy gets into deep trouble, one would expect to see a big impact on the other 75 percent. The question here is the magnitudes involved. Consider an analogy within the United States. Suppose California got into really big trouble. Suppose Bob Parry really screwed up so that the whole Twelfth District had a financial crisis and California looked about like Japan and Nevada about like Indonesia and Oregon about like Malaysia and so

forth. Would that have a big effect on the rest of the United States? Well, of course it would! That region is fully integrated into a single national economic area. We use the same currency. We have a completely integrated capital market. The labor markets are closely interconnected through a lot of movement of the workforce. The goods markets are completely connected. There are no trade barriers except for a few agricultural barriers. Trying to take fruit into California may be a problem, but that's about it.

The relationship of the Asian economies to the economies of the rest of the world is quite different. The labor markets are not integrated at all. The goods markets are integrated. The Asian economies are open, but nothing like California and the rest of the United States. Capital markets are fairly well integrated. There are floating exchange rates, but not a single currency. So, there is a very great difference between 25 percent of the world economy in Asia and a comparable piece of the U.S. economy.

The question is how large are the impacts flowing from Asia to the rest of the world economy and particularly to the United States. Total U.S. exports are something on the order of 14 percent of GDP, and our exports to Asia are something on the order of 3 percent of GDP. These are rough orders of magnitude, close enough for back-of-the-envelope calculations. Of course, we are not going to lose all of our exports to Asia. So, if we anticipate a significant effect, we have to rely on an argument that says there are substantial indirect effects on other parts of U.S. trade that are coming through other countries. Obviously, as Europe loses some exports to Asia, European demand for U.S. goods may go down. But it is critical to get the magnitudes right and not be seduced by the high visibility of the Asian problems. There is no question that these Asian countries are experiencing very severe problems, but the question is how big are the impacts flowing through into the United States economy as a whole.

The research staff at the St. Louis Fed has taken a look at the disaggregated U.S. exports for the first five months of this year relative to the first five months of last year. They have broken down our exports by two-digit SIC industry codes to try to get a real feel for the magnitudes involved. The effects on some of these industries are very large. At the top of the list we find that SIC code 10--producers of metallic ores and concentrates--have lost 50 percent of their exports to Asia. In other words, firms in those industries have seen their orders of such products from Asia cut in half. Obviously, that is very visible. Producers of some other products like refined petroleum and related goods have seen their Asian demand decline by as much as 47 percent. If we go down the list, agriculture and livestock exports to Asia are down 29 percent this year compared to last year. I will not read the whole table.

Of course, the relevant question for the impact on the U.S. economy is not those numbers but the decline in exports to Asia relative to the size of these industries. If we take the industry that has experienced the biggest percentage impact, metallic ores and concentrates, which lost 50 percent of its Asian business, that turns out to be about 1¼ percent of the product of that industry, using 1996 production levels. So, the loss of the Asian business amounted to 1¼ percent of the domestic production of that industry. That gives us the right order of magnitude in terms of the effects within the United States. The biggest impact for any of these industries is that for agriculture and livestock, which lost about 2 percent of its business as a consequence of the reduction in exports to Asia. I don't know what the effects of the Asian problems will be in other parts of the world, but I think it is very important for us to keep the magnitudes in the context of the size of the market in the United States. In addition, we should not forget the indirect offsets that take place because Asia is not an integrated part of a single currency area within the United States, the point that I made before.

I don't think there is any question that the risks in the outlook have become greater in both directions. If it turns out that the impacts from abroad are larger than our best guess currently, obviously demands in the United States are going to be weaker. There may also be substantial financial and political uncertainties stemming from unrest in some of these countries that would have an effect on our economy. On the other hand, it may well be that the underlying strength of nominal demand in the United States is going to be little affected by Asia and that we will find ourselves in an increasingly inflationary environment. I think the uncertainties are quite substantial in that regard. That is about all I want to say at this point. Thank you.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. The expansion clearly is weakening. Real GDP according to the Greenbook is already below the trend growth rate in this half year, and it falls even shorter in the next half year. Unemployment rises in all of the Greenbook scenarios. Depending on the stock market, the rate of unemployment may at least arguably get close to my definition of NAIRU fairly soon. As one listens to the Reserve Bank presidents, one hears much more commentary than a few months ago using words like "slowing," "negative psychology," "less positive," etcetera.

Let me bring Asia back on the table. The Asian forecasts are being progressively downgraded. I believe the staff already has moved about one-fourth of the way to its so-called pessimistic forecast of the last meeting in this forecast. The process probably is not completed. Even in the present forecast, as Ted Truman commented earlier, foreign growth is very weak.

I will talk a bit about the strategy of policy. I am a believer in conducting policy on the basis of the funds rate as opposed to using other indicators such as the monetary aggregates, gold, or any of a number of other indicators that have been suggested. A problem with the funds rate,

as I have mentioned before, is that a lot of attention gets focused on it and it becomes very difficult to change it. It may even become difficult to change any adjectives we use to describe our approach to it, such as symmetry. I think the remedy is to make more changes in the funds rate, and the world will get used to the fact that that is the way we operate. A good driver does not apply steady pressure to the gas pedal but rather tries to keep the car going at an even speed.

A few months ago, I felt that it was time to raise the fed funds rate a bit. I now think that the time is coming, perhaps very soon, when the right thing to do may be to lower the funds rate a bit. Whether a lower rate is needed at this meeting is very debatable, but the way things are going, I believe we could be confronting this issue rather soon. In all the staff documents that I read to prepare for this meeting, the paragraph I liked best was on page 9 of the Bluebook. That was the justification for a lower funds rate.

Having said that, I cannot question the current stance of policy very much either. If the real interest rate is about 3½ percent, steady inflation is arguably about 2 percent, and both inflation and unemployment are reasonably close to their target values--this is my own mental version of the Taylor Rule--policy is roughly about right at this point. The economy may not be well balanced in Jerry Jordan's sense, but I do think that in terms of the level of the federal funds rate, it is hard to argue that we are far away from where we ought to be. That means that there is no significant harm in waiting a bit before we move in either direction. But having said that, I would like hereby to announce that I have joined the small but growing band of those who think that there probably are more downside than upside risks at the present time.

CHAIRMAN GREENSPAN. First Vice President Varvel.

MR. VARVEL. Thank you, Mr. Chairman. It is a real honor for me to be here representing our Bank and subbing for Al Broaddus. You may know that Al's son was married

this weekend. He had an extended trip out of town. He wanted to be sure the Committee knew that the economy of western North Carolina was receiving a big boost this past weekend!

The Fifth District economy continues to grow at a moderate rate this summer. Overall manufacturing activity picked up some in July as a result of strong domestic demand, especially in the building materials and capital goods areas. But, with much weaker orders, our textile and apparel producers continue to have a tough time. Growth in retail sales slowed somewhat, especially in consumer durables, but the nonretail service sectors are experiencing very strong revenue growth. Real estate activity and bank lending remain strong, and there is excess money chasing too few investment opportunities. The Charlotte area continues its very rapid growth, and we have reports of a record amount of new investment there in the first half of 1998. Finally, District labor markets remain very tight. We continue to hear frequent comments from District contacts about difficulties in attracting and retaining workers and an increased dependence on the in-migration of workers, especially in the construction industry.

On the national picture, I have a few comments about the Greenbook forecast. The Greenbook sees the slowdown in inventory accumulation and the deterioration in net exports that occurred in the second quarter as setting the stage for a sharp and lasting slowing in the growth of domestic final demand. As a consequence of that slowdown and a further significant deterioration in net exports, real GDP is expected to expand at a rate just below its potential, relieving some of the pressure on labor markets and lowering core inflation a bit in coming quarters. It would be very nice if this chain of events were actually realized and I hope it will be, but I have some doubts.

First, domestic demand is expected to slow promptly to about half its average pace in the first part of 1998. Given that labor markets adjusted for the GM strike apparently tightened

further in July, pointing to further real wage growth, I am not convinced that domestic spending will slow as much and as promptly as in the Greenbook forecast.

Secondly, as Mike Prell noted earlier, the Greenbook is forecasting a much greater deterioration in net exports than the Blue Chip forecasters. In fact, I noticed that the Greenbook is about as pessimistic as the average of the ten most pessimistic Blue Chip forecasters. The Greenbook's forecast of net exports represents a drag on real GDP growth of about 1 percent in the second half of 1998. By contrast, the Blue Chip consensus looks for a much smaller drop in net exports, with much less drag on GDP. I know that foreign trade developments are very difficult to forecast and I certainly am not a forecaster, but on the face of it, the Greenbook seems to be at the low end on this point.

I see considerable upside risk in the Greenbook forecast of the economic outlook. Inflation itself, continued strong domestic demand, and the second-quarter jump in the ECI are particularly worrisome. The latter may indicate some ebbing in the productivity growth that has been holding down unit labor costs. I also worry that we are at risk of a jump in health care costs that would raise the benefit-cost component of the ECI. And, as Mike Prell pointed out, the special survey data on variable pay suggests that the ECI may understate compensation costs.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. We in the FOMC tend to concentrate on what has happened since we last met, this magical period known only in this room as the intermeeting period, but I find it interesting to go back a little further sometimes. In this case, I went back to March, which is only five months ago, and found myself very impressed, which is a compliment, folks, with the forecasting ability of the staff. The March meeting, as you remember, was held near the end of a roaring first quarter that proved to be even stronger than we expected at that time. The staff was

predicting, albeit somewhat diffidently, a drastic slowdown in the expansion due to inventory deceleration and the impact of the Asian financial crisis on our net exports. There was some skepticism around this table, including my own, but in hindsight it appears that the staff made a quite good forecast. The timing was a little off; the first quarter was stronger and the second weaker than they anticipated, but the basic forecast of slowing to less than potential for the rest of this year and next looks increasingly right to me. They also called the stock market about right--so far. Despite the reduced earnings expectations that are bound to occur with slower growth, they expected only a modest correction in the stock market. So far, that is what we have gotten.

What is evident looking back even five months is that the Asian crisis is proving to be deeper, more intractable, and possibly more contagious than we thought it would be a few months ago. Japan is more deeply mired in political paralysis. Other Asian economies, especially Indonesia, are in more desperate shape. China, including Hong Kong, Russia, and possibly Brazil, are more fragile than we anticipated at that time.

Looking ahead, it seems to me that the overheating of the U.S. economy is likely to be slipping into the category of past worries despite some evidence of shortages of construction and other workers and of some materials that have been mentioned around the table. We have learned over the last couple of years that even with extremely tight labor markets, our economy is much less prone to accelerating inflation than we thought it was. Labor markets now seem likely to ease up a bit as economic growth slows. That does not necessarily mean that we will avoid an uptick in inflation in delayed reaction to higher wages, possible increases in health care costs, and some other factors that have been mentioned. Indeed, we might be in for a bit of stagflation. If that happens, we may unfortunately have to live with it. It is hard to imagine raising interest rates in

the face of softening employment and economic growth that is below potential. What has been learned before is that we do not have a very good tool to combat stagflation if we get it.

I suspect that domestic overheating and inflation are going to be fairly low on our list of worries over the next few months. Rather, I suspect that we will be focused more and more on how to keep the world economy--the non-European, non-North American economy--from unraveling further and how to mitigate the damage to our own economy. It is not hard to imagine that world growth, instead of recovering modestly in 1999 as forecast in the Greenbook, might get a good deal worse before it gets better and that recovery will be delayed at least until the year 2000. Our economy now looks strong enough to weather the storm without a recession, but its ability to do that depends heavily on consumer confidence and the absence of a rout in the stock market. My guess now would be that we will get a series of orderly corrections in the stock market--stair steps down to values more in line with realistic profit expectations--but market psychology is a fragile thing.

This all adds up to saying that I believe the risks are now at least as much on the downside as on the upside and that not moving the federal funds rate is certainly the right policy for now.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. As I review the current economic outlook I am, like others, struck by the strong but at least currently balanced forces that appear to be shaping the future. Potentially weakening developments stemming from the external sector seem to be balanced against a currently strong domestic sector, although some weakness in the latter is a possibility. We also continue to see a dichotomy between the goods sector, including commodities and agriculture, and the service sector. I think the links across these various

balances and dichotomous elements of the economy reside in two areas. One is the labor markets and the other is the financial markets. The challenge to me is that this balance is quite fragile right now, and it seems very much like a high-wire act where a move to either side would be quite detrimental.

As others have indicated, developments relating to the external sector clearly have slowed the growth of GDP. The Greenbook projections suggest that the external sector will slow the expansion less and less going forward. Therefore, one might think that it should be less and less a part of our deliberations. However, the risk that I see here is that the staff may have underestimated the net drag that will come from the external side. I agree with Ted Truman that its negative contribution eventually will turn around, but I see some risk that the Japanese economy will not turn around as quickly as in the Greenbook forecast. The current Greenbook estimates that economic activity in Japan declined at a 5 percent rate in the first half of this year, and it anticipates a flat performance in the second half and an upturn to a low growth rate in the first part of next year. That forecast seems a little optimistic to me. Also, as the events of this week have indicated, global contagion is still very much a risk that could undermine fragile recoveries around the world. The staff forecast, as Governor Gramlich indicated, has moved some distance toward the so-called "worse case" scenario. I hope that that partial movement is not further abetted by unfolding events overseas. In any event, the importance of the external sector is much greater than the 3 or 4 percent of GDP that is accounted for by the U.S. current account deficit.

The domestic economy provides a marked counterpoint to the external sector. The Greenbook forecast calls for some abatement of what has been very strong growth. That abatement is based to a very substantial extent on an anticipated diminution of wealth effects.

Such an outcome is quite possible. The recent so-called near correction in the stock market lends some credibility to this scenario. However, as others have indicated, the stock market is notoriously difficult to forecast. Therefore, I would say with respect to purely domestic developments that I sense considerable tension between factors pointing to an overly strong expansion and those that suggest a potential for some shortfall in demand from current expectations. For me at this point, those two sets of factors seem to be roughly in balance.

The other set of mirror images that we are dealing with is the goods sector versus the service sector. It is clear that the goods sector has thus far taken the brunt of the adverse impact of foreign trade developments. Goods exports and imports seem to account for almost all of the net export drag that we have experienced. Additionally, the goods sector has been an important player in the recent performance of the domestic economy in that the swing in inventory investment was a key factor in the shift of GDP from very rapid growth in the first quarter to much reduced growth in the second. Forward-looking indicators, such as recent purchasing manager surveys, show some weakness in the goods sector going forward. However, I think there are some signs of strength even in that sector. While there was a slowdown in the buildup of inventories in the second quarter, stock building was still substantial, something like 6 percent at an annual rate. For its part, the service sector is a clear story of strength building on strength, and the Greenbook forecast shows that as basically continuing.

The linkages across these various elements of our economy may be seen, as I said, in the labor markets. The overall labor market is obviously tight and likely to stay tight. The tightness seems to be discouraging some layoffs in industries that have been affected by the externally induced drag. Not surprisingly, the strength in demand also has forced employers in other sectors of the economy, in the service sector in particular, to increase the number of workers

that they employ. So, it seems to me that the unemployment rate, as the Greenbook suggests, is likely to adjust very slowly to a moderating economic expansion. While I think the labor markets will be slow to adjust, we will see and have seen that financial markets are quite quick to adjust, and they add a degree of volatility to the economy.

I think the potential interplay that we are starting to see between corporate profits, stock valuations, and consumer performance are the elements that are most relevant to us. I believe they represent the main sources of risk to the forecast. The staff forecast depends on this volatility and an adjustment in equity prices to more conservative profit outlooks to bring the various elements of the economy into an equilibrium at a lower, indeed subtrend, growth rate. Unfortunately, I think there are many risks to this "immaculate slowing" forecast. The most obvious stem from the weaknesses in foreign economies and the international financial turmoil that continue to take some toll on psychology and real economic performance. On the other hand, tight labor markets, which the staff currently expects to have little impact on prices, could potentially translate into greater inflationary pressures than the staff has forecast if businesses attempt to maintain profit margins by raising prices to offset declining productivity. Similarly, the diminishing wealth effect that is expected to come from the stock market may not be as strong as the staff has forecast.

Overall, I think the risks are larger in both directions, and unlike where I was at the last meeting, I now believe they are quite balanced. However, I see it as a delicate balance, and I think our current role is to do as little as possible to upset the various forces that affect the economy. By sitting still now, we run the smallest risk in a scenario that is fraught with uncertainties, none of which is of our own making. Thank you.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. I expect both slower growth and higher inflation over the next year and a half. However, I expect faster growth than in the Greenbook forecast, with the rate of expansion in GDP closer to trend and a slower rate of increase in potential output. These two factors combine to yield a lower path for the unemployment rate than is indicated in the Greenbook. In part because of this, I am skeptical that the recent pattern of a rising rate of increase in nominal compensation will reverse next year, an outcome central to the Greenbook inflation forecast.

The story underpinning the forecast of a persistent slowdown in growth to below trend begins with a sharper external drag associated with the turmoil in Asia. The resulting decline in net exports is projected to slow GDP growth. The multiplier-accelerator effects of the slower GDP growth then moderate domestic demand, reinforcing the slowdown in GDP growth. If for good measure we add a stock market correction that is sharper than might otherwise occur in a period of slowing expansion to reflect some initial overvaluations, we get a slowdown in GDP growth that carries into 1999 even though the external drag is fading. It is a good story. I have told it more than a few times myself. I think it is the story in the Greenbook, with the important substitution of a realized for a projected stock market correction.

What is wrong with this picture? Well, it does not seem to fit the facts of the first half of this year very well. The story in the first half was not that of a significant slowdown in GDP growth. The economy grew at a $3\frac{1}{2}$ percent rate in the first half despite a subtraction of $2\frac{1}{2}$ percentage points stemming from the decline in net exports. This GDP growth rate is only $\frac{1}{4}$ percentage point slower than over 1997, and it is fully accounted for by the GM strike. True, growth was unbalanced in the first half in terms of the pattern of growth in the first and second

quarters, but this difference was almost entirely associated with the pattern of inventory investment.

The real story in the first half was that a stronger-than-expected advance in private demand was offset by a sharper-than-expected decline in net exports, leaving GDP growth about unchanged. That outcome suggests at least a couple of questions. First, why did private domestic demand accelerate? Second, why should private domestic demand now weaken so sharply as in the staff forecast when there are no multiplier-accelerator effects to speak of stemming from slower growth in the first half? One piece, but only a piece, of the puzzle of the further strengthening in private demand may be the same Asian turmoil that was reflected in the sharper-than-anticipated decline in net exports. That turmoil resulted in at least \$3 of the per barrel decline in oil prices and was accompanied by a shift in portfolio preferences in favor of dollar-denominated assets that contributed to lower intermediate- and long-term interest rates in the United States.

But the key question in the forecast is, what will now induce a slower rate of economic growth in the second half and into 1999? It is not the external drag. The decline in net exports in the second half is about half as sharp as in the first half, and the decline then halves again next year. Therefore, in order for GDP growth to moderate going forward, the slowing in domestic demand must be aggressive enough to more than offset the diminishing external drag. The bottom line is that we need a story other than just external drag to explain the slowdown in GDP growth going forward.

Part of the story is clearly the stock market decline, but this is not enough. The FRB/US model forecast identifies a second key underpinning of the slowdown scenario, and one that, I expect, is also a factor in the judgmental forecast. I call it the "X" factor in that it slows

growth through gravity. It reminds me of my defense of a forecast of a sharp decline in long-term rates in 1993. When I was asked why long-term rates were headed lower, I responded that it was because they were too high. The FRB/US forecast talks of error correction rather than force of gravity, but it's the same story. Many private-spending components have expanded at a rate above what that model and most other models predicted. This was true by the way during 1997 but perhaps even more so during the first half of 1998. Now, these spending components are projected to return to fundamentals, hence the economy slows. There is nothing wrong with this story, but it is not an overwhelmingly compelling one, especially in terms of the timing of the slowdown. As a result, I have some doubts about the degree of the slowdown in the staff forecast.

The second major call in the staff forecast is for a reversal in the recent trend toward faster increases in nominal compensation. This is partly due to a rising unemployment rate and partly to the pass-through of lower inflation expectations. The case was quite carefully argued in the Greenbook in terms of a range of forecasts from different wage-price models. Again, such an outcome is possible, but I remain skeptical.

Given the uncertainty about the structure of the economy and the forecast going forward, it is likely that collectively we will become more reactive in terms of policy response. This makes reading the inflation data for signs of a change in the underlying trend more important. But this also has become more difficult. I have noted before, for example, that the core CPI data hinted at a rebound in the underlying inflation rate based on three-month and six-month inflation rates. However, taking account of the last two months of CPI data, the three-month inflation rate of core CPI has receded from above 2½ percent to about 2 percent, very much in line with the staff forecast for the second half of the year.

The data for the chain measure of GDP prices show, in contrast, a remarkable slowing in the rate of inflation. The four-quarter rate of inflation for this measure has declined steadily from 2 percent in the second quarter of last year to 1 percent in the second quarter of this year. The slowing in the quarterly inflation rates occurred quite abruptly in the third quarter last year. Inflation by this measure has now been near 1 percent for four consecutive quarters. The widening gap and different trends in the alternative measures of inflation are making our job of reading inflation signals more challenging, but on balance they are showing few signs of building inflation pressure.

The last topic I want to comment on is the risk to the forecast. Given the tightness in the labor markets, the lack of compelling evidence of a persistent slowdown even to trend growth, and the likelihood of some diminution in the favorable supply shocks, there remains a risk of higher inflation going forward. The other major risk is that of a still worse outcome from the Asian turmoil. The forecast embodies a sensible central tendency for this external effect. It still appears to me, however, that the possibilities relative to the central tendency are asymmetrical. I see more chance of a much worse outcome than a much more favorable one. For this reason, I believe the risks to the forecast have become more balanced than I viewed them earlier. Thank you.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. The morning has moved well along and I am the last in the queue, I believe, so I will be very brief. At the last meeting, the Committee was wrestling with the very uncomfortable dilemma of having two sets of concerns that pulled in very different directions. We have been wrestling with the same concerns all morning. The question for today seems to be what has changed over the last few weeks. The answer perhaps is that not

much has changed fundamentally and definitively, but I think there are some potentially very significant straws in the wind. Thanks to inventories and Asia, the expansion slowed dramatically as expected in the second quarter, confronting us now with the question of whether or not this moderation will settle in as a new regime as suggested by the Greenbook. I thought the case that was made there was quite impressive. But if the stock markets still have the stamina for one or more bull runs left in them, confidence could be reinforced and we could again easily find ourselves in an excessive growth mode for much, perhaps all, of the forecast period. That obviously could present significant difficulties in the long run. My assessment is that domestic risk remains on the upside but perhaps not so heavily as earlier. The next several months should tell that tale.

Internationally, one is hard pressed to identify any news of improvement. To the contrary, deflationary pressure seems to be increasing. Japan appears to be fumbling the ball, which may further endanger the entire region. Long-held fears of contagion with some boost from weak oil prices have become reality and have impacted Russia and parts of Latin America. The downside risk seems to have intensified outside our borders, calling even more strongly for caution.

We still have the bifurcated mix of factors that existed on July 1. My sense, however, is that for the moment at least, the upside domestic concerns may be a bit milder while the downside international concerns may be cause for even more caution. While both of these straws in the wind now blow in the same direction and suggest a softening expansion as a rising probability, I do not think that this warrants a change in our policy stance at this time. But we are moving toward more balanced risks.

CHAIRMAN GREENSPAN. Thank you. Shall we break for coffee?

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

MR. KOHN. Thank you, Mr. Chairman. In opting to keep the stance of policy unchanged at recent meetings, the Committee has been balancing its expectation that policy most likely will need eventually to tighten to forestall an uptrend in inflation against the possibilities that developments in the global economy could make that tightening unnecessary and that any rise in the federal funds rate might worsen instabilities in foreign financial markets. Living with the risk of rising inflation has been made easier by the low level of actual inflation and by the prospect that, despite tight labor markets, inflation will not turn up for some time. Given that prospect, waiting to tighten--in order to be in a better position to judge the course of developments overseas and inflation dynamics in the United States--probably would not deprive the Committee of adequate time to head off a significant pickup in inflation that would be very disruptive to reverse, even allowing for policy lags.

Developments since your last meeting would seem mostly to reinforce the arguments for standing pat. The rise in volatility and in contagion across countries of movements in financial asset prices suggests that investors are more fearful and uncertain and that many markets remain quite vulnerable to a tightening of monetary policy in the United States, especially if the policy action were unanticipated and not clearly dictated by an obvious threat of higher U.S. inflation. And, the deteriorating situation overseas is reflected in a higher dollar and lower commodity prices and in downward revisions to the path of foreign economic activity, which will help to contain pressures on resources and prices in the United States.

Moreover, the reactions of U.S. financial markets of late to the deteriorating situation overseas on balance are reinforcing the restraint on aggregate demand. This is in contrast to earlier when domestic markets were responding to foreign turmoil in ways that seemed to support more domestic spending, partly offsetting the damping of net exports. To be sure, interest rates on Treasury obligations have dropped still further, but the adverse effects of the higher dollar and weaker foreign demand on profit prospects have contributed importantly to the recent decrease in equity prices and rise in credit risk spreads. The cost of raising capital for U.S. businesses probably has risen a bit in recent weeks, and previous gains in household wealth have been trimmed. The key question is whether these recent market movements represent a more lasting reassessment of profits and risk or are simply another hiccup in investors' persistently optimistic view of business prospects. If the staff profit forecast is in the right ballpark, such optimism should prove difficult to reestablish.

In addition, much of the decline in Treasury interest rates in the last few weeks, and even in the last few months, may represent a fall in inflation expectations, rather than in real interest rates, limiting its stimulative effect on spending. In the Michigan consumer survey, for example, partial data for August indicate a drop in expectations for inflation over both the next year and the next 5 to 10 years; expectations over both horizons have fallen a couple of tenths in the last two months, bringing the decline in median long-term expectations to half a percentage point this year. Using these measures, rate declines in recent months or even since December entirely reflect longer inflation expectations. This conclusion is supported by the slight upward creep in yields on inflation-indexed securities over this period. It may be that the downward pressure on real interest rates stemming from market perceptions of greater restraint coming from abroad are being about offset by upward pressure arising from increases in expected real short-term rates over the near term as inflation expectations fall relative to the forecast of an unchanged nominal funds rate.

Of course, not all developments over the intermeeting period point to reduced inflation risks. So far, private final demand remains quite strong, counterbalancing the restraint coming from the foreign sector and lower inventory investment by enough to keep income and employment growing at a good clip. And, as a consequence, pressures on labor markets show few signs yet of becoming less intense.

Moreover, financial conditions continue to be accommodative for spending. Price-earnings ratios are still extraordinarily high, holding down the cost of capital, and consumption has not yet caught up to the previous run-up in wealth. Even if real interest rates have not fallen, recent declines in nominal interest rates will boost mortgage borrowing and spending, particularly for those households who feel constrained by limits on available liquidity or cash flow. And, according to our August survey of loan officers, more domestic banks still are easing terms on business loans than tightening them, though by a smaller margin than in the previous few surveys. Lastly, although money growth has slowed somewhat in recent months, measured over the more relevant time frame of the last few quarters, the aggregates continue to expand rapidly--more rapidly, if they continue on these paths, than likely would be consistent over time with nominal income growth in line with the Committee's desire to keep inflation very low.

Perhaps the immediate question for Committee consideration is whether, on balance, conditions have changed enough to warrant a return to a symmetrical directive. The Greenbook forecast would seem consistent with such a move in that, at an unchanged federal funds rate, it sees inflation remaining quite damped. In that forecast, the rise in inflation has become

even more gradual; indeed, no longer does the rate of increase in the core CPI drift higher in 1999--even after allowing for technical changes to the index. Moreover, the Committee might be more confident now than at previous meetings that the slowing of domestic demand likely needed to contain inflation pressures is in train. For the first time, the reduction in wealth critical to that moderation has actually happened, not just been projected. To date, the restrictive effects of high real interest rates on aggregate demand have been offset importantly by the rise in equity prices. But if those prices don't rebound, much less fall further as seems possible with the staff outlook for profits, the restraining effects of high real short-term rates holding up the real yield curve should begin to show through to spending that already is being restrained by the higher dollar and weak income abroad. A policy stance that keeps real rates relatively high would seem appropriate when, as now, the economy appears to be beyond its sustainable level of production. That rate setting helps to drag the economy back toward its potential--the result that is in the staff forecast.

A symmetrical directive would not seem unreasonable or come as a great surprise to financial market participants. The term structure of interest rates suggests that investors do not see the risks as tilted toward greater inflation and tighter policy, even making allowance for the effects on that structure of the flight to quality. Indeed, a growing number of observers seem to be taking seriously the possibility that the next action may be toward ease.

Finally, even if the Committee views inflation risks as still substantial, it may also see recent developments at least as having postponed the need for possible tightening, both because greater fragility in markets is likely to persist for a while and because price pressures should be quiescent for a longer period. If tilts in the directive are interpreted as having a time dimension as well as connoting the likely direction of the next policy action, a symmetrical directive may better represent the Committee's intentions. Until a few years ago, tilts applied to possible policy actions in the very near term--that is, over the intermeeting period. While the Committee has not emphasized this interpretation in recent years, it still has seemed often to be using tilts to signal that risks were sufficiently skewed to make a policy adjustment in the indicated direction a distinct possibility over the next several meetings, and not just a statement of probabilities in the indefinite future.

Still, Committee members have been projecting more inflation than has the staff, and the Committee may see the risks of higher inflation as large enough and immediate enough to justify retaining the asymmetric directive. Declines in equity prices and greater foreign turmoil may have reduced your inflation concerns, but perhaps not by enough to change the directive. The fundamental situation of the economy has not changed. Economic activity

remains at a level well beyond most estimates of the economy's sustainable potential. That overshoot continues to be reflected in the labor markets, where increases in compensation remain on an upward trend. And, recent profit results may in part suggest that the reservoir of productivity-enhancing investments that could offset the effects of higher compensation on costs and prices is not bottomless.

In addition, the moderation in the growth of domestic final demand so essential to relieve pressures on labor markets is still mainly a forecast. Although markets don't see an eventual tightening of monetary policy as necessary for that moderation, on balance outside economists still do. As recently as last week, the survey of economists of primary dealers showed that a considerable plurality expected your next action to be a firming rather than an easing. And, as Mike discussed, private forecasters included in the Blue Chip survey on average continue to expect an appreciable pickup in inflation next year.

The Committee thus would have reasons for retaining a view that inflation remains the principal threat over time to sustaining the economic expansion. If so, before shifting its directive stance, the Committee may want to see further evidence that the risk of higher inflation has indeed receded--for example, data pointing more clearly to a slowing in domestic final demand. In these circumstances, the Committee might be concerned that returning to symmetry and then perhaps needing to shift back to asymmetry a few meetings later could be interpreted as implying more sensitivity to very recent developments and less regard for the underlying fundamentals and long-run goals of policy than in fact characterizes the Committee's policy strategy.

CHAIRMAN GREENSPAN. Thank you. Questions for Don? If not, let me proceed. I do not have very much to add to what has been discussed around the table this morning. I am in the group that sees no evidence yet that economic and financial conditions are stabilizing in Asia. Indeed, many of you have noted that conditions there continue to deteriorate.

One of the problems that concern me about stabilization in Asia and perhaps other areas of the world is that the flexibility required for adjustments is inhibited to a very substantial extent by worker unrest. I am speaking mainly about Korea, but other areas are affected as well. More generally, the political problems around the world clearly restrict the ability of governments to

make the adjustments that we would consider necessary in these types of crises. Russia is the classic case. It is clearly the case throughout Asia as well, even in Korea where one would assume that President Kim has fairly strong support. In fact,

Japan remains the most difficult area and the greatest concern. I don't have much to add to what has been said, but it is obvious that the situation in Japan is deteriorating. There is no evidence of stabilization. The notion that the Japanese economy will bottom out in the early months of next year is a very interesting thought for which I find the evidence quite lacking, to say the least. I think deflationary pressures are rising around the world. That fact is very difficult to avoid recognizing. There are fewer and fewer areas that are not touched by deflationary developments. Even Canada, which seemed to be such a bulwark, is obviously in some difficulty with respect to its exchange rate that in turn is a function of commodity price pressures from Asia as well as oil price declines. Europe is doing well, but it is not self-evident to me that there is any acceleration there. Very fortunately for the introduction of the single currency, Europe is in a situation in which the ERM has turned out to be a vehicle that is going to ease them into the euro without any obvious adverse difficulty, and this is not something I would have forecast two years ago. But it is hard to argue that Europe is exhibiting the considerable economic strength that is still obvious in the United States.

One of the problems I have currently with our statistical system is that I am having great difficulty figuring out what is going on in certain very crucial areas. The most perplexing is turning out to be in the labor statistics area. We are seeing a widening divergence in the

employment data as measured by the payroll and the household surveys. I don't know the extent to which the problem is a short-term phenomenon, but the numbers are really interesting. The best way to describe them to you is by citing the fact that over the past year payroll employment has gone up by 3 million while household employment adjusted to payroll survey concepts--that is, by taking account of agricultural workers, the self-employed, unpaid family workers, unpaid absences, multiple job holders, and a few other minor categories--has gone up only 1 million. Hence, the statistical discrepancy has widened by almost 2 million. The same pattern exists to an even greater extent in the past six months. In this period, payroll employment has risen 1.2 million and the adjusted household figure has declined 600,000--a difference of 3.6 million at an annual rate. A small part of the larger discrepancy apparently relates to underestimates of illegal immigration, which bias down the population data and, therefore, the household data. There are some other small technical issues in both the payroll and the household data whose resolution would tend to reduce that discrepancy, but only marginally.

We have been accustomed to looking with some skepticism at the monthly changes in the household data because of the characteristics of a limited 60,000 household sample. But for six-month changes, the standard error of the estimates falls quite dramatically, and it is very difficult to dismiss these household data for sampling variation reasons. As a consequence, we are looking at an extraordinarily difficult problem. You may recall that up until the last six or nine months, the evidence had indicated that both payroll and household employment were growing at a 2 percent annual rate whereas the working age population including immigration was going up only 1 percent. Over the past year, the adjusted household data have now also risen 1 percent and the unadjusted household data have gone up somewhat more than 1 percent but decidedly less than 2 percent.

The serious question that we have at this stage is how significant the tightening in the labor market has been over the last six months and the last year. Certainly over the last six months, the number of unemployed people plus those who are not in the labor force but want a job has not changed. To be sure, that number has stabilized at a level that still implies a very tight labor market, but one that is not tightening further. This story, as you are well aware, is quite different from the one we get by merely looking at the payroll data, which still show a relatively strong month-by-month growth pattern. Something is different here. We do not know what it is. It unfortunately turns out to be in a very crucial area for the analysis of what is going on in the labor market.

As some of you have indicated, we are not even quite sure what the inflation rate is. Until 1995, the inflation rate, if we wished to measure consumer price inflation, was evidently fairly close to the core CPI and core PCE rates, which did not diverge greatly. Since then, even without the methodological adjustments affecting the CPI core, the gap in the two rates of inflation has opened up. We are now dealing, for example, with a 12-month change in the PCE core deflator that in June was about a full percentage point less than the CPI core. So, at a crucial nexus in our efforts to make judgments about the inflation process, our data have deserted us, if I may put it that way. We are in a position where it is very difficult to feel comfortable about what is happening.

To make matters worse, when we look at the productivity data, it clearly makes a big difference whether we measure output on the basis of the product side of the national accounts or on the income side in light of the continued widening of the statistical discrepancy. The discrepancy reflects itself quite measurably in the analysis of unit costs and prices. When we look at productivity measured from the income side--which we used to do in the BLS data and we are

effectively required to do in the nonfinancial corporate data--we see that productivity growth continues to be quite strong and total unit cost increases are still quite subdued. However, as the expansion slows, the labor markets appear to be sufficiently tight so that individual employers are quite reluctant to lay people off. As a consequence, increases in measured productivity slow down of necessity. This is another way of saying that the unemployment rate is a lagging indicator.

In any event, we are at a point where a critical evaluation is required for us to understand the inflation process. I still think that most of the evidence, irrespective of the data we are looking at, clearly shows that inflation is low, labor markets are tight, and compensation per hour is accelerating. The productivity data, as measured on both the product and the income sides, are reflected in muted increases in unit labor costs that coupled with the decline in unit non-labor costs result in a still benign inflation process. But our evaluation would be a lot more convincing if we had a set of data that were internally consistent and did not leave us with very large, yawning gaps in significant places in the statistics.

Despite all these data problems, however, I believe that conditions have not changed enough to suggest that we alter our evaluations of the policy choices, for example those that Don Kohn laid out for us to consider. In my view, the bottom line at this stage is that the anecdotal data and either version of the other data that I discussed clearly suggest that "B", meaning "no change" in the rate structure, is the appropriate position at this stage. But I must say that this does leave open the question that many of you have raised of whether we ought to shift from our asymmetric stance back to symmetry. Don Kohn has outlined the arguments pro and con. I must say that I do not have a strong view one way or the other. I sense, but I cannot be certain, that the

Committee is moving from asymmetry back to symmetry. It would be useful if each member made explicit in the go-around where he or she stands with respect to that issue. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. I think your analysis was exactly right in regard to where we should be with the federal funds rate, that is, alternative B. I very strongly prefer that we move to a symmetric directive for reasons that I stated earlier and that were expressed by most of the people in the go-around. Risks have increased on both sides, but they are very well balanced in my view. As of today, I see no likelihood whatsoever that we would decide to move the rate between now and the next meeting, and I think our next rate move is equally likely to be up or down. Whatever one's theological view of how the Committee reaches its decisions on symmetry or asymmetry, one would conclude that a symmetric directive most clearly reflects the current thinking of the members.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. I agree, Mr. Chairman, that a symmetric directive makes sense at this moment. Such a directive reflects my view that we are unlikely to change monetary policy anytime soon and that, when we do, we may move the fed funds rate up or down. Now, I have been wrong before. We all have been wrong before. The only argument that I see for not changing the tilt is the fact that it does not have much operational significance and moving it around a lot risks our looking a little silly if we turn out to be wrong about the balance of risks. So, I could go along with the strong argument for leaving the tilt where it is, but my preference would be to adopt a symmetric directive.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. First, I strongly support your recommendation for no change in policy at this meeting, but I want to focus my attention on the

issue of symmetry versus asymmetry. In my view, the very tight labor markets impose a natural asymmetry to policy in relation to growth prospects. Specifically, a forecast of persistent above-trend growth would, I believe, justify a tighter policy, but a forecast of modestly below-trend growth would not immediately dictate an easier policy. Instead, such a development would help to unwind the very tight labor markets and contribute to a soft landing with maximum sustainable growth and full employment. This, I believe, is the foundation for the asymmetric bias toward tighter policy that we have maintained since the March meeting. I still believe that very tight labor markets and likely growth near or above trend will ultimately dictate that the next move for the funds rate will be up rather than down. This balance of risks is best conveyed by the current tilt in policy.

But there is a second asymmetry in the outlook today. This asymmetry relates to probable outcomes versus central tendency forecasts for Japan and emerging economies in Asia and elsewhere. Relative to such a baseline forecast, there is in my view a considerably greater risk of a much worse outcome in those economies than there is of a much more benign result. I see this downside risk of a worse case outcome in Asia, should it materialize, as likely to spread to other emerging market economies and constituting the most serious threat to the U.S. and the global economies. Such a worse case outcome does not have the highest probability, but it is the most worrisome possibility that we face today. On balance, therefore, I think a symmetric posture is the best choice for now.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I, too, am in agreement with your recommendation of alternative B. I have mixed feelings about whether or not to change the symmetry of our directive at this meeting. The reason is that I continue to believe that our next move should be to raise the federal

funds rate, and I think we would be better off right now from the point of view of speculation in financial markets, credit markets, and real estate markets if we had moved to a tighter policy stance earlier. However, there are a lot of worrisome downside risks right now coming from the external sector of the economy. There is a sense of spreading fragility abroad and a possibility of a feedback to our own financial markets. Given the sense of caution that I feel to a greater degree now than I did at the last meeting, I think the need for a move has been pushed off until we see what the impact of various evolving events abroad will be on our economy. So, I can go along with what seems to be the consensus so far that we move to an unbiased directive.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I have a strong preference for symmetry for the reasons already stated.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Mr. Chairman, I support your recommendation of alternative B. I have a mild preference for symmetry. With President Minehan, I still have some concern about the risks of rising inflation, but I also agree that the external sector has become more uncertain. I sense that symmetry is the best way to communicate these concerns taken together.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. I will support alternative B. As I have said before, I would like to see us move to a regime where we could move the funds rate more often--not randomly but more often. [Laughter] I don't think that would look silly or needs to look silly, and I will go back to my example of using the gas pedal to control the speed of the car.

CHAIRMAN GREENSPAN. Except on the highway?

MR. GRAMLICH. A highway with hills. On the directive, if we cannot move the funds rate around, I would certainly like to move the symmetry clause around. I think the risks are roughly symmetric now, so I would definitely support going to symmetry.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I, too, favor alternative B and I also support symmetry. I almost always am in favor of symmetry. It has the advantage in this case of being appropriate. [Laughter]

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I also support your recommendation for "B." I agree that the risks are greater than they were at the time of our previous meeting, and I think there has been some shift toward the downside. So, I would favor moving toward symmetry. I would suggest, though, that it is a little unfortunate that we will be releasing information on Thursday that is not going to be consistent with this proposal. I hope that we will be coming back to the discussion on disclosure with Don Kohn at a later point.

CHAIRMAN GREENSPAN. Yes. Don has that scheduled. As you know, we were contemplating doing it today. We just could not get the material together in time.

MR. PARRY. I know.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. I support your recommendation for alternative B. Frankly, I have mixed emotions about the symmetry issue. If I were asked, I would probably retain the asymmetry at this point, given the strong domestic demand, but I am very comfortable with symmetry as well.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. I support alternative B. I also support a symmetrical directive because I think that the risks are far more symmetrical now than they have been during the previous few months since I became a member of this Committee. I would like to point out that a key feature of the policy regime in recent years is that the market has moved rates and has done a lot of the stabilization work for us under conditions where the Fed has set the right long-run environment and the market has moved. There currently is plenty of room for the market to move rates higher, and should incoming data start to point in that direction, I would anticipate that the market would back up quite a bit. So, in that sense, there is plenty of room for a tightening policy to take place through the market. In the other direction, there is not that much room, although a little, for rates to decline from where they are now because they are anchored to the current fed funds rate. That would mean that if economic conditions were to weaken quite a bit as the data come in over coming weeks and months, we might be looking for policy easing to follow the market down as that evidence accumulates.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I can certainly accept your "no change" recommendation. As far as the symmetries go, I can accept symmetry without great angst because I think there clearly is a strong case for it. But I would prefer to stay with asymmetry because the basic structure of the risks that we have been living with for some time is still intact in my view. There is a case for reorienting our directive a little by moving toward symmetry, but for me economic conditions have not yet changed enough to change the policy stance. To repeat, I can certainly accept symmetry.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. For what it's worth, during the break I got the data used by the staff to calculate the median CPI. It takes us a little longer to compute this number after we get the BLS statistics. The number for July is 3.0 percent. For July-to-July, it is 2.8 percent. I would take that as the best estimate of what to expect in the next 12 months. What is interesting is that when we break it down, we take the position based on long historical experience that in the case of a divergence, the published CPI almost always converges to the median. A divergence occurred between October of last year and March of this year when the published CPI dropped to an annual rate under 1 percent and the median stayed right at about 2.8 percent. During the four months since March, the published CPI has come back to an annual rate of 2.4 percent. So, one can look at that and say that monetary policy has eased because the real fed funds rate has fallen in the last four months. That is consistent with some other monetary statistics and credit aggregates, especially the monetary base, which I pay a lot of attention to.

The reason for not taking action to restrain monetary growth at this point would be either the effects of developments in Asia and Russia, though I am not sure how to quantify that, or the argument that some tightening would do harm to them and therefore we should refrain from taking action. Well, I am really a believer in tough love. I remember all the periods in the 1980s of rolling over repeatedly the maturing debt of Argentina and other countries to give them time to build up the courage to fix their problems. It really was only when we cut them off that the political dynamics within those countries got to the point where they were willing to do something. When I listen to the discussion about Asia around the table, it seems to me that people are saying that some of these countries are not yet in bad enough shape to fix. I do not know how our taking action for the purpose of helping them creates the pressures for them to help themselves.

The other argument on the domestic side for not doing anything is the Greenbook forecast. Don Kohn and others have talked about a forecast of slowing expansion in domestic demand and related slowing growth in money and credit and so on. It is a forecast. On that score, I am reminded of century date change problems associated with the computer, whose development owes much to Marina Whitman's father, John von Neumann, who was the architect of the modern computer system. I do not think we ought to blame him for the two-digit problem, but he did develop the basic architecture that goes into modern computers.

MS. RIVLIN. I think we ought to blame Alan Greenspan!

CHAIRMAN GREENSPAN. I learned it from John von Neumann!

MR. JORDAN. The other thing on which we as economists place more emphasis was his work with Oskar Morgenstern on the calculus of decisionmaking using mathematical formulations of the minimax type. This helps us to identify which kinds of errors we are willing to make and which are the most difficult to correct. In that light, I still believe that the more costly mistake to correct will be the one that occurs if it turns out that excess demand growth does not in fact slow down. The analysis so carefully done and mathematically developed by von Neumann and Morgenstern basically says that we sometimes should base decisions on something that we not only do not believe and definitely do not want, but that is still the wisest course of action.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support a "no change" policy, and I think the risks have shifted sufficiently to justify a symmetric directive.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I support your recommendation for "no change" in policy. On the directive, it is a close call. I think that on balance the risks are still marginally on the upside. So, I would have a slight preference for an asymmetric directive but I can support a symmetric directive.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. I prefer alternative B as well. I am at the same place as Governor Kelley. I have a slight preference for continuing the asymmetrical directive, at least for a while longer. It seems to me that given the extraordinary visibility and publicity of the Asian and Russian problems, we could give too much weight today to those issues before we have some greater assurance that domestic final demand will slow to a pace that is consistent with no deterioration in inflation. I also have some concern about the confusing signal effect of our delayed announcement of the symmetry in the directive, and I would feel more comfortable with moving to a symmetrical directive today if we were on a regime of announcing that decision promptly after each meeting. However, I do not feel strongly about the symmetry issue.

CHAIRMAN GREENSPAN. First Vice President Varvel.

MR. VARVEL. We would agree that the downside risks have increased, but we still believe that the upside risks are greater, given the strength in domestic demand. So, we would continue to favor a smaller increase in the fed funds rate sooner rather than a larger increase that could well be needed later. There obviously is a lot of sentiment for alternative B around the table. Given Committee adoption of that alternative, we would favor a continuation of the asymmetric tilt.

CHAIRMAN GREENSPAN. There seems to be a fairly large concentration of preferences around "B" symmetric. Would you read the appropriate directive?

MR. BERNARD. The draft directive is on page 13 of the Bluebook, which follows a lot of charts and tables: "In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. 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, a slightly higher federal funds rate or a slightly lower federal funds rate would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
Governor Ferguson	Yes
Governor Gramlich	Yes
President Hoenig	Yes
President Jordan	No
Governor Kelley	Yes
Governor Meyer	Yes
President Minehan	Yes
President Poole	Yes
Governor Rivlin	Yes

CHAIRMAN GREENSPAN. The next meeting will be on September 29. We will adjourn for lunch, at which time two topics will be discussed.

END OF MEETING