

Meeting of the Federal Open Market Committee

May 18, 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, May 18, 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
Ms. Rivlin
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. Baxter, Deputy General Counsel
Mr. Prell, Economist
Ms. Johnson, Economist

Messrs. Alexander, Cecchetti, Hooper, Hunter, Lang, Lindsey, Rolnick, Rosenblum, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

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

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

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

Mr. Connolly, First Vice President, Federal Reserve Bank of Boston

Ms. Browne, Messrs. Goodfriend, Hakkio, Ms. Krieger, and Mr.
Sniderman, Senior Vice Presidents, Federal Reserve Banks of
Boston, Richmond, Kansas City, New York, and Cleveland
respectively

Messrs. Cunningham and Gavin, Vice Presidents, Federal Reserve
Bank of Atlanta and St. Louis respectively

Mr. Trehan, Research Officer, Federal Reserve Bank of San Francisco

Transcript of Federal Open Market Committee Meeting of
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CHAIRMAN GREENSPAN. Who would like to move to approve the minutes of the March meeting?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection they are approved. Mr. Fisher, you have the floor.

MR. FISHER. Thank you. I will be referring to the package of charts in front of you.^{1/}

I will be discussing three distinct topics this morning: first, recent interest rate and exchange rate developments; second, the recent behavior of the funds rate and Desk operations; and third, some preliminary thoughts about the Y2K issues the Desk may be facing.

Turning to the first chart on forward rate contracts for 3-month deposits, you can see in the top panel that after the last meeting U.S. forward rates drifted lower and then began rising, intriguingly, from about the time of the European Central Bank (ECB) rate cut. Subsequently, they rose significantly further after the release of the first-quarter GDP data and the Chairman's May 6 remarks in Chicago. Of course, last Friday the CPI data caused an even bigger jump in the forward rates, with the 9-month forward 3-month rate backing up 21 basis points to 5.51 percent and the 3-month forward rate backing up 10 basis points to 5.18 percent. The September fed funds futures contract rose 8 basis points on the day to 4.50 percent and the long bond backed up 17 basis points to around 5.92 percent.

In the middle panel you can see that the ECB managed to surprise the markets a bit with a 50 basis point cut in its repo rates about a week after your last meeting. And forward rates have shifted lower more recently, with the 3-month forward 3-month rate right on top of the current 3-month rate.

The bottom panel shows rate movements in Japan. While a few brave souls were suggesting a few weeks ago that there may be evidence of a reviving Japanese economy--the Wall Street Journal, for example, brought out the old hackneyed story about a rise in golf club memberships --there are no such signs in the forward interest rate market. Looking at interest rate markets, it is hard not to notice that at this point, almost

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

halfway through the year, the U.S. economy seems to be chugging right along, while the rest of the world is at best sluggish.

Turning to the second page, the top panel shows selected 3-month deposit rates in terms of the change in basis points from January 4 and the bottom panel shows the percentage change in various currencies against the dollar, indexed to January 4. Without going through all the details--the specifics are covered in our written report--twelve central banks have cut rates since your last meeting, six of them more than once. As you can see, much of the world has declining 3-month rates and declining currencies relative to the dollar. But as can be seen clearly in the bottom panel, two interesting exceptions are Mexico and Canada, whose currencies have been strengthening against the dollar. However, it may be worth considering the possibility that the weakening of our exchange rate with our North American counterparts could reflect the strength of the U.S. economy and its spillover to the north and to the south.

The charts on the third page display changes in the Treasury yield curve over the last two years. The top panel shows rates for on-the-run coupon securities from May 1, 1997 through May 14, 1999 and the bottom panel depicts selected yield curves. Again, as a consequence of the CPI release last Friday, you can see that the long end of the on-the-run curve has backed up to about where it was a year ago. That backup is a little hard to see in the top panel because of the brownish-orange vertical line, but the bottom panel shows it more clearly; the yield on the 30-year bond rose to 5.91 percent and the 10-year rate went to 5.61 percent. But it is worth pointing out in the micro picture of the last few days that the 30-year bond had backed up--you cannot see it in this scale--to 5.86 percent on Wednesday in anticipation of the PPI numbers to be released on Thursday. Those data gave the market something of a pleasant surprise and the bond closed Thursday at 5.75 percent. So the market had been bracing itself for a negative inflation shock, got a head fake from the PPI numbers Thursday, and then got faked out again Friday. This morning, the long bond is actually trading at 5.87 percent, only 1 basis point higher than the close on Wednesday. It certainly was a big move, but it is worth noting that some of it had already occurred, was taken away, and then given back.

Of the four yield curves shown in the bottom panel, the steepest was on May 1, 1997, which is before any of the pressures developed in Thailand. The panel also depicts the rather flat yield curve of May 1998, the inverted curve of last October, and last Friday's yield curve. The floating diamonds reflect the twice off-the-run 30-year bond yield, which I have noted there as a placeholder. I think of that rate as providing something of a crude measure of market uncertainty about the level of long-term rates. Which way to look at the liquidity premium is something

worth pondering. To anticipate what the Chairman may ask me after my remarks: Yes, bid/ask spreads on both on-the-run and off-the-run securities are a good bit wider today than they were at the time of your last meeting. They had come in a little further by the end of April, but the noise of the last few days has moved them out a bit.

Turning to open market operations, the top chart on page 4 shows the trading range of the funds rate over the last four maintenance periods. As shown in the upper left portion, covering the first maintenance period from March 25 to April 7, we supplied a high level of excess reserves to try to get through the quarter-end and month-end period, but we faced fairly typical pressures for such a period. However, the intriguing interval was the second period, depicted in the upper right portion of the chart, when we never quite appreciated the speed with which banks shifted to a desire to be on the short side of meeting their reserve requirements. You can see there how softly the funds rate traded over the period, when we supplied only \$900 million of excess reserves on average. Initially, lower-than-expected tax receipts through most of April were a contributing factor, as receipts lagged our daily estimates. They caught up at the end of the month, leaving the market initially in the next period with higher reserve levels than we intended. There also seems to have been some hangover effect from last year when we had a very soft funds rate.

To bring pricing back in line, we left excess reserves in rather short supply at the start of the April 22 maintenance period, which was compounded by a bit of a miss and gave us a rather firm market on April 26 with a standard deviation of 197 basis points. That did seem to shock the market back to a trading level a little closer to the target. But, again, we have seen some oscillation. Yesterday's funds market was a bit firmer than we had hoped, but rather typical for a quarterly refunding day; the effective rate was around 5.01 percent. The average rate for the period we are in now is still just 4.76 percent, including yesterday's firm rate.

Turning to the next page, I've provided a quick summary so you can see that this year's tax season was roughly similar to last year's tax season. The blue dots represent 1998 and the red dots 1999. Funds have traded around zero for the effective rate minus the target rate, as is evident by the cluster of dots near zero on the vertical axis showing the standard deviation. If you look rather carefully--perhaps if you squint--you can see that the softness of last year was not entirely repeated. The shorthand way to see that is to note that there are slightly more red dots than blue dots to the right of the zero, i.e. on the firmer side. But the pattern was roughly similar to last year's.

Let me mention a few other issues regarding our open market operations. We commenced the securities lending program on April 26.

Since then we have lent securities on 16 different days, and on 5 occasions we had overbidding in the 30-year bond, beyond our lending limit of 25 percent of our holdings. There were also 3 occasions when we had more bids than we needed in the 10-year area. There were 4 days of no borrowing. Interestingly, on 8 days we lent bills and coupons that were not being actively traded. I view that as a very good sign for the program --that it really involved securities loans that were very close to maturity and might have led to fails; so, that was very helpful. Let me be clear that I think this program is going well. As I mentioned last time, I am likely to want to raise the limits at some point in the future, but before doing so I will complete a more thorough analysis of our experience with the program, which I will share with the Committee and the Treasury.

In our outright operations since your last meeting, we added a net of \$11.74 billion to the SOMA portfolio in 16 different pass operations over 12 different days. We did a TIPS pass where we purchased \$303 million of inflation-indexed securities against bids by the dealers of \$3.9 billion. The reaction to our purchases in the TIPS market was very muted.

I would note that currency in circulation has been growing more rapidly this year than last year, which explains in part the extent of our outright operations through April. The currency component of M1 has grown at an average annual monthly rate of 10.9 percent versus 6.7 percent last year. For the coming intermeeting period, we are now forecasting a \$9.9 billion growth in currency as opposed to \$5.3 billion over the same period last year.

A number of you have asked me about our preliminary thinking at the Desk on Y2K issues. I thought it would be helpful to share with you some thoughts on this, but I want to be clear that these are very preliminary views. I am not committed to these ideas, but it might be helpful to take you through them, even though I am not looking for approval or concurrence at this time.

If you turn to the next page, I have listed some of our preliminary thoughts on this subject. First and most importantly, I think there is an increased likelihood that later in the year the Desk will be operating on both sides of the market, alternately adding and draining reserves in any given period of time. Secondly, the Special Lending Facility that the Board addressed yesterday, if used as intended, will provide a means for the System's balance sheet to expand as we lend to small banks, who may be perceived to be less well prepared than the large banks to handle any Y2K problems. Small banks may lose deposits either through outright withdrawals or transfers of deposits to larger banks that are perceived to be better prepared.

Now, the large banks may not be comfortable with either holding high levels of excess reserves or recycling deposits back to lesser credits. This could lead to a tiering in the funds market, with the System acting as an intermediary--providing added reserves to the small banks through the Special Lending Facility and perhaps needing to drain reserves from the large banks. Thus, the System's balance sheet may expand through the use of the Special Lending Facility as well as through our outright and longer-term repo operations. We are likely to need to fine-tune more frequently, alternating the use of repos and matched sale transactions. Perhaps the simplest way to put this is just that we may have greater uncertainty; and in a period of greater uncertainty, the Desk is likely to need to be on both sides of the market.

A separate and much narrower issue is that as we approach the year-end, if there appears to be a developing scarcity of collateral, as some fear, we may be inclined to oversupply reserves intentionally early on with term repos. Then we can fine-tune total reserves over the turn of the year through matched sale draining operations, where we provide the collateral; thus we would not be dependent on the securities markets to come forward with the collateral for our operations.

Also, we are giving some consideration to the need for late-day operations. We are still thinking this through, but we think we might need to conduct some operations late in the day; otherwise there might be pressure around the time of the regular 3 p.m. close of the securities wire. To drain reserves, we might do matched sales late in the day, though we would have to find some means of crediting the collateral to the dealers' accounts after what would be the normal close of the wire. To add reserves, we are giving some consideration to the use of a third-party custodian--really just Chase and Bank of New York who could act as custodial agents for us--in the acceptance of certain types of collateral. The Desk's systems simply are not geared up to take some forms of collateral that in fact are eligible for use in our operations.

Finally, the next page is a chart of the year-end butterfly trade for 1999/2000, the red line, and for the previous three year-end periods. The difference between the yields on the 3-month December Eurodollar contract against the average of the two surrounding contracts is an expression of year-end funding anxiety. You can see the rather extraordinary levels to which that differential rose over this past year-end and early this year. It has come off quite a bit since then. While it was trading at the higher levels, we gave some consideration to the question of how we might respond, if you wished us to, to anticipated year-end pressures in the funding market. The only tool that we have in our arsenal now would be a forward RP--to inject reserves by doing forward RPs that the dealers might execute with us. I have to say that gives me some pause

in terms of putting on our books operations that may not be necessary. It seems to me to be a less-than-optimal approach. Conceptually, a tidier tool would be the use of options: We would sell options on both repo and matched sale transactions at strike prices out from the Committee's target and allow the dealers to bid for those as a way of getting assurance that year-end financing would be available. I want to repeat that this is really a conceptual issue regarding how we might respond if this premium began to rise again and the Committee were concerned about funding in the year-end market. That is really all I can say at this point on these Y2K issues that a number of you have asked me about. I hope this gives you a sense of our thinking on the subject.

In conclusion, Mr. Chairman, we had no foreign operations during the period but I will need the Committee's ratification of our domestic operations. I have a separate issue to bring before the Committee about the renewal of our Mexican and Canadian swap lines. I sent a memo to the Committee explaining that the appropriate timing for a vote on that is now rather than later in the year. So, I will also need a vote on that issue. I would be happy to take questions on any aspect of my report, and then, as you wish, we could take the two votes separately.

CHAIRMAN GREENSPAN. Peter, in the event, a low probability event, of very significant runs on smaller banks for currency withdrawals or deposit transfers, do those banks have enough collateral to come to the discount window and liquefy the asset side of their balance sheets to weather that drain?

MR. FISHER. I would not consider myself the System's leading expert on the subject. I think they have collateral. At the discount window we can take pretty much anything they have in terms of customer notes.

CHAIRMAN GREENSPAN. I know we can do that, but I am wondering what they have.

MR. FISHER. Well, if your question relates to what collateral we currently have in our possession, I should note that we also take on-site collateral in some cases. The discount officers have been working on this issue, writing letters encouraging the banks to get their collateral in and pledge it, but we are not there yet.

CHAIRMAN GREENSPAN. Suppose a bank holds a note of a long-term friend of the bank's president, which is 10 percent of the asset side of the balance sheet. Let's say everything about the loan looks fine: It's a performing loan and the bank itself is perfectly comfortable with it; indeed, it is a terrific loan. Can we accept that?

MR. FISHER. Yes.

MR. KOHN. Yes, with a haircut. If it's a loan, there is a haircut because it is not marketable and is therefore hard to value. And there's a further haircut if it is a long-term loan.

CHAIRMAN GREENSPAN. Now the premise changes and the good friend of the president of the bank is in evident difficulty, not in servicing the loan but in repaying it at the end of its term. What is the point at which we effectively throw these people into bankruptcy?

MR. FISHER. That is the issue that I think the most thoughtful institutions in the market are anxious about in terms of Y2K concerns: What will be good business practice with regard to closing out counterparties? How many grace days are going to be appropriate? Will this be a one-day hurricane and then everything will be back to normal, or will it be something more than that? Swap agreements have three days, repo agreements have two days; a grace period is written into the contracts. So having the loan as collateral makes things a bit easier, but there are a huge number of instruments out there that are on what might be considered hair triggers. It is a very awkward subject, and not just for us. We will be part of a larger community that will be grappling with that question.

CHAIRMAN GREENSPAN. But we are the only lender of last resort.

MR. FISHER. Absolutely. But if you think of banks as big as Chase or Citibank, it's a virtual certainty that some of their customers will have computer problems.

MR. KOHN. I think our supervisors would be looking at the fundamental soundness of those customers and whether the liquidity problem is a short-term or a long-term problem. I thought your question had to do with whether this particular customer might be in a difficult long-term situation so the viability--

CHAIRMAN GREENSPAN. I am concerned about our being in a position where we are unprepared to make judgments on which banks we effectively will shut down because we are not going to accept their paper at the discount window and by definition there is no other lender of last resort.

MR. KOHN. Our supervisory people are working very closely with the other supervisory authorities through the FFIEC to make sure that the lines of communication are open and that thought has been given to these very points in advance of the year-end. So it is very much on the agenda of the contingency planners. I don't know if that provides any comfort, but people are thinking about precisely the issue you've raised.

CHAIRMAN GREENSPAN. Communication is fine. But suppose somebody at the other end of the line says: "Hey, I am drowning. What are you going to do for me?"

MR. KOHN. Well, I would point out that in the middle 1980s in Chicago and through the late 1980s and early 1990s in New England and Texas, we made huge volumes of loans to banks that had a lot of bad assets without ever impairing our collateral position. For most banks, if we look hard at the assets they have, I think we can get enough collateral for comfort.

CHAIRMAN GREENSPAN. I think that is the judgment we have to make. All I am suggesting is that we try to make it in advance.

MR. KOHN. That is why, as Peter noted, we are urging very strongly that banks come in ahead of time to pre-position collateral and talk to the discount officers.

MR. MOSKOW. Mr. Chairman, Don is correct that we are doing that. The discount officers are urging both small banks and large banks to have their borrowing documents up-to-date and their collateral in place ahead of time. But given the number of people involved and the speed with which this is happening, it seems clear that many banks are not going to have done this in advance. So there will be a lot of last minute scurrying around.

CHAIRMAN GREENSPAN. We can make a judgment as to whether we are looking at a systemic risk, in which case we can act under certain provisions specified in the Federal Reserve Act. But what do we do if the risk is not obviously systemic but a very significant problem for, say, Texas or some other area where there is a multitude of small banks?

MR. PARRY. Don, are banks executing all-asset pledges? Isn't that a way to--

MR. KOHN. I am not sure, Bob.

MR. PARRY. We have done that in the past.

MR. KOHN. We have done that with banks. The Bank of New York is a classic example where we took the building, the furniture, virtually everything as collateral. In this case, we have the complication of the Home Loan Banks.

MS. MINEHAN. I think we did some variant of that for smaller institutions at the time of the New England banking crisis. We can do these things fairly fast but it is hard to do so for multiple institutions fairly fast.

MR. PARRY. But there is a problem with the Federal Home Loan Banks.

MR. KOHN. Right. We are working on that.

MS. MINEHAN. The other issue we have been tracking on a monthly basis is how many banks versus how many thrifts have filed their documentation and pledged collateral. We are at close to 70 percent on the banks. The thrifts are the concern.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. I have a very quick comment. My impression is that a lot of the small institutions are not setting up lines with us because they are assuming that the Home Loan Banks will provide the liquidity. It is not obvious to me that the Home Loan Banks know where they are going to get their liquidity. So I would think that's a critical point to straighten out with the Home Loan Bank System. We need to make sure that we somehow either backstop that system or that they tell their banks in no uncertain terms what those lines are going to be. That will force the smaller banks to set up arrangements with us.

CHAIRMAN GREENSPAN. If we backstop that system, it will be difficult to unwind it because they are going to want to keep it in place.

MR. POOLE. I agree with that. That is why I think we might be able to get them to be more explicit about how much they will be able to provide through their own resources so that the banks will realize that they must backstop themselves with us. In my conversations with small banks, there is this presumption that it is all taken care of and that their Home Loan Bank will take care of them. I don't think they have really thought that through.

MS. MINEHAN. Certainly not on the cash side.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. The Home Loan Banks put out a statement, over the weekend I believe, which I read as saying: We will take care of all the banks we deal with but maybe we won't, so then you will have to go to the Fed. That puts us in an untenable position. We have to increase the pressure as we get into the summer because we really cannot wait until the last days of December and have some banks that have been asleep all year wake up and decide they have a problem. I think we have to be banging on their doors or banging on their heads, if necessary, to bring this to their attention.

We also have an issue regarding the large banks that will be the recipients of large flows of funds. Some of them are getting very concerned about the flows getting so large that they could become less than well capitalized.

MS. MINEHAN. We have that worry, too.

VICE CHAIRMAN MCDONOUGH. I think we have to find a way consistent with our regulations that allows the banks to do exactly what we want them to do--that is, to bring in the funds and recycle them even though they will blow up their balance sheets as a result. Work is going on in the System now on how to handle that problem.

CHAIRMAN GREENSPAN. Any further questions on open market operations? If not, who would like to move to ratify the domestic transactions?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection they are approved. Mr. Fisher, you wanted to discuss our swap arrangements with Canada and Mexico.

MR. FISHER. Yes, I sent the Committee a memo on May 13 about the renewal of our swap arrangements with Mexico and Canada that were established under the North American Framework Agreement. A reading of the fine print--indeed Mr. Truman's reading of the fine print--made us realize that under the terms of these swap arrangements 6 months' notice is required to terminate them. Therefore, the appropriate time for the Committee to decide to renew or not to renew them at year-end is now and not, as has been our custom, in November. Given some of the Y2K issues as well as the separatist issue still afoot in Canada, our counterparts in Mexico and Canada may be particularly anxious about them. So it is my recommendation that the Committee vote to renew these two agreements at this time.

CHAIRMAN GREENSPAN. Questions for Peter? If not, would somebody like to move that?

VICE CHAIRMAN MCDONOUGH. Move approval, Mr. Chairman.

CHAIRMAN GREENSPAN. Is there a second?

SEVERAL. Second.

CHAIRMAN GREENSPAN. Without objection. Thank you very much. Let's turn now to Mr. Prell.

MR. PRELL. Thank you, Mr. Chairman. The April Consumer Price Index, published the day after we printed the Greenbook, obviously is occupying center stage in the financial markets and I would guess that it's a pretty prominent question mark for many of you today. But, before getting into the nuts and bolts of that report and our interpretation, I'd like to say a few words about the broader aggregate demand and supply setting.

First, on the demand side, the picture is still one of strength overall. We think, however, that the first-quarter increase in real domestic final purchases of 7 percent greatly overstates the underlying trends. A variety of transitory factors combined to boost outlays: the dip in interest rates last fall, since reversed; the stepped-up incentives for auto-buyers, as GM drove to restore its market share; the abnormally mild winter weather; and so on. Given those considerations, it's quite reasonable to anticipate a noticeable slackening of expenditure growth this quarter.

And the latest retail sales figures support that assessment--although we didn't realize it fully when we finished our forecast last Thursday. The surprisingly large increase in goods prices in Friday's CPI report implied that the softening in real spending was even more marked last month than we had thought on the basis of the nominal retail sales data. If we're right, real PCE growth in the current quarter will be somewhere in the neighborhood of 4 percent, at an annual rate--scarcely a weak number, but one that would be at the low end of the range of recent quarters.

Another area of deceleration in our forecast for the second quarter is residential investment. Our thesis has been that, although the demand for homes probably hasn't fallen off much, builders would find it difficult--perhaps practically impossible--to maintain the seasonally adjusted level of starts they recorded during the late fall and winter months. This morning's report is consistent with that notion. Actually, single-family starts fell more than we anticipated, 11 percent; but, as we thought last month, the single-family permits figures may be telling a more accurate story, having fallen about 4½ percent in March and another 3 percent in April.

The final major element of deceleration in spending this quarter is state and local purchases--especially outlays for construction. In this case, we still have no useful data beyond March, but it just doesn't seem plausible to extrapolate the surge that we saw this winter. Unusually favorable weather almost certainly helped move building ahead of schedule, and some reversion to trend is to be expected in the near term. This is not to deny that the underlying trend in public construction could be relatively steep at this time. Among other things, the transportation bill passed last year is helping to spur activity, and states and localities have been experiencing a bit of a wealth effect themselves, as their revenues reflect, directly or indirectly, the capital gains taxpayers have been enjoying.

The wealth effect remains central to our projection of domestic demand and economic activity through next year. To be sure, we believe that waning accelerator effects should be a moderating force with respect to houses, consumer durables, and business capital goods--and, as we noted in the Greenbook, one can discern some hints of this already in various categories of expenditure. But, if the stock market continues to soar, consumers' perceptions of their permanent income will rise and so too will businesses' perceptions of their sales prospects; target levels of household and business investment goods will move still higher. So, the fact that we've anticipated that the market will peak soon is crucial to our prediction that GDP growth will moderate over the coming year.

As it is, the run-up in stock prices last month prompted us to raise our forecast of demand growth during the next several quarters. However, this has shown through to output rather than to prices because of the more favorable supply-side environment we are now projecting. Perhaps most notably, we've raised our sights on the prospects for gains in labor productivity, and that has permitted us to raise projected output without commensurate increases in pressures on labor markets.

Our reassessment of the productivity outlook is yet one more in a sequence of adjustments we've made on the basis of incoming data over the past few years. We'd prefer to rely on deep analytical insights, but the fact is that the behavior of productivity is not well understood, let alone readily predictable; if it were otherwise, economists wouldn't still be scratching their heads over the post-1973 deterioration in the trend of economic growth. Consequently, we've had to feel our way on this.

In our view, the pickup in output per hour over the past year or so has been greater than is likely attributable simply to the rapid growth of output--the so-called "cyclical" influence. Firms do seem to be achieving substantial structural gains in efficiency through technological

innovations, investments in more and better equipment, improved information management, and reorganization of production and distribution processes. Given the continuing high level of investment and what we hear from business people about their efforts to improve productivity, there doesn't appear to be any reason to anticipate that these gains will fall off markedly in the near term--apart from some tendency for reductions in worker hours to lag those in output as the rate of GDP expansion slows. And even that cyclical element might be weaker than in the past, given the heavier use of contingent workers and the pressures on executives to deliver strong earnings quarter after quarter--except, I suppose, in the dot-com sector. So, putting this all together, we've added several tenths to the rate of increase in output per hour through the year 2000.

Obviously, the outlook for productivity is a consideration in the near-term prospects for inflation. Among other things, the recent surge in productivity has helped boost profit margins and thereby given firms more room to compete for market share without forgoing acceptable rates of return on equity. Moreover, the compensation part of the unit labor cost ratio is also looking more favorable. Even taking the first-quarter ECI with a large grain of salt, we now have some evidence that, perhaps in part because of a lagged response to the lower price increases of the past couple of years, nominal pay gains are not moving up--despite a tight labor market. These considerations encouraged us to take a smidgen off our core inflation forecast--as did the surprisingly low price numbers through March. But, especially with oil prices and other "special factors" already, or expected soon to be, taking a turn for the worse, we've maintained our view that an unemployment rate in the low 4s will in time prove incompatible with stable or declining inflation. The question is whether the four-tenths leap in the April core CPI is telling us that the day of reckoning actually has arrived.

We're inclined to be fairly sanguine on this score at this point. In part, this is simply because what we hear from businesses doesn't suggest that there's been anything approaching a sea change in the pricing environment. But on the statistical side, while it's almost always possible to slice and dice these data to find some residual that fits your priors, we think there are elements in the April CPI report that provide at least some grounds for skepticism that the burst in the core index is truly a sign that the trend of inflation has now turned upward. For example, the sizable increase in apparel prices merely reversed surprisingly large declines in the first quarter; we expected an offsetting firming of prices somewhere along the line, and we may simply have missed the timing. And the rebound in tobacco prices after some discounting in March probably is telling us little about fundamental macro imbalances in the economy. Incidentally, it's perhaps worth noting that, setting aside tobacco prices,

which have risen 33 percent since last April, the twelve-month change in the core CPI is the same as it was a year ago, even after we add back in the effects of the technical changes in the index.

All that said, though, we didn't anticipate the outsized April increase and we wouldn't feel comfortable ignoring it. If we were redoing our projections now, we'd tack a tenth or two onto our inflation projections for 1999 and 2000. This would not really alter the basic conclusion that we, and now many bond market commentators, have reached: that the best news on inflation is behind us and that prices will most likely tend to accelerate over time unless domestic demand softens considerably or we experience additional fortuitous external shocks.

Given that we cannot divine those shocks, we've pointed to the likely need for some monetary policy tightening aimed at reining in aggregate demand. The fixed-income markets have been firming on their own in recent weeks--especially in the case of Treasury securities. But it isn't clear that this is wholly a real tightening, as opposed to an escalation of inflation premiums. Moreover, many lower quality corporate bond issuers have seen rates fall and their market access improve of late, and the stock market has weathered the negative news of recent days in remarkably good fashion. Barring further adverse news, we can easily see stock and bond prices turning back up in the coming weeks. Thus, we don't believe that the markets alone can be relied upon to do the work of curbing the financial support for unsustainable levels of aggregate demand.

CHAIRMAN GREENSPAN. Mike, in line with the notion you raised about the inability of maintaining the seasonally adjusted level of housing starts as we move into the period where the seasonals start to rise, I do recall that the unadjusted April starts figures were down. Were the permits down unadjusted?

MR. PRELL. I don't have any additional detail beyond the knowledge that total starts were down something under 3 percent in April.

CHAIRMAN GREENSPAN. Unadjusted starts?

MR. PRELL. Yes. But, given that the level of starts looks low relative to permits at this point, I suspect that in reality we probably did not have an unadjusted decline in permits. That is a rough judgment at this point and I don't have the additional data to refine that immediately.

CHAIRMAN GREENSPAN. You don't recall whether the permits, unadjusted, were down?

MR. PRELL. I don't have that information.

CHAIRMAN GREENSPAN. We do have that?

MR. PRELL. Yes, we do.

CHAIRMAN GREENSPAN. Okay, it is not crucial. Does anyone remember whether or not the seasonal for May goes up over the April seasonal?

MR. PRELL. I think the seasonals do continue to move in that direction to some degree. I have those numbers with me, so let me check. Well, actually, the seasonal factor in May is about the same as in April and then June is the low point for the seasonal factor. It is just a little lower. We have had the major swing in the seasonal factors in the last two months.

CHAIRMAN GREENSPAN. Really from February to April is the big surge?

MR. PRELL. It's basically February to April. The surge starts in February, but from January to April is the story.

CHAIRMAN GREENSPAN. Other questions for Mike? President Moskow.

MR. MOSKOW. Mike, I want to ask you about your statements regarding productivity. That, of course, is something in which we are all very interested. I thought I heard you say in your comments that because of structural improvements and efficiencies you have added several tenths onto your productivity forecast for 1999 and 2000. Part 1 of the Greenbook on page 13 has a reference to an increase of $\frac{1}{2}$ percentage point in your forecast of labor productivity gains. One question is: Are we talking about the same number here? My second question relates to your comment that you didn't think there was any reason to expect this to fall off in the near term. The question is: What is your sense as to what is going to happen beyond 2000 on these structural improvements?

MR. PRELL. On the first question, part of the increase in the productivity growth that we have in our forecast reflects the stronger demand trends and the cyclical component. I would say that a little more than half, roughly, of the increase in productivity growth going forward is attributable to the more positive view we have of the structural improvements in productivity. The second question is obviously very important if one is in the business of making 10-year budget forecasts or 75-year social security forecasts. It is not a totally uninteresting question for us, either, even with our shorter time frame, in part because one would want to have a sense of what expectations

might be and what would be built into peoples' permanent income views. If people felt that we were just experiencing a brief period of prosperity with these huge productivity gains, they might behave differently than if they viewed this as a new era, as it were, that will last decades. I think in a sense the stock market is probably behaving as if it is a new era. That is the way one can best understand the longer-term profit forecasts and so on. So, while we prefer to be noncommittal, it appears that what is going on in the economy may be more reflective of an extrapolation of the kind of performance we built into the forecast, if not a better one. I can easily see this productivity performance not persisting. I can also see this as being a transition phase into a sustained period of more rapid growth. After all, we have had periods of more than decades in duration in which productivity growth has averaged 3 percent. The numbers we are working with are in line with the very long-term trends in the United States. So we are not looking at a radically high productivity advance here in a broader historical context.

MR. MOSKOW. I agree that it is not radically high in an historical context; but compared with three or four years ago when we were talking about a 0.9 percent increase in productivity on average, it is a very significant difference.

MR. PRELL. Some of this reflects changes in measurement--the introduction of new weighting that has altered the history by a few tenths. But, as we look at it, we also had a period in the late 1980s and early 1990s when in particular capital was shallowing, and the low levels of investment did not help to boost productivity in that period. In the mid-1990s and since then, we have seen that change considerably. So there are factors that are readily identifiable. It isn't possible to pin down what contribution investment is making, but the normal kinds of calculations one can do suggest that investment has been a significant element in boosting productivity improvement in recent years. On top of that we do seem to be getting some extra productivity increase, so-called multifactor productivity gains. All that fits with one's sense of what has been going on in the business sector--that firms have been taking advantage of new technologies, have reorganized the way they do things, and so on. It has not been just the brute force addition of capital goods that has promoted this improvement. We are extrapolating this out for a limited time here, given our projection period.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mike, I have two questions, and the first one is on productivity as well. Estimates of the productivity trend seem to have been revised quite frequently in the last few years. To me, this suggests greater uncertainty about the productivity forecast. Wouldn't you have to conclude that the uncertainties associated with our forecast of real output and inflation must be greater given the uncertainties that are associated with the productivity forecast?

MR. PRELL. If the locus of the uncertainty is productivity, I'm not sure that we are more uncertain about it now than we were three years ago or six years ago. I think there has always been a considerable band of uncertainty around the prospects for productivity. We were puzzled by why productivity gains were so low for many years. I guess I don't feel any more uncomfortable on that score. The only way I feel uncomfortable is that, in a sense, we are moving a bit beyond the pack. But I think others are moving up their assessments of productivity trends, too, as they overcome the basic scientific skepticism reflected in the often heard statement that this recent experience isn't yet a statistically significant deviation from the previous trends.

MR. PARRY. The second question relates to the fact that the Y2K effect in the Greenbook forecast appears quite large. Compared with the consensus of Blue Chip forecasters, for example, it is considerably larger. Do you want to comment a little on what your thought process was?

MR. PRELL. This is an area where many forecasters have been reluctant to take a position, and thus it probably hasn't shown up in their forecasts. I know that the National Association of Business Economists just completed a poll of their members, and they indicated that they expected about a $\frac{1}{4}$ percent addition to third-quarter GDP growth and a $\frac{1}{2}$ percent addition in the fourth quarter. But there is still some reluctance, given the lack of hard information, to go out on a limb and write down a number that will stick out in any way. Now, I might note that the latest forecast by Goldman Sachs, which I just received yesterday, looked somewhat like our forecast. They have a considerable increase in inventory investment in the fourth quarter, driving GDP growth up to about 4 percent and then a drop-back in inventory investment in the first quarter, though not to a very low level, which gets their first-quarter GDP down to around zero. I know from having talked with their economists that their security analysts are hearing reports from

various companies that firms are planning to do some precautionary stock building. It is not across the board, but they are hearing this and I think gradually economists are probably building something into their forecasts. But this is an area of enormous uncertainty. It is very difficult to quantify. What we have in our forecast is a very small increase in the number of days' supply; in fact, it isn't even a day's supply. So there is a lot of room to maneuver here if people begin to get worried. In some sense this is just flagging the fact that something may happen. There probably is going to be some turbulence in the data. I am afraid we are going to have a hard time sorting out the underlying trends late this year and early next year.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. I have a question about the outlook for investment, which is driven importantly, as it should be, by acceleration considerations. My sense is that investment has been very strong both because of the labor market tightness and the need to substitute capital for labor and because of the attractiveness of new technologies designed to improve productivity. When you look at capacity utilization, do you have a sense of how much of the reported capacity is really genuine capacity, given the newer technologies that are coming in? I remember what happened in the early 1980s, for example, when the steel industry was being hit hard. There was a lot of steel capacity on the books that, in fact, was never put back to work even though the economy revived. I would guess that we might have something similar going on now with the rapid growth of these new technologies that are simply making some of the old capacity on the books no longer relevant for capacity utilization considerations. Do you have a sense of that?

MR. PRELL. I would say that we have some reasonable anchors for our assessment of capacity utilization. The series is periodically benchmarked to Census data in which companies report what they perceive to be their level of capacity utilization based on a given definition. That definition has been uniform over time, so we think we have a consistent time series. The National Association of Purchasing Managers semi-annually asks its members to report on what they believe their capacity utilization to be. It usually isn't exactly our number. But the two series track together over time, and the

readings through the end of last year still looked reasonably aligned. We should get another reading in a few weeks in the midyear survey of the purchasing managers.

Finally, if one looks at vendor performance, which historically has been pretty well correlated with capacity utilization, we don't see anything to suggest that we are far off the mark. One additional point is that there is nothing in the behavior of producer prices that is signaling that the capacity utilization numbers are leading us astray. Now, one might wonder--given a world in which many goods are available overseas and have relatively low transportation costs and where plants may have the flexibility to adjust their production on a tighter schedule and so on--whether the supply curve has precisely the same slope in the short run that it used to have. That is an interesting analytical question, which we need to continue to explore. But in terms of the reading on capacity use at this point, I don't think we are any further off now than we have been in the past in judging that.

CHAIRMAN GREENSPAN. I remember that steel issue. My recollection is that a lot of plant managers knew at the time that they had open hearth furnaces and rolling facilities which were clearly of an earlier age. It would be interesting to know whether in the Census Bureau data, as distinct from the American Iron and Steel Institute data, the plant managers were reporting that as true capacity under the Census definition, which has a cost element in it as I recall. That is, the question is not sheer physical facilities but what can be brought into production at a reasonable marginal cost. I would doubt very much that those steel facilities would have met that definition back then. I guess we would have to argue at this particular stage that individual managers who are reporting to the Bureau of the Census are aware of whether what they have is obsolescent or not. They can be wrong, but it is their judgment, and I don't know how we could do better than that.

MR. POOLE. There is a strong tendency on these forms for people to put in about the same number they did last year, as we all know.

CHAIRMAN GREENSPAN. Sure. But I think the point that Mike is making is that we don't project capacity independently. What is projected is the operating rate. We get capacity by division, and that is essentially--

MR. PRELL. That is true of the estimation of capacity utilization up to a point.

CHAIRMAN GREENSPAN. Then you smooth it out.

MR. PRELL. Then we look at investments and so on to judge what capacity growth would be going forward. I think the question they are asked to answer is what is their capacity utilization rate given a normal operation of their plants, not allowing for additions of extra shifts and those sorts of things. It is a question that is consistent over time. So whatever it is measuring, it is measuring it on a reasonably stable basis. Given all the other pieces of information, I don't see anything that seems particularly odd.

MR. POOLE. The point is that it may be consistent over time, but you don't want it to be consistent over time if the underlying pace of technology has suddenly changed dramatically. A whole lot of new technology is coming in. That's not unlike the change in the exchange rate in the early 1980s, which permanently put under water a whole lot of U.S. manufacturing capacity.

MR. PRELL. They are not reporting that they have the same capacity as before nor that they are using the same amounts as before, but the question they are responding to is consistent. So, conceptually what they are trying to measure is consistent over time. As I said, I just don't see anything that looks particularly odd in the variables that we would expect to respond to capacity utilization.

CHAIRMAN GREENSPAN. We have two measures--the ones I assume you are talking about--which are the lead times on the deliveries of materials and the number of items in short supply. The lead times are stretching out some, especially in steel with the prospect of a steel strike. The number of items in short supply, which are reported on a reasonably consistent basis by the purchasing managers, has been zero for a long period of time. So the symptoms of capacity restraint are not there and what we see is not inconsistent with the 80 percent or so capacity utilization rate that we show for industrial production in manufacturing.

MR. PRELL. The other point to raise is one that the Chairman reiterated in a speech recently. And that is, if you see incipient labor cost pressures, how readily can you adjust the productive capacity of your plant? How quickly can you purchase and install capital goods? That is another element that one would have to think about in terms of the dynamics going forward.

I might just respond to the Chairman's earlier question on permits. My colleague handed me the press release, which I didn't have with me earlier. The permits for single-family homes in April were the same as they were in March; the drop was in multifamily permits.

CHAIRMAN GREENSPAN. Unadjusted?

MR. PRELL. Yes, unadjusted.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I have a couple of questions about some issues that have been talked about already. First, on the Y2K effect, you have GDP growth moving from somewhere in the high 2 percent to the middle 3 percent area through 1999 down effectively to zero in the first quarter of 2000. That seems to be driven both by the change in business inventories and the change in consumer expenditures on nondurables, which in some sense is a double whammy. I am sure it is extremely well thought out [laughter] but it just seems--

MR. PRELL. Need I say more? [Laughter] I wish I could! We are flying blind again. Maybe we are overly influenced by our experience with snowstorms in Washington D.C. when everybody runs out and buys milk and toilet paper and cleans off the shelves of the grocery stores. I think we should expect, even if we don't get all kinds of dramatic Y2K programs on television and scary stories on talk radio, that people are going to be concerned. Polls suggest that if people are prompted to think about the Y2K issue, they say: "Yes, we will take some precautions." So the notion is that people will buy some extra food and those who are dependent on prescription drugs will try to refill their prescriptions early so they don't have to worry about computer glitches creating a problem in early 2000. There are various things I think people will want to buy, figuring that they will just use them up in January if they don't need them over the year-end period. We also hear stories about people planning to buy guns and ammunition, dehydrated food, electrical generators, and wood burning stoves. These things are happening. The question is whether they are economically meaningful. But some little movement at the end of the year seems inevitable.

CHAIRMAN GREENSPAN. Do you recommend that we move our February FOMC meeting back to December? [Laughter]

MR. PRELL. From what I understand about the thorough preparations that people are making at the Federal Reserve Board, I suspect we would be able to meet here even on January 2nd if we wanted to.

MS. MINEHAN. I was just wondering whether people will be building up an inventory at home of some of the same things that businesses will be building and how much double counting there might be.

MR. PRELL. We have allowed for that on a very limited scale in both cases.

MS. MINEHAN. The other thing I wanted to ask you about is the distinction you draw between the productivity that is driven by additional demand and that which reflects some underlying trend increases. I am wondering how it is that we can be at all sure about that. I know from our own business advisory councils that in many different industries people are beginning to say they are in a sense hanging on by their fingernails. They don't want to add people; they don't want to add to costs; they are driving their own production facilities as fast and as hard as they can. In our own Bank the volumes in our check-clearing operations recently are double our normal volumes for a variety of reasons. And I have heard stories from employees at breakfast about staff running pell-mell to the elevators with cartloads full of checks to try to make the courier times because processing has been so much heavier than usual. I don't think this has anything to do with the economy; it has to do with banking reorganization in our District. Our own productivity undoubtedly looks really great right now, but we would not be able to continue to move this volume of checks out the door for very long. Reconciliation issues and other kinds of issues would come back to bite us if we did that for very long. I am just wondering how you tell the difference.

MR. PRELL. It is obviously very difficult and it is a judgment call. But I think the kind of situation you are describing, though complicated, is one reason to anticipate that at least some companies will hire additional workers. You say companies are working beyond sustainable levels of labor utilization, but you also say they are absolutely determined not to add workers. In other cases, I think people are working very hard, and firms would like to add workers but are finding it difficult to do so in a very tight labor market. For the latter group, we would anticipate that, even if business begins

to flatten out, some of these firms will follow through on their hiring plans to reach a more comfortable position.

MS. MINEHAN. And they would be entry workers.

MR. PRELL. And that would be a source of a cyclical weakening in productivity. On the other hand, there is still obviously a very strong culture of cost control--that may be your first group--and managers will do absolutely anything they can do to keep their labor force to an absolute minimum. And where they use temps and other contingent workers, those people will probably find their hours or employment reduced fairly rapidly. So I think there is a balance in this prospect.

CHAIRMAN GREENSPAN. I think there is a distinction here on which we cannot put a number, but we can get a judgment. The point I was making at Mike Moskow's conference earlier this month, and I may have mentioned it at our last FOMC meeting as well, strikes me increasingly as the really crucial element in making that differentiation. A number of years ago--maybe 5, 8, or 10 years ago--those of us who were working as business consultants of some kind or another spent a very considerable amount of time addressing the fact that all key business decisions were made with a probability distribution around them. And in order to protect either the level of production that the firm needed or the value of the franchise, a company had to introduce layers of safety stock inventory on the one hand and redundancies of people on the other. And as information technology gradually reduced the variance of error in the decision-making processes--in a sense knowledge became more and more crucial--the need to have all of these redundancies gradually dissipated. When they are stripped out of the system, they are permanent structural productivity changes; output per hour is permanently changed. The type of productivity you are discussing is not in a sense real productivity. Well, I guess you could call that productivity, but it certainly is not trend productivity. It is, I would say, a cyclical dynamic. And that is the reason why we try to cyclically adjust the productivity data; we try to get a rate of change with that cyclical factor removed. And the truth of the matter is that I don't see how we will know which is which until after the fact.

MS. MINEHAN. Right.

CHAIRMAN GREENSPAN. Further questions for Mike? If not, would somebody like to start the go-around? President Broadus.

MR. BROADUS. Mr. Chairman, the Fifth District economy remains robust overall. I think I have probably started my comments at the last eight or nine FOMC meetings with that same statement.

CHAIRMAN GREENSPAN. I don't know why I even ask for your report!
[Laughter]

MR. BROADUS. Nevertheless, that is definitely the case. But, if anything, there seems to be some evidence of a possible acceleration in activity over the last several weeks. Manufacturing is still a very important part of the economic base in our region; you name it; we make it in the Fifth District. And manufacturing activity clearly seems to have bottomed out and turned up. Consumer spending is very strong. We had expected it to be strong, but its recent strength has exceeded even those expectations. Probably the strongest sector in the District's economy now is construction, both residential and commercial. We are sitting in one of the hottest markets in the region right here in the D.C. area; that's true in the District of Columbia as well as in the Virginia and Maryland suburbs. There is plenty of money around to finance all of this building, maybe too much. The only apparent constraints that we are seeing and hearing about in construction are the shortages of skilled workers and certain materials.

Elsewhere, both commercial and consumer credit are readily available. So far we do not have any significant evidence of a decline in credit quality. But we are hearing from experienced bankers, anecdotally at least, that the competition for loans is very, very strong--probably excessive--which may be laying the foundation for problems down the road.

On the price and wage side, retail price increases in the region have been accelerating lately, slowly but steadily according to the service sector survey we do monthly. At our last board meeting the Chairman of Reynolds Metals, who has been complaining about weak metals and other commodity prices for at least a year and a half, told us that prices of a broad range of items--not only metals but other commodities he deals with in his business--have turned up. Finally, while there is not yet a lot of hard evidence regarding rising wages in the District, we are hearing more and more anecdotal

comments regarding pay increases and a speeding up of wage increases here and there in different industries.

At the national level, it seems to me that when one puts last week's CPI and industrial production reports in a longer-term context, they indicate that the risk in the outlook has now moved pretty sharply to the upside. Back in November when we put in place the last of our three policy easings, we did so because we were concerned that the financial turmoil and the credit crunch that might come with it could push the economy into a recession. There is no question that those easing moves did calm financial markets at the time. But they also delivered, in my view, a very strong monetary impulse to an economy which, even then, was arguably at risk of overheating. I think we have seen and are seeing the results. Private domestic final purchases rose at a $7\frac{1}{2}$ percent rate in the first quarter. I agree with you, Mike, that that is probably above trend, but it's probably not too much above trend; I think final purchases grew $6\frac{1}{2}$ percent last year. And given the number for the first quarter of this year, the staff has increased its projection of real GDP growth over the next two years by $\frac{1}{2}$ percentage point and now sees the unemployment rate as low as 4 percent by the end of the year.

That is the context in which we have to view this April CPI report. Obviously, I don't want to put too much weight on one figure, especially one that may have some seasonal adjustment problems, as I gather this one may have. But against the background I just reviewed it is worrisome to me because it offers the first direct evidence in some time that inflation pressures may be building. The breadth of the increases in the core index I found especially troubling. But even the headline figure--reflecting the jump in oil prices--had a big impact. The oil price increase is going to get some attention if it stimulates increased inflation expectations going forward. And sooner or later, if it continues, it is going to show up in the core price component of the index.

Finally, the 20 basis point jump in the long bond rate to almost 6 percent, which came on top of an increase after mid-April of about 15 basis points, makes it clear that the markets have taken this report reasonably seriously and have not just dismissed it as monthly noise. So for me, the bottom line is that at this point everyone is watching us. People in the markets especially are watching to see how we are going to respond to what may be direct evidence of rising inflation pressures.

Just one additional thought if I may, Mr. Chairman: The monetary stimulus we injected in 1998 I think is a bit reminiscent of the stimulus we injected in 1987 in the immediate wake of the stock market crash. With that in mind, I think it is worth remembering that the latter was sufficient to help set off an increase in overall CPI inflation--briefly to 6.3 percent in 1990. Oil prices were a factor then, but the core rate also went up in that period. It is true, of course, that we have more credibility now than we did then, but demand is stronger now than it was then. Labor markets are a lot tighter. I know I have been crying wolf around this table for a long time and my fears have not been realized, but we have to take each day as it comes, I guess. So, wolf! [Laughter]

CHAIRMAN GREENSPAN. You've made it impossible for anyone else to come after you! [Laughter] Who wants to try? President Moskow.

MR. MOSKOW. I was hoping it was not going to be me! [Laughter] The Seventh District economy continues to expand at a moderate pace. However, we are starting to see some subtle changes. Consumer spending remains healthy and housing activity is at high levels, but we are now seeing a few signs of moderation in these areas. Conditions in the ag sector generally remain depressed, but results from our recent survey of agricultural bankers suggest that there has been no further deterioration in farmland values. Despite the continuing problems in steel and farm equipment, our manufacturing sector is performing well and may be picking up steam. As evidence, the Purchasing Managers' Surveys from Chicago, Detroit, and Milwaukee indicate that expansion of overall manufacturing activity has picked up in the past three months. Motor vehicle producers continue to experience strong sales. April sales of light vehicles again surprised us on the upside, and heavy-duty truck backlogs are still quite high. In fact, the automobile industry is doing so well that profits are high, leading one senior official at a major automaker to mention to me that he expected very difficult labor negotiations later this year. Tensions are high and there is a strong potential for labor disruptions. One major issue in the negotiations, of course, will be the use of outsourcing.

More generally, our labor markets remain tight, and the puzzle of slowing compensation growth is even more pronounced in the Midwest than in the national numbers. Our business contacts are starting to report less customer resistance to price

increases than was apparent a year or two ago. This is not a sea change, as Mike Prell discussed, but we are hearing more anecdotes, and I thought I would mention a few.

One of our former directors with a large trucking operation noted that his firm was negotiating contracts with higher prices for the first time in many years. A major printing firm reported that advertising rates are increasing. A national specialty retailer mentioned to me that wholesale prices for furniture were up sharply; he added that costs for building new stores, including land, had risen 50 percent over the last three years. Last time I noted that the prices paid component from the Chicago Purchasing Managers' Survey moved above 50 percent in March for the first time since April 1998. That component moved even higher this April, from 52.5 to 56.7 percent. And purchasing managers from Detroit and Milwaukee also reported that prices paid moved above 50 percent in both of those months. The Milwaukee report provides evidence that energy was not the only culprit, as 11 of the 21 commodity prices surveyed were above 50 in April.

This regional pricing news leaves me quite sensitive to the data contained in Friday's CPI report. As Al Broaddus mentioned, of course, we should not make too much of a single month's data, though the increases appear to be broadly based. In fact, my biggest concern remains not inflation this year, but rather the acceleration in core inflation expected next year, perhaps from a higher level than we forecasted before. In addition, incoming data have remained strong since our last meeting when we raised our forecast of real GDP growth for both this year and next; if productivity growth remains as rapid as it has been for the past few quarters, then this projected real growth would be sustainable. But if, as my somewhat pessimistic staff keeps telling me, trend productivity growth has not picked up as much as the Greenbook asserts, we could face a substantial increase in inflation by the end of next year. Thus, I think the risks have become tilted decidedly to the upside, and I think the time has come to reevaluate our policy stance.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, economic growth in the Twelfth District has shown some signs of moderation, but it is still rapid. In Nevada and Arizona, the pace of job growth has slowed somewhat from last year's very fast pace, but these states still rank first and third in terms of employment growth over the past twelve months. In the Pacific

Northwest, employment growth picked up in Oregon but cutbacks in aerospace manufacturing jobs held down such growth in the state of Washington. California's relatively rapid pace of job growth also moderated a bit in recent months as a contraction of the state's manufacturing payrolls partly offset employment gains in other sectors. Overall, California employment has grown at roughly a 2 percent rate so far this year, which is down about 1 percentage point from last year's pace. Even so, California's unemployment rate of 5.6 percent is down significantly since the end of last year.

Turning to the national scene, obviously the data have revealed a stronger- than-expected economy once again, causing us to revise our real GDP forecast upward. The contour of the forecast has not changed very much, however. We still expect the economy to slow, only now the phrase "slowing economy" means a growth rate of about $3\frac{1}{4}$ percent for the remaining quarters of the year. The GDP price index is projected to grow at a rate of about 1 to $1\frac{1}{2}$ percent over the same period. However, recent forecast errors suggest that there is considerable uncertainty associated with this outlook. We are all well aware that real output has consistently grown faster than predicted in recent years. And if we had somehow known how fast the economy would grow over this period, we would have overpredicted inflation even more than we actually did. It seems clear that we are experiencing a positive supply shock but one whose magnitude and duration are hard to determine. The existence of a supply shock makes it hard to judge inflationary risk by looking at real output growth, since such shocks tend to change the output/inflation mix in the economy.

A reasonable response to this uncertainty is to follow a strategy that is fairly robust in the face of such shocks. One such strategy would be to pay more attention to the growth in nominal GDP or spending. As supply shocks change output and inflation growth in opposite directions, they will obviously have a smaller impact on nominal GDP. Keeping an eye on spending would allow us to keep inflation within reasonable bounds, even if we are unsure about the economy's potential growth rate. Using nominal GDP in this way--that is, as an indicator--is similar to the way that we actually employed the monetary aggregates before velocity shifts made them hard to interpret. The data show that nominal GDP growth has averaged close to $5\frac{1}{2}$ percent over the previous three years. This suggests to me that, despite the uncertainties associated with the supply

shock, the policy choices made during this period have been appropriate. By allowing growth to come in higher and prices lower than anticipated, we have in effect been stabilizing nominal GDP to some degree. In this light, however, the recent acceleration in nominal GDP in the past two quarters causes me some concern. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. Discussions with directors and advisory council members since our March 30 meeting have gone in the direction of reconfirming that the regional economy is very strong. Even the communities that are most influenced by steel, which had been registering some concern earlier, have reported that business conditions never got as bad as they had feared and that they have started to show some improvement. Wheeling Steel, for instance, is already recalling workers. Structural steel orders are still strong and it was suggested that some "strike hedge" stockpiling may be going on at the present time, with the backlog building.

Because of worldwide overcapacity, steel industry people expect to see significant consolidation in the steel industry. In particular, they expect Western European companies to be acquiring U.S. producers. In the first quarter, an overall decline in steel imports had been expected, based on the view that less Japanese steel would be coming in. And there was a decline in Japanese steel and Russian steel. However, that was more than offset by an increase in Korean and Brazilian steel. So, steel imports in the first quarter were up 4½ percent versus a year earlier.

In motor vehicles, production is reported to be flat out at the plants around the District, with some of the larger plants, at General Motors in particular, operating 7 days a week. And the workers are getting tired of it. One of the truck body manufacturers responded to a shortage of welders by starting to offer courses in the high school, where he pays his employees to go and teach welding shop.

We have an interesting situation with Honda. They have a number of plants in Ohio and they have in the past been considered a model of labor/management relations in the non-unionized sector. The UAW attempted to organize them twice, in 1985 and 1989. Early this year, a petition from workers asked the UAW to try again. The UAW declined, based on a low expectation of being successful, so the workers went to the Teamsters. The Teamsters went to the UAW and the UAW said the attempt would not

work and they were not interested in trying again, so the Teamsters decided to try. Out of 8,000 workers at the various plants, they have already collected 3,800 cards--they have not certified them all and they need to have about 2,400 certified--which got the UAW's attention very quickly. The UAW has petitioned for a hearing, which is being held today, to decide whether or not the Teamsters do in fact have jurisdiction or whether they will have to turn the organizing effort over to the UAW. A contact in the Teamsters local in Columbus said that they had not expected the organizing drive to be successful the first time around. They were caught completely off guard by the response of the workers. So, that is one we plan to monitor closely. Union communications workers just settled with a company in Cincinnati; the contract is for three years and the package is 6 percent per year for the three-year period.

In construction, the situation has been described as a surge of new business, even though there continue to be shortages of workers with various crafts and skills. Some said those shortages are worse than before. The Ohio building trades now expect to have at least two more years of high levels of construction activity. On the residential side, builders say the problem with starts activity is that they are so far behind schedule on existing projects that they are seeing more delays, longer times to complete projects when they do start new ones, and thus they are reluctant to extend the pipeline any further. People from Pittsburgh say that the city is in the early stages of a major construction boom that will last five years; and that includes the building of stadiums, convention centers, theaters, bank operation centers, downtown retail space, tunnels, and bridges. Earlier, people from western Pennsylvania had been saying that they were lagging considerably behind Ohio and Kentucky but now they claim that they have closed the gap. They have experienced very rapid growth and have labor shortages in an increasing number of communities. A contact from one of the community banks in southwest Pennsylvania said that a significant employer for their community decided to go out of business and laid off 200 workers. So the bank joined with some others to co-sponsor a job fair for the displaced employees. But they had to cancel the job fair because the workers had all found jobs before the fair took place.

A food processing company in Ohio reported continued strong sales at both what they call the in-store retail and their 800 Internet services or catalog sales. They are very

happy about that. But they are not happy on the cost side: Freezer storage rates in the first quarter were up 13 to 18 percent from a year earlier; health care costs in 1999 are now budgeted to be up 14 percent from a year earlier; and prices of corrugated packing material in the first three months of the year were 15 percent above year-earlier levels. Other manufacturing reports included tool and die companies who say they have now fully recovered from the earlier loss of business to Asian imports. A manufacturer of safety equipment for mining and manufacturing companies reports that in addition to continued strong U.S. orders, they have recently seen some pickup in orders from both Asia and Europe.

Bankers in the region report strong loan demand in every category. We asked our Community Bank Advisory Council why we no longer hear the stories we were hearing a couple of years ago about people walking in and turning over the keys to their vehicle because they could not afford to pay for the car, the truck, or whatever it was. And the bankers did not really have a coherent response. They said these stories have stopped totally. Some guess that it has to do with wealth effects from the stock market, the equity taken out from refinancing homes, and debt consolidations. They mention various reasons why they conjecture that those “stretched” consumers no longer exist. But no one had any stories to tell.

In agriculture, conditions in our area sound a little better than in Mike Moskow’s District. Bankers and one agricultural supplier have told us that it has been a very good planting season; all the planting has been done. They experienced falling seed, fertilizer, and energy prices during the planting season and--assuming they get appropriate amounts of rain--they are optimistic at this point about having a good year, the first in three years. We still hear references to, in one person’s words, “outrageous prices” being paid for farmland. The reports are that it is not the neighbor farmer buying the land but somebody coming from somewhere else, and often these are cash deals. Another banker said that he tracks what he calls the debt service per acre of farmland and it is the highest level he has ever seen.

Let me turn to the national scene for a moment. I always have trouble using the word “inflation,” mainly because of the way people also use words like “deflation.” So instead I think in terms of the purchasing power of our currency and I try to give some

meaning to the expression “price stability.” What we mean by price stability is that people make decisions in the expectation that the purchasing power of a dollar in the future is going to be the same as it is today. When that condition is met, we get efficient allocation of resources at the business level and the household level, and we get maximum growth in our standards of living. We have had the experience of people revising downward their expectations for the future about what we call inflation, though perhaps not by as much as the decline in the reported numbers for late last year and the early months of this year. And that was, in words that we used some time ago, a period where we could have exercised “opportunistic disinflation policy” and locked that progress in. We clearly missed that opportunity and did not lock it in. It’s much more likely that people expect the purchasing power of the dollar to decline faster in the future than has been the case in their recent experience. I think we have to anticipate that from this point forward people are going to expect higher rather than lower inflation.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. The economy in the Kansas City District remains quite strong: Employment edged up again in March; retail sales remain generally strong; and construction indicators are quite strong.

The price of construction materials has increased significantly so far this year, both in the region and more broadly. As a side note, I will tell you that about 10,000 homes and businesses were destroyed or severely damaged by the recent tornadoes in Oklahoma and Kansas. While the short-term effect is obviously devastating, that does imply some additional building boom coming our way. That will be a factor in our District. More specifically, though, one of our directors who is in the construction industry has seen sizable price increases on materials in that industry since the beginning of the year. Prices of rock, gravel, and aggregates are up 10 percent, lumber 6 percent, concrete 4½ percent, and sheet rock, of course, is up about 50 percent.

While manufacturing activity has been a little sluggish in the District up until recently, it is picking up. Some of our manufacturers are seeing an increase in demand from Asia, and that includes China, despite some of the other developments in that region. Also, at least from our directors’ point of view, some of the recovery in aluminum prices reflects increased demand in Asia. Energy activity within the District

has steadied in the sense of not declining any longer; firms in that industry are waiting to see to what extent these energy price increases will stick before making their own plans for future activity.

Wage pressures appear to be increasing in the District, at least somewhat. Our unemployment rate is about 3.4 percent and we have a very high participation rate, so we have very strong pressure on our labor markets. In fact, in the construction industry, which is obviously under the most pressure, and in the crafts industries such as carpentry and plumbing, contracts for wage increases of 5½ percent per year for the next three years have recently been signed in our area.

Retail prices have edged up, as someone else mentioned. And I would echo the point, based on talking with business people in our region, that there is a hint of a different attitude toward price increases. There is a sense of challenging the status quo and seeing if perhaps price increases will stick this time, with more of an expectation that they will. Whether that will occur will only be known in time, I realize.

The farm economy remains fundamentally weak. Supplies are large and export demand has not picked up that we can see. Despite this, farm finances remain strong, and there is a lot of anticipation about what will come out of Congress this year on that issue. Our land values have remained resilient despite these kinds of pressures, although our last survey indicated about a 1 percent decline in land prices in the aggregate.

Turning to the national economy, I see another year of strong economic activity. While growth in GDP may moderate, I think it is going to moderate to a rate well above its longer-term trend and remain significantly stronger than the FOMC central tendency forecasts from our February Humphrey-Hawkins meeting. I must say that I am struck by the strength of the domestic economy. Over the last four quarters private domestic spending has grown about 6¼ percent and we are forecasting that it will grow about 5 percent this year. If one put trend productivity at a very optimistic 4 percent--higher than I think one might expect--and added on 1 percent for labor force growth, that would result in potential output of, let's say, 5 percent. And private domestic spending at least has been growing faster than that. Offsetting this, of course, has been the weakness in net exports; in a sense the deterioration from the external sector has been the relief

valve. But I think some of the relief now is coming from domestic demand rather than the weaker external or foreign demand. That is something we have to keep in mind in terms of the pressures on global resources going forward.

In sum, what I am saying is that I see increasing upside risks to our forecast. Look at the Greenbook forecast, for example, which shows a \$450 billion deficit in net exports by the end of next year--though I know the staff may reduce that--and still good growth in the 3½ percent range. Should our domestic demand or foreign exports pick up, we could have even stronger growth. The point is that against this background I have become, as I think Al Broaddus has, increasingly worried about the current stance of policy and our ability to maintain low inflation going forward.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Little has changed in the Eleventh District economy since our March meeting. Overall, the economy in our region continues to show healthy growth. Over the last six months employment growth has averaged about 3 percent, and the near-term outlook is for more of the same. Activity in both commercial and residential construction has been robust. In recent weeks concerns about commercial overbuilding have become more common as the credit strains that developers faced last September and October have eased. Just in the last month or two the residential market, particularly in the Dallas area, has heated up. For the first time in many years used homes have been selling the day they are listed, sometimes above the listed prices. Were it not for the continued shortage of cement and some other building materials, building activity would be even stronger, and perhaps we would see less upward pressure on existing home prices. To some extent the shortages will get worse in the coming months as crews and materials are diverted to Oklahoma to rebuild areas destroyed by tornadoes a few weeks ago. Efforts to relieve some of the short-term capacity constraints are in the works. U.S. Brick completed a new and entirely automated plant adjacent to its existing facility; the \$17 million plant will produce 60 million bricks a year, tripling output at the site. Fifteen new jobs will be created, a testament to productivity increases. Texas Industries, a firm on whose board Governor Kelley used to serve I believe, is also expanding capacity that will make its facility the largest cement plant in the United States. That \$200 million

project will increase cement capacity from 1.3 to 2.8 million tons per year by the fall of the year 2000.

The energy industry continues to consolidate and contract in spite of the higher oil prices in the last few months. The Texas rig count is at a 30-year low and our projections are that Texas drilling activity and oil and gas employment may not have bottomed out yet. The rebound in oil prices has surprised our industry contacts and they remain skeptical that these prices will last.

The computer and telecommunications industries have rebounded slightly. However, we are beginning to hear complaints that more and more sectors of the business are becoming commodities with falling prices and shrinking, razor-thin margins. A few years ago it was DRAM chips; more recently it's pagers. Now there is talk of saturation in the market for inexpensive computers.

The higher oil prices together with a stronger peso have boosted consumer and business confidence in Mexico. Our border cities have been seeing very strong retail demand from Mexican shoppers. In spite of ever-tighter labor markets, we are hearing less and less discussion of upward pressure on wages. With capital becoming increasingly substitutable for labor, tight labor markets are less likely to add to inflationary pressures unless the cost of capital rises significantly.

The main development in the national economy was the giant mood swing in financial markets in April. Suddenly everyone decided that the crisis countries had bottomed out and that, given the flattening in commodity prices and the rebound in oil prices, the best days on the inflation front were behind us. Interestingly, the bad news on oil prices for the country has not been celebrated as particularly good news in our area. As I said, our industry contacts didn't expect the rebound and they question its durability. The blockbuster, of course, was Friday's CPI report. I will have to concede that it was only one month's data; however, the risks have shifted upward.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, conditions in the Eighth District are largely unchanged. The only significant development is the announcement, which I think everybody is aware of, that Boeing will be laying off about 7,000 workers from a defense

plant. But, of course, that business is going to go to some other defense plant; those aircraft, though different models, will be built someplace else.

My contacts at FedEx and UPS reported that conditions were largely unchanged domestically but that the volume coming out of Asia was substantially stronger. They both made a point of emphasizing to me the pickup in Asian markets. And both said that Latin America remained weak while Europe was solid--neither strong nor weak, but just solid.

My FedEx contact reported that their labor situation is easing a little due to aggressive recruiting, but the company is still short of labor. The UPS representative said that the labor market in Louisville is the tightest the company has ever seen. One other point about FedEx I thought was interesting: Domestic volume for shipments of auto-related parts has expanded substantially. I guess Fed Ex does a lot of last minute delivery of auto parts coming out of Mexico and from within the United States. And that would confirm the other evidence we have that the auto industry is operating at a fairly high rate.

As for the national outlook, I think that depends critically on our policy, so I am going to delay my discussion of the outlook until I fold it into the policy discussion in the next go-around. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you. The District economy remains robust, which is not a change in conditions. That is true virtually across the board, whether one looks at consumer spending, tourism activity, or manufacturing activity. Construction is very strong, both residential and commercial, and houses are selling as soon as they hit the market. The one obvious exception is agriculture, which remains in the doldrums. Despite the problems in that sector, I think it is worth remembering that they are not nearly as severe as they were in the mid-1980s nor do they have the implications for the banking system, at least at this point, that they had back then.

I had a meeting recently with a range of representatives from the financial services industry in the Twin Cities, and generally they confirmed this very positive view of regional conditions as well as broader conditions. There was a sense in their conversations about the economy that is a bit different this time from past experience.

One might expect that from some of the financial people, at least those who are close to the equity market. I think one reason they feel that way relates to the international situation. They see the U.S. economy as being able to tap into capacity abroad, both traditional manufacturing capacity as well as labor. They also feel, of course, that the United States is playing a particularly critical role at the moment in the global economy.

As far as the national outlook is concerned, I believe the prospects for real growth are favorable. I don't think there's much question about that. Aggregate demand is strong and I am relatively optimistic about aggregate supply. I agree that we have a lot of problems in measuring productivity, much less forecasting it. But I ask myself what I think determines productivity. If one approaches the analysis in that way, there is reason to believe that productivity is on a more durable and positive trend. And I think it is worth bearing in mind that business people have been saying for quite some time--well before it started to show up in the statistics--that they were getting sizable increases in productivity.

As far as inflation is concerned, that CPI number captured lots of attention, I think justifiably. It is worth reminding ourselves, though, that we have been anticipating a modest acceleration of inflation. In my judgment the problem with getting too comfortable with that observation is that that modest acceleration may depend crucially on monetary policy assumptions. Thank you.

CHAIRMAN GREENSPAN. President Gynn.

MR. GYNN. Thank you, Mr. Chairman. The Southeast economy continues to operate at a very high level of utilization and that constrains us from experiencing the kind of growth rates that we saw earlier in the expansion. Recent retail sales gains in our area have been modest, and single-family housing activity has been up only slightly. At the same time, office and other commercial construction has been a bit stronger since our last FOMC meeting. Manufacturing has picked up. Our important tourism industry continues to do well, especially along the Mississippi Gulf Coast where another huge gambling casino has just opened. That grand opening and the associated demand for another 5,000 casino workers have given rise to the latest tight labor market story. The casino operators reportedly bought or leased a complete apartment complex to house

workers they are now bringing in from other less tight labor markets throughout rural Mississippi.

Of the specific areas of regional weakness that I noted last time--namely, energy, agriculture, and trade--problems in our energy sector have moderated slightly to the extent that wells are no longer being capped; but we have not been experiencing increases in production and drilling yet. There is no sign of a turnaround in the District's trade deficit with Latin America or with Asia for that matter, and agriculture continues to suffer from low commodity prices.

Anecdotal information on regional price pressures is quite similar to what I have been reporting, as have others. Labor markets are clearly tight. Business people are complaining about finding workers. Our directors and other contacts continue to emphasize the growing role of nontraditional compensation--bonuses, signing bonuses, and incentive pay--with those non-base salary types of compensation being pushed further and further down the organizational level in many firms. One director reported that truck drivers are being paid a \$5,000 signing bonus in order to get more trucks on the road. Benefits are also being made more widely available, especially in small companies, but at the same time some companies are restructuring some benefits, notably medical, to control their costs.

Two final observations from our regional contacts: First, one large regional retail chain has reportedly scheduled several van loads of spring goods from China for delivery two months early as a hedge against possible Y2K disruptions; and secondly, to build on Al Broaddus's comment a few minutes ago, our bank examiners tell me that they see some evidence of a deterioration in credit quality. From their field work they have found that lenders are concerned about over expansion in the hotel/hospitality industry and some relaxed credit standards and increased credit risks in the health care sector.

At the national level, like others, I have continued to enjoy observing and talking about this good ride that we are experiencing. That's something that someone at the last meeting reminded us all to take the time to stop and do. Like others, my staff and I continue to think through the arguments for why some slowing of the pace of growth and consumer and investment spending should begin to show through. Compared with the construct of the Greenbook, we're inclined to attribute a bit more of the strength in

consumer spending to current income, some of which we suspect we may not be fully capturing and measuring, and somewhat less to the wealth effect.

Although I would not argue that the fundamentals have changed significantly since our last meeting, I find myself still, and perhaps increasingly, uneasy about the inflation outlook. My staff, most other forecasters, most other people who have spoken around the table this morning, and now it appears the bond markets see some gradual deterioration in core inflation looking ahead to 2000 and 2001. The perceived recent improvement in inflation by some measures has to be viewed in the context of the technical adjustments that have masked some of the upward pressures.

It seems to me that there is good reason to be concerned about the inflation outlook regardless of which economic model one subscribes to. We are already seeing some reversal of the favorable trend in commodity prices, and some part of that very likely will begin to feed through to prices sometime soon. Labor markets are very tight and unemployment is below even recent estimates of the natural rate. The money supply, as several people have already noted, has been overly expansive for the past two-and-a-half years, and that may begin to show through in inflation pressures.

The seesaw pattern of productivity gains over recent decades, even allowing for the sea change that may have taken place most recently, leaves me at least somewhat cautious about counting on the extraordinary productivity gains we've experienced most recently to offset most or all other upward cost pressures. Of course, the trick is to know when to say when, as the commercial suggests. It seems to me that if we come to a shared sense that it is time to begin at least leaning in the direction of tighter policy, we have a window of opportunity to do that right now. The international situation is at least somewhat less fragile than it was the last time we contemplated a tightening. The U.S. economy is still sufficiently balanced that a tightening move is not likely to be terribly disruptive. If we were to move today or lay the groundwork for a possible move at our next meeting, we could get ahead of what I think we will come to see as a problematic period later in the year, when I imagine we will give considerable weight to preparing for Y2K uncertainties and possible volatility and will prefer policy stability. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Thank you, Mr. Chairman. The regional economy of the Philadelphia District remains on an upward trend. Manufacturing is strengthening. Retailers report growth in sales. Construction has been increasing. Business lending has picked up. Labor markets remain tight in most areas. Apart from oil and tobacco prices, inflation is benign and pricing power remains largely nonexistent according to most business contacts. The outlook for the regional economy is positive.

Turning to the national economy, the strength in domestic demand continues unabated and prospects mostly are for more of the same. There may be a moderating trend out there, but it is elusive. Financial markets, fixed-income markets in particular, look increasingly normal following their seizing up last summer and fall. Developments abroad, although mixed and still worrisome in some areas, look better or at least not as bad as feared a few months ago.

Taken together, these developments--robust domestic demand, more normal financial markets, and less bearishness abroad--indicate to me that the balance of risks has more of an upside tilt than at our last meeting. At the same time, inflation remains quite benign despite recent headlines. Core CPI, absent tobacco, is very tame. The broader measures of inflation are mostly decelerating. Compensation and productivity are still in a virtuous cycle.

So, while risks on the demand side of the economy have shifted somewhat to the upside since our last meeting, developments on the supply side remain largely favorable. To me that means a somewhat heightened state of alert for policy is called for. How that heightened state should be expressed is better discussed later in the meeting.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. New England's economy remains much the same as it has been for the last several meetings. The region's job growth continued to be slower than the nation's but the unemployment rate is well below the nation's as well. The supply of labor continues to be a concern. Jobs would grow faster if there were people to fill them. Wages, however, still don't reflect this lack of supply; in fact, almost everywhere one is greeted with anecdotes about how business is coping by offering largely non-wage incentives--training and that sort of thing--to keep employees. Manufacturing jobs continue to decline at a faster pace in New England than

nationally. However, merchandise exports are picking up, particularly to the Asian region. Manufacturers also report raw material cost increases and not just in oil. Aluminum, copper, silicon, oil-based products, chemicals, paper, leather, and other such inputs are all rising in price. Some manufacturers are now beginning to talk about trying to increase profit margins. They are perhaps not ready to raise prices as yet, but there is talk about price increases in the range of 3 to 5 percent.

Residential real estate markets are very active, especially in the Boston area. Rents are rising precipitously and house prices are up. New home building, particularly in the suburbs, is focused on very high-end homes. Commercial real estate is healthy as well. We are beginning to see new hotel and office building construction in Boston proper and in the surrounding areas, as well as some speculative building.

Over the course of the last several weeks we've had many opportunities to discuss Y2K issues with banks and businesses, large and small, around New England. In general, banks are confident about their own readiness and that of their large customers. On the inventory side, by no means is there a consensus on the need to build inventories as the year comes to an end. Rather, most comments reflect a rather balanced view, and many see the challenge not so much in Y2K terms but in the normal inventory planning for year-end. Cash inventories at banks seem to be a special case, however. In that regard there is much concern about consumer panic and much encouragement for whatever proactive statements or action the Fed can take to calm things down.

We recently held a meeting of the Bank's Academic Advisory Council which, as you all know, includes two or three Nobel Prize winners and people from Harvard, MIT, Yale, and so forth. The discussion focused on issues related to productivity growth, labor market tightness, and asset market bubbles. The group was lively, to say the least. But some consensus was reached on the need for action that might take the wind out of asset markets, even in the absence of tighter monetary policy, perhaps through increased margin requirements or increased supervisory oversight on credit extended, particularly in the day trading operations.

On the national scene, the Greenbook forecast with its higher growth, stable and very low unemployment rates, and inflation that only creeps up in 2000, strains credibility. Yes, we can agree that productivity has improved over the last two or three

years or so, and that for a time anyway the potential of the economy to grow without inflation might be 3 percent or so versus the roughly 2½ percent we had thought. However, even given that, with about the same growth we see unemployment falling to the high 3 percent area and inflation ticking up by year-end 1999. Even if that forecast is viewed with some level of agnosticism--and here I should say "wolf" along with Al Broaddus--credit conditions are now coming back to the narrower spreads and are reminiscent of the ease we had last summer. At the same time, corporate debt is soaring along with household debt. True, affordability is better than in the late 1980s and banks are supplying less of the credit and are better capitalized, but the signs of excess are beginning to show. Stock markets, real estate markets, and corporate and personal debt may not all be similarly extended, but they are getting there. Thus, whether one comes at this economy with concerns about inflation or concerns about imbalances and excesses, I think the concerns are real and actions related to policy corrections need to be considered, if not taken.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The Second District's economy continues to grow at a sturdy pace, with few signs of increased price pressures. Private sector employment grew at a 1.8 percent annual rate in the first quarter; that's down from 2.2 percent in the fourth quarter of last year. Retailers report that sales were at or above plan in March and April, but a bit less robust than in January and February. They also note modest declines in selling prices. Residential and commercial real estate continue to flourish in the New York City area. Home prices have risen sharply and both new construction and remodeling activities gained momentum in the first quarter. While Manhattan's office market remained tight in April, rent inflation has slowed markedly from a rate of more than 20 percent in 1998. Purchasing managers indicate that manufacturing activity continued to expand in April, though at a slower pace than in March. Those in the New York City area report an uptick in commodity prices and persistent increases in the cost of service inputs. The latest Banker's Survey shows a pickup in loan demand, tightening lending standards on commercial and industrial loans, and further declines in delinquency rates.

Looking outside the Second District, let me speak first of the growing view that the international crisis, which began in July 1997, is substantially over. There is no doubt that the crisis is less severe by a reasonably large degree than it was last fall, but it surely isn't over. I believe Japan has made virtually no progress in restoring growth and has increased its public sector debt to a level that is dangerously high, especially considering the strains on the Japanese public sector that their aging population will bring in the very near future.

At our last meeting I raised a concern about what I called in China as a sign that the massive economic restructuring of the state-owned enterprises is not going as well as Premier Zhu Rongji had hoped. The orchestration by the government of the very strong response to the bombing of the Chinese Embassy in Belgrade heightens my concern. I believe that the leadership felt--for some reason not connected with the restructuring but rather to the happenstance of a memorial date in Chinese history of a student uprising in the last century on the fourth of May--that they had no choice but to allow the young people to demonstrate. But the size of the demonstration I believe also indicates that the leadership felt they had to use it to let off pressure from the domestic situation. And that makes me even more concerned.

Korea is growing, but unfortunately one of the results of the growth has been that the restructuring of the Chaebols, which is absolutely necessary for the long-term health of the economy, is very much less certain. And in the best of cases it will not be as complete as one might have hoped it would be.

Thailand's recovery is spotty even though it is slightly positive. But the principal author of the recovery, the finance minister, seems to be in increasing political jeopardy.

Europe's growth is sluggish at best, with Germany very weak. As for Russia, even with a bit of luck, I think the most we can hope is that it will hold itself together financially and politically until the very uncertain outcome of the Presidential and Congressional elections next year.

The performance of the domestic economy I think gives us a difficult, if delightful, challenge, perhaps especially in how to describe it. Until last Friday's CPI the performance of the economy had been characterized by good, solid growth fueled by

productivity. Now outside economists talk of growth as being somehow dangerous. But it seems to me that our job as central bankers is in fact to seek sustained, noninflationary growth. In this regard, I think we have to be rather careful in our public speeches and statements to remember that we know a lot more than our audiences do. We have to be very careful to note that the enemy is inflation. It is not solid economic growth and it certainly isn't people finding jobs.

Now, what does last Friday's report of an increase in the core CPI tell us? Clearly there is a lot of noise in the data, and one could decide to dismiss them and just wait for another month to see what happens. However, we've tried to take apart the data statistically to see if there is any considerable likelihood that an increase of that amount could be giving some sort of signal that we ought to be concerned about. And we've come to the conclusion that the statistical probability is sufficiently high that the increase actually is telling us something important that I believe we definitely have to take it into consideration in our discussion of policy. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. At the last meeting, and indeed for some time before that, it seemed that the risks to the outlook were balanced, with a slow, steady drift to the upside. That continues with little sign of a significant moderating trend setting in. Like others, I have been expecting such a shift for a long time, but I would like to be more confident than I am now that it will emerge spontaneously.

Industrial production has resumed vigorous growth. We've continued to generate a quarter of a million jobs per month, which is wonderful of course. Inventories are low, and major cyclical swing factors like housing, autos, and capital spending, which should have eased before now, simply have not done so. Of course, I should note that we have some contrary news on housing this morning. The stock market continues to create wealth. Inflation remains remarkably quiescent, but here again I would like to be more confident that this will continue. The April CPI was a jolt of yet to be determined significance. But beyond that commodity prices may have begun to turn and, of course, energy prices already have turned up. Foreign growth should improve and will have an impact on commodities and other import areas. And unemployment in the United States, driven by demand pressures, appears to be headed to 4 percent or lower. The magnificent

productivity gains of recent quarters, even if they are largely continued, cannot be depended upon to hold these forces at bay indefinitely.

At the last meeting two factors seemed to inhibit the Committee from considering any action and both of those have dissipated. Six weeks ago any change by the Fed would have been a great shock to the market, but not today. The Balkans was an important unknown then but, for better or worse, it now appears to be headed for a stand-down. To be sure, there are still downside risks and we have no clear and present inflation danger. And we could bask in this virtuous cycle for some time yet. The question before us, of course, as it has been, is how best to help prolong this excellent economic era for as long as possible. The emergence of an inflationary surge with some gain in momentum would surely mark the beginning of the end of that. No actual move would appear to me to be required today, but it may well be time to assess how best to start leaning into the wind. Thank you.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. For the last few meetings, I have been trying to determine rules of thumb or guides for how we should be making our decisions. The Taylor Rule, a favorite of many academic economists studying monetary policy, does not work well when it is difficult to define operating targets for inflation or unemployment. As we have discussed often in this room, this difficulty may now be showing up particularly with respect to the unemployment term, given the problems in identifying the NAIRU. One could make a case that the NAIRU is 6, 5, or 4 percent.

There are several substitute approaches. One is just to drop the unemployment term from the Taylor Rule, in which case the rule becomes an inflation-targeting rule. Under this modification, the Fed would move against inflation deviations or in the present circumstances accelerations of inflation. Another approach, which I have championed here, is to go to a change rule. Assuming both inflation and unemployment are in their desired band, the Fed would try to lead the growth in aggregate demand to be equal to the long-term growth in aggregate supply. This rate used to be about 2.5 percent per year, but now may be as high as 3.25 percent if one is a productivity optimist. A third approach is Bob Parry's nominal GDP standard. I haven't thought about that thoroughly, but I think most of the time that would give the same suggestion as my change approach.

Whatever the approach, I felt we were in policymaking equilibrium up to our last meeting. As long as inflation was not accelerating--and it did not seem to be seven weeks ago--the inflation-targeting approach called for no change in the funds rate. As long as the forecast rate of growth in aggregate demand was under 3.25 percent, as it was then, the change approach did not either. But seven weeks can make a difference. The recent bad news on the CPI, even if one adjusts for special factors, suggests a possible acceleration, as do the balance of the Reserve Bank anecdotes. But the news on inflation suggests only a possible acceleration because the numbers are for only one month and anecdotes are anecdotes. Yet, there is a definite new inflation threat in the data. The change rule is also pointing differently because the Greenbook growth forecast now averages slightly above 3.25 percent until this growth is contained later on by a rise in the funds rate included in the baseline forecast and by Y2K. The Blue Chip forecasters are even more out of line. Their forecast rate of growth is 3.8 percent, even further above the long-term trend. We focus on the disturbing CPI numbers, but in fact it is true that a number of additional signs are beginning to point in the direction of a tightening of policy. This reasoning is either based on very recent information or on forecasts, so I suppose there is some time before we have to act, but not too much. As has been pointed out often in this room, the good recent performance of the economy is no doubt due partly to a feeling that the Fed will move against inflation. We risk losing this credibility if we tarry too long. There are strong arguments for doing something pretty soon, perhaps a modest step but a clear step. The market seems to expect us to and we'd miss Jack Guynn's window of opportunity if we didn't.

Let me address one final matter. Suppose we move; does this box us in? If we were to take the modest step of introducing a tilt, in more than half the recent cases an upward tilt was not followed by a rise in rates. So I don't interpret that as boxing us in. If we took the more drastic step of actually raising rates, we might find that a bit harder to undo; but I would still repeat an argument I have made here before, which is that a huge policymaking advantage for monetary policy is its flexibility. We could take advantage of this flexibility. So, I personally do not find the box-in argument very persuasive. Thank you.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. I, like others, have come to recognize that the forecast outcome is quite desirable, but I think the risks are really to the upside. A number of people have already talked about the CPI. I agree with Mike Prell in that the latest CPI number does not to me indicate that the day of reckoning has arrived. If one looks at the details, besides apparel, owners equivalent rent, lodging away from home, and airfares seem to be the drivers, along with the category called "other services." None of those is unimportant, but on the other hand they don't necessarily suggest that inflation--or if you will, the wolf--is at the door.

To go to another view, there are some straws in the wind that I think we do have to be focused on. First obviously, as Governor Gramlich has indicated, almost regardless of what one thinks the NAIRU is, it is probably somewhat higher than 4.2 percent. Therefore, one should expect some increase in labor costs at some point. The most recent ECI would not bear that out, but that index was obviously driven in part by the fact that commissions and bonuses turned down, perhaps because of a slowing in some of the underlying activities. On the other hand, a complementary measure, the NIPA measure, showed quite an increase in labor costs, and I don't think we can necessarily reject that. That is at least one of the cautionary flags that labor costs may be rising.

The other thing that one might look at, of course, is the aggregates; a few others have talked about the behavior of the money supply. I was looking at commercial bank credit, which showed strong loan growth across the board in the fourth quarter of last year and continuing, though somewhat abating, growth in the first quarter of this year. There clearly seems to be a great deal of demand for credit out there and, indeed it turns out, a great deal of availability of credit.

If one looks to the international side, I also think some of the risks that we have been most concerned about have abated. The fat tail that we were concerned about at the end of last year has become a lot thinner. I agree fully with the Vice Chairman's comment that the difficulties abroad certainly are not over yet. All things have not settled down internationally, but a start has been made. If one looks at the stripped Brady bond yield, there is some indication, at least from the markets, that they expect some turnaround in that area.

One might also look at import prices and at the BLS indicators. All suggest, particularly industrial supplies and capital goods, that the decline in import prices has bottomed out. It is a forecast in some cases, but I think it's a reality as well. So that is another one of these trends. President Minehan and others have talked about increases in the prices of a number of different commodities. Indeed, if one looks at spot prices, those are pushing in the same direction.

I strongly agree with the comments that the Vice Chairman made. I don't think it is our job to lean against growth; I don't think it is our job to stop the creation of jobs or the creation of wealth necessarily. But I believe that we do have to be concerned about how nominal GDP is split between solid, sustainable growth versus inflation. And my concerns now are that the risks are moving a little more to the inflationary side.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. I continue to be impressed by the recent exceptional growth in productivity. The case for an increase in trend productivity growth is now more compelling after the strength in productivity over the last five quarters--and especially after the last two quarters--than it was based on the data for 1996 and 1997. And I believe the staff's pattern of incremental upward steps in trend productivity growth makes sense, with some acceleration in productivity beginning in late 1995 and a further acceleration in 1998. My problem with the staff forecast is that its projection of a 2¼ percent productivity trend over the forecast period is just too aggressive for my taste. This revision to the productivity forecast basically drives their entire forecast. It allows a significant upward revision in growth over the two-year horizon with little effect on the unemployment rate and, hence, on inflation.

It is important to note, however, as the Greenbook makes very clear, that the revision of the productivity trend delays but does not remove the day of reckoning that is still implicit in the staff forecast. It is interesting that this "day of reckoning" seems to have become the theme of this meeting. The tight labor market gets still tighter. The favorable price shocks are still dissipating further. Ultimately, the very tight labor markets and the dissipation of supply shocks put inflation on an upward trend. This is an important message. Growth does not cause inflation; excessive utilization rates do. But another unexpected shift in the productivity trend, as assumed in the Greenbook, imparts

another disinflationary bonus and allows rapid growth to be accommodated for a while longer with relatively stable inflation.

My less optimistic assessment of the underlying productivity trend essentially moves forward in time the rise in inflation that current initial conditions make so likely. I do believe that we are at an important turning point in this episode. Inflation, after falling throughout the last few years, is stabilizing in the near term, I believe, and is poised to move higher going forward. That's how I read the recent CPI data.

The continued favorable financial conditions and high level of consumer confidence are helping to sustain robust demand. While I still expect growth to slow somewhat going forward, I believe it is more likely that growth will be above trend than below trend in the near term, and that growth will not spontaneously slow enough over the forecast horizon to prevent a rising trend in inflation.

It might be useful to recall the forecast that motivated the easings in monetary policy last fall. At our September meeting, the staff projected a 1.2 percent growth rate in 1999, assuming an easing in monetary policy. The current staff forecast has growth almost three times as fast. The unemployment rate by this point was projected to be $4\frac{3}{4}$ percent, $\frac{1}{2}$ percentage point above where it is today. It was projected to rise toward $5\frac{1}{2}$ percent by the end of 2000, $1\frac{1}{4}$ percentage points above the current forecast. And equity prices have rebounded by about 40 percent from their trough in early October. To be fair, the other major developments since the September forecast were the much-sharper-than-expected increase in productivity growth in 1998 and the upward revision to trend productivity going forward. Productivity growth over 1998 turned out to be almost double what the staff projected at the September meeting--2.7 percent versus 1.5 percent. And the trend productivity assumption is $\frac{1}{2}$ percentage point higher now in the staff forecast than the $1\frac{3}{4}$ percent assumed at the time of the September meeting.

One question we have to ask is whether we have become sufficiently optimistic about the productivity trend going forward to justify keeping in place the full amount of the decline in the federal funds rate that was motivated by a forecast that has since been so significantly revised and by a set of financial conditions that have so dramatically improved. The second question we have to ask is whether we should maintain the current policy setting for the funds rate if growth continues strong and labor

markets tighten further while inflation remains steady in the near term and is projected to increase thereafter. I will pick up from here in my policy position statement.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. I was quoted in a recent New Yorker article, one of the flood of articles on our Chairman and the new era, as being “mystified in a pleasant way by the recent performance of the economy.” I think that describes the mood that has captured this group for quite a while now. Now, we weren’t mystified about everything. Much of what was happening was explainable: the global pressures on commodity prices; the decline of agricultural prices; and the weakness of exports to Asia, which now seems to be turning around. Much of the domestic growth was explainable: the strength of consumer demand as employment and incomes rose and stock prices soared; the housing boom as interest rates fell; the durables boom as people furnished those houses and bought new cars. Also explainable was the downward pressure on prices from the strong dollar and commodity prices--that fierce global and domestic competition.

Other parts of the puzzle seemed less clear, basically pleasantly mysterious. Why was wage growth so subdued in the face of labor market tightness and the persistent anecdotes around this table about reported wage increases and shortages of workers? Above all, why did productivity accelerate so rapidly in the last two quarters? There were plenty of plausible reasons, but no certainty that the reasons were the right ones or that they would last. There were cyclical factors, capital deepening, the timing of the technology revolution, and new management skills and attitudes. None of it was very conclusive but the numbers were there. Through all the pleasant mystification, our collective common sense kept saying things like “good things don’t last forever.” Some of the positive forces, such as the strong dollar, will turn around--supply and demand laws still work. Eventually we’ll run out of workers and wages will push up costs and/or consumer prices will begin to rise for some exogenous reasons--oil or whatever--and keep going up. And then we must be prepared to act.

Are we at that point or close to it? The CPI is worrisome, but it’s only one month’s number and we are used to a good deal of volatility in that measure. Cost factors still seem quite benign. Wage growth, though, is not accelerating, at least in the statistics. Productivity is on a roll. The ECI still seems to be coming down with profits rising.

Market alarm at the CPI has sent long rates up a bit more, to do our work for us. So the question is: Do we need to reinforce this with a hint or a tilt? I would be inclined to wait, but I can see the case for telling everybody that the Fed is awake.

CHAIRMAN GREENSPAN. Thank you. I think coffee awaits!

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

MR. KOHN. Thank you, Mr. Chairman. At your last meeting, many of you remarked that you were concerned that inflation would eventually turn up and you therefore saw monetary policy as more likely to firm than to ease, though you weren't sure when such action would be appropriate. The question for today's meeting would seem to be whether the time has drawn closer--perhaps even close enough to tighten or, at least, to shift to an asymmetric directive and let the public know right away that the Committee's concerns about inflation had increased significantly.

Many of you may view the period ahead as an especially important one for the inflation outlook. As Mike noted, some of the one-time price declines that have played a role in damping inflation are expected to be ebbing or reversing. Among them, energy prices have already risen substantially, the prices of other important commodities have turned around lately, and declines in other import prices should come to an end as the effects of a more stable dollar since last summer and strengthening in foreign economies are felt. How domestic inflation responds to these developments may help to resolve questions about the causes of the recent inflation performance. And the decision you make could be important in determining the degree to which these price level changes become embedded in inflation expectations, thereby affecting longer-run inflation trends.

However, judging the need for a change in the stance of policy has been complicated by uncertainties about the supply side of the economy and the associated lack of confidence in forecasts of inflation. Preemptive actions that turn out to be unwarranted would tend to create unnecessary variations in economic activity and increase uncertainty, impeding planning by businesses and households and impinging on economic growth. At the same time, however, waiting for compelling evidence of an actual upturn in inflation before changing policy also would lead to sizable adjustments in financial conditions and economic output. In the circumstances, the Committee presumably will want to be as forward-looking as possible, searching for early signs of changes in inflation prospects and acting, perhaps forcefully, when it detects tendencies that could reasonably be expected to impair economic performance over time.

Since the last FOMC meeting, developments on the demand side of the economy would seem to weigh on the side of greater concern about future inflation. Demand has been strong and economic growth has continued at a pace in excess both of prevailing expectations and of most estimates of the long-run expansion of potential. Moreover, indicators of a prospective moderation in spending are still quite tentative. Unless productivity is even stronger than the upward revised estimates of the staff forecast, growth will have to slow appreciably from the pace of the last few quarters, if labor markets are not to come under increasing pressure.

Changes in financial conditions over the last six weeks probably have not materially added to the restraint on demand needed to moderate expansion. Rather, the run-up in yields on Treasury securities in recent weeks seems to owe in part to the rolling back of the earlier flight to quality as investors appear to have reduced their concerns about risk and increased their appetite for assuming it. As a result, the nominal cost of business credit has remained about flat on average over the intermeeting period. And equity prices have climbed further, boosting wealth and spurring consumption.

More troubling, the movements in Treasury interest rates likely also evidence some deterioration in inflation expectations, as yields on indexed debt have edged lower and the foreign exchange value of the dollar has slipped off some even as the interest advantage of U.S. nominal instruments has widened. Of course, some caution in interpreting this deterioration seems warranted. To some extent, you may only be looking in a mirror and merely seeing the market's perceptions of the Federal Reserve's concerns, rather than an independent assessment of emerging price pressures. In addition, inflation fears may not have penetrated Main Street, where the spending decisions are made, judging from the lack of movement in price expectations in the Michigan survey. But those judgments are difficult, given the inertia in household decisionmaking and the lags in surveying.

Lastly, developments in international markets may also suggest the increased potential for greater inflation pressures. At a minimum, the resilience of foreign markets and economies suggests that the asymmetrical downside risks that concerned the Committee last fall have greatly diminished. As already noted, the dollar has edged off recent highs in the exchange market; a persistence of this trend would put upward pressure on prices and demand in the United States, reversing the stabilizing role that the strong dollar and deteriorating trade balance have played over the last several years. For now, the relatively flat dollar means that productive resources in the United States will not be shielded from the additional demand brought about by policy easings and returning

confidence abroad. As a consequence, the staff forecast now embodies a sustained growth in exports.

But, the economy has demonstrated a remarkable capacity to absorb demand without generating cost and price pressures. Four percent growth in output over the last four quarters has barely nudged down the unemployment rate. Moreover, some broad measures of nominal wage and price increases fell further through the first quarter. The extraordinary increase in productivity that has enabled demand to be met without appreciably lowering unemployment has also helped to keep cost pressures subdued. Unit labor costs show no sign of picking up, despite an unemployment rate at or below 4½ percent over the last year. Moreover, except for energy we have seen only small and very recent increase in the prices of commodities and intermediate goods in the pipeline.

If, in light of this mixed evidence, the FOMC does not wish to tighten policy at this time but still sees the inflation risks as having risen, the Committee should consider whether to adopt an asymmetrical directive toward tightening and whether such a directive should be announced.

It is difficult to predict how markets would react to an announcement that has no precedent. And details will matter in that the response will depend in part on the wording of the associated announcement. The market's reaction will be influenced by the height of the hurdle the Committee set for itself when it reaffirmed its disclosure policy. The Committee said it would reserve such announcements for significant shifts in its thinking, especially where the absence of an announcement risked seriously misleading the public and the markets. With the bar set at that relatively high level, the market is likely to build in substantial odds on tightening at the June or the August meeting if the Committee announces a tilt, perhaps on the order of 50-50. Friday's data moved market participants in the direction of expecting an announcement of a tilt today and raised their assessment of the chances of policy firming in coming months. But market prices do not yet incorporate 50-50 odds of a tightening until the fall. The Committee may well be in a situation in which, because of its announcement policy, it cannot leave markets unaffected by its decision today, even if it follows the strong market consensus and makes no change in the stance of policy. Announcing the Committee's heightened concern about inflation is likely to raise rates; omitting such an announcement is likely to lower them.

If in fact the Committee is now more concerned about inflation and hence more likely to give serious consideration to tightening at the next few meetings, it might consider adopting and publishing an asymmetric directive. In the context of greater inflation risks, the resulting further

back-up of yields and restraint on equity prices would tend to contribute to economic stability; a reversal of recent rate increases and equity price declines would be counterproductive. Indeed, not publishing a tilted directive might be seen as misleading markets in that it would lead to a structure of market interest rates that inadequately reflected the Committee's assessment of the economic situation. A tilt would be taken as indicating that the Committee might be especially sensitive to information suggesting that price pressures were likely to build. With the markets on notice that policy action was under consideration, responses to incoming data are likely to be relatively intense and markets volatile. But, to the extent participants understood your concerns and hence could anticipate your actions reasonably well, the resulting price movements should be constructive and stabilizing, on balance.

If, on the other hand, the Committee were not so sure inflation risks had risen appreciably, it might choose to retain the symmetrical directive. The Committee might be hesitant to act before it had more concrete information that prices were likely to accelerate. Such evidence could come from data on costs and prices or from added pressures on resources--that is, a further decline in the unemployment rate. Because neither of these sets of indicators has moved much of late, the Committee might believe that it was unlikely to get definitive enough evidence in the next few months on these pressures to take action. If this were the Committee's view, then publishing a tilted directive and encouraging the market to build in expectations of tightening could ultimately be misleading and could lessen the power of asymmetry to convey information over time. Indeed, some rally in credit markets, which would be expected to accompany no announcement, might well accord with such a less concerned view of the inflation outlook, particularly if the Committee saw the sharp reaction to Friday's data as overdone.

CHAIRMAN GREENSPAN. Questions for Don?

MR. HOENIG. Don, since you spent a fair amount of time on whether we should go asymmetric or symmetric, my question has to do with the wording in the directive that relates to the tilt. The way the current wording reads, the tilt applies to "the intermeeting period;" it does not say that we might act on the tilt at the next meeting or the meeting after that. How important is the fact that it is confined to the intermeeting period and not longer term in influencing your thinking of whether we should put that language in the directive?

MR. KOHN. The Committee has discussed at length whether it should change the wording in the directive to be less specific about the intermeeting period and has had

trouble finding a consensus about how to make that change since everybody seemed to have a different interpretation of the meaning of asymmetry. I think that problem could be handled in the announcement that accompanies a shift to asymmetry if that's the way you choose to go. First, I wouldn't mention the words "over the intermeeting period" in the announcement; secondly, I might put in wording about looking at information "over the coming months." If the announcement is clear, I doubt that people will care about the specific wording in the directive.

CHAIRMAN GREENSPAN. Further questions for Don? If not, let me get started on the policy side.

I would like to differentiate between history and forecasts. The history at this particular stage, with only very slight variations that have surfaced anecdotally in the last two or three weeks, is unequivocally that of a period of declining rates of increase in unit costs. In fact, the numbers for the nonfinancial corporate sector have gone down to zero change in total unit costs over the four quarters ending in the first quarter of 1999. I don't recall a four-quarter number that low in the current expansion. The zero change reflects quite subdued growth in unit labor costs and a decline in the level of unit nonlabor costs. Prices generally are flat, but they have been associated with a rise of modest dimensions in profit margins, on average, in the past few quarters.

In the manufacturing area where we have data through April, we see similar results in that unit costs remain very subdued. Indeed, the monthly numbers on costs are quite soft and profit margins were rising significantly further in April. All the reports on projected profits that we pick up from security analysts point to an improvement in the second quarter. I don't mention that as a forecast but as a report of what people are saying. The data indicate that productivity continues to accelerate. Indeed, we have very little evidence as yet that the upsurge in cyclically adjusted productivity has leveled out. The first sign that that is occurring may be reflected in the long-term earnings forecasts of the security analysts, which as you know have moved up about 2 percentage points. The earnings forecasts and productivity growth rates may differ, but the two are interrelated. Because we are talking about a forecast with no change in labor's share, an increase in expected earnings over five years has to show up either in an acceleration in the rate of

inflation, in the rate of productivity growth, or in the rate of hours growth. The latter is extremely unlikely, strictly as a matter of demographics.

There is very little evidence to date of a pickup in inflation expectations, and until very recently the notion regarding pricing power in the business sector has been uniformly that it is zero. Theoretically, it is possible that foreign affiliates are increasing their share of the earnings. But given what has happened to oil, that seems doubtful. Therefore, we are led to the conclusion that the earnings expectations are essentially projections of productivity growth. The rate of growth in productivity has been rising during the past several years. In the past two or three months, however, we have seen some indications that the growth rate might be leveling out. That suggests that companies are no longer telling security analysts that productivity growth is on an ever rising trend.

If we look strictly at the current data, what we end up with are increasing profit margins and noncredible reductions in the rate of increase in average hourly labor costs. The latter come from the figures on aggregate wages and salaries in the NIPA data divided by hours or they come from the average hourly earnings in the payroll data; both show a very dramatic drop in the rate of gain in average hourly labor costs. I believe it was you, Roger, who was raising the issue of the NIPA data; those data are obviously picking up a larger aggregate hours figure. The trouble with the NIPA data is that we are dividing an uncertain numerator by an uncertain denominator, and the result is perfection!

MR. FERGUSON. That's a fair point.

CHAIRMAN GREENSPAN. The trouble unfortunately is that, as a number of you have commented, the ECI cost data are probably not picking up a number of the nontraditional ways of paying people--training costs, stock options, and a few other forms of compensation. But leaving aside the uncertainties that are involved in measuring wages, the interesting issue is why wages are not rising faster if productivity is doing what all the evidence suggests it is doing. We have a unique anomaly.

Nonetheless, granted all of this, we still have erosion in the pool of people seeking work who do not have jobs. To be sure, that number has not gone down as fast in the last year as it did in preceding years, but it is still going down at a 500,000 annual

rate. That is a substantial decline. The current level is at or below its previous low in the history of this series, which goes back to 1970. We know that has to have inflationary consequences at some point even if the acceleration in productivity has damped the influence of tight labor markets on wage increases.

I also find a bit of an anomaly in the anecdotes concerning what is happening to prices. A number of you have referred to anecdotal reports that it is now easier to raise some prices. I suspect that may be right, given the extent of overall vibrancy in this economy. Nonetheless, participants in the Business Council meeting in Williamsburg said the other day that such pricing behavior absolutely was not occurring and that they had not seen it for quite a long period of time. I don't know whether that phenomenon is just starting to be built into the pricing structure.

There is some evidence that commodity prices may have tilted up to some extent after declining earlier and then flattening out. Copper and aluminum prices are up modestly, but they are well beneath their recent highs. Steel scrap prices are little changed. It is hard to find anything resembling upward price pressures on non-oil commodity prices. Nonetheless, I can't get away from the fact that the growth in aggregate demand still exceeds the rate of increase in productivity and is continuing to put pressure on the system. I find it very difficult to uncover any useful evidence that suggests the increase in aggregate demand is slowing. Obviously, we are absorbing goods from abroad at an unprecedented pace.

This situation could go on for a while, as Governor Kelley has said, but credulity gets strained more and more the longer it goes on. It is hard to avoid the conclusion that there is an increasing imbalance here that we have to address. While I am not ready to move rates, I do think that those of you who have raised the issue of moving to a tilt toward restraint have the arguments strongly on your side. And if we do go to a tilt in this particular environment, I can't see how we can avoid announcing it. I think failing to do so would be exceptionally confusing to the market. As far as I can see, we do not have strong evidence of rising inflation, especially if we move away from what I consider to be a flawed consumer price index. If we look at the implicit PCE deflator, the numbers don't look as bad. Indeed, the April rise in the PCE deflator is 0.3 for the core and 0.5 for the total. The three-month average for the core PCE is a rise at an annual rate

of 1.1 percent. This is not evidence that somehow we are far behind the curve, that inflation pressures are mushrooming, and that we had better move.

I see very little to be lost at this stage in going to an announced tilt except perhaps in using a tool that we might be able to use more effectively later. What it does in my view is to position us to move in light of a lot of small indications in the CPI that may suggest a rise in inflation. I suspect that is the case but I do not know for certain. In other words, even adjusting for the measurement problems in the CPI with regard to the abnormal weight that it puts on apparel and on owner-occupied rents, there are indications in the latest numbers that the decline in inflation is coming to a halt. There is very little evidence that I can see that the rate of inflation is still moving down. But we also have seen very few, if any, signs that it is turning up. And therefore I think we will be in a position where we can move if necessary at the next meeting or the meeting after that and not be caught by what I consider to be a relatively low, but by no means zero, probability of having to move suddenly. We have been in a situation for so long where we have seen labor markets tighten continuously with nothing happening to prices that we may lull ourselves into the belief that markets don't turn quickly. They have turned quickly in the past. Such behavior will not show up in our models largely because models, by having fixed coefficients reflecting average characteristics, cannot produce a rapid change. But markets can. And even though I think such an outcome has a low probability, I believe it finally is time for us to start to position ourselves. I am far from convinced that we will need to act on an asymmetric directive in the near term. But not having such a directive in place and then being forced to act by events that come upon us fairly quickly, which may mean acting during an intermeeting period, could in my view create market forces that might ultimately be destabilizing. So while I sense that it is definitely premature to move rates, it is by no means premature to move toward a tilt and to announce it as well. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I fully support your conclusions and the associated reasoning. I believe it would be very ill advised to raise rates today. Such a move would be taken as a knee-jerk reaction to the CPI number regarding which all of us have some questions. But to fail to adopt an asymmetric directive toward firming also would be ill advised, and it would be very ill advised not to

publish such a decision. Oddly enough, by publishing a tilt toward tightening, I think we actually will have more flexibility. It is not necessarily the case that we will in fact have to tighten, though I am a little more inclined to think we will have to do so than you just suggested, Mr. Chairman. But I believe adopting a tilt and shocking the market without preparing it would create some very serious problems for the economy, which we can easily avoid by announcing the tilt.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. Mr. Chairman, I agree with your proposal. I don't see strong economic reasons for not waiting another month before making your proposed change even though only a tilt is involved. After all, the only really disturbing economic news is the core CPI for one month. But we may have to move in the next few months and, if so, I have concluded that psychologically there are some good reasons for moving to a published tilt now. Indeed, if a slowdown in the expansion is in prospect and we reinforce its probability with the higher rates and lower equity prices that might follow our announcement of a tilt, the markets may do our work for us and we may not have to move at all.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, what you are proposing is certainly a step in the right direction, but my preference would be to go ahead and move the funds rate up $\frac{1}{4}$ percentage point today. I would respectfully disagree with Bill McDonough about the interpretation of such a move as a knee-jerk response. Some people might read it that way, but I really don't think it has to be seen that way.

As I have said at some earlier meetings, I believe there has been a case for tightening our policy for some time now on a lot of different grounds. We have talked a lot about productivity trends at this meeting. To me it seems increasingly likely that trend productivity growth is rising. Some may see that as a reason to stand pat on policy, but higher trend productivity growth will lead at least some households and businesses to expect higher incomes in the future. Some are going to try to act on that expectation now by borrowing to increase their spending even though the actual increase in output is not yet available. In that situation, interest rates need to rise to keep demand from becoming excessive. The extraordinary growth in domestic demand of late seems clear if one looks

at a measure like private domestic final purchases, which grew at an annual rate of 7½ percent in the first quarter after growing at a rate of 6½ percent last year. That has to be above any reasonable estimate of the sustainable growth in output, and it is one reason for tightening policy.

Beyond that, as Governor Meyer mentioned earlier, when we last reduced the funds rate in November, I believe a lot of people around this table saw that move as extra insurance, so to speak, against the possibility that the financial difficulties we had experienced would undermine the general economy. Those fears clearly have not materialized, so I think there is a case for taking back that last rate reduction.

With regard to the CPI for April, again it is only one number. But it comes at a time when we are already on the lookout for rising inflation on the basis of a variety of other developments and at a time when financial markets clearly are taking the risk of higher inflation seriously. We have fought long and hard to win the credibility we now have, and going forward I think our credibility can be an enormously powerful weapon for keeping inflation under wraps at minimum cost in terms of lost output and jobs. I don't pretend to know exactly what we have to do now to preserve that credibility, but I have a sense that we need to show the flag, get back in the ball game--whatever metaphor you want to use--and to do so more decisively than by just moving to a tilt. So, I would favor alternative C.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Your recommendation of announcing a tilt captures my sense of what we ought to do today. I think it strikes the right balance between showing that we are indeed awake at the switch and at the same time showing the appropriate restraint. Even more importantly, I believe it positions us either to act on the tilt in the future, should that be necessary, or not to act. But I do think it sends the right signal, and I fully support what you are proposing.

CHAIRMAN GREENSPAN. President Gynn.

MR. GYNN. I support your recommendation as well, Mr. Chairman, and I would echo the comments that President Boehne has just made. I also identify with President McDonough's comment that we may get an added kick from the announcement effect since it will be the first time that we inform the public about a change in the tilt

immediately after a meeting. In addition to the arguments that you made, I am pleased that such an announcement will not leave all of us vulnerable to having our individual public statements or even our body language picked apart over this next period. I think a leak would be a most unfortunate way for people to learn about a change in the tilt, and I see that risk as a very important reason to make the announcement. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I felt last time and I feel now that we could appropriately identify an immediate move as an unwinding of our earlier effort to stabilize financial markets--an effort at which we were successful. I would prefer that explanation. At the same time, I would buy your recommendation today in terms of the tilt. I would be careful about what the announcement says with regard to the period to which the tilt may apply, whether it is the intermeeting period or some longer period, but I certainly would accept your tilt recommendation.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. I certainly concur with your recommendation. I am a little concerned, however, about the interpretation of the tilt. In my view the Committee should not feel that it locks us in to an early move. Everyone no doubt recalls that last summer our directive was asymmetric toward tightening for three meetings from late March until mid-August and we never did tighten. Subsequently, of course, we eased in the fall. Something unforeseen could happen again. We should be open to that possibility and remain flexible.

One further thought, Mr. Chairman: I would hope that in our public statement we will de-emphasize the April CPI number and stress the underlying trends that I think are really motivating us.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. I support your recommendation for no change in the federal funds rate target and enthusiastically support your recommendation for a move to an asymmetric directive that would be announced after the conclusion of this meeting. The balance of risks in my view is toward continued strong growth, possibly even tighter labor markets, and ultimately higher inflation. As other members of

the Committee have noted, a case could be made for an increase in the funds rate to reverse some of our easing during the fall in light of the upward revision to the forecast and the improvement in financial conditions since that time. It is especially important in my view for us to respond to any further tightening in labor markets or to any increase in inflation because I believe the unemployment rate is more likely to decline than to rise in the near term. And because I think it is more likely that inflation will be rising rather than falling over the next several months and quarters, I believe an asymmetric directive is appropriate at this time.

Long-term interest rates have risen in response to the Chairman's recent speech and in response to the recent CPI and industrial production data. Some might argue that this rise in long-term interest rates alone provides a desired restraint and removes the necessity of Fed action. However, the rise in long-term interest rates reflects the expectation of bond market participants that monetary policy will tighten in the not too distant future, presumably in response to the considerations that I have just outlined. The bond market is in effect pricing in relation to the market forecast and our perceived policy reaction function. Such preemptive pricing in the bond market is in my view desirable and stabilizing, but it will occur only if we consistently ratify the expectations on which it is based when those expectations match our own.

There has been some concern that the first time we move to a bias and announce the change will have an unusually large effect on the market. But today's meeting provides an opportunity to implement such a move with a relatively modest effect precisely because the bond market has already priced in some expectation of a near-term policy move. While there is very little or no expectation of a change in the federal funds rate target at today's meeting, financial market participants are to an important degree expecting the FOMC to move to an asymmetric directive. In fact, I would expect that the response to no announcement, which might be viewed by the market as implying that there was no change in the bias, might be greater than the response to an announcement of a change in the bias. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, I too think that your recommendation is a step in the right direction. But, like President Broadus, I would be more comfortable

with an increase of 25 basis points in the funds rate that would in effect undo the last decrease that we made last fall. I think such a reversal could easily be justified in our public statement without reference to the CPI increase; we could say that it reflects the stability--in fact, the improvement--that has occurred in our financial markets since last fall.

Looking back to a year ago, we had an asymmetric directive toward tightening for three months or so, as Governor Kelley has reminded us. We were facing an outlook at that time that we never expected to be as good as the situation we are facing now. We have witnessed a recovery from many of the problems that the economy was experiencing during the fall. I for one hope they cannot be repeated, at least in terms of their seriousness. At this point I think we are looking at underlying levels of demand and labor market pressures that are far greater than those we were seeing last year at this time and a monetary policy that is definitely easier.

So in my view there is a good case to be made for increasing the funds rate and taking back that last decrease. If we go ahead with the tilt, which appears to be the likely action at this meeting, I agree that announcing our decision would be desirable. Don Kohn made one striking comment, I thought, about the fact that there would undoubtedly be a rally if we did not make an announcement. That is the last thing we need at this point. So, if we go ahead with the tilt, we definitely should publish.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I support your recommendation. The most important thing to me in all of this is that we make an announcement because I believe it is very important at this stage that we give the public some sense of our thinking in the current environment. I would second Mike Kelley's emphasis on inserting some thoughts in that statement about longer-term trends as opposed to focusing on the latest CPI number.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I support your recommendation, although I still hope we won't have to follow through anytime soon. Also, I don't see why we couldn't make a modest change in the directive to refer to the "coming months" rather than to the "intermeeting period."

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, I believe that the reference to the tilt needs to be announced this afternoon. That is the correct thing to do. I also associate myself with those who believe that a modest firming should be put in place now.

I'd like to talk briefly about the analysis that underlies my views on policy. I don't think there is any question that financial conditions are accommodative as measured by money growth, the ease of financing in markets, and the behavior of the equity markets. The issue is how fast the economy can grow, assuming there is an ample amount of money. We have talked a lot about productivity, but I think it is important to keep in mind that one thing that economic theory tells us about productivity growth is that it determines the gap between wage growth and price growth; it does not determine the level of either one. With the uncertainty about productivity growth, I believe we ought to be splitting it about down the middle. That is, if we have a favorable upward surprise in productivity growth, we should let half of it go into wages and half of it come out of prices rather than try to hold price inflation where it is and let it all show through in faster wage growth. There is an argument for taking some of it out of prices. In any event, there is no question that the outlook for productivity is subject to a great deal of uncertainty going forward.

There are lots of different ways of formulating this. To make it very simple and straightforward, if we look at this in terms of a Phillips curve issue, there is a lot of concentration on growth or on the gap or whether the natural rate of the NAIRU has changed. In fact, I think the expectations component of the Phillips curve is at least as important and that the best way to understand what has happened in the last couple of years is to say that expectations have trumped the gap. The reason that we have been able to run an economy as well as it has unfolded is that there have been firm expectations of continuing low inflation. But expectations will not continue to trump the gap forever. The underlying realities of the pressure on resource markets will gradually take hold; and once we lose the advantage on expectations, I believe it is going to be painful and difficult to get it back.

So, my policy recommendation stems to a large extent from the view that allowing any substantial risk that price expectations will get away from us is a very great

risk to run. In the staff's inflation forecast--though we can always quibble over the point estimates here because we all know what the standard errors are--I think the probability of an outcome $\frac{1}{2}$ point higher on the inflation rate is substantially higher than the probability of $\frac{1}{2}$ point lower on the inflation rate. And given that assessment of the probabilities, it seems to me that we need an appropriate policy bias to reflect that bias in possible outcomes.

If we do not tighten policy soon and if for whatever reason we are unlucky and the rate of inflation rises, we will then face the real risk that expectations will start to turn against us. We will find ourselves playing catch-up. And once the market comes to believe that we are falling behind, our effort to catch up is going to be very painful for the market and for us. On the other hand, if we tighten and inflation remains low, I believe it would be easy for us to reduce the funds rate later. That is part of the analysis underlying my view that to raise rates in present circumstances is in some sense a safety play.

I anticipate a tightening trend. Some people have expressed the hope that we won't have to move, but for those of us who believe that some tightening is going to be required, I think we need to have some idea of how much that is going to be. That to me is important because once we are seen to be in motion it is possible that the markets will move long-term interest rates higher than we might consider justified. I think we are now at about the outer time limit of being able to make a credible case that we are simply undoing some of the policy easing from last fall. The more distant in time that becomes, the less credible it will be to appeal to that as a way of providing some cap on market expectations of where this tightening process might take us. But if we have some bad luck on some of the inflation numbers coming in over the next few months, I believe we will find it difficult to manage under those circumstances. And that is why I believe it would be better to get ahead of the curve now.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I agree with your recommendations of an asymmetric tilt and an immediate announcement. I am concerned about the high level of aggregate demand and the related outlook for inflation. It is important that we show we are concerned about inflation and are ready to take action. In my view, this step will help us to maintain our credibility.

There were a couple of considerations mentioned by Don Kohn that I thought were important. He said if we change the tilt we should announce it if we think: (1) it is a significant change in our thinking; and (2) if the absence of this step would mislead the public. My assessment is that the current situation fits both of those criteria. So, I think it is important that we change the tilt and announce it right away.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, since we met in March we have had a number of conflicting signals about the future course of core inflation. Taken as a whole, however, I believe there are upside risks to inflation, although they may not be sufficient to warrant an increase in the funds rate at the present time. I must admit it would not take much more evidence of upside risk to convince me to raise the rate. So, I would be enthusiastic in supporting an announced upward tilt to the directive at this time.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. I, like others, support your recommendation for a publicly announced tilt toward tightening. I believe the risks, supported by some very early signs in the data, are sufficient for us to change at least our tilt. In my view publicly announcing the tilt will give us sufficient room to move if the cost pressures do emerge, but they are not, as you observed, yet evident. That doesn't mean that we should wait until they become full-fledged inflationary pressures, but I do think we have a little more time.

As others have indicated, the markets have already priced in some of this policy tightening, so we need not be concerned about an outsized reaction on their part, although there may be some as Don Kohn has indicated. Like others here, I would be concerned that if we don't move to asymmetry and announce it now, there might be an undesirable reaction in both the equity and the fixed income markets. Also, I believe not changing the tilt would, in fact, be viewed as an indication that we are not being vigilant to early inflationary signs and that might lead to some small erosion in our credibility. For all these reasons, I support your recommendation.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. As probably everyone knows and as Peter Fisher's charts showed, the level of intermediate- and long-term government

yields in May of 1999 is almost exactly where it was in May of 1998. So, in looking at nominal interest rates and the yield curve, we are right back where we were a year ago, and I thought policy was too expansionary then. I still am from the school of thought that believes a steeper yield curve indicates a more expansionary monetary policy rather than one that is less expansionary, and the yield curve is distinctly steeper today than it was a year ago. Governor Meyer said that the markets moved the rates back up in expectation of our tightening policy--raising the funds rate. I hope so because I don't like the alternative explanation. That explanation would be that the markets don't expect us to tighten, and for that reason interest rates have risen and will keep on rising. That would be especially disturbing.

The shock of last August and September was exactly that--an external shock that is unpredictable by its very nature. Those things happen. They have happened before. For a time they lead the central bank to suspend the normal considerations that go into its monetary policy decisions. I strongly suspect that it happened to the Committee with the onset of the Gulf War in 1990. It certainly happened in the fall of 1987 with the stock market crash in October of that year. I dread all Octobers, and since we are having a meeting this October, I am going to dread it, too. [Laughter]

MS. MINEHAN. Let's all go away for October!

MR. JORDAN. Right, let us just skip October. But I still believe in long lags, in variable lags too, but especially in long lags. I think our policy stance on balance has been more expansionary than was necessary or desirable for the environment in which we found ourselves. I say that even though we would have had to interrupt the policy that I would have thought appropriate a year ago because of what happened in August and September. Now, we should get back on the track that we otherwise would have been on. We are not back on that track and in my view monetary policy right now is more expansionary than desirable.

With regard to the issue of announcing a change in the tilt, I am bothered by the idea of saying we have cocked the gun but hope that we don't have to use it. That bothers me a lot. I don't like that practice in foreign policy let alone monetary policy, namely telling people that if one more thing happens--I don't know what that one more thing is--we are going to use this tool. Also, once we adopt an asymmetric directive and

announce that decision--with the understanding that we are providing information about a shift in our thinking about policy--then I assume at a later point we would have to announce a decision to remove the tilt if we determine we will not use it. To do otherwise would be to misinform the marketplace. Announcing the adoption of a tilt and not being very clear about the circumstances under which we would or would not use it is in my view going to lock us into making further announcements. I am not sure whether such a practice will give better information to the markets or not.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. I'll support the notion of instituting a tilt and announcing it. I am very glad we established this disclosure procedure because I think it gives us the ability to communicate more clearly. I am sitting four-fifths of the way from you to Al Broadus both geographically and policywise. [Laughter] I have something like four-fifths agreement with him and also with Bill Poole, Cathy Minehan, and Jerry Jordan that we should be raising rates. Four-fifths is not 100 percent so I won't dissent, but that's where I am.

CHAIRMAN GREENSPAN. I think there is a consensus among the voting members in favor of alternative B asymmetric and an announcement. There is a question about the reference to the "intermeeting period" in the directive. I have a preliminary version of a press statement that we would use if the vote on changing to asymmetry is affirmative. It does talk about "the coming months" as distinct from "the intermeeting period." Does anybody have strong views as to what we might or might not do about the language in the directive on the presumption that we go ahead on the asymmetry? We have to decide that now because legally we have to vote on a specific directive. Don Kohn, do you have a recommendation as to how we ought to handle this?

MR. KOHN. Well, as my answer to President Hoenig suggested, I think you could go ahead with the present wording of the directive. It strikes me that people may not want to change the wording on the fly but would prefer to have a chance to think about the pros and cons before reaching a decision. So the Committee may want to retain the current wording for now as long as the press statement makes the intent clear.

CHAIRMAN GREENSPAN. Okay, why don't we just leave the directive as is, but leave the issue open in the event that we want to go further. So, read the directive as is.

MR. BERNARD. I am reading from page 13 of 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 maintaining the federal funds rate at an average of around 4¾ percent. In view of the evidence currently available, the Committee believes that prospective developments are more likely to warrant an increase than 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
Governor Rivlin	Yes
President Stern	Yes

CHAIRMAN GREENSPAN. Let me read a proposed statement and get your reactions to it. "While the FOMC did not take action today to alter the stance of monetary policy, the Committee was concerned about the potential for a buildup of inflationary imbalances that could undermine the favorable performance of the economy and therefore adopted a directive that is tilted toward the possibility of a firming in the stance of monetary policy. Trend increases in costs and core prices have generally remained quite subdued. But domestic financial markets have recovered and foreign economic prospects have improved since the easing of monetary policy last fall. Against the background of already-tight domestic labor markets and ongoing strength in domestic demand in excess of productivity gains, the Committee recognizes the need to be alert to

developments over coming months that might indicate that financial conditions may no longer be consistent with containing inflation.”

MS. MINEHAN. That’s good. It gets in all the elements.

CHAIRMAN GREENSPAN. Is that acceptable?

SPEAKER (?). Excellent!

CHAIRMAN GREENSPAN. We will issue this at 2:15 p.m. Our next meeting is June 29th and 30th and we adjourn for lunch.

END OF MEETING