

Meeting of the Federal Open Market Committee  
November 16, 1999

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, November 16, 1999, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Mr. Boehne  
Mr. Ferguson  
Mr. Gramlich  
Mr. Kelley  
Mr. McTeer  
Mr. Meyer  
Mr. Moskow  
Mr. Stern

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

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

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

Ms. Cumming, Messrs. Howard, Hunter, Lang, Lindsey, Rolnick,  
Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Messrs. Ettin and Reinhart, Deputy Directors, Division of Research and  
Statistics and International Finance respectively, Board of Governors

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

Mr. Whitesell, Assistant Director, Division of Monetary Affairs,  
Board of Governors

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

Messrs. Stone and Stewart, First Vice President, Federal Reserve Banks of Philadelphia and New York respectively

Messrs. Beebe, Eisenbeis, Lacker, Rasche, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, St. Louis, and Cleveland respectively

Messrs. Bentley, Fuhrer, and Kahn, Vice Presidents, Federal Reserve Banks of New York, Boston, and Kansas City respectively

Mr. Wynne, Research Officer, Federal Reserve Bank of Dallas

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CHAIRMAN GREENSPAN. Would somebody like to move the minutes for the October 5<sup>th</sup> meeting?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection. Peter Fisher.

MR. FISHER. Thank you, Mr. Chairman. I will be referring to the usual set of charts and some additional materials that should be on the table in front of you. 1/

As usual, the top chart in the package shows the current 3-month deposit rates implied by traded forward rate agreements. Looking at the top panel of the first chart, you can see that in the United States forward rates continued to back up after your last meeting and peaked with the release of the CPI on October 19<sup>th</sup>. They have been declining since then, particularly on the release of third-quarter GDP data and the ECI. Thus, 3-month expected rates for most of next year are now at the same levels as they were just prior to the Committee's meeting in October

In Europe, forward rates have roughly the same pattern, but moved up to twin peaks on the release of our CPI and the release of Euro area M3 data on October 27<sup>th</sup>; they also have come off their peaks. Thus, despite a 50 basis point rate increase on November 4<sup>th</sup> by the ECB, expected 3-month rates in Europe for next year are now at the same levels as in early October. It seems to me that what has happened in Europe is that one or two rate increases that for some time had been expected to occur in the first half of next year have been brought forward into November of this year and nothing else has changed.

In Japan, despite interest in political circles in Bank of Japan policy meetings, you can see from the bottom panel that forward rate expectations took quite little notice of those meetings. However, there has been an updrift in the current LIBOR 3-month rate, the black line in that panel. This appears to reflect some increased tiering in yen money markets of the type we have seen in past years but it is not yet anywhere nearly as severe. It also suggests, as I understand from our traders, some shifting back and forth in views about who will and who won't be lending money over the end of the year, causing changes in expected rates for the turn of the year in Japan.

Turning to the second page, the top panel shows 10-year yields in the United States, the United Kingdom, and Germany. On the left side--the little numbers

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<sup>1/</sup> A copy of the material used by Mr. Fisher is appended to the transcript.

there are basis points--are the 2- to 10-year spreads on July 1<sup>st</sup> and on the right side are the 2- to 10-year spreads as of last Friday. What I enjoy about this chart in particular, as it relates to what is of interest to me, is how little I understand about what's going on here. German and other Continental yields began to rally just ahead of, but through the release of Euro area M3 data, which to all observers were higher than expected. But the bond markets took off on a nice rally that continued with the release of our GDP data and then continued through the 50 basis point ECB rate increase. Now, this has been explained different ways in Europe. Most have focused on the idea that uncertainty about near-term ECB intentions has been removed and a related perception that the ECB is now on hold. Another theory is that the ECB has gained credibility by being pre-emptive and is now ahead of the curve.

The first theory uncomfortably suggests to me that the uncertainty premia for anticipated central bank actions have a larger positive basis point impact on long-term rates than does an actual central bank rate increase. For the second argument about credibility to hold water, Europe would have to be more sensitive to short-term rates than to long-term, because otherwise the decline in long-term yields would undermine the restraining influence of short-term rates. But throughout my career and through current events, my colleagues in Europe have always told me that Europe is more sensitive to long-term rates than those silly Anglo Saxon economies that are so focused on short-term rates. So, I am not quite sure how the credibility argument plays here either.

Looking at the United Kingdom, it's intriguing how the 10-year gilt yield has marched along with German and other Continental yields despite the fact that these countries are at very different points in the economic cycle. To draw a point on it, the 2- to 10-year spread in the UK is inverted to the tune of 85 basis points while the German spread, as you can see, is positive from 2- to 10-years in the amount of 115 basis points. Notwithstanding the economies being at different points in the cycle, these yields are marching along rather in lock step. Maybe the rally in gilts is what is pulling Continental yields lower.

Looking at U.S. yields, I'd just note that with 2- to 10-year spreads having narrowed from 26 basis points on July 1<sup>st</sup> to 15 basis points last Friday--and I think to 12 basis points this morning--one might understand that there are few if any voices in our bond market who are prepared to join the "bubble-ologists" in proclaiming that the Fed is behind the curve.

Looking down the page, the next three panels depict yield spreads of various instruments over U.S. Treasuries. In the first of these three panels you can see that the emerging market index spreads to U.S. Treasuries have been narrowing consistently since last summer's highs; and they have narrowed by an additional 150 basis points since the October release of the CPI. In the next panel you can see that the spread of the Merrill Lynch high yield index, or junk bond index, to Treasuries has been relatively stable but has widened recently, moving in just the

opposite direction of the emerging market spreads. Market talk is focused on an explicit shift of funds out of U.S. high-yield instruments into emerging market high-yield instruments and also on increased sensitivity to rising default rates in domestic high-yield markets. Finally, in the last panel you can see that spreads on 10-year swaps and the Fannie Mae benchmark have come off their recent highs of last summer and returned more or less to the levels of early July. And corporate spreads are off their highs, but are still just a tad wider than in July.

Turning to the third page and year-end funding markets, this chart shows the three components of the current butterfly. That is, it depicts the November, December, and January LIBOR 1-month contracts. As you can see, the decline in the December contract from late October to mid-November has been noticeable. That seems to reflect at least a couple of things coming together. First, in an exaggerated way the December contract follows the same pattern as the November and January contracts, I think reflecting the ebb and flow of expectations for rate action by the Committee, particularly following the release of the GDP and ECI data. However, it also seemed to get quite an impact from our third round of auctions of options on November 3<sup>rd</sup> and particularly from our announcement on November 4<sup>th</sup> that the Desk would hold four more rather than only two more auctions.

Turning to the next page, let me go over the details of each of the auctions we've held. The vertical columns give you for each of the three strips the actual auction amounts, the total propositions, the bid-to-cover ratio, the awards we gave out or the stop-out rates on a Dutch auction, and the high and low bids. Having told the dealers we would try to meet demand for these options, we felt a need to respond to the high bid-to-cover ratios of the first two auctions. In all cases these were at rather elevated levels: 4 to 1, 4.7 to 1, 6.4 to 1, etc. So we raised the amount sharply for the third auction, doubling the amounts for both the turn of the year strip and for the January strip.

While the bid-to-cover ratio came down in the third auction, the stop-out rates and thus the Dutch awards came in quite high. You can see that in the awards column in the third entry in each panel: 11 basis points, 16 basis points, and 11.5 basis points. So, after the third auction we left the amount for the turn of the year strip constant at \$50 billion but raised the amounts for the surrounding strips. We also announced that we would hold at least four more auctions for a total of seven, rather than just two more for a total of five.

We think this helped calm the dealers and their customers considerably, as reflected both in the December LIBOR contract and in the much reduced stop-out rates for the fourth auction. We've reduced the amounts for the fifth auction to be held tomorrow for each of the three strips to \$15, \$30, and \$20 billion and, obviously, we will see how the subsequent auctions go.

Looking forward, as I've mentioned previously, I would consider this operation a complete success if none of these options is exercised. The motivating principle still seems valid to me that the more we sell, the less likely it is that they will be exercised. But there still is a risk that they will be exercised. If relatively small amounts are exercised on any one day for reasons specific to an individual firm--its own funding position or its own collection of collateral--we should be able to drain sufficient reserves to manage the impact on the funds rate that day through our own matched-sales operations. But if all, or even substantial amounts, are exercised on any day it is harder to anticipate the impact on the funds rate. Any shock sufficient to cause a large-scale exercise of these options can also be expected to have a profound impact on the funds rate and on other short-term market interest rates. So, it is hard to know in advance with any clarity what it is we would be doing vis-à-vis that day's funds rate. In any event, if such an exogenous shock were to happen, we would likely be trying to drain reserves not to manage that day's funds rate, but to try to moderate the impact on cumulative excess reserves for the period--the impact over the rest of the period. But that is obviously something we'll have to decide on a case-by-case basis.

Turning to the next page and our more traditional open market operations, the top panel depicts various forecast scenarios involving a cumulative reserve drain from currency in circulation. Reserve needs have continued to grow recently--reflecting, it seems to us, typical seasonal growth in currency in circulation and the strong demand from banks for increased vault cash in anticipation of Y2K-related demands of the public. Shown in the bottom dotted line of this panel is the New York staff's previous "low" projection for currency in circulation. We called that a base-case scenario in which we imagined there would be no Y2K impact. The higher dashed line is what we called a "high" forecast--not a worst case scenario but just a strong Y2K effect. The two solid lines reflect how we've revised up both of those forecasts because the actual levels have come in more or less right on track with our high, but not worst case, forecast. So, we've revised up our low forecast for currency by almost \$20 billion for the turn of the year, based on the experience we've seen through mid-November.

In the bottom panel is a chart depicting the pricing of our long-term RPs. Let me give you a little background on that before I describe the chart. We have conducted five long-term tri-party RPs that run through the turn of the year, totaling about \$27 billion. We have done more than 20 overnight and short-term tri-party RPs. In each of these RPs we have separately priced U.S. Treasury securities, agency debt, and mortgage-backed collateral and have carefully tried to maintain a consistent relationship between our sense of current market rates for each type of collateral and our stop-out rates, consciously choosing not to violate the existing spreads.

What is depicted in this chart is the cumulative propositions we've received on all five of these long-term--through the year-end--RPs. The vertical axis is the

dollar value expressed in millions; therefore, the top amount is \$55 billion of collateral propositions. Across the horizontal axis is the deviation of the rates given us from our sense of where market rates were for each type of collateral. So, the lower left corner represents 4 basis points above where we think market rates are and, moving across that axis, the progression goes to 44 basis points below our sense of market rates.

In the table at the bottom is listed the collateral we accepted--about \$13.7 billion of Treasuries, \$2.2 billion of agency debt, and \$10.5 billion of mortgage-backed collateral. On average, our stop-out rate has been about 4 basis points below our sense of where market rates were. Now, some observers in the markets have been disturbed about the quantity of Treasury collateral we have taken off the market--\$13 billion--through our year-end operations. I felt pretty strongly that we should not be disturbing the existing spread relationships unless we made a very conscious decision to do that. So we have been trying to take collateral as the dealers have priced it. And the fact of the matter is that the dealers have shown us very lackluster--and they will concede greedy--pricing, particularly on agency debt and to some extent on mortgage-backed collateral. They have been more aggressive in pricing the Treasury collateral to us. We will continue to be disciplined about this. At some point the time may come when in order to calm widening spreads we might intentionally change our behavior and take disproportionate amounts of agency and mortgage-backed collateral. My sense at this point is that we would probably do that by simply reverting to one pricing. In that case the three types of collateral would all be given to us in one set of propositions, which would automatically advantage the higher yielding collateral. But so far we've taken the spreads as we have found them rather than taking on the job of setting the spreads ourselves.

Finally, on the last page you can see that in the period since your last meeting the fed funds rate has traded slightly on the soft side except in the last couple of days, even though daily volatility has been relatively contained. For my taste, there appear to be too many unsatisfying explanations for this softness rather than any single persuasive one. Many have focused on our novel long-term operations and the general perception that we will be generous about year-end funding, but that doesn't quite get me far enough to explain the softness in the first two maintenance periods.

In the last couple of days funds have been quite firm, and yesterday we had an elevated effective rate of 5.6 percent, even though we had \$10 billion of excess reserves on the day. But yesterday was quite an extraordinary day. We had a Treasury refunding, a minor corporate tax date, some security problems at Bank of New York that delayed the close of the securities wire, and moves of 1/16<sup>th</sup> or 1/8<sup>th</sup> or so in the market in anticipation of Committee action today. All those factors contributed to a rather elevated rate yesterday. And the hangover from yesterday is with us today as the funds rate is trading at 5½ percent.

Mr. Chairman, we had no foreign exchange intervention operations during the period. I will need the Committee's ratification of our domestic open market operations and, of course, I'll be happy to answer any questions.

CHAIRMAN GREENSPAN. Would you give us a hypothetical scenario of what would happen if a very substantial number of these options were exercised on a single day, triggered obviously by some bank? How would you arrange to meet that? What would you do?

MR. FISHER. They would give us notice of exercise. We would then do RPs with them through the tri-party vehicle. Anyone who exercised an option would have to deliver collateral to the custody banks. And we would then be putting out the funds to them through the custody banks.

CHAIRMAN GREENSPAN. And the amounts we are likely to be dealing with are well within your capacity, as best you can judge?

MR. FISHER. Yes. On the reserve adding side, we have looked at this to make sure we have the capacity to do it. We are still reviewing it but we think we can handle the exercise of the options with no problems. The question is going to be how many matched sales we can do if we want to drain all the reserves back out again. We are working on that. There is a limit on our bill portfolio. Our traditional means of doing this is just against bills; we are mostly geared up to do matched sales against bills, which involve easier pricing than against coupon securities. That is one issue we are looking into. We are also looking into whether we can do matched sales or reverse repos through the tri-party agents, as I mentioned at previous meetings. There are operational issues that are throwing some sand into the gears--which we had a faint fear of before--causing us concern as to whether that will actually work. The bigger constraint, I feel, is whether we could do as much as \$150 billion or \$200 billion of matched sales to drain out the reserves we've put in. But I think it is possible that we will be able to drain amounts of around \$100 or \$125 billion or maybe even \$150 billion. It will be a complicated operational exercise to do it. But we think the capability is there on both sides. The quantity of the reserves to be drained back out is the issue, not the exercise of the repos in the first instance.

CHAIRMAN GREENSPAN. I assume that in the turmoil of that sort of market the issue of draining the reserves is not all that immediately urgent.

MR. FISHER. Absolutely. That is just what I meant by my remarks that our focus will really be on the impact on the cumulative average of excess reserves in the period. As to whether we will actually drain them all out that one day, I doubt it. But we will try to if what



is involved is the sort of exogenous shock that you are imagining. That is just what I meant. We would not be pretending that we know where the funds rate should be trading or that we are trying to target it.

Now, to get the scaling right, it's important to keep in mind that the total balances traded in the funds market run about \$15 to \$25 billion daily; \$25 billion is more likely at year-end. Who knows what the upper range of the repo market is? But \$600 billion and up is the turnover in the repo market, so the scale there is quite extraordinary. It is possible that once we announce significant exercise of these options, the fed funds traders will realize the rate is going to go to zero regardless of any exogenous shock. That is, we will smother whatever pricing up for fear may be there. That is going to be in the minds of the fed funds traders and the bank treasurers and it is very hard to anticipate.

CHAIRMAN GREENSPAN. Other questions for Peter?

MR. POOLE. Just continuing this line of conversation: If a lot of funds go into the market because of the exercise of the options, it drives the funds rate down, as you said. But then I assume that reduces the probability of any further options being exercised later on. So in a sense it is a one-time hit.

MR. FISHER. That is a likely scenario.

MR. POOLE. To make sure that my understanding is correct, I had a question about currency. My understanding is that currency outside the banking system is growing at a very normal rate. We do not see any particular increase in the hand-to-hand circulation as yet. Is that your sense?

MR. FISHER. Yes.

MR. POOLE. Currency in circulation includes the currency in bank vaults?

MR. FISHER. It is the vault cash that clearly has exhibited an extraordinary buildup. As for the rest, we think of it as a slightly stronger than usual seasonal impact but still in the range of the normal seasonal increase.

MR. POOLE. But not much more.

MR. KOHN. Money stock currency has been growing at 9, 10, 11 percent.

MR. POOLE. As it has been earlier?

MR. KOHN. It is in line with the rate at which it has been growing all year and it is comparable to the rate of growth last year. So there does not seem to be much, if anything, going on there.

CHAIRMAN GREENSPAN. Other questions for Peter? If not, we need a motion to approve the domestic transactions.

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

CHAIRMAN GREENSPAN. Without objection, they are approved. Let's move on to Mike Prell.

MR. PRELL. Mr. Chairman, Karen Johnson is going to lead off our remarks, but let me just mention to the Committee that we released industrial production data this morning--I trust a few minutes ago. We failed to put a copy of the release in front of you, so let me just tell you about it. There were some small net revisions to the data for August and September that left September IP down 0.1 percent instead of the 0.3 percent decline that was published previously. And the October increase in industrial production was 0.7 percent. In manufacturing we had a 0.1 percent increase in September, also an upward revision, and 0.6 percent in October. I think these numbers are significantly above market expectations, so perhaps those of you with electronic gadgets can see whether there has been any market reaction.

CHAIRMAN GREENSPAN. I just looked and the tape is delayed.

MR. PRELL. I'm not sure whether that's good news or not.

VICE CHAIRMAN MCDONOUGH. The reaction is delayed?

CHAIRMAN GREENSPAN. This gadget is very slow. [Laughter] Let's turn now to Karen Johnson.

MS. JOHNSON. The news about the global economy that we have received over the intermeeting period has generally been quite favorable. The signs of strengthening activity, particularly in Asia, that we saw earlier in the year continue to be confirmed, and positive developments in real output growth now appear to be widespread across other regions of the globe as well, including importantly the other industrial countries. Taking into account what production data we have so far for the third quarter, along with indicators for the remainder of the year such as orders figures and confidence measures, we have revised up our estimate for total output growth in the rest of the world during the second half of this year from about 3¼ percent in September to 4 percent in the current Greenbook.

In updating our forecast, we had to wrestle with the implications for 2000 and 2001 of these signs of more robust activity abroad. Embedded in them likely is some boost from transitory precautionary demands reflecting Y2K concerns on the part of households and firms abroad. Present also, at least for some countries, is the spurt of activity that can come in the initial phase of a cyclical rebound as a result of swings in inventories, the release of pent-up demand, and the stimulus of favorable financial conditions. Some moderation from the initially very high growth rates is normal under these circumstances. More fundamentally, some of the robust indicators we are now seeing no doubt signal strength in underlying demand. Moreover, to the extent that confidence is bolstered by the current strong growth, demand may expand further in the future.

We have balanced these factors by revising up the near-term level of foreign output to reflect the positive indicators of the past several weeks, but we are projecting only very slightly higher growth than in the previous Greenbook on average over the remainder of the forecast period. As a consequence, the level of foreign activity is higher throughout this forecast than in September. The near-term upward adjustments are spread throughout the industrial and developing countries in the forecast. The small upward changes we have made to growth in 2000 and 2001 are notably in China and Mexico among the developing countries and in Japan and Canada among the industrial countries.

With the dollar still projected to depreciate somewhat in real terms over the forecast period, we are looking for a rebound in the growth of real exports of goods and services from the low rates experienced in 1998 and the first half of this year. The upward revision we have made to projected foreign activity implies a rebound in exports that is just a touch stronger than what we expected in September.

There is clearly a risk that these recent indicators of strength are not the result of transitory or cyclical factors. In that case, we are probably being too cautious in not extrapolating more of the recent good news from abroad into our forecast for foreign activity and for U.S. export growth over the next two years. To get a handle on the magnitude of the effect of a possible miss on our part, we included in the Greenbook a simulation of the implication for U.S. real GDP growth of expansion abroad that is 1 percentage point stronger at an annual rate, sustained over the coming eight quarters, than what we have in the baseline. Such an extremely buoyant outlook for foreign activity would raise projected U.S. real GDP growth by about  $\frac{1}{4}$  percentage point in 2000 and  $\frac{3}{4}$  percentage point in 2001. At the same time, it would raise the rate of U.S. core inflation by nearly  $\frac{1}{2}$  percentage point in 2001.

Of course, even the cautiously optimistic outcome in the Greenbook baseline forecast is not assured. Considerable uncertainty remains in the foreign outlook. Among the most important unfavorable risk elements are: renewed weakness in Japan, perhaps as a consequence of withdrawal of fiscal stimulus; a premature end

to the expansion in the euro area should tightening by the ECB prove excessive and/or confidence falter; and additional upward pressure on world oil prices from further OPEC production restraint or severe winter weather.

Alternatively, the risk of a greater downward move in the value of the dollar than we are projecting, either by itself or in conjunction with pressures on other U.S. asset prices, cannot be ruled out. Such an exchange rate change would stimulate export demand more and result in additional upward pressure on import prices.

MR. PRELL. I think it's pretty clear that, even gauged with our re-calibrated GDP thermometer, the economy has continued to run hot in recent months. The bigger issue right now would seem to be whether its temperature has reached the inflationary flash point. The recent indications have been mixed on that score, but as you know, we aren't very optimistic. We see underlying price trends moving in an inflationary direction, even as demand growth slows a bit from the recent pace.

In that regard, we noted in the Greenbook that there have been some signs of moderation in the expansion of household spending since midyear. However, the news received in recent days has taken a bit of the edge off those signs. Friday's report on October retail sales showed a 0.4 percent gain at the so-called "control" category of stores. That isn't an especially large gain, but it's more than the chain store figures and anecdotal news had led us to expect. And what makes the surprise still more disquieting is the fact that the early results of the Michigan SRC survey point to a considerable resurgence in sentiment this month.

Of course, PCE is not the only component of domestic spending for which ongoing moderation is less than assured. In the housing market, the rise in interest rates this year appears finally to have taken some of the wind out of builders' sails. However, with consumer confidence seemingly so strong and mortgage rates having slipped back some in recent weeks, we'll have to keep a close watch on the indicators of demand in this sector as well. As it is, continuing reports that short supplies of inputs have been delaying projects suggest that actual construction spending may hold up fairly well for a while.

On the business investment side, apart from our reading of the zig-zags in computer shipments as supporting our notion of a near-term Y2K lock-down effect, there are no compelling signs that the strong uptrend in spending on capital equipment is weakening. Meanwhile, yesterday's retail inventory figures left the overall stock picture for the third quarter about as we anticipated it--lean, and ripe for some greater buildup in the near term, perhaps even apart from any Y2K hedging.

The bottom line is that it's far from certain that we're on track for the substantial deceleration of domestic demand needed to offset the oncoming external impetus Karen described and thereby avoid a further escalation of labor

market pressures. As you know, in our forecast, we only get there with 50 basis points of funds rate tightening over the next year and, importantly, a plateau in share prices. The renewed exuberance of the stock market this month seems to underscore the upside risks to demand coming from that realm.

One might argue that such upside demand risks are of little concern because they in effect mirror an upside risk to aggregate supply in our forecast. As you know, looking at the patterns in the revised national income accounts, we've found grounds for upgrading the structural gains in labor productivity in the period ahead. It is, of course, possible that we didn't go far enough. It might even be asserted that the unanticipated strength of the stock market, especially with its focus in the tech sector, is an indication that we're still lagging beyond the reality of the information revolution. I'll admit to remaining more than a little skeptical that the market is providing an informed, rational assessment of the prospects in this regard. But, in any event, as we attempted to illustrate with a model simulation in the Greenbook, it would take a much greater improvement in productivity performance than we've allowed for to avert a deterioration in inflation trends.

Another way we might avoid that deterioration would be for 4 percent unemployment to prove sustainable without putting pressure on real wage increases. A look at some of the data we've received in recent weeks could easily tempt one toward that conclusion. Certainly, the third-quarter ECI and October average hourly earnings figures were benign. Even the rather large,  $4\frac{3}{4}$  percent annual rate, rise in nonfarm compensation per hour in the third quarter did not interrupt the broader deceleration since last year. But these observations don't provide much comfort with respect to the outlook if one buys our explanation for the slowing in nominal wage increases--namely, last year's particularly low price inflation, since reversed.

Moreover, anecdotal indications of wage behavior have been less than propitious. While the picture is far from uniform, what I hear is that coping with a tight supply of qualified workers has become a preoccupation for many managers; that short-staffing is creating strains, with excessive pressure on workers and sometimes quality problems as a consequence; and that more employers are concluding that they will have to break down and raise wages by more or on a broader front. Of course, these stories aren't entirely new, and my perception that they've become more common and intense may be colored by my analytical priors. So you'll certainly want to check them against your own impressions.

Switching gears, however, and looking directly at prices for the signs of mounting inflationary pressure, the data again are mixed. Awkwardly, the October CPI isn't coming out until tomorrow. Like private analysts, we're expecting that both the total and core indexes will post increases on the order of a quarter percent--something that would not alter significantly the recent trends in

either measure. One question is which measure to regard as most informative about the prospective trends, and I'll repeat the thought I conveyed at the last meeting that we should not focus entirely on the more subdued core index. People and firms do buy energy products, and the rise in oil prices this year is likely to leave its mark on wages and core prices going forward. In this regard, the spurt in crude prices in the past few days is scarcely good news.

But there are other indications as well that inflationary forces may be intensifying. The prices of non-oil imports have continued to rise, and this probably has contributed to the further noticeable increase in the core crude and intermediate PPIs. Manufacturers of final goods and retailers still complain that they lack pricing leverage, but these developments in the pipeline would seem to heighten the likelihood of at least some up-drift in inflation.

Broadening the perspective a bit, I might say a few words about inflation in assets--a popular theme in some circles these days. I won't return to the matter of the stock market; nor will I talk about what has been happening in the rarified world of the art auction houses. Rather, I'll focus on the houses we live in. The latest numbers for house prices--the Freddie Mac repeat sales index and the Census constant quality new home index--show accelerated increases of about 6 percent over the past year. It isn't at all obvious that this is a reflection of increased inflation expectations; indeed, judging by the responses to the Michigan SRC survey, people haven't been buying because they view homes as an especially good investment. In the main, I think we're simply seeing the kind of relative price movement that occurs in a market where demand, driven by strong gains in jobs, income, and stock market wealth, is pressing on what is an inelastic short-run supply of land, labor, and materials.

But, even if these price increases don't reflect heightened inflationary expectations per se, they're not irrelevant to the outlook. It is likely that the higher house prices will show through at some point in the CPI through higher owners' equivalent rents. And the price increases can themselves contribute to an inflationary psychology. Certainly, rising prices on reproducible assets like houses tend to spur more investment activity in the future and add to the general strength of demand--as may the increases in wealth enjoyed by the owners of the assets. As I've noted, this is not an economy in need of more positive wealth effects on demand.

This brings me to a final observation. There has also been a lot of discussion recently about the internal and external saving imbalances in the economy. The NIPA revisions shuffled things around a bit, but the basic contours remain the same: The personal saving rate has plummeted in this decade; the private saving-investment balance has swung sharply into the negative, the counterpart being a considerable run-up in business and household debt that might someday prove burdensome; and we've opened up a big current account deficit, mirrored in a rapid growth of external liabilities that might weigh on the dollar.

These patterns reflect a complex set of forces, one that I fear is beyond the state of the art to sort out. But it seems likely that part of the story is the “crowding in” of private investment by the shift in the federal budget, some of which has been structural. Another element undoubtedly is the recent slump in emerging market economies and the attraction of the United States and U.S. dollar assets as a safe haven. Probably the central question for you is to what extent these so-called “imbalances” are reflective of an unsustainable cyclical boom fostered by excessive financial ease.

This, of course, just brings us back to the same fundamental issues I was discussing earlier. In essence, the ex post saving-investment balances don’t seem to add much to the picture; they simply provide a different vantage point on the matter before you.

CHAIRMAN GREENSPAN. Questions?

MR. JORDAN. Mike, you mentioned oil prices spiking. When I was reading the Greenbook, I was struck by the fact that in the very week in which oil prices were spiking, you were writing down a forecast that has the price going back down by \$5 a barrel, 25 percent or so. Oil prices are among the many things that I have absolutely no confidence in my ability to predict, so I will go with your forecast. But I am curious about how sensitive your inflation outlook is to that, because there are a lot of volatile personalities who still have powerful positions in places in the world that produce oil. So, who can predict what will happen? Suppose we just draw a straight line and assume that for the next two years, the forecast horizon, oil prices remain the same as they are today. What would be the implications of that?

MR. PRELL. That is a good question and one to which I do not have a precise answer. We do not anticipate a plummeting in oil prices; we have a gradual decline over the two years. The level clearly has moved up since we established our assumption; oil prices rose after the Greenbook was published. There is still a downward tilt in the futures markets, though maybe not quite as sharp as there had been earlier. The futures price is still pretty high for the next several months. But if the prices were to remain where they are now, it would add at least a little to the core inflation rate, particularly in 2001. I do not think it would create a night-and-day difference in the inflation outlook.

MR. STOCKTON. President Jordan, based on our model, \$5 a barrel more on oil prices over the forecast horizon would add roughly  $\frac{1}{4}$  percentage point to consumer price inflation in the next two years.

CHAIRMAN GREENSPAN. Other questions?

MR. PARRY. Karen, you made the point that economic prospects in the United States are certainly affected by the improved situation in foreign countries. I wonder if you would comment briefly about how your views have changed on Japan. It seems to me that the situation there still looks quite troubling in the sense that the Greenbook projects deflation to continue through 2000 and really through 2001 since prices are flat in 2001. The fiscal stimulus program they are proposing is very large and it suggests that they have significant concerns about real growth prospects in the future. I just wonder how your views have changed about Japan, which is certainly an important ingredient to the foreign GDP prospects.

MS. JOHNSON. I think we have done two things. We have recognized the fact that we were wrong about the second half of this year. In fact, everybody was wrong; even the Japanese are continuously surprised by the strength in the numbers they are producing. Secondly, we have widened enormously--although it is obviously not written down anywhere in the Greenbook--the confidence intervals that we are putting around our forecast for 2000 and 2001.

If there is a locus of uncertainty anywhere, it is centered on Japan, at least in my mind. On the one hand, we are getting stronger indicators, at least to some degree, regarding what is happening now. Although we have not seen a private investment response, we were certainly surprised by the private consumption numbers we saw. Strength in the rest of Asia has helped Japan as well, and the combination has produced GDP numbers that are much larger than we were expecting. Earlier this year we had expected a negative offset to the very strong first quarter; we did not get that. We now are expecting a fairly substantial positive number for the third quarter. Yet one does not get the sense that domestic demand has become self-sustaining in Japan. Officials from the Bank of Japan in the statements they have made recently talk about having seen the trough and having seen a pickup. Yet they talk about demand perhaps not yet being sustained and say that for that reason they are prepared to keep the zero interest rate policy in place.

So, we are looking at their fiscal policy and at what is happening in the rest of the world. The announcement of the 18 trillion yen package probably had a smaller share of "real water" spending than these packages have had in the past. We often use a rule of thumb of one-half as the estimate of real spending in the fiscal programs that are announced by Japanese



officials, and we think this one does not come up even to that. Common assessments are more like 6 or 7 trillion, which is a number on the order of one-third as opposed to one-half of "real water" spending. But even that amount would not produce the forecast that we have written down. So, embedded in our GDP forecast for calendar year 2000 is the assumption that when they decide on the budget they will put in about another  $\frac{1}{4}$  percentage point of stimulus through the fiscal channel. That is not a certainty. No doubt the medium-term concerns about the size of the outstanding debt and even short-term concerns about financing problems--as they have been struggling with the issue of who is going to buy the Japanese government bonds and so forth--might lead them to take a less aggressive fiscal posture. And that would reduce their growth to less than we have forecast. Even so, I think we have a very cautious forecast--one that suggests still a lot of problems in the Japanese economy and growth that is going to remain very low.

There are other forecasters around the world who see the acceleration of Japanese activity proceeding, as opposed to falling back the way we do. I think the basic answer is the one I gave you. There are upside risks and downside risks. The confidence interval around any forecast on Japan has to be far wider right now than would ordinarily be the case.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mike, I was interested in both the Greenbook discussion and your own comments about your reevaluation of the degree of structural versus cyclical change in productivity. It certainly has an implication for the potential rate of growth of GDP. I am wondering whether the decrease that we have seen in the unemployment rate since the beginning of the year, which has been about 0.4 or 0.5 of a point over the first ten months--. Wasn't it somewhere around 4.6 percent at the end of last year?

MR. PRELL. This is not going to materially affect the additional--

MS. MINEHAN. No, but we have seen a decline of several tenths in the unemployment rate over the year.

MR. PRELL. Yes.

MS. MINEHAN. How does one reconcile that with the idea of an increasing level of potential in the economy?

MR. PRELL. I think if potential had been as low as we previously had been gauging it--this gets a little confusing because we have changed the books here--one might have

wondered why the unemployment rate had not fallen more. So I think this does fit. And indeed we have reestimated our Okun's Law relationship and feel reasonably comfortable with the conformity of our assumptions with what has occurred in terms of the movement in the unemployment rate.

MS. MINEHAN. So you feel that makes it more understandable rather than less understandable?

MR. PRELL. Yes. It wasn't a really big problem, but it does seem to be compatible with our assumptions. Indeed, it is even compatible with Okun's Law relationships that are estimated from the income side of the national accounts. There doesn't seem to be a great mystery in that respect. The little uptick in labor force participation rates we have had recently is a bit of a comfort in terms of our understanding of the basic dynamics in the labor market. We don't feel too uncomfortable with things in that regard.

CHAIRMAN GREENSPAN. Potential is rising largely because of productivity.

MS. MINEHAN. Right.

CHAIRMAN GREENSPAN. It is not a labor force phenomenon.

MS. MINEHAN. No, I realize that.

CHAIRMAN GREENSPAN. Further questions for our colleagues? I want you to understand that this is a record low number of questions! The Vice Chair predicts that you will catch up later. Who would like to start the Committee discussion? President Jordan.

MR. JORDAN. Thanks. The general sense of both business and labor contacts in the District is that the boom continues and that it will be even stronger next year. I have been expecting our region of the country to be among the first to show signs of flattening out. And I still think that's a reasonable expectation, given the composition of the regional economy; at some point, for example, the slowing of auto sales in the last couple of months should lead to production adjustments. But it still basically looks and feels like a supply-constrained economy. Business people complain that they could be doing more if only there were more warm bodies around that they could put into positions of all types. The idea of caution is almost totally absent from the discussions we have with bankers and other business people. In the last two meetings of both the Community Bank and the Business Advisory Councils we have asked the participants to discuss the conditions under which they would think about the possibility of a recession on the horizon. And they just dismiss it as utterly implausible and not a fruitful thing to spend time

thinking and talking about. We tried to press the idea, especially on the bankers, that there is a downside risk. And some do admit that they know of deals that others are doing that they have walked away from, suggesting perhaps an element of caution someplace--but not among their competitors at least. I find that very troubling.

It may work out that as the domestic absorption of goods produced in our region of the country levels out, some international demand will pick up and that will keep the level of activity in our area more or less even. But I still think the most likely scenario is that we are going to get back to what in the 1980s some of us called the soufflé economy--one that is rather soft in the middle and firm around the edges. Activity up and down the West Coast and the East Coast may stay hotter longer. And if we see some weakness in our area, that will make it difficult for those of us in the middle part of the country to have a proper perspective on the appropriate national, let alone international, monetary policy.

As a note on one of Karen's comments about Japan, one of our contacts from an industrial company just returned from Japan and said he detected a dramatic change, in a positive direction, in the mood he encountered there. His firm had a large pickup in orders for roller bearings for industrial inputs.

All sectors of the labor market continue to be very strong. One of our construction contacts said that their union views the auto company contracts as a problem because they commit the auto companies to hire apprentices, which is going to draw on the pool of workers that otherwise would have been considered available for construction work. So, there is some sort of rivalry there. Honda motor company announced that they will not build a major plant in Ohio after all. Until now all of their production has been in Ohio. They said there is an inadequate pool of labor in Ohio, so they are going to build in Alabama instead, right next to where Boeing is building an enormous operation. So we'll see how they sort out the workers down there. We hear more stories of fast food restaurants going to a drive-through only operation and suspending their eat-in service because of labor problems. We are told that contractors in the region are hoping to avoid the usual winter curtailment of activity because they are concerned that if they were to shut down for the usual two or three months the workers simply would not return in the spring. One report from a construction union in Ohio now estimates that there are 25,000 Latino construction workers in the state alone and that at least 50

percent of them are illegal. And the complaints about higher health care costs occur without exceptions, really.

Retail trade overall is reported to be strong, although the Bob Evans restaurant chain said that they have experienced a sharp slowing in traffic recently. They relate it to substantial increases in their menu prices that they felt they had to put through because of higher wages, higher health care costs, higher transportation costs, and unfilled vacancies in their restaurants. They boosted menu prices and people stopped coming; so their earnings fell and their stock price fell. In manufacturing, one director said his firm is in the early stages of getting some price relief in major industries. He thought that was a good thing. He said industrial companies have been put through an earnings squeeze in the past year or two and are now going to find it easier to improve profit margins.

In conversations with directors as well as advisory council members and others, the suggestion that inflation over the next year or two might remain the same as it has been over the last year or two is simply not credible. The expectation that inflation is moving up just does not have any dissenters. And a surprising number think that that's not a bad thing. If I say to people that a reasonable forecast for the consumer price index for the next year might be that it will rise a percentage point or so faster than in the last twelve months or so, there is almost no reaction to that.

A frustration has been that some bankers--and maybe a few others, but it is particularly worrisome about bankers--think an increase in the federal funds rate will have an adverse effect on interest-sensitive industries such as housing and autos. It's a sort of interest rate push idea that a rise in the overnight interbank rate pushes up all interest rates and, therefore, will hurt real economic activity which they care about. If you say to them that if it turns out later that the funds rate was artificially held down and inflation accelerates and that is what really hurts housing and autos and other interest-sensitive sectors--because intermediate- and long-term interest rates will rise more because of inflation premiums--it falls on deaf ears. It is simply not a story that resonates well at all. I think our biggest problem, if it is necessary to tighten in order to contain rising inflationary pressures, is how we explain the rationale behind such an action and find people who support it and applaud it.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. Not a lot has changed in New England since our last meeting. Growth continues to be vibrant. Labor markets are very tight, and both published data and anecdotal evidence point to increasing cost pressures, especially as they regard health insurance premiums and rising materials costs. New England's unemployment rate fell slightly in September to 2.9 percent, equaling the series low since data began to be collected on a regional basis in 1969 and attained only once before in April 1988. Wage increases have accelerated this year, at least in manufacturing, by more than a percentage point over 1998. Moreover, the range of average prospective wage increases cited by Beigebook contacts rose as well, with the upper end now in the 6 percent rather than the 5 percent area. Even in the absence of wage acceleration, employers see compensation costs rising via significant increases in health benefits costs. Half the manufacturers contacted mentioned very substantial increases in health insurance premiums. In addition, while retailers reported vendor and selling prices as steady, manufacturing contacts reported rising materials costs. The most commonly mentioned price increases were for fuels, plastics, petrochemicals, copper, aluminum, paper, and cardboard.

Real estate markets remain relatively strong as well. While construction of new homes has hit a bit of a lull, sales of existing homes remain solid and above year-ago levels. Home prices are a clear sign of market strength. The price of a typical home in New England rose by nearly 8 percent versus 5 or 6 percent for the nation; home prices rose 9 percent in Massachusetts and about 16 percent in the Boston metropolitan area. Office markets continue to be strong as well, with Class A space in Boston continuing to be the most expensive in the nation.

Turning to the national outlook, both current data and prospects for the near term continue to defy expectations of a slowdown of any magnitude. To be sure, housing and durable goods sales were a bit slower, as were auto sales, but interest rates have backed off a bit, the stock market remains positive, and consumer confidence is high. We now also seem to have evidence more firmly in hand to explain the economy's current ability to grow without undue strain. With the revisions in GDP data, we are now looking back at higher rates of real growth, higher productivity, and a higher level of potential GDP. This is great stuff, but it is backward looking. One can hope the future will look like the recent past, but it may be wise to be a bit skeptical about whether it will.

I find the Greenbook forecast to be very interesting, and I think Mike seemed to indicate that he does as well, because in many ways it's pessimistic. To be sure, it assumes that productivity is higher not only because of the revisions but also because of a larger share that is thought to be more structural than cyclical. It also assumes that potential is correspondingly higher, that monetary policy tightens by 50 basis points over the next year or so, and that the long awaited moderation in consumer demand and stock price growth actually take place. And even with all that, core inflation ticks up nearly  $\frac{1}{2}$  point from 1999 to 2000 and a bit more in 2001. It would seem that a rise in prices is baked in the cake, even if all of these moderating influences actually occur. But will they occur? To me the answer to that question revolves importantly around whether or not one believes productivity growth can continue to accelerate, not just as a reflection of output growth but as a reflection of a higher trend rate.

I've thought a lot about productivity since our last meeting; it would have been hard not to. On the one hand, as I look around my District, it seems obvious that tight labor markets are bringing entry level workers and others whose skills are marginal into the workforce. This is a good thing for them and for society as a whole, since obviously work provides the best opportunity for them to improve their chances in life. But they are not exactly enhancing the firms' productivity, at least in the short run. On the other hand, I see wages being linked to profits more tightly than ever; and even very large companies are continuing to be very cost conscious. My 17-year old son, whom I have mentioned in the past, recently graduated from selling CDs at Circuit City for \$9 plus an hour to selling small electronics. After a two-week training program, he is now totally on commission--no base salary at all unless he fails to make the minimum wage, in which case he will likely be back selling CDs. The company has a real time system that lets him know at any moment during the day how much he has earned so far that day or how much in the hole he might be because a customer has returned an item he sold. Believe me, he has become very focused on closing a sale! He knows what he makes from every single product. He may not know the exact price, but he knows his commission, and he is very focused on selling the right thing to the right customer.

I also attended a conference at IBM at which Lou Guerstner talked for two hours or so about the restructuring of IBM's internal business processes using web technology, taking \$6 billion or so off a \$50 billion procurement budget, for example. Productivity increases are real. They are embedded in how people are paid and how businesses work. That seems undebatable.

I think what is debatable is how long rising productivity growth will continue to provide the needed buffer between all the resource pressures in the economy and higher and potentially rising rates of inflation.

In that regard, it would seem that there is an increasing degree of resource pressure. Labor markets show no sign of easing. Rising overall costs should cause employees to seek higher wage increases, and rising profits should lift bonuses, which fell off earlier this year. Benefits costs are rising, especially for medical insurance. Export growth is strengthening as foreign growth takes off, and the dollar is more likely to depreciate than not. That is a long-winded way of pointing out that all of the risks to the forecast seem to me even more firmly planted on the upside than they were at the last meeting. Accelerating rates of productivity growth may have provided breathing room, and who knows whether they will last. But in my view anyway, the direction if not the timing of the next needed move in monetary policy is less uncertain than ever. Thank you.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Economic activity in the Eleventh District advanced at a healthy rate in the third quarter, and employment growth continued to run at rates about twice the national average. In retrospect, it appears that the District was more adversely affected by the Asian crisis than we initially thought and we are now benefiting from the rebound. For example, exports are posting solid gains, the oil business is up, the chemical industry had an excellent third quarter, and District high-tech companies continue to do well. At least one chemical producer is expecting the best quarter in his company's history due to the rebound in Asian demand.

The construction sector, which played an important role in sustaining employment growth for the first half of the year, has softened somewhat in recent months, in line with national trends. The single-family segment has softened. Houston homebuilders are reporting that they are beginning to catch up on past backlogs and that materials shortages are disappearing. Infrastructure projects, such as new sports stadiums in Dallas and Houston and expansion at Houston's airports and the port, are helping to sustain the construction sector in the face of a weakening in the housing component.

The oil and gas sector also is recovering but cautiously. Many producers remain uncertain about how committed OPEC is to the round of production cuts announced earlier this year and are unwilling to make big bets that the recent increases in oil prices will stick. Thus,

most of the increase in U.S. drilling activity since April has been directed to natural gas. Also, recent merger activity has immobilized some of the larger players. And if you would like a pun, one might say that Mobil has immobilized since they reorganized. All of the increase in recent activity is concentrated among the independents, although many of them are finding themselves financially constrained for having violated bank loan covenants during the period of low oil prices.

On Mexico, there is little new to report on the macro front. GDP growth remains strong along with the peso. The main developments since the last FOMC meeting center on issues regarding the taxation of the maquiladoras and the possibility of tighter restrictions on cross-border movements of people and vehicles.

Turning to national conditions, it is clear despite the broad-based--and likely to be upwardly revised--expansion of GDP in the third quarter that economic growth is slowing somewhat. The residential construction sector has clearly peaked and consumer spending has been decelerating over the course of the year. There are some signs that manufacturing slowed as we moved from the third quarter into the fourth. However, the pickup in global activity will provide a boost to growth as we move forward.

On the inflation front, most of the deterioration in recent months has been in energy prices or other transitory phenomena such as the spike in cigarette prices and possibly distorted seasonals in auto prices. When stripped of the food and energy categories, our broadest measures of inflation, the deflators for personal consumption expenditures and gross domestic purchases, have been stable in the 1 to 1½ percent range all of this year. We do not expect significant acceleration any time soon. I believe there are a number of reasons for optimism about the inflation outlook. While labor markets remain tight, or if anything have gotten tighter, we still don't see a significant acceleration in wage pressures. The evidence that there has been an increase in productivity growth is stronger now than it was early this summer. The pickup in productivity growth can account for a lot of the favorable developments we have seen at the national level recently, and to me there is no reason to believe that it will be reversed any time soon. Finally, other leading indicators of inflation such as commodity prices are giving mixed signals at best. Having said that, it must be acknowledged that a number of the inflation indicators are flashing red and warrant close monitoring. I am thinking in particular of the September PPI numbers, including the core rate.



We've seen recent movements in the supplier deliveries and prices paid components of the National Association of Purchasing Managers' report on manufacturing, both of which have exceeded 50 percent for six consecutive months. The crude goods and intermediate goods PPI indexes, ex-food and energy, have accelerated steadily over the course of the year and we've seen a recent acceleration in non-oil import prices. However, on closer examination some of these trends are less disturbing than they appear. While non-oil import prices have posted increases in recent months, the fact remains that they are still down from where they were this time last year. Secondly, despite the recent adverse trends, the core crude and intermediate goods components of the PPI seem to have stabilized somewhat, looking at the 3-month moving average of the annualized monthly changes, which leaves only the Purchasing Managers' report as a real source of concern. While these indicators suggest the need for continued vigilance, in the absence of corroborating evidence of accelerating inflation these data in and of themselves do not constitute a clear and present danger.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the Twelfth District economic expansion continues to outpace the average for the rest of the nation. During the third quarter, employment grew at a 2.4 percent rate, exactly equal to the pace during the first half of the year. However, growth in most of our states, including California, has been slower this year than it was in 1998, so that the District growth rate has been edging down toward the national average. Other than Alaska and Hawaii, District states remain strong, though I would point out that tourist spending is producing even a further pickup in Nevada this year. California has been expanding a bit more rapidly than the remainder of the District, and the state unemployment rate has fallen just over a percentage point since the end of last year to 4.8 percent in October. The short-run outlook for the District expansion remains quite favorable. Housing market activity has been vigorous, although the increases this year mostly have been in fast-growing southern California. Growth has been somewhat slower elsewhere and residential construction activity has been flat or down in several urban areas. Slower appreciation in sales prices for existing homes is evident in some areas as well.

On the upside, we are seeing renewed demand for District electronic products. Following three lean years, prices and sales of key semiconductor products have picked up this

year, and in California electronics manufacturers have gained back many of the jobs lost during 1998.

Turning to the national economy, labor markets certainly have tightened a bit further since we last met. The rapid real GDP growth in the third quarter led to a further slight decline in the unemployment rate, and our forecast for real GDP growth of about 3½ percent next year is, of course, very similar to that of the Greenbook. This suggests that labor market pressures are unlikely to abate any time soon. But while labor costs may well pick up in the future, these costs do not appear to have been particularly burdensome to businesses in the recent past. Despite apparently tight labor markets the ECI has risen only 3.1 percent over the past year. And while compensation per hour has risen much faster, unit labor cost increases receded last quarter due to strong productivity growth. Moreover, rapid real GDP growth and low price inflation in the third quarter, together with what appears to be a pickup in profits, also suggest that aggregate supply has continued to expand at a robust pace. This provides room for at least guarded optimism about inflation.

After balancing these signals, we come out with a slight upward trend for the core CPI. Our forecast shows a rise from 2.1 percent this year to 2.3 and 2.4 percent respectively in the next two years. Even such a slight upward trend in future price inflation is a concern. As we know, however, such an upswing has looked likely for several years but has not materialized. In deciding on policy, we will be faced again with whether to put more weight on forecasts of problems ahead or on past results that have been quite favorable. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. The Seventh District economy continues to be quite healthy, but reports from our directors and other business contacts suggest that activity is moderating somewhat in a number of sectors. At the same time, we are also getting more frequent reports of increasing wages as a result of still very tight labor markets. We have seen some slowing in housing activity, but that sector seems to be holding up better than elsewhere in the nation. Many of our retailers indicate that sales have been running below expectations recently, but they generally remain quite optimistic about the upcoming holiday sales season.

Nationally, sales of autos and light trucks have come down from the stratospheric levels reported for the third quarter. Of course, the 16½ million light vehicles sold in October

still represents a very high sales level. Indeed, that base is 1 million above total sales for all of last year, which the industry considered a very good year. In fact, some of the automakers and suppliers we have talked to welcome some moderation in activity. Some suppliers tell us that they are actually losing money on incremental business when activity is as high as it has been because of their high marginal input costs.

Some potential slowing is also apparent in the heavy truck industry where the backlog has been whittled down from 9 months to just over 7 months, but that is still higher than the historical norm. One of our former directors noted that shortages of truck drivers have led his firm to cut back in ordering new trucks. Reports also indicate some slowing in cement, paper, and printing, although business is still considered to be good in these industries. In contrast, the medium-duty truck industry shows no signs of slowing, our steel industry continues to improve, and gypsum wallboard shipments are still up sharply from a year ago.

The District's farm economy, however, continues to struggle as a result of abundant supplies and low commodity prices. On the other hand, one large farm equipment manufacturer that I was talking to surprised me by saying that they plan to boost production next year and rehire workers they laid off even though demand for the firm's products is going to remain weak. The reason is that the firm significantly reduced dealer inventories this year. They took a lot of products out of the pipeline and they are going to have to restock next year.

Our labor markets are still very, very tight. However, the latest Manpower survey of hiring intentions indicates that most industries will continue extensive recruiting efforts into next year's first quarter--more of the same. This report, of course, should be considered confidential until it is publicly released next Monday, the 22<sup>nd</sup>. So far actual price increases continue to be subdued. However, our latest survey of Michigan retailers indicates that they plan to raise prices over the next three months and most purchasing managers around the District continue to report paying higher prices for their inputs.

Y2K, of course, remains a big question mark in the near-term outlook. We have checked with a wide variety of businesses, and the general sense we get is that companies feel they are prepared, although concerns remain about the readiness of firms abroad. We made a special effort to contact convention and tourism bureaus in our major metropolitan areas, and they said that they had not heard of any adverse impact on business plans for early next year. In fact, they were all pretty optimistic that Y2K would actually boost business for them.

Turning to the national economy, the Board's staff has raised its forecast of output growth in the next few quarters, as Mike mentioned, but it has raised its estimate of trend growth even more. Thus in the Greenbook scenario, growth slows to below potential, easing some of the pressures in the labor market. Even so, core CPI inflation accelerates markedly by 2001 to a level that on a methodologically consistent basis would be the worst since 1995. We, too, have raised our estimates of productivity growth and potential output, although not to the extent of the Board's staff. But we don't see actual growth falling below these higher levels of potential over the forecast period. Certainly the higher long-term interest rates that have already impacted the housing market should act as restraint, but business and consumer confidence remains quite high, and the stock market, of course, has recovered most of its recent losses. More importantly, in contrast to the last few years, with improved conditions abroad we expect much less drag from the external sector, similar to the Greenbook. Thus we see growth slowing only to about its new trend and only after labor market conditions have become slightly tighter. Not surprisingly, we are even more pessimistic than the Greenbook about inflation. Hard evidence like consumer price pressures outside the energy sector is still scarce, but the continued increases in the PPI are worrisome.

Thus, I think we need to be especially careful not to sacrifice the progress toward price stability that has been a cornerstone of this expansion. The low inflation environment is clearly responsible for some of the faster productivity growth that we have experienced, and we all want to maintain that momentum.

CHAIRMAN GREENSPAN. President Broadus

MR. BROADDUS. Thank you, Mr. Chairman. In our District, activity continues to grow at a solid pace overall, maybe even a bit more than solid. Sales in our region seem to have accelerated in October and those strong sales appear to be continuing in November. Generally retailers in our region are fairly optimistic about prospects for the holiday season. Activity elsewhere in the service sector is less buoyant, particularly in the real estate industry. Manufacturing activity remains on a rather significant upswing. The exceptions, as I have mentioned before in these meetings, are textile and apparel manufacturing in the Carolinas. A lot of those companies are moving their operations to Mexico.

Like everybody else who has commented, what can I say except that labor markets are still very tight? But I would underline Mike Prell's comment that stories about pressures in labor

markets seem to have become more common and intense. We are hearing not only the usual tight labor market anecdotal comments, but they are more frequent and they are much more emphatic on the part of employers than earlier. Also, over the last several weeks I have heard a number of employers talk, again emphatically, about very sizable wage increases. I attended the annual meeting of the Virginia Governor's Revenue Forecasting Committee yesterday, which includes a number of CEOs of large companies. At that meeting they have a business conditions go-around, and I would say that at least a third and maybe half of the participants mentioned recent increases in wages, which in some cases were sizable. One person talked about 10 to 15 percent increases for skilled workers. Firms are doing this in order to attract and to retain people. Often the wage increases are for skilled workers, but others are involved as well.

With respect to prices, we still don't see any general increase in the price level in our area, but underlying pressures may be building. Intermediate prices appear to be rising broadly in the industrial sector according to many of our contacts. We hear the same kinds of comments a lot of others have already mentioned about rising health care costs. One of our Richmond directors who runs a hospital in Charlottesville referred to HMO costs as "exploding" and said it was clear that those costs would have to be passed on. That is the District situation.

With respect to the national economy, I have read a lot of Greenbook forecasts over the years and, naturally, have found some more persuasive than others. But I found this month's projections and the reasoning behind them very persuasive. The bottom line as I read it--and I think it's the way Cathy Minehan read it--is this: While recent increases in long-term interest rates and a less buoyant stock market may slow the growth in aggregate demand to some extent in the period immediately ahead, we probably are already somewhat behind the inflation curve. And that is likely to become more apparent as time passes. Beyond this, the overall tone of the Greenbook--and also I think much of the recent economic data if one looks at them carefully--suggests to me that the risk of error in this even quite strong forecast remains on the upside. We hear some comments about signs of softening in the economy. That sounds to me a little like saying that Mark McGuire had a softer season this year than last year. Overall spending growth is currently still very strong despite the recent leveling off in home sales. The big jump in hours worked in October suggests to me that real GDP growth in the current quarter could well exceed the 4 percent Greenbook projection. And there is a possibility, as Karen Johnson mentioned, of a greater-than-expected depreciation of the dollar. In general, I think these upside risks compound

the prospective deterioration in the inflation outlook that is already built into the Greenbook forecast.

Let me make just a couple of other quick points. First, I think the Greenbook is quite correct in suggesting that the moderation in wage increases we have seen over the last two or three months may well reflect the drop in inflation last year. In fact, I think the record shows that wage-setting behavior in the last few years has generally responded to recent movements in prices. With both overall and core inflation accelerating lately, I think we can expect to see faster wage growth next year. And in my view that is consistent with the anecdotal information mentioned by me and by a number of others earlier.

Second and finally, I was pleased to see the explicit recognition in the Greenbook that faster trend productivity growth implies higher real interest rates. I think one of the principal policy questions we need to ask ourselves later in the meeting is whether the tightening actions we have taken to date are sufficient to allow the upward adjustment in real rates that is necessary to keep the economy in balance, given recent productivity developments. The alternative is that we may be holding rates below where they need to be to accomplish that objective, with all of the inflation risk that would imply. Thank you.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, the Tenth District also continues to do quite well; we have not seen a lot of change since our last meeting. On the basis of our surveys of District activity, there has been some slowing in the residential housing market from the earlier rapid pace and a bit of slowing in some areas of retail sales.

In the manufacturing sector, the picture is somewhat mixed. While domestic demand has slowed some, there has been a pronounced pickup in foreign demand in some of our manufacturing industries. For example, a foundry and some of the metals manufacturers in our District have seen a very strong pickup in foreign orders. Our energy sector continues to expand right now as they look at these favorable prices. We are primarily natural gas driven and, of course, weather has some impact. But even with some of the current mild weather patterns, our producers still see a good outlook as they judge their supplies.

Mike Moskow mentioned the weakness in the agricultural sector. We, too, have had very strong production this year, so prices remain low and that sector is very much dependent upon the continued strength in transfer payments. One of the secondary elements in our

agricultural and rural areas is that, frankly, there has been strong demand for autos and especially trucks as these transfer payments have been made. So, actually, cash incomes remain fairly good, and that has been reflected in a strong economy in some of those agricultural areas. Overall, though, economic activity in our District is extremely strong. Labor markets are tight everywhere. We hear constant discussions about the difficulties that firms are experiencing in their efforts to find workers to fill jobs.

Let me turn very briefly to the national outlook. We, too, see the growth in GDP to be at better than a 3½ percent pace, and we also are taking into account some of the improvements in productivity in that outlook. Looking forward, we see the foreign sector picking up and offsetting some of the deceleration on the domestic side. So as we look at these various elements, the preponderance of evidence suggests to us that the risk to the forecast is on the upside in terms of total demand within the U.S. economy.

Personally, I still think there is a good case for acting now, though we haven't quite come to that discussion, whether one looks at it as preemptive or as a reversal of the insurance policy we took out a year ago. We took that insurance in the face of a very strong real economy. Its effects are still working in the economy and I think that factor is aggravating the upward risk that I see. Thank you.

CHAIRMAN GREENSPAN. President Gynn.

MR. GYNN. Thank you, Mr. Chairman. Overall growth in the Southeastern region remains healthy, but with some unevenness across sectors. For example, manufacturing, which as I reported was a bit soft at the time of our last meeting, has bounced back, with current production and shipments higher and the outlook viewed as optimistic as well. Tourism, on the other hand, appears to have slowed, but a closer look reveals very large increases in capacity in hotel rooms and cruise ships, and thus the maintenance of past occupancy rates is difficult. Housing in our region continues to show some slowdown, mirroring the national reports, and that is being attributed to the rise in mortgage rates. Several large banks are reporting that their mortgage loan originations are off as much as 50 percent from six months ago. Other lenders tell us that the volume of refinancing is running less than 10 percent of the volume this time last year. Single-family new construction is flat and both nonresidential and multifamily construction has slowed somewhat.

By contrast our energy sector continues to reverse earlier declines in drilling, with the rig count up still another notch from a month ago. Lenders report that corporate loan demand continues at a high level but is moderating. Interestingly, our international examiners tell us that they are now seeing significant capital flight out of Venezuela and Colombia, and some from Ecuador. Some of that money is going into second homes in south Florida. And some Colombians have moved their families to Florida and are commuting to and from Colombia each week.

Our overall regional unemployment rate is below the national average, but the very tight labor market still has not yet resulted in widespread wage pressures. The most notable large price increases reported once again, as others have observed, are in health care.

This month we asked our directors to probe hard in three areas: for evidence of potential liquidity problems at financial institutions and among their customers over the coming year-end period, for signs of a Y2K-related pull back in investment activities, and for evidence of credit quality problems. At this point, there is just no grass roots evidence of Y2K-related liquidity problems, as everyone seems to have locked in their financing needs for the end of the year. Indeed, we often heard that many still are expecting to see a significant inflow of funds into the United States, particularly from Latin America, over the remainder of the year. As best we can judge, Y2K is just not a big deal for people we talk to in our region. Our directors tell us, and our bankers confirm, that credit quality generally seems to be improving. There are exceptions in the health care industry and agriculture, and we have reports of a few isolated problems at community banks.

On the national front, moderate inflation and further advances in employment, together with a recent upward revision in the GDP statistics, make the economy's performance even more remarkable when assessed against the historical record. We read the new data as suggesting at least a somewhat greater likelihood of continued strength in the consumer sector that will carry the expansion forward. The broader definition of personal savings suggests that consumer balance sheets are not as weak as some may have feared. Newly revised data on consumers' debt burdens suggest that consumers are carrying less debt relative to income than they did in the peak periods of the 1980s. Finally, bankruptcies appear to have leveled off. I think the fundamentals are still in place for strong growth.



Despite the good news and favorable data on the price front, I think there are still valid reasons to be concerned about the inflation outlook. My own staff's judgmental and VAR model forecasts are similar to those contained in the Greenbook. Our work suggests only a small probability that inflation will average below 2 percent in 2000 and a not insignificant probability that it could move to slightly more than 3 percent. On a percentage basis that would be a very large and worrisome deterioration.

In addition to the identified price pressure points that a number of people have referred to, I would note again that other than productivity many of the safety valves and mitigating factors that might have continued to cushion inflationary pressures have one-by-one turned against us. World economic growth is improving, exchange rates are responding to the U.S. trade deficit as expected, import prices are increasing, and energy and other commodity prices have reversed their moderating effects.

Our policy choices today seem to me to be quite similar to what they were at our last meeting. We still have a good window of opportunity to provide modest additional low-cost insurance that will improve our chances of locking in our good inflation performance and tempering inflationary expectations. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you. The District economy remains healthy. If anything, it has improved even further because a couple of the sectors that were lagging--namely, iron ore mining and oil exploration--have picked up recently, albeit in the case of oil exploration from a relatively low base. Otherwise, manufacturing is strong and construction activity is uniformly strong. Retail sales are robust and in general retailers are quite optimistic about the upcoming holiday season. Labor markets remain very tight. But interestingly--and I have no explanation for this--if you ask retailers about the availability of temporary part-time workers for the holiday season they say it's no problem finding them. How they are managing that I don't know, but that's the report.

The exception to all of this is the same old exception, which is agriculture. The principal problem there, of course, is commodity prices. There is no question that problems in agriculture per se have spilled over to the rural economy more generally if one looks at employment measures in the rural areas. Those people don't have any trouble finding jobs in the

cities, so they don't remain unemployed for long. But, of course, they do have the adjustment of moving or commuting from the farm to the city.

As far as the national economy is concerned, it seems to me that we are in a circumstance where substantial real growth is assured and the question is what inflation will accompany it. What can we say about inflationary prospects? The Greenbook has what I, at least, consider to be a major new look at productivity and comes out, I think, with a significantly more positive picture. And the Greenbook forecast now is in many respects a lot like our VAR forecast. One might think that the more favorable path of productivity, other things equal, would lead to a diminution of concerns about prospective inflation and inflationary pressures. But the Greenbook basically has the same old song as far as inflation is concerned. And I guess I have to say that I'm just not entirely persuaded. Our model has for some time been more sanguine about the inflation outlook and it remains that way. I think it's very clear that a lot is happening on the supply side of our economy, perhaps more than we know. If we calculate productivity from the income side rather than from the output side, we continue to come up with significantly more favorable numbers. So, if anything, my uncertainty about the inflationary outlook has increased rather than diminished at this point.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The economic growth in the Second District has moderated since our last report. Overall consumer price inflation has barely accelerated, though there are scattered reports of some rising prices--for example, in manufacturing inputs, housing, and hotel rooms. The unemployment rate continued to hover close to 5 percent in September, but private sector job growth slowed to a 1.1 percent annual rate, well below the 1.9 percent pace in the past 12 months. Retailers note that sales have been somewhat sluggish in recent weeks. They remain fairly optimistic, however, about the upcoming holiday season. But a number of retailers think that the pricing environment is shaping up to be more competitive than last year. Housing activity has moderated somewhat from a spring-summer boom, though markets remain quite tight. In the New York City metropolitan area a shortage of available homes has evidently crimped sales and spurred double-digit increases in both selling prices and in rents. Multifamily construction activity in the District remains brisk; single-family building has tapered off. Purchasing managers report some moderation in growth in October along with persistent price pressures. Banks report a decline in

loan demand, a noticeable tightening in credit standards, and continued improvement in delinquency rates. There is much virtue in the banking sector, if you believe all they tell you.

On the national outlook, we forecast growth at a 4 percent rate in the fourth quarter. We think growth will moderate further in 2000 and 2001. The primary cause of this slowing is the rise of long-term interest rates thus far in 1999, which has caused housing construction and sales to decline in recent months. Higher interest rates have also brought mortgage refinancing activity to a virtual halt; for many homeowners refinancing had lowered household debt service burdens and had provided a convenient way to extract equity from their homes. Finally, the rise of interest rates has been associated with a leveling off of stock prices, which may be contributing to the moderation in growth of consumer spending evident in the third quarter and apparently continuing in the fourth quarter. Net exports are expected to continue to exert a drag on the economy, while the boost from inventory building fades somewhat. We believe that the potential growth rate of the economy is now about 3½ percent. Our growth forecast for 2000 is 3.2 percent and for 2001 it is 3 percent. If we are wrong, however, we think growth will be somewhat higher because of possibly stronger growth abroad and a possibly stronger wealth effect if stock and bond markets return to their upward trend.

Since our baseline forecast has core inflation creeping up from about 2 percent now to 2¾ percent in 2001 under an assumption of no policy change by this Committee, a modest additional tightening would be appropriate insurance against aggregate demand exceeding the supply side's ability to produce goods and services. I should note, however, that I absolutely and vehemently disagree with any notion that this Committee is behind the curve.

In addition to the likely help on price stability that a modest tightening would involve, I think it would also help to reduce the current account deficit somewhat. We have to be careful about the current account deficit. It's easy to finance it because of the attractiveness of U.S. assets. But it is clearly a longer-term problem. And when we have an opportunity to do something about it, we should take it.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, I can summarize the information from our contacts in the Eighth District in four points. First, housing activity is definitely a bit slower, but not a whole lot. Second, labor market pressures continue, but despite isolated areas of sizable wage gains there is no generalized break-out from the recent experience of modest wage increases.

Third, product pricing remains under good control overall. Fourth, everyone is tired of talking about Y2K. Nobody has anything to say there; nothing in fact seems to be happening.

My FedEx and UPS contacts both reported recent increases in volume. Measuring on a year-over-year basis, the August-September months are stronger than the earlier months. So, they see things accelerating. And UPS, anyway, is revising up its volume projections for next year. Both UPS and FedEx confirm the Greenbook view that Asia and Europe are strong. Latin America is relatively flat; not much is going on there. Firms continue to cope satisfactorily with the labor market pressures. UPS relies a great deal on college students as part-time labor. The firm has increased the rewards, and my impression is that students are coming out of the woodwork to throw packages.

Changing gears to a different topic, I want to emphasize my view that the asymmetry announced at the last meeting did exactly what I certainly had hoped it would do. In response to the strong incoming data, market rates moved up. Then as the data came in benign later in the intermeeting period, rates moved back down. So I think the asymmetry did precisely what we, or at least I, expected it to do. That's all I want to say at this point.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. Using orthodox reasoning, I think a case for tightening policy at this meeting could be made fairly readily. The flat funds rate version of the Greenbook forecast has aggregate demand growing at a rate of nearly 5 percent in this half year and nearly 4 percent for the next two years. Starting from a position where labor markets are already very tight, this demand growth is even more than the upgraded estimate of potential GDP growth. It represents a little too much demand pressure even for our new economy and would seem to call for a tightening of policy to trim some of this pressure.

But at the last meeting, Mr. Chairman, you challenged us to think about the economy in new ways. I'm afraid I don't have a new way of thinking about aggregate demand and aggregate supply, but there is a new way to think about monetary policy--one that we have not talked about much in this room but one that is sweeping the globe outside of this room. It is inflation targeting, a monetary approach that I'm told is now being used in 44 countries. In most of these countries inflation targeting has seemed to be successful in controlling inflation. And in many of them it has seemed to be successful in limiting output variation as well.

First, on inflation targeting itself, one can get to it through a fairly logical progression. The idea of monetary targeting ran into difficulty because of shocks in liquidity demand. These shocks made it difficult to interpret the growth of the monetary aggregates. Did growth mean that the economy was overheating or simply that there was an upward shift in demand for liquidity? The next step was to move to nominal income targeting, an approach that many still favor. But again there are shocks, this time from productivity. If nominal income is growing rapidly, does that mean that the economy is overheating or simply that productivity has risen? Given these shocks, one might reasonably conclude that the central bank should target inflation directly. Inflation is what we are trying to stabilize, so we should just stabilize it.

One could use either a model or a non-model approach for inflation targeting. In the present circumstances, the Greenbook model approach clearly suggests tightening policy. Acceleration of inflation occurs gradually in the flat funds rate version of the Greenbook forecast and it would take a fairly emphatic tightening of policy to stop it. As we all know, this occurs because the economy is now operating below the Greenbook's estimate of NAIRU. To be sure, there is growing professional doubt about this estimate. In early 1997, Staiger, Stock, and Watson had a piece in the *Journal of Economic Perspectives* in which they estimated a confidence band for NAIRU that ranged from 4.3 to 7.3 percent so that unemployment was not found to be a particularly good predictor of future inflation. Recently, a paper by Brainard and Perry built in coefficients that follow a random walk through time and are not constrained to revert to any particular level. This procedure gives estimates of NAIRU that are even below present unemployment rates. These papers are controversial, but that's just the point. It may make sense to look for other ways to target inflation.

Turning to nonstructural approaches, these can be preemptive if there are lags in monetary policy. In that event, nonstructural approaches would involve finding leading indicators or other forecasts of inflation and having the Fed move on the basis of their signals. Unfortunately, there are not many good leading indicators. One that I will call the "pipeline" indicator is the core PPI. The latest numbers for that index are not very reassuring; the core PPI is growing at an annual rate of about 6 percent. Mike Prell cautioned us earlier not to look only at the core but at the total PPI. I don't have that figure here, but it would similarly be not very reassuring. Given the likely fall in the dollar and the strength in world commodity prices, not all of which are reflected in the core PPI, there could be even more price pressure in the pipeline.

It's always risky to generalize from a few monthly numbers, but I would still consider these data as suggesting that policy should be tightened.

A further approach might be to look at the inflation forecasts of others. The Greenbook Part II has useful information on this on page II-34. For the past three years now, the consumer surveys by Michigan have expected a rise in inflation, meaning that their forecast of inflation has been above current rates. On the other hand, their median forecast of inflation is now no higher than it was two years ago, indicating that they may not be fully current on the impact of supply shocks, tight labor markets, and so forth. It's hard to know whether to read this as a forecast of rising inflation or stable inflation. Things should be clearer for the professional forecaster, but they are not. Those surveyed by the Philadelphia Fed also have expected more inflation than actually occurred for the past few years. Again, these forecasters have not raised their forecasts in recent months. It is sometimes argued that that is because they expect the Fed to stabilize inflation. But these forecasters have also built into their forecasts only a very slight rise in short-term interest rates, as have the Blue Chip forecasters, which could be a partially overlapping group. The Blue Chip forecasters do not look for a particularly big rise in inflation and they seem to be forecasting that the Fed will only have to tighten policy very slightly to prevent this rise. In the end the forecasts of inflation do not help us much, though there may be a very weak vote for tightening policy.

Where does all this leave us? To me, the structural model approach to inflation targeting suggests rather clearly that we ought to tighten. The pipeline approach suggests the same somewhat clearly, and the approach of consulting other forecasters gives only a weak vote. While the intensity varies, all indicators do point in one direction, however, and I am inclined to think we should point that way, too.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. At the last meeting I think many of us were willing to take a patient but vigilant attitude, recognizing that a great deal of data would become available during the intermeeting period. Now those data have become available and we seem to be faced with a choice between what I'll describe as policy optimism and policy caution.

On the optimistic side, the most recent NIPA revisions do give a reason to believe that productivity trends have continued to rise. Capital deepening, I gather, is probably the source of this positive outcome as outlays for equipment and software have been extremely strong. While

the staff's new estimate for trend labor productivity growth must be approached with some caution, I do note that a number of private sector forecasters also have revised upward their estimates over the last year or so. I think we should be open to the possibility that the staff, though perhaps ahead of others, may have gotten it right.

However, policy caution also sets in when one recognizes that even if the speed limit is somewhat higher, the economy is still at this stage exceeding that limit at a time when labor markets are already stretched thin. While there is evidence of some slowing in housing and, as others have indicated, in other sectors as well, overall third-quarter GDP barreled ahead at an estimated annual rate of 4.8 percent that will probably be revised up. And the outlook, according both to Board staff and private forecasters, is for continued very strong growth that at this stage is probably above trend and may be slowing only gradually to trend.

The major new factors that emerged during the period and that are a source of some concern I think are both domestic and international. Domestically, the pattern of tight labor markets continues and if anything those markets have tightened even further. Unemployment, which had been stable at around the 4¼ percent level or maybe a little lower, has clearly ticked down again. At the same time, the percent of the population not in the labor force who want jobs also has declined. The labor force participation rate has remained in a tight range around 67 percent since March 1998, which is quite unusual I think in such a strong economy. That suggests that perhaps the supply of available workers is indeed nearly exhausted, and this is occurring just as aggregate hours data show a continuing uptrend. So even if the productivity trend is somewhat higher, I think there is a real risk that sooner rather than later wage demands may try to catch up with productivity increases.

Now, the tautness in the labor market is continuing just as the strength of the rest of the world is becoming a little clearer. Karen Johnson is right to caution us that there are still some risks that there could be policy mistakes in some places. Japan is certainly a question. But overall, I believe it's more likely that global healing is actually becoming a bit of a global recovery which, as someone said earlier, is taking away one of the safety valves that could prevent a potential overheating of the U.S. economy. In fact, that global recovery may be adding a bit more fuel to the fire. I think exports have probably turned the corner and will, I believe, continue to press on domestic resource utilization. Real exports grew at an annual rate of about 12.4 percent in the third quarter, which is about three times the pace of the previous quarter.

And the final component, which Mike Prell alluded to in his remarks, is that the IP picture seems to be showing strength throughout the economy. So in a world of stronger global markets and increased industrial activity at home, I think we are seeing a bit of an impact, including some early signs of bottlenecks. Bob Parry alluded to the Purchasing Managers' survey, which did in fact show for both prices paid and for delivery times the worst relative performance in several years--since May of 1995, I believe. And while Bob is right to suggest that one survey does not necessarily present us with a smoking gun, I don't think it's appropriate to ignore bullets being put into the gun, if that's what is happening.

So taken altogether, it appears that we have a tightening labor market, a firming of industrial and external conditions, and perhaps some early signs of emerging bottlenecks. And I think the risk, if anything, is skewed even more strongly to the upside. So, in my view the choice between caution and optimism is becoming even more stark.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. We have a wealth of new and especially revised data to incorporate into our assessment of the outlook. On balance, the data suggest that both productive capacity and demand are advancing more rapidly than previously expected. The further upward revision of the estimate of trend productivity does translate, as reflected in the Greenbook, into a slightly more favorable inflation forecast over the next couple of years. That is, the temporary disinflationary force of higher productivity growth has been enhanced and renewed in this forecast. While this has taken some of the quantitative edge off the Greenbook inflation forecast, it has not changed the qualitative picture or the balance of risks, which in my judgment definitively continues to point toward an increase in core inflation over the forecast horizon. And I might note that if the Greenbook has lost some of its quantitative edge it hasn't lost any of its rhetorical edge, arguing very forcefully that inflationary pressures are building.

The key to inflation prospects is not how fast supply or demand is advancing but rather the degree of imbalance today between supply and demand, particularly in the labor market, and whether or not this imbalance might be further aggravated going forward. In the Greenbook forecast growth slows to trend. There is some discussion at several points in the Greenbook that growth is slowing to below trend and that pressures in the labor markets are easing, but I do note that the unemployment rate is 4.2 percent at the end of 2001. So that 0.1 percentage point increase in the unemployment rate is not much of an easing in labor markets.



At any rate, my point is that the slowdown projected in the Greenbook only prevents the degree of labor market tightness from becoming more acute.

I agree with the staff that this degree of labor market tightness has prevailed for some time and has been offset in recent years by a combination of favorable price shocks and the disinflationary effect of the significant acceleration of productivity. But I think the situation has changed in a very important way with respect to the future. We already can see that overall inflation has increased significantly this year. So we can look forward now to reinforcing developments instead of offsets. Rising inflation this year will reinforce the already tight labor markets, putting upward pressure on nominal compensation next year. That will be reinforced by the effect of higher health care expenses, and the pass-through of those costs to inflation will be reinforced by further increases in import prices.

One of the most critical aspects of this projection of trend growth is that at the end of the period--after which inflation has increased by perhaps as much as  $\frac{3}{4}$  percentage point--the degree of labor market tightness is the same as it was at the beginning of the period. Inflation is rising just as fast at the end as it was at the beginning, and it's hard to see how this process gets contained without inflation moving above 3 percent in the period going beyond the forecast horizon.

If I take one thing importantly away from the Greenbook, it is that it's possible to be an optimist about productivity and a pessimist about inflation at the same time. I think that's important to keep in mind.

CHAIRMAN GREENSPAN. I wish to note that our governor is literally a one-handed economist. [Laughter] Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. By this time of the morning most of what needs to be said has already been said. But let me briefly summarize how I see the state of play and offer several comments that I hope might be useful as we move toward our policy formulation.

It seems clear that the economy remains very strong, with a lot of ongoing momentum. True, we do see some better defined indications of slowing activity, with housing apparently topping out and quite possibly autos as well. Other air pockets may well appear, but the momentum remains impressive. New jobs continue to be created in substantial number, driving unemployment down even further. Consumer sentiment has rebounded from its brief and

shallow dip. The stock market paused for a time, but recently the strength appears to be broadening and the market seems to be moving into a new up leg. Foreign economic growth looks both more solid and more rapid--possibly a very potent influence on our own outlook. The year 2000 is an election year and those are generally strong. Inflation remains quiescent. One should always look for signs of serious potential weaknesses or a slowdown, but other than the ever-present danger of shocks it's hard to identify very many looming in the forecast period. In short, the risks seem distinctly on the upside.

My formulation of the key question before us is: How and when might today's healthy strength deteriorate into unhealthy overheating? And the obvious second question to be addressed shortly is: What policy today is most likely to be beneficial a year from now?

Let me make several quick observations. First of all, stronger world growth is highly desirable. However, it does complicate our inflation outlook. A lower dollar, stronger export demand, and a higher level of world resource utilization all put new upward pressures on our price level. This is an important reversal of the favorable disinflationary impact we got from a weaker world in the past several years.

Second, the baseline Greenbook forecast calls for some tightening over the forecast period but still projects a rising rate of inflation through 2000. While a case can be made--but not by me--that the rate of inflation likely to be reached by the fourth quarter of 2001 would still be within acceptable limits, I'm concerned about what that rising trend might imply for policy. This Committee could be required to make very strong tightening moves to counter it.

Finally, there is the apparently strong growth in the rate of productivity improvement, the Chairman's second derivative. It has served us wonderfully well. But going forward from here, what are the parameters of its likely impact? At one end of the spectrum the improvement could continue for some period of time, but as the Chairman observed it will not do so indefinitely, with overheating potentially a subsequent condition. At the other end, while the probability may be low, it could disappear very soon and we could find ourselves scrambling to avoid the consequences. To me perhaps the highest probability is that the rate of change will remain positive but will not be strong enough by itself to hold off the cost increases resulting from stronger world growth, the wealth effect, and ever tighter labor markets. And an earlier and stronger rise in prices could result.

At the last meeting the Chairman summarized his analysis by observing that we are not far from where we want to be and we're not behind the curve. I agree. But we may need to move further in order to be sure that we stay there. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The regional economy in the Philadelphia District continues to grow. Labor markets are tight, yet there are few signs of any upward trend in inflation despite rising raw materials prices. The outlook generally remains positive and there has been no basic change in recent months. One continues to hear stories about innovation, new ways of doing things that improve productivity. For example, the Internet is likely to have a major impact on the way people buy all kinds of goods, from food to automobiles. And while there are a number of examples that I could cite, given the hour I'll skip that. But the bottom line is that existing distribution networks are likely to become less expensive over time as a result of all of this.

Turning to the national economy, demand remains strong. Resources are stretched, but productivity growth is also strong and inflation remains benign despite repeated predictions to the contrary. The traditional models have not held up and longer-term inflationary expectations remain well anchored. What does the future hold: More of the same or a less favorable mix? Even if a less favorable mix emerges, it is likely to emerge slowly. If more of the same emerges, then we can continue to have the benefits of higher growth without higher inflation. Vigilance and patience have much to offer in this situation. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. We have just created another record. We are on time for coffee.

[Coffee break]

CHAIRMAN GREENSPAN. Let's turn to Don Kohn for his report.

MR. KOHN. Thank you, Mr. Chairman.

Based on the information received since your last meeting, most market observers have characterized your decision today on whether to raise rates or leave them unchanged as a "close call." And in the interest rate futures market the odds on a 25 basis point policy firming at this meeting are not far from 50-50.

On one side, data related to costs and prices generally have continued to be favorable. Despite tautness in labor markets, nominal wage and compensation increases by most measures remained more moderate than many had anticipated and betrayed few signs of a pickup. Moreover, revised NIPA data have bolstered

the case for accelerating productivity that could keep inflation pressures contained for a while. Taken together, this information has led the staff to flatten slightly the trajectory of price acceleration in the Greenbook forecast. An alternative simulation in the Greenbook suggests that even with an unchanged federal funds rate for the next two years, total CPI inflation would remain relatively damped by historic standards, probably at a little under 3 percent in 2001.

Committee members have often noted the difficulty of making preemptive policy changes when they are unsure about the underlying relationships of the forecast. By leaving open the possibility that the NAIRU could be a lot lower than the staff has allowed for or that productivity is picking up faster, the information becoming available since the last meeting might be seen as only accentuating uncertainty about key supply relationships. Either development could allow the economy to operate at or below the current unemployment rate for some time without inflation rising. In such circumstances, tightening policy could well prove to be unnecessary or at least premature and could incur costs for the U.S. economy in the form of fewer jobs and lower income and wealth for a time than it was capable of producing.

If this were a serious concern, the Committee might well want to await further information about likely developments in costs and prices, and stand pat on policy, choosing alternative B. Judging from surveys of households and economists and from the gap between nominal and inflation-indexed bonds, expectations that inflation will remain contained are firmly entrenched. Survey measures of long-term inflation expectations haven't changed in several years despite wide variations in headline consumer inflation and occasional bond market jitters. And, with overall inflation remaining muted in the staff forecast, inflation expectations seem unlikely to increase much in the near term in a way that would make the subsequent disinflationary effort especially painful should it turn out that tightening policy at this meeting was in fact an appropriate step.

On the other side, however, incoming information on economic activity and demand also continues to indicate that the economy is growing at an unsustainable pace, in excess of the expansion of supply, as Mike discussed, further drawing down the pool of available workers. In the Greenbook forecast, financial conditions already in place are, in effect, sufficiently restrictive to bring the growth rates of supply and demand roughly into alignment. And they stay in approximate alignment over the next two years with only some gentle nudging on the funds rate next year to counteract the effects of the upward drift of core inflation on real interest rates and the strengthening of foreign economies.

However, not only has this balancing of growth rates failed to occur yet, but the Committee may see significant risks that it will not materialize and labor markets will tighten further in the absence of a near-term firming of policy. Mike and Karen have mentioned several possible factors that might boost demand. I'd like to highlight in addition what appears to be a global shift toward more

accommodative financial conditions, despite recent actions by a number of central banks.

In the United States, most credit spreads are down somewhat over recent months. A portion of this decline may reflect reduced concerns about potential problems over the century date change, in which case it is only bringing forward by two months an anticipated shift that would have occurred next January. But some of the narrowing seems also to be related to greater optimism about long-run prospects for businesses and the economy. This same optimism is reflected in the more ebullient investor attitudes in equity markets and the associated run-up in stock prices in recent weeks.

The shift appears to be even more pronounced for many foreign economies, judging from sharp increases in their stock prices and declines in emerging market debt spreads to levels predating the Russian debt default. The interplay between improved economic performance and reduced financial headwinds may produce stronger global growth than allowed for in our forecast. If so, pressures on prices in the United States could come not only from accompanying greater resource utilization, but also from a sharper decline in the dollar as foreign prospects come to seem relatively more favorable and foreign demands on the world pool of savings strengthen.

The sense that financial restraint on spending in the United States is easing might be one reason why the Committee would favor a tightening of policy by 25 basis points, as in alternative C. Such a firming, by reducing the odds on more accommodative financial conditions developing, would provide the Committee with better assurance that at least the growth of demand will come into better balance with that of supply, though leaving the unemployment rate at an unusually low level. In the past few years, the Committee often has been willing to live with the risk and the fact of tightening U.S. labor markets. But it may see the situation as somewhat different at this juncture: The unemployment rate is already lower than it has been since the late 1960s. Decisions to remain asymmetric but not to tighten over extended periods in 1997 and 1998 were made against the background of continuing moderation in inflation. Today, growth in most broad price indexes has risen, while the rate of increase in core measures has been flat, with the notable exception of declining core CPI inflation. And, declines in oil and import prices are no longer holding down inflation, but instead are contributing to a pickup in pipeline price pressures.

The cost of not tightening at this time if a firming turns out to have been needed could be a further overshooting of the economy beyond its long-run potential, and hence a larger or more prolonged and possibly more disruptive adjustment later. Equity prices may be a particular risk in this regard. The staff forecast has equity prices remaining near current levels with no near-term change in policy, but if an absence of tightening is read as suggesting a significantly lower path of interest rates going forward, equity prices could strengthen

significantly, boosting consumption and investment. If such an increase pushed the economy further beyond its sustainable potential and equity prices further above their long-term levels, it would distort resource allocation and pose a greater threat of macroeconomic and financial instability when markets and the economy eventually adjusted.

Century date change concerns should not prove a barrier to tightening policy at this meeting, if the Committee wished to take this step. To be sure, markets are still somewhat skittish and illiquid, so their response to a tightening may be a bit more volatile and unpredictable than usual, especially because it is not fully anticipated. In addition, deteriorating conditions between now and year-end remain a threat should lender caution intensify or household demands for currency build by even more than depositories have allowed for. But it is hard to see why a flight to safety and liquidity would be triggered by a 25 basis point increase in the federal funds rate, particularly since it would be seen as the last for the year--or why the effects of any such flight would be much accentuated if it occurred against the backdrop of a slightly higher federal funds rate.

With regard to the symmetry or asymmetry of the directive, the Bluebook assumed that under alternative B you would retain the existing asymmetry. While the Committee might not see the incoming evidence as justifying tighter policy, the further rise in labor utilization presumably would suggest continuing risks of future inflation and the potential need to tighten policy before too long. If the Committee were concerned that a biased directive--under either alternative B or C--would add to volatility in financial markets in the weeks leading up to the century date change, the announcement could also indicate that the Committee was likely to postpone consideration of action until next year, given the special situation in the markets through year-end.

Under alternative C, the Committee's choice of directive bias would depend importantly on whether you think that after tightening the risks were still pointed significantly toward higher inflation--enough so to make added firming in the early part of next year a realistic possibility. The Greenbook forecast might be seen as supporting a case for keeping a tightening bias under alternative C, especially if the Committee were intent on acting preemptively to truncate the rise in inflation in that projection. Indeed, the tighter policy alternative in the Greenbook suggests that 100 basis points of tightening by the end of next year may not be sufficient to cap inflation.

But, as noted, the Greenbook forecast depends importantly on the judgment that an unemployment rate in the 4 to 4½ percent range is decidedly not consistent with stable inflation over time. If the Committee had reason to question this judgment, or to believe it did not pose a pressing argument for substantial firming because of the possibility that productivity might continue to accelerate by more than in the staff forecast, it might view its strategy as having two stages. First, stabilize resource utilization. Second, evaluate incoming data for building

inflation pressures at the existing resource utilization levels before tightening further.

In this case, the Committee might be more agnostic about the amount and timing of additional tightening actions, justifying a symmetric directive. By reducing uncertainty and sending a signal that the Federal Reserve was a bit less concerned about inflation risks, the symmetric directive would offset some of the effects on financial markets of the partly unexpected tightening. But markets should not be greatly surprised by a symmetrical directive, which could be read as implying that the Federal Reserve did not necessarily see itself as most likely in the middle of a substantial upward movement in the federal funds rate. The yield curve and futures markets have a total of only around 50 basis points of tightening built in. At the same time, the spread between nominal and indexed bonds is in the neighborhood of only 2 percentage points. Taken together, these suggest that investors do not see the same potential for rising inflation as the staff has forecast and anticipate that relatively modest tightening will be needed to keep inflation well contained.

CHAIRMAN GREENSPAN. Questions for Don? If not, let me get started. Some very interesting questions are being raised around this table today and around a lot of other tables where I have participated in discussions during the last month or two. What is coming across is a quite remarkable divergence of opinions. For example, those around this table are, as a group, much more concerned about upside inflationary pressures; and I must say that I'm more comfortable being here than elsewhere. But when you sit around the Business Council table, they will tell you that their pricing power is nonexistent, that their ability to offset cost increases has no limit, that their margins are in reasonably good shape, and that there just is no evidence of the inflationary pressures that a lot of us are talking about. The Business Round Table members gave me the same story. The question is why people who are looking at the same elephant are viewing it in quite dramatically different ways. I believe the reason is that there is something fundamentally important going on in the economy, and how one evaluates it is critical as to how one comes out in the end with respect to policy.

My bottom line for today, frankly, is that the benefits of moving outweigh those of standing pat. However, I think the issue is very complex. First, on the side of those who are less inclined to move, there is growing evidence that interest-sensitive areas of the economy are beginning to slow, at least at the margin. Motor vehicles, which are a very big industry in a lot of areas around the country, were quite soft in October, and the Chairman of General Motors said to me that he views the market for motor vehicles as really quite weak. The calls that we made

to industry contacts concerning November sales indicate very little change from the October data. So, as far as the first half of the month is concerned, there has been no evident rebound. I don't know whether you've picked up the same thing, President Moskow, but that's what our sources tell us.

The housing market is a little more difficult to assess. We all have seen a significant decline from the peak in starts and in sales. The obvious cause is the increase in mortgage rates, though they have backed off their recent highs. This afternoon the National Association of Homebuilders is going to put out their early November survey of builders; their numbers show some bounce-back in housing sales currently and over the next six months. Conversely, a private survey of the larger builders that the National Association of Homebuilders has made available to us shows that sales remained weak in October. We know that the official numbers for September were down sharply--and probably in a certain sense a little noncredibly, since markets don't move as sharply as those numbers suggest. Nonetheless, I think it is safe to argue that some general softening is occurring in the interest-sensitive areas of the economy. That's not saying they could not rebound. A rebound has happened before, and I think we have to wait and see what materializes.

On the productivity side, the data if anything continue to be strongly supportive of increasing rates of productivity gains. This morning's industrial production index for the month of October, when put into productivity terms and extrapolated for the rest of the quarter, engenders a quarterly output per hour growth figure of 7.6 percent at an annual rate. Two of the months for the quarter are forecasts, but the level in October is already high.

I think all of you have seen the note distributed by Larry Slifman on the productivity data updated through the third quarter. We do not as yet have all the details because Commerce has not put together the detailed tables that we need for the full compilation of numbers that we usually send out. Nonetheless, it's quite interesting that on the product side the official number for nonfarm business productivity was up 2.9 percent in the third quarter from the third quarter of last year. That's obviously a significant acceleration. From the income side, reflecting the sharp widening in the statistical discrepancy over the last year, the number for the increase in productivity is 4.2 percent, year-over-year. In addition, if we recognize that the conceptually consistent denominator in the calculation of business productivity should be the work hours reported in the household survey instead of the establishment survey, the 4.2 percent number



from the income side moves up to 4.4 percent. We need to keep in mind that the household survey of hours worked is the only one that's truly internally consistent with the unemployment rate. This distinction is quite important currently because, as I indicated at the last meeting, we have a difference in excess of 50,000 a month in the changes indicated by the conceptually identical definitions of household nonfarm business versus payroll employment. As a result we are getting quite different estimates of productivity. The official data indicate a 2.9 percent increase over the four quarters, but if we use the same conceptual framework with a change in both the numerator and the denominator, we end up with 4.4 percent. So the choice that Commerce makes is at the low end of a range whose upper limit is suggestive of far greater acceleration.

It's really quite interesting to find that the escalation of productivity is far more pronounced, in terms of its second derivative so to speak, if we use both the income side measure of output and the household survey measure of hours to make the calculations over the past several years--indeed, going back into the 1980s. Just to give you a case in point, the estimate using the income side and household hours data for the decade of the 1980s indicates a productivity growth rate of only 1.1 percent. For the period from the fourth quarter of 1997 to the third quarter of 1999, the number is 4½ percent, up more than 4 times. Cyclically adjusted, that number is only marginally lower. So something profoundly important has happened here. And the question is how that should be interpreted.

One thing that is important to interpret is whether accelerating productivity engenders a stable economic system. The answer is, in fact, that it does not, and it's in this regard that accelerating productivity exerts upward pressure on real long-term rates. The reason is that if we get accelerating income-side or supply-side growth and the propensity to consume out of the income engendered from that is unchanged, then arithmetically we end up with demand equal to supply. The unemployment rate does not change. The associated inflation pressures are nonexistent. But there is a problem in the fact that if productivity is accelerating and if it is presumed that the underlying cause of that acceleration will change the long-term outlook for corporate earnings at any existing fixed discount rate, the expectation of higher earnings will engender an increase in stock market wealth. And of necessity if there is a wealth effect--and there is some dispute about that between New York Bank and Board staff--we invariably will get

a decline in the propensity to save out of income. So, we end up with the need to satisfy aggregate demand in excess of domestic supply.

We have been meeting that demand in two ways. One is by increasing the share of imports relative to total demand. Because of the increased productivity and its root cause, the uptrend in technology, we have had a much higher rate of expected earnings on new projects. Over the long run, the rise in expected earnings has been a major factor in facilitating the widening of our current account deficit in that the latter has been readily financed, as one can tell by the fact that the dollar hasn't gone anywhere. The net import-export balance, or the current account if you want to put it that way, has recently been adding close to a full percentage point to the aggregate supply available to satisfy domestic demand. Second, we have seen a continued decline in the pool of unemployed workers not currently seeking a job but saying they wish to work. Employers have been willing to hire these new workers even though their productivity is somewhat less than the average. The employment of these workers has added another  $\frac{1}{2}$  percentage point to GDP growth. That source of labor together with higher imports is how the gap between aggregate demand and aggregate supply has been closed statistically in the last several years.

Clearly, neither of those adjustment processes can continue. As a consequence, what we will be ending up with is demand exceeding supply or its equivalent, investment ex ante exceeding saving ex ante. The pressure to move investment and saving together induces a rise in real long-term interest rates. The rise in long-term interest rates has been quite significant until very recently. Rates on U.S. Treasuries have risen somewhat less than a percentage point since before the Asian crisis, but the spread on BBB-rated obligations versus Treasuries has widened. And judging from the rise in inflation rate expectations, and at this point I'm using the TIPS to measure inflation expectations, there has been a very substantial rise in real BBB corporate yields, which are close to the average yield that most corporations have to pay.

I think the process of restraint clearly has begun to work, as the behavior of housing and motor vehicles suggests. The trouble is that the lags are invariably quite long, and we do not know how much long-term rate tightening is required to bring supply and demand into balance. Since real rates have been rising for so long, the presumption is that the adjustment process has been fairly well established and the fact that the stock market is unchanged over the last six months is another indication that the pressure is there.

The result of all of this is that we have a market that is adjusting to what is essentially --I don't know what the word should be--let's call it an "unbalanced" expansion that is being engendered by accelerating productivity. The reason that this acceleration creates imbalances is basically because of the wealth effect. And to the extent that real long-term rates are rising, the wealth effect increases are being neutralized or reduced and we are experiencing a slow adjustment process toward an equilibrium or balance. We have never seen anything like that phenomenon in this century to the best of my knowledge. It may have happened in the previous century with the huge changes in technology that occurred a hundred and more years ago, but data that would enable us to evaluate what was happening then are virtually nonexistent.

The problem that I think we have in setting monetary policy is the relationship that was raised in a previous meeting by Governor Gramlich, namely the relationship between short-term real rates and long-term real rates. As best I can tell, the gap between them at this point, especially if we were to move the funds rate up another 25 basis points today, is not all that large. In other words, there is a slight upward tilt in the real yield curve but by no means one that would suggest an inflationary imbalance that we would infer from a very steep yield curve. We don't have such a curve at this point. So I agree with the Vice Chair. I don't think we are behind the curve, and I don't think that the markets are saying that we are. And indeed the implication of the forward markets is that they anticipate only a very modest increase in rates on our part, and they are looking at very much the same sort of evidence.

The bottom line is that we really do not know how this system works. It's clearly new. The old models just are not working. And the reasons they are not working are essentially that we have a rapidly changing structure whose parameters are very difficult to estimate, and, therefore, we have to depend in part on anecdotal information and in part on some sort of risk evaluation. At this particular stage, if I were convinced that the hourly earnings data we saw in the last employment report--like that 2.7 percent rate of increase over the last three months--were real and if we were in a position to move in December, I would say that we could take a chance and wait until our December meeting. But that 2.7 percent number as best I can judge is not real because if we adjust it for mix, it turns out that the figure is not 2.7 percent; it's 4 percent. Now, 4 percent is not of great consequence when productivity is as strong as it is. When we look at total compensation per hour, the figures are closer to 5 percent, but unit labor costs are not accelerating; indeed, they are declining.

I do not think the issue of import prices per se is of huge consequence largely because we can explain the disinflation wholly in terms of the gross product that originates internally. Import prices do have an effect on domestic prices but it is indirect. I'm not saying that there is no effect there. I'm just saying it's tough to evaluate. I'm a little more concerned about the price of oil. Even though it's clearly in the long-term interest of the major Gulf producers to keep the price down so as to keep competition from other sources down, we need to remember that they have very large oil reserves. And it's quite easy to demonstrate that it is not in their long-term interest to allow the value of those reserves to decline, which is what they would do if there is a sharp increase in the price of oil in the short run owing to the loss of market share. The difficulty is that the Gulf producers also have very severe fiscal and debt problems. There is always the inclination for OPEC producers to agree that the price of West Texas Intermediate should decline to, say, \$18 a barrel and to agree that such a decline will happen eventually. But isn't it nice for now to get \$25 a barrel! The revenues are coming in. The long run can wait until mañana. And indeed there is a serious potential problem here: Even though the importance of oil in the U.S. economy has gone down quite significantly as the importance of energy more generally has gone down as a share of the GDP, oil can still have a potentially quite destabilizing effect, especially on consumer confidence.

In conclusion, I think we have a lot of uncertainties at this stage and the bottom line is that as long as we have a continuing decline in the total number of people who are unemployed, including those not currently seeking a job, that is telling us that the growth of demand exceeds the growth of supply. That gap between the two has not been closing. It has been open at this level now for a quite significant period of time. And while it showed early signs of narrowing last year, it has reopened. In my judgment, as long as we have this gap and we can't move in December, it is much too risky for us to stand pat at this time. There are possibilities for all sorts of problems when we move interest rates up, but I think the risks currently are less than usual. I would prefer to see somewhat greater anticipation of a tightening move in the financial markets, but I don't think it is all that critical a factor.

As a consequence, let me just end by saying that I would like to put on the table a 25 basis point increase today and a symmetric directive. The symmetry in this case is almost automatic in the sense that we effectively are saying that we are not going to move in December. Indeed, short of a very significant set of surprises, it's just not credible to me that we would risk

such commotion so close to the century date change. Therefore, I would like your reactions to a 25 basis point move plus a shift to symmetry. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I agree fully with both the reasoning behind your recommendation and with the recommendation itself. I agree that we should increase the funds rate by 25 basis points. I think we must be symmetric or we will create uncertainty in financial markets during the end-of-the-year period, when markets are always somewhat illiquid. Given the Y2K effect on year-end markets, it simply would not be good public policy for us to be creating confusion in that kind of situation. So "C" symmetric seems to me exactly the right conclusion.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I find going up 25 basis points and the symmetric directive acceptable. I think whether we move today or not is a close enough call that reasonable people can differ, and the difference is so little that what one prefers and what one finds acceptable are fairly close together. I actually feel more strongly about the need for a symmetric directive. We have gone to extraordinary lengths to try to get through the year-end period and all this Y2K business. For us to have an asymmetric directive in the face of that would look as if the right hand doesn't know what the left hand is doing. I think we want to err on the side of calming markets rather than exciting them, even if the risk of exciting them is very small. So, I feel strongly about the symmetric directive and I find the 25 basis points acceptable.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I agree with your recommendation on the funds rate and, of course, with the symmetric directive. I was pleased to hear and interested in your analysis of how productivity changes, especially in a positive direction, can have secondary effects if one puts that acceleration into a larger general equilibrium context. I know the staff has been doing research on this. I have been reading some of their work and I would encourage them to do more so that we can flesh that whole idea out more fully. It's important because I believe that it's affecting not just the United States, but if we're lucky--and I think we all would hope it will turn out this way--the rest of the world may yet experience similar kinds of things. And understanding how the wealth creating process affects both goods prices and asset prices I think is going to be really important to us in the years ahead.

CHAIRMAN GREENSPAN. President Broadus.

MR. BROADDUS. I agree with your recommendation, Mr. Chairman. I think an economic case could be made for retaining asymmetry, but I won't press my luck.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I certainly agree with your recommendation, Mr. Chairman. I, too, think one could make a distinction between the economics associated with asymmetry and the potential for market uncertainties related to Y2K concerns at year-end. But on the whole, I'm persuaded that we're better off with a symmetric directive for the reasons that President Boehne articulated.

CHAIRMAN GREENSPAN. President Gynn.

MR. GYNN. I can support your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, I support the recommendation. I'd like to offer two observations. First, in terms of low inflation expectations and the lack of pricing power, that's because the market trusts us to contain inflation. And, therefore, we can't use those low inflation expectations as a good signal about when it might be time to move. If we start to lose that trust, then we have gotten behind. But we haven't lost it and we're not behind. Secondly, if the data come in perfectly benign, right down the center of the point forecasts, it doesn't really matter whether we move today or not. It seems to me that what's important here is that we've positioned ourselves should we get data on the high side, with greater strength in activity and inflationary pressures. If we don't move now, then the market could well say we're frozen until the end of January. That would risk our getting behind. There's plenty of room for rates to go down should the data come in on the soft side.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I can accept your recommendation, Mr. Chairman. Although I think there is some chance that this action may be unnecessary, I doubt it will be harmful. Let me just reiterate my own uncertainty about what the appropriate model is in this environment. It seems to me that many of the conventional models that we've been looking at over the last several years have simply been wrong on the critical issue of the acceleration of inflation. I think we need to bear that in mind.

An alternative explanation, undoubtedly also oversimplified, is that what we've seen in the last several years has been a series of positive supply shocks, presumably related to

productivity, that have given us more growth and less inflation than we otherwise would have expected. It was just a movement along the demand curve. I don't know whether this will continue. I'm not sure what the appropriate policy stance is in this environment. I'll go along with the recommendation, but I think we are a bit at sea here.

CHAIRMAN GREENSPAN. Governor Kelley.

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

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I agree completely with your recommendation. I think the risks of not moving are much higher. I do feel asymmetric, but it would be very misleading and confusing to the markets for us to come out with an asymmetric directive. So I agree with both parts of your recommendation.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, this month we once again face the issue of how much weight to put on a forecast of rising inflation, a forecast that so far has been on the high side compared with the more favorable actual results. When the October meeting concluded, I was fairly confident that we would need to raise rates at this meeting. However, the wage and price inflation data in the intermeeting period have been better certainly than I expected. As a result, I would prefer to leave the funds rate unchanged at the present time and to retain a bias toward a tighter policy. But I must admit that if we do that, the strong likelihood that we will stand pat until at least mid-January makes me anxious, since I do believe our next move will be up. And that need could be compelling before we feel comfortable in moving in the new year.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I think both your recommendations for a  $\frac{1}{4}$  point increase in the funds rate and a symmetric directive are prudent, and I support them.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. I support your recommendations of a 25 basis point increase and a symmetric directive. Let me say one thing about process. At the November meeting Bill McDonough mentioned the awkward timing of our regular December meeting and Bob Parry just intimated a concern about that also. So, at some point we might look at the meeting schedule. The late December meeting doesn't seem to help us much and there might be a better

way to arrange our meeting schedule so that we wouldn't be making policy for such a long period of time. I think that's something that whoever does the schedule might take into account.

Let me also comment on your economic model, which I liked because it's a good way to tie together two imbalances that we often talk about, the labor market imbalance and the saving/investment imbalance. It strikes me that there are at least two implications from that. One is that given the saving/investment imbalance, there is a very natural reason why we ought to look for increases in long-term interest rates even apart from what we do at this table. The Greenbook touched on this, and I think it's something that we ought to talk about more. The second is that tying together the two imbalances may actually uncover a reason why we haven't seen more inflation. There are two ways that the steam can escape. Until now we've had a situation where the steam could come out in a very high level of imports and trade deficit. As that becomes less true, we might have to worry even more about inflation. But going back to the issue on the table, I support your recommendation.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Mr. Chairman, I can support your recommendation for a ¼ point increase in the funds rate and I can accept your recommendation for a symmetric directive. The problem I have is this: While I want to convey to the markets the view that there is little chance that we would make an additional move between now and our February meeting, I don't particularly want to convey to the markets that we now feel that we've done as much as is necessary, that we've rebalanced the risks, and that it's just as likely thereafter that rates will go down as go up. What I really want to avoid is turning a tightening into what appears to be an easing. We've had that problem before. Now, I could make a case that it's not that hard to convey what we actually mean in our announcement. I could argue that we could go asymmetric and tell the market that asymmetry doesn't mean that during the period leading up to the century date change we will tighten but that it reflects a policy tilt that would be in place thereafter. I can accept the symmetry, but I just want to raise the issue that we need to be careful about how we convey our message in the announcement. Now we've put added burden on the announcement, which is okay as long as we use it effectively.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Mr. Chairman, I can support both halves of your recommendation. Let me say just one thing about the symmetry. In a strategic sense I think it's exactly the right



place to be because I do think, for reasons that you and others have outlined, that there is a great deal of uncertainty about where policy is going to go next year. And I would prefer not to build in momentum in policy inadvertently by adopting asymmetric language that may have the effect of tying our hands. I think we really need to wait and look at incoming data, and I think symmetry is the right approach at this stage.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I agree with your recommendation for a 25 basis point increase and for symmetric directive language both because I think it's better to take the cloud off the markets and also because I'm not sure that move won't be the last in a series of tightening actions. I feel rather symmetric myself about where things will be around the middle or end of January.

We had an estimated GDP number in the last quarter of 4.8 percent and we had an unemployment rate of 4.1 percent and a labor productivity number of 4.2 percent. In view of those strong numbers on the real economy, I would hope that in conveying our policy decision to the public we will focus on inflation, inflation in the pipeline, and leading indicators of inflation. I would not want us to give the impression that we're trying to slow the economy down or that we don't like these strong real growth rates. A lot of our critics really don't mind much what we do so long as they don't think we're doing it for the wrong reasons. And I tend to agree with that. So I would urge that the rhetoric be given some consideration.

CHAIRMAN GREENSPAN. We have a consensus on 25 basis points and symmetry. Would you read the appropriate directive?

MR. BERNARD. I'll be reading from page 14 in the Bluebook: "To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 5½ percent. In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period."

CHAIRMAN GREENSPAN. Call the roll please.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Boehne	Yes

Governor Ferguson	Yes
Governor Gramlich	Yes
Governor Kelley	Yes
President McTeer	Yes
Governor Meyer	Yes
President Moskow	Yes
President Stern	Yes

CHAIRMAN GREENSPAN. A draft press statement is being distributed so that we can all look at it.

As we agreed last time, it's very difficult for us to write communiqués in these meetings. Experience with the G-7 and other groups, as I've told you before, suggests that if we take the writing of our statement overly seriously, we're going to end up with two-thirds of our meeting spent on that task. So, while I'm acutely aware that there are phrases or sentences and perhaps even some substance that each of you might modify slightly, I would appreciate it if comments for any changes were limited to only those parts you find really unacceptable. [Pause] Has everyone finished reading the text? Okay, President McTeer.

MR. MCTEER. This says that "the pool of available workers willing to take jobs has been drawn down further, a trend that must eventually be contained...." I don't think we ought to say that. I think it ought to be drawn down until there's no one left.

CHAIRMAN GREENSPAN. That is the limit of how far it could go. [Laughter]

MR. MCTEER. I understand the practical problem of achieving that, but it seems to me that we just shouldn't be saying that.

CHAIRMAN GREENSPAN. Let me put it this way. We've said this a number of times in the past, and this is essentially the language we've used. So we don't want to convey something over and above what I think has been said previously on this issue. Governor Meyer.

MR. MEYER. I'm concerned about the third paragraph. It talks about slowing growth down toward trend and I think there is a reasonable prospect that we might do that. But I heard concerns expressed around the table--and others can speak for themselves--that that might not be sufficient to contain inflation going forward, or that at least the risks would still be unbalanced and consistent with a likelihood that rates would have to rise more. So if we're going to be symmetric, I don't want to be so radically symmetric. The idea of being symmetric was to convey to the markets that we were unlikely to move in the very near term, but this

wording conveys a different message. This says we think we're done tightening now. Okay, bond and stock markets, have a nice day!

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, I think I would delete the second paragraph altogether. [Laughter] To be frank, it doesn't seem to me to add very much. Often it's better to say less rather than more unless we're convinced that what we're saying is constructive and will produce the result that we want. I also share Governor Meyer's concern about a possibly misleading reaction in the marketplace from some of the language in the third paragraph.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I'm inclined to echo what Governor Meyer just said in terms of the impression we create in the market. Rather than give you another iteration of that concern, I'll leave it that. So, in terms of this statement, I'm in agreement with Governor Meyer.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I like the presentation as it exists. Let me say why. I think the second paragraph has to be included because it does say that at a certain point we just run out of resources and the likely resource that we're going to run out of is available workers. I also share Bob McTeer's view. There was a fascinating article in last Sunday's New York Times about mentally challenged people having jobs; I think that's wonderful. But in the real world at a certain point, if this drawing down of the available pool of workers continues, we will run out of workers, and I think this paragraph states it in a very sensible way. In the third paragraph there are some good central banker words and the last words of the second line are "appears likely." We don't make a theologically dogmatic statement. But what I like about it is that it says that we are in the growth business; we are in the business of allowing the American economy to grow as fast as the supply side of the economy makes possible. And I think that is something that we need to say.

CHAIRMAN GREENSPAN. President Broadus.

MR. BROADDUS. I would like to associate myself with Larry Meyer's comment; I have the same concern. I don't know what substitute language to offer, but perhaps something along the lines of "after taking three actions, we think this is sufficient for the time being but continued vigilance is needed" as opposed to something that has this sense of finality about it.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Mr. Chairman, if each of us sat down to write this statement, we undoubtedly would come up with somewhat different language and somewhat different emphases. But, frankly, while we'd all do it a little differently, I think this is close enough that we ought to accept it and move on to the next item on the agenda. It's not only the G-7 that has trouble doing this. If you've been around this Committee long enough, you know that we've tried at times in our past to edit draft language as a Committee and I will tell you that the effort is totally unproductive. I believe our attitude should be that this largely has to be left to the Chairman. I do think we have to have something that is broadly acceptable, and in my view this draft is in that broad area of acceptability and we ought to go with it.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I have a great deal of sympathy for what President Boehne just said. I know rewriting by committee is really hard to do, having done it more than once myself on things of less importance than this statement. But I have two real concerns. First of all, I share Bob McTeer's concern about using the pool of available workers as the proximate cause for this change. I think we could say something like, "as a consequence, tighter policy is necessary if inflationary imbalances are to remain in check," etc. Secondly, I agree with Governor Meyer on the time frame issue. Certainly, the second sentence in that paragraph says over the near term, but I think the first sentence is going to give the markets real reason to rejoice and take things to new heights over the next couple of months. Unless we can find some qualifying words in that sentence--and I don't think "likely" does it--we're going to have some real issues in the markets.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I am sympathetic with much of what has been said around the table, particularly President McTeer's views and those of Governor Meyer and President Minehan. But I really do believe that Ed Boehne has it right, that we just cannot do this by Committee. I hope you can find some ways to make some changes in this draft that will accommodate the views that are being expressed. But, basically, I think we have to leave it to you after you hear what the rest of us have to say.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Let me associate myself with Mike Kelley's and Ed Boehne's comments. As you all know, I've been working hard with many of you to think about how we can best do this. [Laughter]

MS. MINEHAN. This is not how to do it!

MR. FERGUSON. And this is not how to do it! In a more substantive way, I've read this four or five times as people have commented on it, and without question there are words that one could change. The reality is that if we all try to change those words, we'd end up with gobbledygook. What we have now is a message that is clear. We might not like every word, but it generally reflects what I heard as we went around the table. In particular with respect to the symmetry issue, all it says is that we are going to focus over the near term on being symmetric. To my mind that doesn't say it's all over. So I think both in terms of process and in terms of substance, we as a Committee are much better off leaving this statement pretty much as it is rather than trying to change it. Perhaps the Chairman will want to edit it slightly here or there, but I would be very cautious going down the path on which we seem to be headed. I've spent the last intermeeting period trying to think about a way to do this and this is not the way to do it.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I understand the difficulty of trying to do something as a committee, and ultimately I think we do have to defer to you on the language of this. But I do find the first sentence of the third paragraph troublesome. I think we could delete the sentence and just modify the following sentence about the directive and symmetry, and we'd have it right.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I really agree with Ed Boehne's point, but I can't resist! [Laughter]

MR. BOEHNE. That's the problem!

MR. STERN. So, let me make a couple of constructive suggestions. One is with regard to that reference to the pool of workers in the second paragraph. I would just drop that sentence. Whether we've said it before or not, I don't think really matters; I don't know why we'd want to raise it again. My only other comment is on the next sentence, the first sentence of the next paragraph. I think there should be a way to qualify that phrase "appears likely" a bit so that the markets don't get carried away.

CHAIRMAN GREENSPAN. Let's continue to go around. I have some suggestions on how to resolve this issue.

MR. GRAMLICH. I yield. What's your suggestion? [Laughter]

CHAIRMAN GREENSPAN. First, let me just say that I think the second paragraph is essential because it's trying to convey a recognition that on the one hand the economy is showing at least some signs of slowing but that on the other hand the pool of available workers is being drawn down. And that is the measure of the gap between supply and demand. It's the best measure we have and that's what we're hanging on.

MR. MCTEER. Mr. Chairman, may I? [Laughter] My objection has more to do with saying that the trend must be contained. If we just referred to it as an unsustainable trend, I think it would serve your purpose and be a little milder.

CHAIRMAN GREENSPAN. Well, an unsustainable trend is contained.

MR. MCTEER. The sentence as it is now implies that we're going to stop this decline in the pool of available workers.

CHAIRMAN GREENSPAN. Oh no, the market is. Market forces--

MR. MCTEER. Well, it's not the market that is issuing this press release.

VICE CHAIRMAN MCDONOUGH. This is an argument that the Chairman has made very consistently and I happen to think he's right.

MR. MCTEER. I do, too. And we know it's going to come to an end. The process has limits.

VICE CHAIRMAN MCDONOUGH. It's not so important whether we think he's right or not, but he is the Chairman of the Committee. And if something like this weren't in the statement, I think Lynn Fox would get 85 phone calls in the first hour asking about the available pool of workers. Don't we worry about that anymore? I think we have to have this in here to be consistent with the Chairman's recent speeches.

CHAIRMAN GREENSPAN. Well, I'm not worried about any comparison with my speeches. Does anyone else want to comment before I make this great recommendation? I think there's a legitimate question about the third paragraph because it's a substantive issue. The rest of the comments, I think, were more analytical. The alternative is to go back to something similar to our August release with some mild editing. My suggested language would read as follows: "Today's increase in the federal funds rate, together with the policy actions in June and August and the firming of conditions more generally in U.S. financial markets over recent months, should markedly diminish the risk of inflation going forward. As a consequence, the

directive the Federal Open Market Committee adopted is symmetrical with regard to the outlook for policy over the near term.”

SEVERAL. That’s better.

MR. MEYER. It would be better if you take out the “markedly.”

MR. BROADDUS. You better get rid of that.

MS. MINEHAN. Take the “markedly” out.

CHAIRMAN GREENSPAN. No, it’s the real interest rate issue that I think is relevant. Listening to our discussion, that strikes me as an adequate solution to the problem. So why don’t we do that?

MR. PRELL. Mr. Chairman, could I make a minor suggestion?

CHAIRMAN GREENSPAN. Certainly.

MR. PRELL. You referred to the firming of conditions in our financial markets “over recent months,” and there’s been much discussion about the slight easing recently. So if you changed that to “over the course of the year” or something like that, the wording might accord better with the facts.

CHAIRMAN GREENSPAN. I think that’s a reasonable suggestion. Okay, why don’t we substitute that rewording for the third paragraph? Is that satisfactory to everybody? Not really! Let me put it this way. By definition it can’t be satisfactory to everybody, but we shouldn’t care. [Laughter]

MR. BOEHNE. We shouldn’t have these drafts floating around. I suppose we ought to turn them back in.

MR. PRELL. Throw them in the middle of the table!

SPEAKER(?). Pass them to me.

CHAIRMAN GREENSPAN. The Board of Governors is going to take a short recess and vote on a discount rate change. Luncheon is available. When we’re finished we’ll come back into session. The FOMC meeting will continue because Roger Ferguson has distributed a memo on disclosure issues for us to consider. We’re obviously not going to complete our discussion of this topic today, but I think it’s not a bad idea to spend a little time on it. Remember, we’re assuming that we’re not going to make any policy moves in December, so the resolution of the disclosure issues is really not necessary at this time. But it is probably worthwhile to try to make some progress in resolving them.

[Lunch recess]

MR. FERGUSON. If you don't mind, why don't we get going even though we still have some food to eat. Let me start by saying that what we would like to discuss in this part of the meeting is the reaction of the entire Committee to the November 10<sup>th</sup> memo that came from me. I signed that memo on behalf of the whole Working Group on the Directive and Disclosure Policy and it reflects a number of points of consensus in that group. There are a few points on which there were slight divergences within the Working Group itself, but on those points the memo may reflect broadly the views of the Committee as a whole.

Let me explain what I would like to try to do. As the Chairman indicated, this will be the first chance we have to discuss these issues but not the last. So we should not necessarily look toward trying to reach a formal vote or anything of that sort today. This is simply the first opportunity for the whole Committee to look at what your Working Group has done and give us some feedback.

Secondly, there are some elements in here where we have draft language and, if possible, I would prefer not to focus on the details of the wording just yet. Let's try to keep the conversation on a conceptual level for now.

Thirdly, we have a number of points of agreement and then a few points on which there was not clear agreement among the members of the Working Group. It would be helpful if you would just give a general sense of your views on points 1 through 9 where there is agreement. But then if you will focus a bit more on the comments about the wording of the sentences for symmetry or asymmetry, which starts on page 4 of the memo, that would be useful. Again, I'm not talking about the specific wording but the two concepts laid out.

With that preamble, let me tell you where the consensus did emerge. I think there is a strong consensus in the Working Group that there be an immediate announcement after every FOMC meeting, even if it's rather perfunctory. That announcement would convey the Committee's basic thinking and would include some expression about our views going forward; symmetry/asymmetry is the shorthand we're using here. Secondly, there was a strong consensus that the FOMC should at every meeting vote on both the intended fed funds rate and the symmetry or asymmetry, which is exactly what we do today. So, those points involve maintaining the status quo. The third point of agreement was that the operating paragraph should no longer contain any sentence referring to the Committee's consensus about symmetry or



asymmetry. The theory in that case was that the operating paragraph is really meant to direct the Desk and its behavior during the intermeeting period; there is nothing specific in the symmetry/asymmetry that is a clear directive to the Desk, though it may provide context.

The fourth point on which general consensus was reached, as of this meeting of the Working Group anyway, was that after the FOMC's vote a draft copy of the announcement would be passed out to the governors and presidents, with an opportunity for them to offer substantive reactions. That is where we came out. We did decide that we should not pass out any draft announcements prior to the vote. The concern was that the focus of the vote on policy would then be much more heavily weighted to the draft words as opposed to the actual substance of policy. And it seemed as though the focus of the voting should be policy and not the draft wording.

The sixth point on which I think there was agreement was that the directive should be shortened to eliminate any backward-looking material describing recent developments. The seventh issue on which we reached agreement was that the directive should continue to be released on the Thursday after the next FOMC meeting and not earlier. And I will tie that in with number eight, which is that the minutes should also continue to be released on the Thursday after the next FOMC meeting and not earlier. The rationale there, just to be very clear, was twofold. One is just that the process of producing the minutes is time consuming, which makes it very difficult actually to get the minutes out much earlier than we do now. Secondly, I think there was a strong sense in our group that the Committee should speak once during a meeting cycle, not twice, and thereby avoid having the Committee be too actively engaged, if you will, in market deliberations during the periods between meetings.

The ninth point of agreement was that there should be a clearer way of describing the Chairman's latitude to make intermeeting moves. The theory we had, after discussing this with Virgil Mattingly, was that there was some language that the Committee could adopt in its organizing meeting in late January-early February every year that would clearly outline what the Chairman's latitude is for making intermeeting policy moves. The reason this becomes important is that a number of people had looked to the symmetry or asymmetry of the language as giving some guidance and latitude for the Chairman to act on behalf of the Committee, and we thought it was better to be clear about that authority. Again, there is some suggested wording in the memo.

Now, the area where there was slight disagreement within the Working Group was on how to describe our view of things going forward, if you will. Just to remind you, the current approach that we discussed after our vote today involves issuing a statement that effectively talks about potential adjustments of policy during the intermeeting period. I think most, but not all, people in the group seemed to feel that that is probably not a good approach, though there are arguments that perhaps it's not so bad. But within the Working Group we came up with two alternatives.

One approach, and I'd like to focus on it at the conceptual level as opposed to the wording, is to try to get the forward-looking elements much more focused on what we have described as the balance of risks. The thinking behind that concept was that what the market really needs to know is what the Committee's concerns are or the risks that the Committee sees and what it will be looking at in the intermeeting period but without necessarily jumping to policy implications.

The second approach was that in fact we should proceed further and include a reference to the policy implications. The thought behind this concept was that to do anything other than that is to stop without addressing the obvious question of "so what?" The policy implication is an issue we should speak to directly. Those issues are outlined on pages 4 and 5 of the memo.

Now, with that perhaps too long introduction, what I'd like to do is to go around the table in the usual fashion and get reactions to the memo, since I know you have all read it. On the points where there is consensus in our Working Group if you have a strong reason to disagree, that's fine, please so indicate that. But more importantly, indicate whether your general preference is toward having the forward-looking elements of our announcements tied more to providing a sense of the balance of risks or whether you would prefer something similar to the current symmetry/asymmetry approach, which addresses possible adjustments in policy more explicitly. Those are the issues on which the Working Group needs some guidance.

Let me mention one other process issue. We will take your guidance, obviously, and then go back and try to craft the appropriate wording. We have some draft language in the memo, but I don't want this discussion to become too heavily focused on the specific words we used, since we have plenty of time to continue to work on the wording. But if we can get

guidance from you on whether or not we've generally got the consensus right and how you would handle the future-looking element, that would be most helpful.

CHAIRMAN GREENSPAN. You know what I think would be useful? You have seven members on the Working Group?

MR. FERGUSON. Yes, we have seven.

CHAIRMAN GREENSPAN. Since you've all thought about this, it might be helpful to hear from the individual members about the reasons why they came to the views that they did.

MR. FERGUSON. I think that's absolutely fine. Why don't we start with the one who is closest to me, Mike Kelley, and then we'll go around the table to the others.

MR. KELLEY. I would welcome an opportunity to review a little further the language that was suggested about the Chairman's latitude to act between meetings. I have no problem with the substance of it, but I would like to work with the language a bit more.

Concerning the wording in the announcement that Roger referred to at the end of his remarks, I would strongly support alternative I--describing the balance of risks--because I think it's appropriately informative and accurate. And I like the fact that it avoids implying in advance that a determination has been made by the Committee to move one way or the other. We do not, in fact, make such a determination. We review the situation from a zero base at each meeting. So, in my view, what appears in alternative I is the more appropriate presentation of how the FOMC leaves each meeting.

MR. FERGUSON. Okay. Larry Meyer.

MR. MEYER. I am not particularly wedded to the language in either of the options. But I strongly prefer the spirit of the second option, which focuses on the policy implications, and here is the reason. What is the tilt about? What is the market trying to learn about? Does the market say "You are our favorite forecasters and we want to know how you view the balance of risks in the outlook so we can think about the forecast"? Or does the market want to glean some information about our policy intentions?

Now, we can leave it and just say we're going to talk about the balance of risks, but then they will say that a balance of risks toward higher inflation means the Fed is more likely to tighten. There's no great damage in that; I'm just saying they are going to infer that. We can't hide it. Why would we want to hide that? If we want to hide that, we shouldn't get into the business of having a tilt at all. If we don't want to hide it, then we can just be more transparent

about it and say here is what we think the balance of risks is and as a result of that we think it's more likely that rates will be rising rather than falling.

The next question is: Can we really tie the hands of the FOMC with respect to the future? Of course not. I wouldn't want to do that. We are not tying anybody's hands. At every meeting we sit down and we start from scratch making an assessment about the economy and the outlook. We do the best job we can at that meeting. So the question is whether we also should provide some honest assessment of how we are leaning in the future. That's all we are doing, and we can do that every time.

Is the market going to be more focused on the policy decision at the next meeting if we talk about it in terms of a policy leaning as opposed to talking about the balance of risks? I can't understand why. But if we're concerned about that, why don't we just communicate? We can tell the market that we don't view this tilt as having any particular focus on the next meeting. We are not saying that we prejudged that we are going to move and that's why we have the tilt--that we decided just not to do it this time but will do it next time. We can tell the market that our decision on symmetry encompasses a near-term horizon, typically perhaps a period of two or three meetings.

Another factor that goes into my thinking is that I believe it's much more difficult to convey why we might want to tighten than whether we might want to tighten. There are a lot of nuances, a lot of different models, and a lot of different perspectives around the table. So we might have more difficulty--though this is probably a minor thing--talking about what exactly it is in the balance of risks that we're weighing. In the draft language in the memo we only have two things that drive our policy each time--the risks are weighted either toward weakness in economic activity or toward higher inflation.

CHAIRMAN GREENSPAN. Or balanced.

MR. MEYER. Or balanced. I think that's a relatively minor point. But what I didn't like about the language was that it focused on the likelihood of a particular policy move. That is perhaps a little stronger than the language we have been using. Instead of saying that in the future we're more likely to tighten, now we simply say that we're more likely to raise rates than to lower rates. That's a much softer way of conveying an asymmetry as opposed to saying we're more likely to raise rates than to hold them constant.

So I would have preferred to marry the balance of risks and the likely direction of interest rates. I'd give a simple statement about the balance of risks and say that as a result it is more likely that rates will rise rather than fall or that those risks are balanced, with an equal likelihood that rates will rise or fall. I'd go back to the same language that we have now in the directive, but precede that with a sentence on the balance of risks.

MR. FERGUSON. Bill Poole.

MR. POOLE. I agree with Larry. I think the focal point of the decisionmaking is the interest rate decision, the federal funds rate decision. There will be many different views at any one time about why we converge on that particular decision, and trying to explain the different nuances is not going to be helpful. However this comes out, it should never be viewed as a prediction or forecast of what's going to happen at the next meeting. The fact that it has had and may continue to have low predictive value seems to me irrelevant. If it had high predictive value, that could mean we should have acted right away. We shouldn't want a high predictive value. I regard our aim as trying to give a sense of direction. I think it really is going to be easiest for us to reach a consensus on that if we focus entirely on a sense of direction with respect to the policy instrument, the federal funds rate.

MR. FERGUSON. Mike Moskow.

MR. MOSKOW. I was with the majority on this one. I liked alternative I. The problem I had with alternative II, which is close to where we are today, is that phrase "possible need for an adjustment in the stance of policy." It just gives the impression that it is more likely that we're going to be making an adjustment in policy--that we are going to be changing rates--than if we take a step back and talk just about the balance of risks. So I like the balance of risks approach better. It appears less likely that we have our finger on the trigger and we're ready to pull the trigger and make the move at the next meeting. So, I favor alternative I.

MR. FERGUSON. Bob Parry.

MR. PARRY. I favored alternative II. [Laughter]

MR. FERGUSON. As you can see, this was a well-managed group!

MR. PARRY. And it was for many of the reasons that were mentioned by Larry and Bill. I saw it as the alternative that would be consistent with the fewest additional sentences of explanation, which I viewed as a great virtue. And based on our experience today, I see that as a really big virtue for which to aim. Moreover, it seemed to me that the most important point was

that the focus clearly be on the implications for policy. I think if we were somewhat more explicit about that, over time our experience would be good in providing that information.

MR. FERGUSON. Ned Gramlich.

MR. GRAMLICH. You all are getting the impression that this was a very divisive group. I would note to start with that we did all agree on each of the first nine points. [Laughter] On the point where we had trouble, I'm with the majority. I favor alternative I. I think the point about keeping the finger a little farther from the trigger is a factor but, as several people mentioned, since the market knows how to read these statements, in the end there isn't a whole lot of difference between the two alternatives. I suppose I favor alternative I because this sentence will usually be a part of a broader discussion about what we are up to and why--of the sort that we just talked about today. It strikes me that when there is a choice in language, we at the Fed always go for the understated, terse form and I would like to continue in that tradition. There is slightly less risk of misleading people the fewer words we say. I like the understated approach and I would like to keep the distinction between how we see the balance of risks and what we are likely to do. So, I'm more comfortable with alternative I.

MR. FERGUSON. I was more comfortable with alternative I as well for the reasons that Ned Gramlich has articulated. I think there is a distinction between talking about potential unfolding macroeconomic developments and trying to link that too tightly to a certainty about them and, therefore, the policy reaction. The experience we've had before suggests that markets often, or at least occasionally, are prone to over-interpret where we are. And I would like to give them fewer words, if you will, with which to do that and, as Ned said, move the finger just a little bit away from the trigger even though it's not completely away. I think, as Larry has pointed out, that that movement away from the trigger is very helpful. So we ended up with a preference for alternative I by a margin of 4 to 3. I will say that as we did this many people said they could live with alternative I. Again, with regard to Ned's point about the group not being as divided as it might seem, our views weren't held with such a hard and fast force that individuals could never see moving to another option. So, that's where we were.

VICE CHAIRMAN MCDONOUGH. Could I ask a question?

MR. FERGUSON. Yes.

VICE CHAIRMAN MCDONOUGH. I'm confused on a point of fact. Is the proposal that, when we finally decide on the words, there will be three available statements, and at the end

of each meeting we will choose either to use the statement that the risks are balanced or that there is a likelihood of economic weakness or heightened inflation pressures? Is the proposal that one of those three statements will be made at the end of each meeting without any additional prose?

MR. FERGUSON. I think the proposal on the table is that one of those three statements will definitely be made after each meeting. There may be a bit of additional prose if we feel there should be more explanation as to why we voted in a certain way. But in terms of how we view the future, the intention of this working group was that that one sentence would handle the vast majority of the future statements. Now, we did have one experience, which I think drove us a bit. That was in our October meeting when we adopted asymmetry and had a follow-up sentence that suggested a bit of a time frame. There was a sense in our Working Group that if things were very closely balanced then we might need a follow-up sentence, and that's always an option. But the expectation would be that this sentence would carry most of the information on how we might weigh future developments. It was our hope--I don't know if we can achieve this or not--that we would end up with a situation in which markets are less focused on future policy decisions and much more focused on the existing policy decision.

CHAIRMAN GREENSPAN. Bill, I'm not a member of the Working Group and I wasn't in on the deliberations, but I have the suspicion that one can figure out how all this happened. None of us likes the words "symmetry" or "asymmetry" so, therefore, people start to think about what can we do in lieu of it. And we end up with symmetry/asymmetry, [laughter] or in this case, asymmetry/symmetry. What this comes down to is merely a choice of words, which convey the same notion. The issue basically is whether we want to have a soft statement, which is a recognition in my judgment of the fact that we really don't know what our next move will be, or whether we feel sufficiently confident to have a forecast of what we are going to do. First of all, the differences between these two alternatives are not that big. The only issue I see here is that if we decide on alternative I, at a later date we can go to II. If we decide on alternative II, we can't go back.

VICE CHAIRMAN MCDONOUGH. I agree.

CHAIRMAN GREENSPAN. I would be a little concerned about that because in a crazy way our experience over the last number of years is that we seemingly have understood what was going on in the economy. We may not have understood it as well as we would have

liked, but we didn't make any major blunders in policy. We really were never far behind the curve. We really were never in a position where we were forecasting recessions that did not happen or vice versa. But that has not been the experience over the decades. And I'm concerned that we may have the impression that we're better than we are in fact. I think having our finger off the trigger or a bit removed from the trigger, as Ned put it, is a measure of humility. And as Larry pointed out, the markets will read it anyway. I think that's probably right. So I think the only question is whether we put more burden on them to be certain and less on ourselves. I myself would prefer alternative I, but the arguments Larry made are very formidable arguments, I think.

MR. FERGUSON. Are there any other perspectives from those on the Working Group? I guess we will do this in the usual way, with a go-around. Jerry Jordan.

MR. JORDAN. As we saw in our actual deliberations earlier today, we need to take into consideration the risk that later on down the road with new information we will find out that we had the stance of policy calibrated wrong. Even if we take an action with the expectation of the risks being balanced in some way, the costs of changing are not symmetrical. As we've seen very often, we find it relatively easier to correct in one direction than the other. In part that is because the pressure on us from the outside is asymmetrical and always will be asymmetrical. That's a risk that I don't think it would be useful to put out in a press release. So I'm a minimalist on this. The least we can say about it the better, since we are not going to be talking about this other risk of suddenly changing course when we get new information and find out "oops," we had it slightly wrong. So, saying something about the balance with respect to likely policy actions I think is going too far. Saying something about the balance of risks to the outlook for the economy and inflation is the most that I would like to see us do at this stage.

MR. FERGUSON. Al Broaddus.

MR. BROADDUS. Roger, let me first say that I compliment your Working Group. You took on a tough set of issues and dealt with them I think very forthrightly and got all of the significant issues on the table.

Let me make just a couple of comments about the points of consensus. Generally I'm comfortable to one degree or another with all of them, and very comfortable with the first one. On the fifth one, which recommends that we not get a draft statement in advance, I came into the meeting thinking I would like to have it in advance, but after the discussion today I won't worry



about that. [Laughter] I guess the recommendation that I have serious reservations about is the ninth one, which involves the proposed change to the Authorization for Domestic Open Market Operations. I hope it goes without saying that in my mind the reservation is certainly not about Chairman Greenspan or any other chairman in particular for that matter, but about the crucial institutional relationship between the Chairman and the Committee. I can't say this absolutely, but to the best of my knowledge and that of staff members in Richmond who have studied the history of the Committee, I don't think the FOMC has ever previously authorized the Chairman to take policy actions without prior consultation with the Committee in a manner that would be--and this is the crucial part--so explicit, so public and, in my view at least, so permanent as is suggested in this recommendation. Instead, we have extended such latitude informally and internally and non-publicly. In my recollection in thinking back about it, the latitude has evolved over time with changes in our operating procedures, in the language of the directive, and as chairmen and members of the Committee have come and gone.

I have two principal--and I think practical--concerns about this. The first is that if we were to change the Authorization language as recommended, we might get to a point in the future where the Committee is not so comfortable with giving some future Chairman this latitude. But if we had this language, it would be very difficult to remove it because if we didn't renew the Authorization in its existing form, it would be like a vote of no confidence and almost a constitutional issue. So once we change the language, I think it would be not impossible to reverse that decision but it would be very difficult.

Secondly, it seems to me that doing this may expose the Chairman to more political pressure. Under the existing approach the Chairman is in a position where he can say, if pressure is put on him: "I can't do this by myself; I have to go back to the Committee." He would lose a bit of that cover. That may not be such an important point. The first of these two points is really the crucial one to my mind. As I understand the argument in the memo for doing this, it is that it is tied to taking the symmetry/asymmetry statement out of the operating paragraph. If that's a problem, then put it back in the operating paragraph. The language of the memorandum didn't strike me as indicating that removing it from the operating paragraph was urgent or truly compelling--desirable but not absolutely necessary.

As far as the choice between the language of the two alternatives is concerned, I suppose I could live with either but I have a pretty strong preference for the second one. The use

of the word “possible” suggests to me that the trigger isn’t fully cocked. The problem I have with the first option, looking at it as a whole, is that it almost formalizes a simple Phillips curve tradeoff between inflation and a recession. It’s quite possible, of course--we only have to remember our experience not too many years ago--to have the risk of both higher inflation and a recession simultaneously. In such circumstances, I think this choice would be problematic. We could change the language at that point, but after having argued about it for so many years in so many different forms I would hope that we can make a decision and stick with it forever.

MR. FERGUSON. You are an optimistic man! Cathy Minehan.

MS. MINEHAN. Actually, I find myself more in agreement with Al Broaddus on other points than on the final one he discussed just now. I think the Working Group has done us a favor by de-linking the discussion of symmetry from the implied authority of the Chairman to change monetary policy between FOMC meetings. My understanding is that the asymmetry phrase always has been interpreted as having two meanings. One is that it gives the Chairman some latitude and the second is that it conveys some sense of our discussion of the balance of risks at the meeting. It seems to me that unlinking those two things is an obviously good thing to do. As for making the Chairman’s authority explicit, I disagree with Al. I think it’s better that it be explicit than not. It offers the Committee the opportunity to object because it requires that the Committee be consulted afterwards if the Chairman did not find it feasible to do so beforehand. And we do have an opportunity in our annual review process--though I can’t imagine it ever coming to that--to renew this authorization or not. It seems to me a lot better to have this spelled out rather than have the degree of confusion surrounding the meaning of symmetry or asymmetry language I have seen in my experience sitting at this table. Often in the course of their comments on policy Committee members would give different interpretations of what they thought the symmetry or asymmetry phrase implied for policy. So I think it’s better to be explicit about this and give the Committee an opportunity to say yes or no on an annual basis.

As for the wording, I’m drawn to alternative I because it is less explicit about possible policy adjustments. And I think the Chairman has a good argument when he says we can go to alternative II if we find it necessary, but we can’t move back to “I” if we start with “II.”

MR. FERGUSON. Ed Boehne, you were next.

MR. BOEHNE. Thank you, Roger. I think that you and your colleagues on this Working Group have really done quite an extraordinary job to move us this far and you are to be complimented. My comments are intended within that overall framework.

As for the two alternatives, I favor "I." The main reason is that the finger ought to be a little further back from the trigger. Risks sometimes materialize and sometimes they don't. When we add the policy side to our assessment of the balance of risks, we're really making a two-step statement whereas a description of the balance of risks makes it a one-step statement. And it is easier to go from "I" to "II" if we want than to do the reverse. So I come down for "I."

As for the proposed wording of paragraph 2 of the Authorization, as shown near the top of page 4, I think the Chairman absolutely has to have the authority to move between meetings in extraordinary circumstances. I don't think that's debatable. The world is not always predictable and I think the Chairman simply has to have that authority. It has been implicit in the directive. In fact, we got into this symmetry and asymmetry language partially for that reason--to try to fine-tune the extent of the authority that the Chairman has between meetings. So if we are going to make the adjustment and de-couple this from the directive itself, then I agree with Cathy that we have to be clear about it and expressly state it. I do have some concern about the precise wording. I think it ought to be the Committee authorizing the Chairman to direct the Federal Reserve Bank of New York, etc., etc. I don't think we ought to be delegating authority directly to the Federal Reserve Bank of New York and putting the Chairman in a consultative position. But I agree with the basic premise that the Chairman has to have this authority; the precise wording is another issue.

I have just one more comment, which relates to the points of consensus, and I don't feel strongly about it. Point two says that the FOMC's vote at every meeting should encompass both the intended federal funds rate and the symmetry or asymmetry. And point three says the operating paragraph no longer would contain any sentence referring to the Committee's consensus about symmetry or asymmetry. As I read it, on the surface at least, that appears to be an inconsistency. But I don't feel strongly about that issue.

VICE CHAIRMAN MCDONOUGH. Roger, I think President Boehne was just practicing law. It seems ironic that the General Counsel would propose something different and I want to know why.

MR. FERGUSON. I was actually pointing in the General Counsel's direction. I think it is important for everyone to know that the language proposed is Virgil Mattingly's language. He can continue to work at it, if you think that's appropriate.

MR. BOEHNE. Virgil, if I had known it was your language, I would not have questioned it. [Laughter] But I'd still like to hear your explanation.

MR. MATTINGLY. What is involved here is the fact that only the Committee can direct a Federal Reserve Bank to take action. What the Chairman's authority derives from is the ability to interpret that direction. And that's what this language is intended to address. I don't think it's possible for the Committee to give to the Chairman the authority to move monetary policy on his own.

MR. BOEHNE. I withdraw my suggestion on the words. My main point is the substantive issue that the Chairman needs such authority.

MR. MATTINGLY. The Working Group did change the draft wording to say the New York Bank could adjust the rate but only with the approval of the Chairman, instead of after consultation.

MR. BOEHNE. Okay, that's fine.

MR. FERGUSON. I think Tom Hoenig was next.

MR. HOENIG. Thank you. On the alternatives, I strongly prefer alternative I. In my view it's more honest in the sense that we are balancing the risks. If we weren't, we could take the action only at the time of the meeting. So I think it is the better way of expressing how we see the likelihood of developments in the future rather than implying that we have our finger on the trigger. So I strongly prefer alternative I.

In terms of the proposed amendment to paragraph 2 of the Authorization, I welcome it because the Chairman's authority to initiate a policy action between meetings has been a source of confusion in this Committee for as long as I've been a participant in these meetings. This defines and clarifies his authority and his responsibility for consulting with the Committee so we won't differ on what we think we've done in adopting symmetry or asymmetry. I consider it a clarification. It puts some understandable parameters around the Chairman's authority, which I think is a good idea. So I'm in favor of that.

MR. FERGUSON. Gary Stern, I have you next on the list.

MR. STERN. With regard to the alternatives on symmetry or asymmetry, I strongly favor alternative I as well for the reasons that the other advocates have cited. With regard to recommendation number nine and the Chairman's authority, I'm in favor of something like what is proposed here. I'm willing to leave the decision on the exact language to others, but I certainly favor something like that.

MR. FERGUSON. Jack Guynn.

MR. GUYNN. In the interest of time, I'll echo Gary Stern's comments. I also strongly prefer alternative I. I think there's less chance of the statement being seen as a tentative policy decision. I, too, would like to see us be as explicit as possible in finding the right words for the Chairman's authority. I would emphasize the desirability of consultation with the full Committee whenever feasible, and I would hope that that would be the case in almost all instances. I, too, stumbled over the words about the New York Fed and consultation with the Chairman. I hope we will look at that some more.

MR. FERGUSON. Bob McTeer is next.

MR. MCTEER. I continue to think that the best thing for us to do is not to vote on a bias at the meeting and, therefore, there won't be one to report on. I think it creates too many opportunities for us to be wrong, to come up with a bias and then not follow through on it. Sometimes I worry that we might follow through on it because we had the bias in the first place. But the argument to so away with the bias statement is obviously not going to go anywhere.

So given the choice presented by the Working Group, I find it a very close call. I guess I would go along with alternative I, but would urge some more thinking about the appropriate words to use. On the execution of the Committee's policy decisions between meetings, if Al Broaddus and Virgil Mattingly could get together and keep it legal I would hope that Al's points could be taken into account. I agree with Jack Guynn on the desirability of consultation with the Committee.

MR. FERGUSON. Bill McDonough.

VICE CHAIRMAN MCDONOUGH. First of all, I respect highly the ability of the General Counsel to practice law. But I think we have to be careful that in the process of clarifying the Chairman's authority we don't overlook the fact that the Committee's agent to carry out its responsibilities is the Federal Reserve Bank of New York or whichever Reserve Bank is selected at our annual organizational meeting. We wouldn't want to be in a position

where we had the world going up for grabs and have somebody decide that the Desk couldn't do anything until it had talked to the Chairman. The Desk obviously is not going to change the official fed funds rate, but surely it is going to provide the liquidity or drain liquidity if that's necessary. And I think we have to be very careful that the Desk's authority to do that is not placed in question by anything we do to solve this other problem.

CHAIRMAN GREENSPAN. Does it actually say "in consultation with the Federal Reserve Bank of New York"?

MR. FERGUSON. No, what it says is that the Federal Reserve Bank of New York will consult with you.

CHAIRMAN GREENSPAN. Does it say the Federal Reserve Bank of New York?

MR. FERGUSON. This draft says the Federal Reserve Bank of New York.

CHAIRMAN GREENSPAN. We can't have that because we vote on that every year.

MR. FERGUSON. This would be voted on every year as well. The point is that both would be voted on annually.

CHAIRMAN GREENSPAN. This would be voted on after we decide which Reserve Bank will execute transactions for the System Open Market Account.

MR. FERGUSON. Yes, after we have decided that. This is written with the current status quo in mind, but if we voted to select a different Bank, then we would make a conforming amendment in the Authorization. Bill, did you have a perspective on alternative I versus alternative II?

VICE CHAIRMAN MCDONOUGH. My main desire is that we get away from the business of looking at ourselves in the mirror. Therefore, I like the idea that most of the time-- ideally all the time--we would have one of three psalms. The 23<sup>rd</sup> psalm, my favorite, which starts out "The Lord is my Shepherd," has been around for 2,850 years and it has been doing a pretty good job. So I think if we have our own 22<sup>nd</sup>, 23<sup>rd</sup>, and 24<sup>th</sup> psalms and the only thing we have to decide is which one we are going to use, that will supply the needed information to the market. That's option I. That would avoid the confusion caused by the modern version of the Fed watcher deciding that if we change this word or that comma, there are grave market implications in that change. What I like most of all is the consistency.

MR. FERGUSON. I think Larry Meyer had another comment.

MR. MEYER. I just had a comment on the Chairman's latitude. When Ed Boehne talked about it, the first thing he said was something like: Of course, the Chairman must have the authority to move in exceptional cases. I didn't see anything here about "exceptional cases," and that's part of my problem. If this were handed out as a public statement, I think it would seem to convey the notion that the Chairman has more latitude than the market might have expected. There's almost a sense of encouraging the Chairman to review the data during the intermeeting period and to make adjustments as he sees fit. I don't think that interpretation is something we want to encourage. Most decisions should be made in FOMC meetings; that's the best place to make them. In exceptional cases, though, it's important for the Chairman to have that authority. October 15<sup>th</sup> of last year was a perfect example of it being used to its best effect. That may be understood inside this organization, and I wouldn't want to convey an impression outside that this latitude was for other than those exceptional cases.

The other question is linked or de-linked, coupled or de-coupled. It seems to me that this statement says any decision and adjustment should reflect the Committee's discussion and decision at the previous meeting. That might be a sufficient linkage. There should be some linkage. If the Committee's vote was for symmetry--if the Committee put out a statement that said there was little chance that a move was going to be necessary--that doesn't mean that a move couldn't be made in exceptional cases. It just raises the hurdle a bit higher than would otherwise be the case. Whereas if we thought it was more likely that the risks were tilted toward higher inflation, there would be less of a hurdle for the data to push the Chairman toward an interim adjustment.

MR. HOENIG. Larry, could you clarify your position? Are you saying that this paragraph should have stronger language?

MR. MEYER. I read this change as almost an encouragement of more frequent intermeeting adjustments. I would prefer it to say that the Committee appreciates that in rare cases the Chairman has the authority to act on the Committee's behalf.

MR. HOENIG. All right.

MR. FERGUSON. Let me say a couple of things. First, there is no intention to change our standard procedure. And when it comes time to adopt something like this language, I think the minutes should reflect that this is not intended to expand or contract the authority the

Chairman normally has. Secondly, Virgil and others can look at this again and see if we can put more words around it to make sure it truly reflects the sense of the discussion here.

Let me tell you where I think we have come out and what I would like the Working Group to do. I have a sense that there was general agreement, since I heard very few exceptions, on the consensus points reached by our Working Group. So I will assume that we will keep those on the table as they are. I did hear some questions or suggestions--though not significant changes--on the language with respect to the Chairman's latitude. Virgil is here and he heard the comments too, so we can continue to work on that. But I think the sense of the discussion was that we don't want to expand or contract the Chairman's authority and that we do want to keep the consultative process involved. We know we are looking for some consistency of interpretation. And the final thing was to make sure that we have some sense of this being the exception and not the norm; in no sense are we encouraging the Chairman to do things that currently are not encouraged.

On the issue of how we talk about the future--for which we will use the shorthand "symmetry/asymmetry"--while a few people preferred alternative II, the vast majority seemed to prefer alternative I. Therefore, I would like the Working Group to go back and try to continue to polish those words and then present them to this Committee. Depending on how quickly we can do that, we will distribute another memo, hopefully in the upcoming intermeeting interval, with the expectation that at the next meeting the FOMC will make a formal decision to adopt the recommendations of the Working Group. That would include a decision on the language, with the focus on alternative I as the general direction. I think that's where we are.

CHAIRMAN GREENSPAN. We got a lot more done on this than I expected. There are no other items on the agenda except to confirm the date of the next meeting, which is Tuesday, the 21<sup>st</sup> of December.

END OF MEETING