Meeting of the Federal Open Market Committee

August 18, 1987

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, August 18, 1987, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Boehne
Mr. Boykin
Mr. Heller
Mr. Johnson
Mr. Keehn
Mr. Kelley
Ms. Seger
Mr. Stern

Messrs. Black, Forrestal, and Parry, Alternate Members of the Federal Open Market Committee

Messrs. Guffey, Melzer, and Morris, Presidents of the Federal Reserve Banks of Kansas City, St. Louis, and Boston, respectively

Mr. Kohn, Secretary and Staff Adviser
Mr. Bernard, Assistant Secretary
Mrs. Loney, Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Oltman, Deputy General Counsel
Mr. Truman, Economist (International)

Messrs. Lang, Lindsey, Prell, Rolnick, Rosenblum, Scheld, Siegman, and Simpson, Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account

Mr. Cross, Manager for Foreign Operations, System Open Market Account

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International Finance, Board of Governors
Mrs. Zickler, Assistant Director, Division of Research and Statistics, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Office of Board Members, Board of Governors

Mr. Hendricks, First Vice President, Federal Reserve Bank of Cleveland

Mr. Fousek, Executive Vice President, Federal Reserve Bank of New York

Messrs. Balbach, Beebe, Broaddus, J. Davis, T. Davis, Ms. Munnell, Mr. Thieke, and Ms. Tshinkel, Senior Vice Presidents, Federal Reserve Banks of St. Louis, San Francisco, Richmond, Cleveland, Kansas City, Boston, New York, and Atlanta, respectively

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MR. JOHNSON. In the absence of the Vice Chairman of the FOMC, I'll try to kick things off. I think we need to begin, though, with nominations for the chairmanship of the FOMC. And I'd like to nominate Mr. Greenspan as Chairman of the FOMC.

MS. SEGER. And I'd like to second.

MR. JOHNSON. Are there any objections? [Laughter.] Mr. Chairman.

CHAIRMAN GREENSPAN. That was a longer pause than I expected. [Laughter.] I'd like to entertain a motion to move the minutes.

MS. SEGER. I'll move that.

CHAIRMAN GREENSPAN. If there are no objections, then they are approved. Mr. Cross.

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Comments anyone?

MR. JOHNSON. I have one, Mr. Chairman. I was looking this morning at the Telerate. A lot of the reasons given on the dollar's decline are that oil traded down yesterday and oil prices are dropping this morning in foreign markets. And I wonder how much of an influence that is having on the exchange rate too; it seems to move in parallel fashion.

MR. CROSS. It has been mentioned that oil prices have clearly softened. This morning's price is almost half a dollar below what it was yesterday and it's almost a dollar below where it was a week or so ago. This has been cited as another factor. Most of the people that our traders have been talking to seem to think that today's decline in the dollar is perhaps related to that, in part, but after the initial impact of the decline, it seems to be more a reflection of rather sour trade figures. Yesterday in New York, in the latter part of the afternoon, the dollar began to soften without anything very dramatic happening; it was just gradually declining. And we are told that the Japanese are saying that when their markets opened, they began to think that maybe they should cut some of their positions, so there was some selling both in Japan and in Europe subsequently, which brought us down to current levels. It's possible that oil prices are now a factor but more talk seems to be given to this general attitude resulting from the continuing serious problem with the trade deficit and the larger number announced on Friday.

CHAIRMAN GREENSPAN. To what extent is the general apparent reduction of tensions in the Persian Gulf, which was obviously the cause of the decline in the oil price, actually the cause of this retrenchment? In other words, periodically, when we see tensions in the world, everyone rushes into the dollar; and, it looks to me as if we are just unravelling that particular position. It strikes me as rather difficult to believe that there is a secondary reaction to a published news event. Is it possible that the markets are just easing because of the decline in tensions, and people are just reaching for explanations of this sort? Or is there some reason to believe that it's really more than that and that there has actually been some Japanese reevaluation, rather than this view being just somebody's hypothesis.

MR. CROSS. Really, we don't have enough evidence, other than what people are telling us. When the Middle East tensions flared up here a couple of weeks ago, it was hard for us to see why that, in itself, should have caused the dollar to go up so rapidly. We saw some increase in [the price of] gold, but it came back down. We did not see evidence that it was lots of [unintelligible] flows. It could be that there is a kind of writing down of the dollar in light of the somewhat less troublesome situation in the Middle East. But we don't see much evidence of a lot of movement from this back and forth which would lead to that conclusion; it's possible that people's attitudes are influenced by it and, therefore, they are changing their views about what is the proper level for the dollar, to some extent. It is pretty much a matter of guessing.

CHAIRMAN GREENSPAN. What happened to the DM this morning?

MR. CROSS. Well, the dollar fell in terms of both the DM and the yen. It's now trading at about 1.85-1/4 DM and 147-1/4 yen. So it has declined about 3-1/2 percent, I guess, from the levels prevailing toward the end of last week before the trade figures were announced and whatever has happened that relates to them. It's a substantial move.

MR. PARRY. What about in relation to sterling?

MR. CROSS. I don't have the sterling quote today. But sterling has been under its own pressure because of the [unintelligible].

MR. PARRY. That may indicate whether or not it is related to oil.

MR. CROSS. Well, sterling sometimes acts like a petro-currency and sometimes it doesn't. You can't rely on it reflecting what happens in the Middle East. Well, sterling is up to 1.60-1.65.

MR. PARRY. That's not oil.

MR. CROSS. But it should not move that way if you followed the hypothesis.

MR. PARRY. That's right.

CHAIRMAN GREENSPAN. Anything else? May I have a motion to ratify Mr. Cross' actions?

VICE CHAIRMAN CORRIGAN. So move.

CHAIRMAN GREENSPAN. Without objection, they're approved. Mr. Sternlight.

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

MR. JOHNSON. Mr. Chairman, I'd like to second that recommendation for the additional amount.

CHAIRMAN GREENSPAN. Why don't we hold that until we get through the total discussion of Mr. Sternlight's remarks. We'll go to that later.

MR. FORRESTAL. Peter, in light of the increase in Japanese interest rates, have you detected a decline in Japanese participation in either the debt or equity markets?

MR. STERNLIGHT. At times, there certainly did seem to be an abatement in their interest in the debt market; as for the equity market, we are continuing to hear that they are pretty active. And they have certainly continued to participate in Treasury auctions; in this last auction they were there in the 10- and 30-year issues. As for purchases in the secondary markets, at times over the period we were hearing of some pulling away from buying in our market as their own rates were pushing higher.

MR. HELLER. Can I follow up on that one? Both in Germany and Japan, do you see the run-up in rates as mainly a result of policy actions taken or do you see it as a result of general economic conditions in the country changing?

MR. STERNLIGHT. Well, Sam Cross or Ted Truman might be in a better position to comment. At least as it was passed along to me, I got a sense that it was a bit more of the policy move type of thing.

MR. CROSS. In Japan, the short-term rates haven't changed; the long-term rates have gone up sharply. It seems to be a little element of both of the factors that you talked about. Certainly, the market forces led to a substantial increase in their longer-term rates and they have been quite concerned about the vulnerability of their financial situation given the stock market rise, the increase in real estate prices, and so forth. They also have allowed changes in some of these rates, like the long-term prime; they tell us they are resisting this, but at the end of the day it is clear that the long-term rates have gone up substantially. In Germany, I think there has been a little snugging, but again, it is hard to say how much, because there have been some other things going on.

MR. TRUMAN. I don't have anything to add to Mr. Cross' comments.

CHAIRMAN GREENSPAN. Further comments?

MR. JOHNSON. Peter, on your concerns about September: Are we anticipating, or is the Treasury anticipating, a cash balance problem?

MR. STERNLIGHT. We are anticipating a sizable buildup. I wouldn't say it's an unmeetable problem at this stage. I don't think we'll approach the record levels that we had last April when their total balance got up to $54 billion or so, and the balance at the Fed was $30 billion. I think their total balance could get up to the $40-50 billion range and that could put the balance at the Fed somewhere at $25 billion, or something like that. It could be a substantial reserve-draining factor.

CHAIRMAN GREENSPAN. Anything else? I need ratification of two items. First, I'll entertain a motion to ratify the open market transactions since the July meeting.

VICE CHAIRMAN CORRIGAN. So move.

CHAIRMAN GREENSPAN. Any objections? Secondly, we need another motion to approve the increase in intermeeting leeway.

VICE CHAIRMAN CORRIGAN. I move on that.

MS. SEGER. I second that.

MR. ANGELL. I guess the question is: Why not ask for enough? If $10 billion might not do it, why not ask for $12 billion?

MR. STERNLIGHT. Well, I considered that. But for almost any number I would pick, Governor, I could imagine circumstances that would take it a little beyond that. So, I'm picking what I think might well do it, but I just want to put the Committee on notice that it could conceivably come in beyond that. If I presented $12 billion, I'd like to feel more confidence than I can feel at this stage of [unintelligible].

MR. ANGELL. My question is: Is there any real danger of erring on the side of having too much leeway to be able to manage the account the way we want to manage it?

MR. STERNLIGHT. I wouldn't see it as a danger. I think it may just be that the Committee would want to keep close to the situation and realize that if some even larger increase were needed, you'd like to be informed in some formal manner and have a chance to note that.

CHAIRMAN GREENSPAN. Governor Angell is raising the right question. This is an extraordinary circumstance. If it happens, I don't think there's any reason not to expand it, so why don't we increase it--what did you want?--to $12 billion.

MR. STERNLIGHT. As best our projections look.

CHAIRMAN GREENSPAN. Give us a number which you sleep well with.

MR. STERNLIGHT. I was shrinking from that, Mr. Chairman, because I just did not have that degree of confidence, but I'll stick my neck out at $12 billion.

CHAIRMAN GREENSPAN. This is a technical problem which does not confront the Committee very often.

MR. STERNLIGHT. It does get published and people will look at it and say: "Gosh, did they really think it was going to go that high?"

MR. ANGELL. And I guess the answer is yes. [Laughter.]

MR. JOHNSON. The answer is, we want to be prepared if it does.

MR. GUFFEY. It is a simple matter, however, to get that authority by wire if the need exists.

MR. STERNLIGHT. There has never been any difficulty in getting the authority as we needed it, if a situation arose.

MR. ANGELL. Do you want to formally recommend?

CHAIRMAN GREENSPAN. We have to formally change the motion. Was it Jerry Corrigan who made the wrong motion? [Laughter.]

VICE CHAIRMAN CORRIGAN. I think I can make it $12 billion. [Laughter.]

CHAIRMAN GREENSPAN. I assume it is approved. Thank you. Mr. Prell.

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

MR. PARRY. I have two questions about the forecast. If you were to take another look at your forecast for the third quarter--incorporating the most recent data with regard to employment, retail sales, and production--do you think the number you'd come up with would be higher? And is it possible that the weakest quarter of the year, in fact, could turn out to be the second quarter?

MR. PRELL. Well, we won't know for sure what the second quarter looked like even in next week's numbers. At this point, the incoming expenditure flow numbers don't point clearly to an upward or a downward revision. For the third quarter, I suppose if we were to recalculate today, our best guess is that our number would be fractionally higher; I would say that it would not necessarily differ significantly from the second quarter. But, just on the basis of the retail sales data, we could see a number that would be closer to 3 percent.

MR. PARRY. My second question involves inflation. You have a very sharp drop-off, as you did last month, in the second half's inflation rate in terms of the GNP fixed-weight deflator. It seems a little surprising to me, particularly given the revisions to GNP data that we saw in the last month and also the somewhat brighter glow to the economic statistics. I'm not sure I understand what's causing that.

MR. PRELL. Well, if we dissect the forecast, the deceleration is primarily in the consumption area and, in part, that reflects better food prices, as I noted. And, unless something goes seriously awry, the increase in energy prices in the second half will be distinctly slower than in the first half. We may get a little bulge in the near term, but for the second half as a whole, we are expecting considerable slowing. Also, we have been moderately encouraged by the trend in the non-energy services area for consumer expenditures; it seems to have decelerated a bit over the last 6-12 months, so that has carried through for a little while longer in our forecast.

MR. PARRY. But you have more than a doubling of the growth rate of PCE, and final sales are up very substantially in the third quarter.

MR. PRELL. Of course, part of that surge in consumption expenditures--and certainly a large part--is in the automobile area where, to get that surge, they're going to have to give some concessions in the way of lower interest rates or a more generous rebate program.

MR. BOEHNE. I'd like to explore a couple of areas. You made the point that 6 percent unemployment, more or less, is getting into the kind of full employment zone where you start to get inflation pressures. It seems to me that as you look across the country, and even within regions, there is such a variability of unemployment rates that this average can be awfully misleading. Take my District, for example. We have a number of areas where the unemployment rate is around 3 percent. We also have a few areas where the unemployment rate is 8 percent. And I would guess that across the country, you would find unemployment ranges from 3 percent to, maybe, 10 or 12 percent. Doesn't a lot depend on where the additional growth comes from? For example, we're going to see the growth coming in manufacturing. Does that 6 percent mean what you would think it would mean, on average? It seems to me that is the kind analysis which, while it has an appeal, is greatly oversimplified, given the variability. That is one area you might talk about.

MR. PRELL. Well, I did try to highlight some of the geographic disparities in the chart show [presentation to the Committee] last month, where I showed that, regionally, the unemployment rates are substantially different and we have been seeing different wage trends. Clearly, the Northeast is the area where the average unemployment rate has been distinctly lower, and we have not been seeing the wage deceleration, judging by the employment cost index, for example, over the past couple of years. Historically, obviously, the economy has never been perfectly level. We try to compress this into one statistic, but there are always disparities in unemployment rate levels. At the present time, the disparity might be a little greater than it typically has been. But, when you get into the question of where the pressure points are going to be, this is hard to say. Clearly, there is some slack in some of the prime heavy industry areas of the country. On the other hand, some of the industries that may benefit from the improvement in trade are located in areas of the country where the labor markets are a little tighter. For example, some industries in the Northeast will probably be benefitting from increased competitiveness. We approach this question with a degree of humility. We can't state precisely what the natural rate of unemployment is; we assign a fairly broad band, and we recognize that the question of bottlenecks or fortuitous precise matching of the increase in demand to the areas that have the most slack could create some variation in those spots. Basically, though, we think the anecdotal evidence is there. It's sort of a Sports Illustrated story: Once you're on the cover, it's the kiss of death. The Business Week type of headline that we are now in a crunch is overblown a bit. We have a sense that the labor market has tightened, though we have not seen the pressures on wages in--

MR. BOEHNE. The other area I'd like to explore is the trade numbers. You made the point that, in the forecast, we count on improvement in foreign demand to more than offset the weaker domestic demand. And yet, if we're moving sideways in terms of real exports--in a context of weak activity in Germany and real doubts in Japan--how does all that fit together? How do you get a boost from the foreign side when real net exports are moving sideways and you have weakness?

MR. TRUMAN. In nominal terms, you have a slight weakness. We are expecting, after all, that in the translation that you go through, we will end up later this month with a trade balance for the second quarter which is essentially the same, in nominal terms, as we had in the first quarter. But you would still have some small improvement in the second quarter in real terms on top of improvements in both the first quarter and the fourth quarter [of last year]. Basically, the effect of the sustained period of exchange rate depreciation that we have had, despite the slower growth abroad which you quite correctly point to, is now giving an added boost; in fact, it's striking something off.

MR. BOEHNE. So you expect the improvement in real net exports to continue. Is that--

MR. TRUMAN. That is correct.

MR. PARRY. Not in the third quarter.

MR. TRUMAN. In the third quarter, we think we're going to have this special effect with the oil--

MR. BOEHNE. But out beyond that?

MR. TRUMAN. Beyond that, we expect essentially the same forecast as this time--most of it accounted for by the exchange rate depreciation, taking account of the weak growth abroad.

MR. MORRIS. I have a gut feeling that the economy in the last half of this year and going into 1988 is going to be stronger than we have projected, and I've been examining numbers trying to figure out where the greater strength will come from. It seems to me that it could well be from the producer durable equipment sector where you show a continued rise in manufacturing capacity utilization throughout the period. In recent months, we've seen a very strong trend in new orders for capital goods. Yet in your projection, after the current quarter, you show only a very modest growth rate. Do you view this as an area of vulnerability in your forecast?

MR. PRELL. I think if we were to identify the areas in which we would be most likely to get some upside surprises, that is one. Our forecast for this year for nominal business fixed investment continues to be below what the surveys were indicating a few months ago, and it's clear that orders are picking up. Basically, we have a forecast, though, that seems in line with historical patterns, giving consideration to the cost of capital and what presumably would be a rather modest accelerator effect here. We don't have output growth on the whole as all that strong, so we have a moderate increase in fixed investment. But that certainly is one of the areas where a surprise would be less shocking to us.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I guess I just want you to play a "what if" game with me. With respect to oil prices--I'm not an expert on foreign affairs or any kind of affairs--but the disruption in the Persian Gulf, I think, definitely has had an impact on oil prices, as you mentioned earlier. But what if they sweep the mines away and the tensions are relieved. Then, if we were to see oil prices coming down, let's say, to $15 or $16 per barrel--that's not my estimate, just assume that would happen--what would that kind of change in this one factor do to your overall forecast? It just seemed to me, as I read through this material a number of times, that the high oil prices, and rising oil prices, were driving many of our concerns on the forecast over the rest of this year and into next year.

MR. PRELL. If I may turn briefly to Mr. Morris' question, one thing that we've had in our minds as a sort of cautionary note on these orders figures and so on, is that we can't tell how much of that might be potential exports; so, at this point those numbers need to be read cautiously. Our view on the oil situation, as I tried to suggest, is that we could see a downside risk. Evidently, there has been a considerable move to stockpile oil. If we get into another one of these swings where there's a movement toward destocking, and the OPEC swing producers don't cut back promptly enough, we could see at least a temporary drop in crude oil prices, maybe to an even lower level than you've suggested. But, basically, we think we have perceived, since the end of last year, a reasonable enough coherence in the OPEC countries in containing production within levels that enable them to sustain prices at their target level. So we tend to think that any crunch is likely to be relatively short-lived and would, perhaps, introduce some [unintelligible] in prices of final products, petroleum products. But we would be quite surprised to see something that was permanent enough to produce a significantly lower trend in energy prices over the forecast horizon.

MR. TRUMAN. Governor Seger, we have not raised our oil price assumption for next year; in fact, it's the same one we had in February. So, in some sense, you have to have some drawback in order for our forecast to be correct. Obviously, there are some risks: we were talking about the risk that the OPEC agreement that they made late last year would fall apart and that--

MS. SEGER. I think there's no honor among thieves. As those prices rise, I think those people are going to be more and more tempted to cheat, and they will continue to cheat. They're cheating now in that they're exceeding their own quotas--ones that they set among themselves. I guess I'm not prepared to think that they'll get religion real quickly.

MR. TRUMAN. Well, that's one of the reasons why you're damned if you do, and damned if you don't; it's one of the reasons why we had essentially stuck with an assumption that was close to what they were targeting six or eight months ago. What will come out over this forecast period, not certainly that there was cheating among--. The real issue has to do with the behavior of the key producers in the Gulf region--[whether] Saudi Arabia, just as it is now producing more oil, will cut back sufficiently to sustain the price at something like $18 a barrel. One of the factors which is [unintelligible] production over this period more than is necessary to take off being driven by the stockpiling.

CHAIRMAN GREENSPAN. I think that the Saudis are a self-correcting mechanism because they have maintained that posted $18 a barrel light Arabian crude price, and if the spot price goes under it, their liftings will fall, because no one is going to pay $18 if the spot is $17-1/2. So, it's a sort of self-correcting mechanism, which worked in the very beginnings of this. And I think that's one of the reasons the cheating is really an issue and was relevant to bringing crude price from, say, $22 a barrel down to $18. But the Saudis have demonstrated that they can lock the price at that level.

MR. PRELL. Mr. Chairman, of course, [unintelligible]. Governor Seger, if you wanted to adjust your thinking on this in terms of our rule--

MS. SEGER. That's not my forecast.

MR. PRELL. But in terms of our rule-of-thumb, $5 a barrel is worth something like a percentage point on the CPI over the course of the year, and significantly less than that, obviously, in GNP prices, in domestic output prices.

MS. SEGER. Wouldn't that also help our trade balance? Again, it seems to me that the higher price of oil that we are importing has been a negative. I would assume that that would cut current dollar imports, anyway, if nothing else changed.

MR. TRUMAN. In the short run, I think it's going to be the other way.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. Let me comment that I think our forecast parallels the forecast that appears in the Greenbook this time. But a question, I guess to Mike: With regard to the really sharp swing that you have between the third and fourth quarters in personal consumption expenditures, and the resulting buildup in inventories, which we have somewhat [unintelligible] for the period ahead, is that in your forecast totally as a result of the auto sales picture that you've described?

MR. PRELL. Effectively.

MR. GUFFEY. No other factors--

MR. PRELL. That's the key factor.

MR. GUFFEY. The other question I would pose has to do with your outlook on inflation and your rather sharp jump in the unit labor cost that appears between the third and fourth quarters and continues on out through the projected period. It's my impression, at least, that other than the autos that come up in September, the union-labor negotiations [calendar] is very thin, and we can't see where you're getting that kind of a jump in the output, the decrease in productivity, and so forth.

MR. PRELL. Well, maybe we didn't successfully answer this, but the productivity numbers are being bounced around by our expectation of what the timing of Labor Day will do to the hours numbers in September. We feel that this is a sound enough arithmetic point, in terms of our understanding of how the data have run over the years. We have a very low September level in these numbers, which affects the average level of hours in the fourth quarter; so we have this gyration of 2 percent growth in productivity in the third quarter going down to 1/2 percent in the fourth. On the compensation side, we have the beginnings of an acceleration in compensation over the second half of this year, but there isn't a big third- to fourth-quarter jump; the big jump there is in the first quarter next year when higher payroll taxes take effect.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. We have already touched on this, but have you done some analysis of the impact of higher energy prices on the acceleration in inflation we have seen so far this year?

MR. PRELL. Well, I'm not sure what kind of analysis you have in mind. It's clear that it has been a very significant factor. For the year as a whole, we have energy prices contributing 2-1/4 percent, roughly, to the acceleration in the prices of consumption and investment goods. It's clear, though, that the first-half acceleration in consumer prices is largely in energy prices; food prices haven't done so well, but that's a rather small contributor to the first-half acceleration; it's primarily energy prices.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Mike, I wanted to ask about short- and intermediate-term business demand. How do you conceptualize the slowdown that is occurring there? How would you explain that?

MR. PRELL. Short- and intermediate-term business credit?

MR. MELZER. Yes.

MR. PRELL. Well, part of it, we think, is the move to longer-term financing after we had an interruption of the flow, so to speak, when rates backed up earlier this spring. The rates came down a little, and maybe [unintelligible] corporate treasurers began to think that they shouldn't be waiting for still more decline. They seem to have come to market in significant size. As best we can sort these things out, that's the one thing we can put our finger on that the data would seem to support very clearly. We don't see it as reflecting a sudden drop-off in inventory accumulation, for example; the data just don't show that.

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. Michael, in the federal deficit reduction to $123 billion that the Administration is projecting, can you provide us with more details? Is it mainly on the expenditure side or the revenue side?

MR. PRELL. I haven't had an opportunity to commit all this to memory yet. You're focusing on which year?

MR. HELLER. On your handout, there is a drop from $158 billion to $123 billion, and then you say with policy action--

MR. PRELL. Basically, we assumed, in addition to some Congressional action that has already occurred, that something akin to their program will be adopted--an action which gives you on the order of $35 billion in deficit reduction. That's on a par with the Congressional budget resolution number as well. The outlay number for 1988 that they have now is $8 billion a month above their January estimate. Obviously, the revenue is the other thing, and the receipts number is $7-1/2 billion below the January estimate. That's largely a reflection of the downward revision in their forecast of corporate income tax receipts. That's the major [unintelligible]. On the outlay side, they have had to respond to the higher interest rates they have seen. They're expecting somewhat higher interest payments and they're also responding to the higher inflation that we've had, which will feed through to a larger cost-of-living adjustment for social security recipients and federal pension recipients. These are the major features of the changes of the baseline for the 1988 budget number.

MR. HELLER. Thanks.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I think the staff has done an unusually good job in describing the outlook, and I know Mike has done a very exceptional job in handling some very difficult questions. I guess I come out pretty close to where Frank Morris is on this. I think that the recent spate of statistics indicates that the economy is really beginning to strengthen quite a bit and a lot of that apparently is resulting from improved exports. I would sort of discount the last figures we got from Census on the trade balance on the grounds that you have a lot of price increases of imported goods in there, and price increases on oil, and probably some anticipatory buying because of the oil problems and also because of protectionist legislation. So, if this is true, then I think we could see some bigger figures than the staff is projecting. We are approaching the end of the fifth year of economic expansion at a time when we would expect bottlenecks to begin to appear, and I think they are in some industries. This is the kind of environment in which we could see wage and cost pressures begin to turn around from what we have been fortunate to have had in the immediate past, along with this further heightening of inflationary pressures and attendant upward pressure on long-term interest rates. So, I think it's a situation where we have to increase the care with which we look at the situation; we're now in a different era from where we were a couple of months or so ago.

CHAIRMAN GREENSPAN. Mr. Forrestal.

MR. FORRESTAL. Thank you, Mr. Chairman. Our forecast has changed very, very little since the last FOMC meeting. We still have growth in '87 turning out to be in the 2-1/2 to 3 percent range; if there is any change in the forecast, it is that we now think we may very well get closer to the 3 percent level than to the 2-1/2; so, the forecast really is for growth to be just a tad below 3 percent. If we have any differences with the Greenbook, they're very minor. In '88, I think we may very well get somewhat higher growth. I'm also not as optimistic about the deficit picture; I just have a gut reaction that, given the election year, and so on, it may be difficult to achieve any meaningful improvement there. Last month I mentioned that we had a sizable difference of opinion with the staff about personal consumption expenditures; I see that the staff has adjusted their numbers up, but I still think they're a bit on the low side; but the staff has come a little closer to our forecast, anyhow. On balance, Mr. Chairman, we don't have much difference with the staff forecast on growth.

As far as inflation is concerned, we have the deflator rising to about 4 percent or a little more in 1988 and, I must say, this gives me some cause for concern. I think that we were all hopeful that the low numbers we saw in price gains in 1986 were permanent, but I'm beginning to think they are not; and I think that we still seem to be stuck with a trend of inflation that's somewhat higher than we would like to see. At earlier meetings over the past couple of months, I was worried that economic activity could fall on the short side of the forecast. Now I've changed my mind in that I think perhaps the risks are on the other side, as some other speakers have indicated. Revisions to the earlier data and higher activity in the first half suggest that the appreciable decline we have seen in the unemployment rate probably is not a fluke. We kept thinking that there was something wrong with those numbers and that the unemployment rate would go back up. But it hasn't done that. And with the rate at 6 percent, I think we are awfully close to the point where some pressure on wages is likely to emerge, as the staff has indicated. So, in this environment, it seems to me that the inflationary risks of economic activity turning out higher rather than lower are fairly substantial; and it wouldn't take very much, in my judgment, for expectations to build pretty significantly for higher inflation.

I'd like to say a word about the District. Economic activity in the Sixth District continues to be fairly good and, in fact, it's gaining momentum. The weak areas in the economy, particularly Louisiana, are beginning to show improvement partially, or perhaps primarily, due to the increase in the price of oil. For example, the number of active rigs in Louisiana and in the Mississippi coast area of Alabama is the highest in two years. So that is fairly good news. The other thing that is perhaps interesting to note is that, whereas a few months ago, people that we talk to around the District were not reporting any significant price increases, now they are indicating that the prices of their raw materials, for example, are going up. And for the first time, we're hearing people say that they are, in fact, able to pass through some of these price increases to their customers. That's a significant change from reports that we had had previously.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Our forecast is certainly quite consistent with the staff forecast as it relates to this year. However, I will say that our outlook for 1988 is somewhat stronger. And, I would join those who have commented that, as we go along, the revisions are likely to be up rather than down.

Our District has lagged the rest of the country in the recovery, but since the end of last year that has not been the case. As we look at our industries and our indicators, we are tending at least to equal the national numbers. This year, for example, as we have gone through the year, employment increases in our five states have been consistently equal to the national increases. The increases have tended to be on the nonmanufacturing side, but even in the manufacturing category, we are significantly above the low level of manufacturing employment prevailing at the end of 1982. Unemployment continues to be a little higher than the national average, about a percentage point higher; nonetheless, that margin seems to be coming down. And, I do think that some of the manufacturing sectors that have been going through a very difficult period are showing really surprising strength. In steel, for example, which is a very tough industry, the steel plants that are producing sheet steel are about at capacity. Those producing structural steel are lower than that, but nonetheless stronger than you might expect. And, there are a number of other categories in the machinery side that are showing improvement. A large manufacturer of diesel engines in our area is now really having a hard time keeping up with the demand; construction equipment is stronger; and even the railroad equipment business, which has been absolutely moribund, is beginning to show some signs of life. All of this, of course, excludes autos, though the sale numbers for autos, as Mike is suggesting, continue to look like 10 million or more [unintelligible] this year or next year. The production schedules in the third quarter will be down by about 13 percent; and for the fourth quarter, though the schedules are not final, it looks like they'll be down about 5 percent. And the inventories do not seem to be out of line.

On the agricultural side, I have just a quick comment. I am almost hard pressed to say that, certainly, we have stabilized; and there are even some signs of improvement. The land values, which in the first quarter were level, at least, did show improvement in the second quarter; those land values continue to move up a bit, albeit from very, very low levels. Nevertheless, transactions that are taking place show some sign of strength in land values. There was, as you know, a recent revision in farm income; and the outlook for this year is for a significant increase and, therefore, those farm income numbers look pretty good. Surprisingly--or at least I find it surprising--the increase in farm income is not a result of higher subsidies, but rather of a decrease in production costs, which is an encouraging sign. So that part of the agricultural sector looks pretty good. Admittedly, we have a long way to go before the harvest, but at this point the growing conditions look good. We would anticipate good crop yields per acre and, in some areas, there will be record production. The overall production will be down by 12 percent; the acreage is down even more-- say, 14 percent; but, again, we have a net improvement in yield. So, I do think the conditions in the District are much improved for the rest of this year and into next year.

But, as I pointed out, there are a couple of key areas. On this trade balance issue, I've had the feeling all year that we were seeing a correction; the people I talk to suggest that that is the case. The June numbers were certainly disappointing. I hope there's nothing fundamental there. But if the major economies in the world do not turn around and begin to pick up and take our exports, this obviously will have a big impact. On the inflation side, we are seeing some of the price increases that Mike mentioned. They are in a couple of categories. Specifically, in steel, one manufacturer increased prices 4 to 6 percent and this time they're sticking--again, at very low levels. But if these price increases begin to become pervasive, and then go through to the labor side, I think the outlook for inflation will be quite different. I don't yet sense that. All the people I talk to who are negotiating labor contracts are continuing to get very good results: reasonably modest increases on an annual basis, and importantly, very good work rule changes, so that productivity and unit labor costs seem to be better. But, I do think these are, of course, the two key areas: the trade balance and inflation. Net, I think the economy, both nationally and in our District, continues to look good and seems to be improving. As we go along here, there is the opportunity for increasing the growth forecast.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, our forecast is in basic agreement with the Greenbook forecast, but I'd agree that the risks, in terms of growth, are on the upside, for many of the reasons that have been mentioned. For example, we have assumed the $25 billion deficit-reduction measures which are indicated in the Greenbook, and it's possible that some portion of those measures will not be enacted. That's another area, in this case resulting from the government sector, where we could see a greater boost to GNP, at least until some of the secondary impacts of a greater deficit are felt. Moreover, when we look at the 12th District, the data to us, particularly in the area of employment and retail sales, indicate strong growth. And the discussions I've had over the past month with directors--not only at the head office but also at our four branches--indicate a greater optimism about business prospects than I have ever seen in the year and a half that I've been with the System. I'm more pessimistic on inflation than the Greenbook, since I believe that the fixed-weight price index will continue to advance at a 4 to 4-1/2 percent rate in the last half of this year and remain in that range in 1988. It seems to me that recent tightening in labor markets raises the chances of price increases in 1988, and it certainly heightens my longer-run concerns about inflation. It would appear to me that, at this point, our room to maneuver is rather limited, with the labor market around full employment, nominal short-term interest rates rising about 100 basis points next year--at least in our forecast--and real interest rates rising only slightly. The current forecast that we have and the one that is in the Greenbook hold out little or no prospect of the inflation rate subsiding in the near future.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, our forecast also is pretty much in agreement with the staff forecast. We have strengthened our outlook for the national economy for the rest of this year and going into next year. We think we do have a rate of expansion that is sustainable. Subjectively, it is a little hard for me really to believe all that, given what has been going on in our particular part of the country. While we are seeing a little improvement, we certainly are lagging the rest of the country. Both anecdotally and statistically, we can kind of show that we are working through the trough; but the recovery, to the extent that there is one, is so fragile that it would not take very much to have us continue the downturn that we've been in for the last couple of years. Reference has been made to energy. We have seen a little improvement there, certainly, in terms of perceptions. There has been a little improvement in construction, but it's not in building; it's in roads, public construction, that sort of thing. Manufacturing looks pretty good. In agriculture, we are continuing to see cropland values decline and we are not through yet; of course, we came into this a year or two after the Midwest, in particular. And, of course, everybody reads about the conditions of the financial institutions. One concern that we are hearing, primarily from people in mid-sized and small businesses, is that they're very concerned that they're not going to get credit. And without credit, they're not going to be able to grow and expand and create jobs. This is something that we're hearing more and more. The banks are not willing or able to lend, and a cutoff of credit has occurred; and they don't see very much end to it.

VICE CHAIRMAN CORRIGAN. Is it because banks and thrifts are getting super conservative? Is that the idea?

MR. BOYKIN. That's a lot of it, Jerry. The bankers say that there just is not any loan demand. The small and mid-sized businessmen say we have the demand but banks won't take the risk. So, I think it's probably somewhere in between--the banks are not seeing the kind of demand in the loans that they are willing to make.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. I agree in general with what the Greenbook says and what I've heard about the outlook. I do think it's picking up; it looks better and there is some growing upside risk. However, I have a number of concerns that really cause me to question this view completely, and there are a few problems that I have with the Greenbook forecast, in particular. So, I'm still uncertain, overall. First, the growth that we see appears to be primarily due to the improvement in real net exports; export volume is causing the stimulus that we see right now. And, if that is indeed the case--if most of the growth is coming in the external area rather than in domestic aggregate demand--you have to really ask yourself how much of the potential Phillips-curve type effects on pricing you can get from that kind of growth. And that modest expansion in aggregate demand, I think, is being verified somewhat by the aggregates, as well as by other types of evidence for consumption. You really have to ask how much inflation pressure can be produced by that type of a scenario. When you look at the broader inflation indexes, the CPI, excluding energy, shows some pressure, but the PPI shows no influence outside the energy area. As a matter of fact, it has been decelerating this year, ex-oil. So you really don't see a broad buildup yet on the price side.

The staff forecast has rising interest rates, and I think some of their policy assumptions are inconsistent with the forecast. That rise in interest rates, at least if the aggregate models are correct, is going to produce a further weakening in the monetary aggregates. Looking at a further weakening in the monetary aggregates, you have to ask yourself: How much nominal GNP can you get out of those kinds of aggregate growth rates, and does the velocity number that is consistent with that make any sense at all to you? I don't think you can get too much from a rising interest rates scenario out of the aggregates to produce enough nominal GNP to produce a serious risk.

The other point I have is on the movement of the dollar. One problem I have on the dollar is what I pointed out yesterday in the Board meeting: we really have had no net depreciation of the dollar this year. Now, there's always the possibility, and I continue to worry about the downside risks on the dollar. I know it has come off a little today; we've talked about some of the reasons. But the fact of the matter is that there has been no net dollar depreciation this year and we're late into the year. The forecast is contingent upon a 10 percent depreciation in '87 to produce the lagged effects on prices in '88. Of course, there are still four months of opportunity for that. But you have to ask yourself, if you're not going to realize that kind of dollar depreciation this year, how are you going to get those lagged effects for '88? The other point is that if the oil price is expected to hover in the $18 range--and it's my feeling that the dollar is being influenced some by the oil price--an oil price in that range will keep the dollar high relative to the currencies of major industrial surplus countries like the mark and the yen. And if the dollar stays stronger because the oil price hovers in the $18 range, how are we going to get the dollar depreciation? On all of these questions, I'm not saying that they can't be overcome, because I see the outlook picking up some, too. But I really haven't resolved these questions in my mind and I think they are serious alternative issues to deal with. So, given these problems, I don't think we have enough evidence to expect a big upward move.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. In many ways, Manley, you've made my speech, because I think what I hear you saying is that there is more uncertainty than some of the comments might indicate. It does seem to me that it's appropriate for us to assume that inflationary pressures need to be dealt with, and that it's appropriate for us to have a monetary aggregate growth path such as we have been having. To me, a 4 percent M1, M2, and M3 path is, in itself, a rather significant antidote for these inflationary pressures that exist. Even though those inflationary pressures are there, and we are far from having turned the corner in abating these price increases, there might be some possibility that we will be successful if we are willing to maintain a monetary aggregates growth path such as we have. And there's something that I notice when I get out in the country and I talk to farmers and people in the oil business and realtors: there is a sense of unease that's in our country that really goes against what you were suggesting, Si, in regard to farm income. It is true that 1986 was a record year for net cash farm income; and 1987 is going to be another record above that record. But what I notice is that there is a conservatism, or even a super conservatism, that exists. Those people who are the survivors, and those businesses that are successful, are the ones that kept their borrowing down. I notice no rush to borrow; I notice no stories from the entrepreneur types about how it makes sense to borrow money to do this or to do that. I notice instead that the fast-food business is not quite what it was, and that owning houses doesn't seem to be quite the way to profit. And I notice some unease and a scare out there that moderates behavior.

So, it might be that this growth path of the monetary aggregates could bring a stop to the commodity price rises that we've seen during the last year, beginning last August. And if these commodity price rises do abate and the inflation expectation goes away, there is some possibility that deflationary forces could once again return. I think what we need to do at this point is to be open: to look at the various possibilities and to see if we can do the trick of getting commodity price rises stopped in sufficient time before they feed back into the wage/price cycle. If that can be accomplished, then it seems to me that a 4.1 percent GNP deflator and a 4.5 percent increase in the fixed-weight index for 1988 is totally unacceptable. We just must not let that occur. But having said that, let's not get ourselves too ready for an overkill.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Well, I am considerably more comfortable with the Greenbook forecast at this meeting than I was in July, because it seems to me that the thrust of the latest statistics on the economy, with the revisions, serves to bolster the underpinnings and credibility of that forecast, at least in my mind. I think the revisions are important, as well, in this story because I think they help to put things in a more consistent picture. Throughout the expansion, it seems to me, we've had consistently strong increases in employment and we were seeing weaker increases than I would have expected in GNP and so forth; and at least in my mind, some of that gap has been reduced. I think we are looking at an economy that really has been performing rather well.

That's certainly consistent with what's going on in the Ninth District. I have talked before about the two-tier economy and the divergence between what's happening in the urban areas, which are doing well, and the rural areas. But the latest developments suggest that that gap has diminished; that is, the rural economies are doing better, in part because agriculture is doing better, and in part because other aspects of the natural resource industries that the rural area of the Ninth District depends on are doing better. And that's encouraging. I might also comment on the fact that I've received a number of unsolicited reports from businessmen in the District about increased interest in export opportunities--that is, potential foreign customers coming to them to explore the possibilities of sales abroad of various products. This is everything from the high-tech end of the world to some very basic commodities. Again, I think that's consistent with what we have seen happening in the economy recently and what our forecasts suggest.

I do think that, with all that good news, we probably are approaching a critical point when it comes to inflationary pressures. As Mike indicated, I think you can attribute much of the acceleration in the broad price indexes so far this year to the effects of higher energy prices. But I think that looking forward, we have a number of things on the horizon that give me some pause even if energy prices level off or maybe even come down a bit from here. One is clearly what we're seeing in the bond market here and elsewhere around the world, where there are some signs of heightened inflationary expectations that manifest themselves in long-term rates. Secondly, I guess I'm not confident at all that in fiscal 1988 we'll achieve a Federal budget deficit significantly below this year's level. In fact, it could could be higher, if we're not a bit lucky. And, finally, as far as the labor market goes, I don't know what the natural rate of unemployment is, but whatever it is, we certainly have to be a lot closer to it today than we have been recently. And not surprisingly, if you look at unemployment by various demographic groups, as you would expect, we are at the lowest rates of unemployment in general since 1980 and, in some cases, since 1977. For some groups you have to go back to 1977, at least using quarterly average data, to find unemployment rates that low. I think we have benefitted heretofore from the rigidities in the wage determination process with which we are all familiar; I'm not talking just about what goes on with unions, but just the way business is run. But I don't think that we can count on those rigidities in that wage determination process always working in our favor, particularly if price indexes start to move up here.

CHAIRMAN GREENSPAN. Vice President Hendricks.

MR. HENDRICKS. Thank you, Mr. Chairman. Our views of economic conditions closely parallel the staff's forecast in the Greenbook. As some others have suggested, there are a couple of areas where we differ a bit. One is in the growth of income, and the other is in consumption. On balance, it appears to us that the economy is picking up strength. Employment, output, and exports are expanding, as we see it, and we have noticed a jump in prices. Comments by our directors and others support this view. Even the hardest hit sectors --commercial construction, agriculture, and metals--are said, particularly by our directors, to be enjoying a period of stability and possible turnaround. So it's not surprising, I guess, that we would suggest that our forecast shows more strength, on balance, than is indicated in the Greenbook.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I hope that the staff forecast is right on target, but I do have some questions and some doubts, I guess. One of them that I expressed yesterday at the staff briefing [to the Board] involves our emphasis on the trade turnaround. I'm just not convinced that we will get as much of a boost to the overall economic picture from the trade turnaround as we are counting on in the forecast either for the rest of this year or in 1988. It was mentioned earlier that some of the trading partners have economic situations that are far short of robust. So I think that's a key factor. Also, no one has mentioned it, but there are trade barriers out there that business people tell me about. And some of the obvious ones involve trying to get into the Japanese market. Also, I'm not convinced that the dollar is going to fall as much as we're assuming in our forecast. I realize it can be banged down but, as Governor Johnson said, there are things going on that may prevent that from happening. Also, the staff is talking about some gradual upward drift in interest rates. That may happen, depending, of course, on what policy stance we take. But I guess I don't see as much of a bite on the economy from that upward drift as I might have expected. Looking at autos--and this would be more of a near-term situation than for '88--I think it's going to be a lot tougher to reduce those inventories than apparently you think, Mike. Some of the specific makes have over a 100-day supply; that's not worked down easily even at 1.9 percent interest rates. One of the reasons they have so many is they haven't a lot of sex appeal in the models; they may have to just give them away on some Saturday night, I don't know. Anyhow, I think it's a lot greater challenge than --

MR. JOHNSON. That's pretty awful.

MS. SEGER. That's right. I don't like it myself. My final comment involves inflation, and here Governor Angell made my point about commodity prices. I don't think it's guaranteed that these are going to just keep rising. We all know that commodity prices are very volatile and influenced by many, many things above and beyond monetary policy. And I believe, as he said, that there are factors at work that may, as a matter of fact, keep those under control. Particularly when I think about the crude oil situation, I'm not certain that we're going to get what's in the staff forecast. On the labor market shortage, I just don't think there is _a_ labor market; I think there are all sorts of labor markets--for different skills, for different industries, and for different geographic areas. So I don't know that it makes any sense even to talk about a natural rate of unemployment because I just don't know how to use it as a guide. Finally, one of the things that I really don't think we're emphasizing enough is the real change in managerial attitudes. I see more backbone among corporate executives in their labor negotiations than I've seen in my whole working career, which goes back a long time. And I'm really delighted to see that they no longer assume that they can just pass through these higher labor costs--which they used to do, particularly in the major industries. Also, the company heads are more and more aware of import competition, more and more aware of the need to be efficient and to get even more efficient. They're pushing the employees for moves that would enhance productivity. This is going on all the time in the auto negotiations. The emphasis is on job security; there is even talk of freezes on actual wages. To the extent that there are pay adjustments, in a number of major companies they are making sure that the productivity gains do offset them because the 1.1 percent--or whatever the overall national number is--is not what the productivity gains are in specific companies. And so, I think, they are tending more and more to tie their own wage settlements to their own productivity enhancement moves. And I think that's all to the good. I put all that together and I don't see zero inflation, but I don't see 4-1/2 percent heading towards 14 percent either. Thank you.

CHAIRMAN GREENSPAN. President Corrigan.

VICE CHAIRMAN CORRIGAN. Well, Mr. Chairman, I think we'll probably get a little better sense of things when we get back to work in earnest in September and businesses start doing their planning for 1988. But, as I look at things right now, first, I think that the outlook for the economy is better--not that I thought that it was all that bad to begin with. And second, I have to conclude that the inflation risks have risen. In terms of the "body english" that can be put on that, some can say--as I think Mike Prell did a long time ago--that one way to look at it is simply with a higher degree of confidence that something approaching 3 percent real growth could be realized. I would simply add that, in the current circumstances, I do think we have to keep in mind that something like the staff forecast for real growth isn't far from what is optimal, considering the need to effect the external adjustments that we have all been talking about and to maintain some hope that the inflationary process does not get away from us, as a number of people have suggested.

On this all-important question of the external adjustment, for what it's worth, the New York staff forecast is a little stronger overall in real GNP. Interestingly enough, it is also one in which there is no assumption of further dollar depreciation in 1988, but despite that, we get a better showing in the trade account and the current account in nominal terms and end up at about the same place in real terms. Now, the reasons for those differences, I think, are important. One is that we do have slightly stronger growth--not a gangbuster pace by any means--but marginally stronger growth in the non-U.S. industrialized world than is in the staff forecast. A second factor, of course, is that without the second or third J-curve effect, the nominal effects work in the right direction. And finally, we do have U.S. export prices going up more rapidly than the staff forecast does. Each one of those, obviously, is a big "if" and, taken together, they are a lot of "ifs". But the key point is that they do suggest at least the possibility that you could get an outcome that is better in nominal terms and about the same in real terms, without having to rely on a further depreciation of the dollar, with its inflationary implications and the risk, of course, that further depreciation of the dollar could get away from us. I think that is important for another reason. I tend to look a lot at what I call "a domestic savings gap" in trying to figure out where we are in terms of capital and savings requirements. As things stand right now, and assuming a Federal budget deficit in 1988 somewhere in the $150 to $160 billion range, the fact of the matter is that we have made precious little progress in reducing the so-called domestic savings gap. If the budget deficit next year is in that $150-$160 billion range, and if total net private investment is only about 5 percent of the GNP, which is darn small, the savings gap relative to GNP is still going to be 2-1/2 percent or more of GNP. It is still going to be $145 or $150 billion in absolute terms--not down at all from its peak in 1985 or 1986. So, that fundamental disequilibrium is still there. In fact, it has not improved much at all, despite the reductions that we have seen in the budget deficit, because the saving rate for the economy as a whole has slipped off its peaks of 1985 and 1986--not decisively, but enough so that the problem, both in relative and absolute terms, is still very much with us throughout the forecast period. That in itself says to me that we have to be especially cautious, because one way or another that residual is going to have to be filled from abroad, if interest rates and exchange rates are going to remain consistent with the kind of economic profile that the forecasts are talking about.

On the inflation question, I can be very brief and simply say that a number of us, including myself, have fretted in the past about crossing that threshold of 4 percent in the deflator and 5 percent in the consumer price index; and it seems to me that the consensus view, though not the universal view, among private economists and others is that we are there. That, I think, is the reality. As things stand right now, I can postulate conditions that would produce a result better than that, but I certainly don't think that those are the likely outcome. Indeed, I guess I'd be on the side that says that I could also postulate conditions in which, heaven forbid, we could find ourselves looking at 5 percent on the deflator and 6 percent in the consumer price index. If we get to that point, then we are looking at a situation that inevitably carries with it the risks of highly destabilizing consequences for the real economy here and around the world. Indeed, I think the lessons of the past are clear: if you wait to see that kind of problem staring you in the face, the costs of unwinding it are going to be exponentially greater than the costs of checking it in the first place.

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. Thank you, Mr. Chairman. I think the overall numbers, which are rather satisfactory, are good not because the aggregate economy is really good, but because the sectors which have been weak so far are the sectors that are picking up. If you keep that in mind, I think the inflation picture also will look a little different than it does when looking at the aggregate economy as a whole. We are eliminating the sectoral imbalances in trade and in the government sector as well as in the regional sectors that were pointed out before. Overall, I think that makes for a healthier economy because, in essence, we are pulling the weak sectors up without really hurting the strong sectors at the present time. Consumers are still moving forward but at a rather subdued 4-1/2 percent pace in the overall forecast. And I agree with what President Morris said earlier: that the investment picture may actually be a little better than the numbers of 3.8 to 4.2 percent next year suggest. I'd be slightly more optimistic there, but not all that much. On the export front, I think also that our growth will be sustained in the double-digit area; 12 percent in the Greenbook is certainly sounding good.

Turning to the price area, because we're having that pickup in sectors that previously were very subdued, we should not experience the burst in prices that would be associated with an overall Phillips curve. Therefore, I also think the employment gains which have been achieved are in areas and in sectors, such as manufacturing and agriculture, that were previously very, very depressed indeed. Overall, I think the producer price index, as has been pointed out, is rather stable. And I agree with what Mr. Corrigan just said: the final user prices, the GNP prices, are drifting up at a 4.5 percent rate. But then again we have to ask ourselves--this really should be reserved for the next part of our discussion, but let me bring it up--if we're having monetary growth right now of 5 percent and we're having price increases of 4 to 5 percent, what does that mean for the real economy if you want to make that equation square? I certainly disagree with the view of the world that we're having a zero growth. So something else will have to give. Either we have to produce a lot more money or price increases will not be sustained at a very healthy consolidation phase of the economy; and I don't really see very major risks on either side.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I've already made comments with respect to our outlook and our general agreement with the Greenbook forecast. I'd like to make this very brief, in view of the time. The regional economy that we're experiencing in the Tenth District has some positive outlook to it in the sense that, as others have already commented, the agricultural sector is having and will have one of its best years, with this major rise in net farm income. There has been a good crop. The red meat industry is in very, very good shape. As a result, there has been some uptick, or at least modest turnaround, in what had been falling agricultural land values. One survey shows that from the first quarter to the second quarter, agricultural land values have increased about 1-1/2 percent; and that's to be contrasted with a long period of declining land values. I would just note, however, that the sales that have translated into that greater land value number are one of two kinds: 1) cash transactions in which neighboring producers are picking up depressed or troubled land ownership; or 2) the Farm Credit System is offering very attractive financing rates to move land off of their books in order to avoid any additional loss. I would just note that, as a result of this, the margins in the production of red meat are very good at the moment. However, the inventory is beginning to build, and we would expect that there would be little or no additional pressure on prices from the food sector as a result of the [uninteligible]--no real hope of increased commodity prices either in terms of crops or red meat. Lastly, there is some optimism being generated in the energy sector. There is some drilling now taking place; the rig count is up modestly from a month or two ago. So, psychologically, given what we see, we would expect things to continue to improve but at a very slow rate. In the commercial real estate area, we have overbuilding in Denver, Oklahoma City, and Tulsa, which is depressing that market; and those conditions, obviously, rose out of the depressed conditions of agriculture and energy that they depend on greatly. We believe things are looking up, but we have a long upward pull to get back to better conditions than we have now.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I wanted to pass on just one piece of anecdotal information that bears to some extent on what Jerry and Bob Heller were saying: one businessman in our District in the shoe business mentioned to me that they're running at essentially 100 percent of capacity now. I sense that's close to true in textiles, and, at least in some respects, in the steel area. So I mention that. I guess what concerns me, when you think about this external adjustment process that Jerry talked about, is that we shut down capacity so quickly over this period of years that I think we are bumping up against capacity constraints in those industries a lot sooner than anybody could have anticipated. I asked a logical follow-up question to this executive: "Well, are you going to expand capacity?" In that case, they have closed facilities that they could probably reopen without a major capital investment. But, basically, the message was that chief executive officers and financial officers, having been through this period of shutting capacity down for so long, are going to be very slow to make the investment to reopen. As a result, even in these industries that have been depressed, I think the pressures on the labor markets are apt to build a lot faster, because the investment is not going to follow as quickly as it might have in a more orderly period, if you will. I wanted to pass that on; I thought that was interesting.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. I'd like to spend just a second on a little different perspective. There has been a very good staff forecast and a lot of very good comment on it. But it might be worthwhile to put our attention just a little on whether or not there may be some very fundamental long-range changes running underneath the surface of the world economy and our economy. If there's an analogy there, it may be what happens in the sea: you have the Gulf stream running up the East Coast from south to north; the storms come and go and calms come and go; and the tide shifts back and forth with the Gulf stream still running north up the coast. It kind of dominates everything in the long run. I wonder if there's any of that effect going on in the world economy. I see several things out there that could be fundamentally deflationary in the long term. That's not to quarrel with the kind of forecast that we're seeing here over the forecast period. But it seems to me that if we can avoid falling into the protectionist sinkhole--and maybe we won't--that there is a super abundance of pretty capable labor across the world that's waiting to produce, and it's currently grossly underemployed. And there's capital that's mobile enough to get there to set up factories and economic capabilities, and do whatever is necessary to employ that still quite low-cost labor. And we're going to be competing with that labor. In a great many commodity areas there is a worldwide abundance of capacity. Absent political events, there's plenty of energy for the next few years at least. The world is coming into a surplus of farm commodity production on an aggregate basis; there are lots of metals, and so forth. The third factor may be that it probably was inflationary to increase the enormous levels of international debt that we now are struggling with, but it probably is going to be deflationary to try and service that debt, now that we have it. There's a lot of pressure on a lot of economies to produce in order to earn foreign exchange to try to service their debt. So there are some things out there which seem to me to possibly be exerting a [unintelligible] deflationary effect. And, while I see the pressures that we have over the forecast period, and I would not quarrel with those, I think that maybe these long-run deflationary effects under the surface might damp that, as they play through in the inflation numbers.

CHAIRMAN GREENSPAN. Mr. Boehne, do you have any comments you'd like to make at this time?

MR. BOEHNE. No, I have none.

CHAIRMAN GREENSPAN. I'd like to make just a few observations. We spent all morning, and no one even mentioned the stock market, which I find quite interesting in itself. I think it's important in the sense that as an economic force, history tells us sometimes it works, and sometimes it doesn't. It's conceivable to me, however, that this may be one of the times in which we may begin to see some opening up in the capital goods markets. It's very dull; appropriations are not expanding at a rapid rate, but they are expanding. And I think what the new orders are showing is a mixed bag. Mike mentioned that there may be some exports in those orders, but we also may be seeing an increase in the share of the total domestic capital investment markets because, remember, those figures are orders at domestic facilities only. And the one thing that seems to be appearing in the numbers, in real terms, is that irrespective of the nominal trade figures, the share of capital investment coming from abroad has been increasing dramatically, although it's now beginning to taper off. That will create a much stronger set of new orders figures for equipment, as we see in the aggregate appropriation numbers and the aggregate investment numbers. I'm a little concerned that we may be looking at more than the opening up in this area that the staff numbers show, in part, because I think profit figures are moving fairly quickly. The ability to pass through prices is another way of saying margins are opening up. And we are beginning to see very clear evidence in a number of areas that we are picking up some form of potentially significant profit expansion. That would lead me to conclude that we could very well be running into trouble at these monetary aggregate levels; but my impression is--at least my hope is--to get to it a little later. But we may be looking at the possibilities of a turn in velocity numbers at this stage. I think the presumption that velocity will stay somewhere down in this area, or even approximate the staff forecast, may be wishful thinking. I think there is more of a potential on the inflation side, on the nominal GNP side, at fairly low credit and monetary aggregate expansion than I think we're willing to admit, if for no other reason than I think we're merely projecting the most recent past. I think that is turning; and if it turns, we'll have some possibly significant difficulties.

On the exchange rate question, even though the staff forecast, as I understand it, has implied profit margins on imported goods flat at very low levels--meaning that the import prices of goods shipped into the United States are essentially reflecting very little change in profit margins--I think history tells us that that doesn't happen often either. The evidence suggests that, from these levels, the likelihood is for more of an increase in those margins--meaning an increase in import prices relative to the exchange rate. What I conclude from all this myself is that, while the staff forecast is in a way the most likely forecast, I'd be inclined to suppose that the risks are clearly on the upside, both on volume and on price. And my last forecast is that that's likely to be the way Mike will come out the next time around.

MR. KELLEY. I wouldn't be surprised.

MR. HELLER. Got the message?

MR. ANGELL. Sometimes he's hard to influence.

CHAIRMAN GREENSPAN. In case there's any doubt, I think the real world is going to influence him. If there are no further comments on the economic outlook, let's move on to Mr. Kohn.

MR. KOHN. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Thank you. Why don't we break until 10 minutes to 12.

[Coffee break]

CHAIRMAN GREENSPAN. As we sit here, the dollar seems to be dropping. Maybe we ought to adjourn for awhile. I would like to open the floor now for a general policy discussion and some indications on the directive and borrowing requirements and any tilt that you would like to express as we go on. The Vice Chairman starts off.

VICE CHAIRMAN CORRIGAN. Thank you, Mr. Chairman. I can be rather brief. As I said earlier, in the totality of circumstances that we face, I view something like the staff forecast as about as close to optimal as we can get right now. But I also regard the risks in that forecast as being strongly asymmetrical on the side of the economy being stronger and the inflation rate being higher. Because I have that view as to the asymmetries of the situation, and because I regard the risks of that type of an outcome to be potentially so severe, I would favor, at this point, a modest move in policy that would take the borrowing level to $600 million--in other words, something between "B" and "C". It's not that I think that kind of a move in and of itself is going to be decisive; but I do think that it will be enough of a move to show through in the marketplace, and to convey a sense of concern on the part of this Committee as to the potential for things working in an adverse way. I see that kind of an approach as relatively risk-free in that the initial change that it would carry, whether in terms of interest rates or things like that, is inconsequential as far as the forecast for the economy is concerned. I do not regard signal value as being inconsequential. So, on the theory that a stitch in time may indeed be worth nine, I would proceed along those lines.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Mr. Chairman, I think that there is a case to be made for some tightening for all the reasons that have been stated: the risk of inflation in the economy and also the history of probably waiting too long. I am not ready to make that move at this point. I have enough doubts, and I think there are enough uncertainties, about the outlook for inflation and other aspects of the economy. The sentiment around this table has fluctuated a good bit in recent months, and I think we very well may be heading into a period where some tightening is appropriate; but I think it is premature at this point. I would favor a directive that would maintain the $500 million of borrowing, something along the lines of alternative B. However, I would give the directive an asymmetrical tilt indicating that if policy needs to be changed in the intermeeting period, that we would more likely lean in the direction of some snugging than some easing. So, I would be for no change, alternative B, with some asymmetrical wording that would tilt it in the direction of some tightening, should a change be necessary.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, I was going to say that, ordinarily, I would have been in favor of some slight tightening, but I also was going to say that I would be reluctant to do that in light of the dollar's strength in the foreign exchange market. However, given what you have just said, perhaps my thinking will change a little. I also was going to say that I thought the strength of the dollar was temporary, so I guess the markets are proving me right in advance. Given my view about the economy and what I see as the potential for more inflation, particularly in early 1988, I think that we probably should make the move now, recognizing that there are some uncertainties in that forecast. I wouldn't want to do anything very dramatic, but I would opt for what I would describe as alternative B-plus with borrowing at about the $600 million level. That implies that I am willing to accept M2 growth that is below its range for the year; and I think it is pretty doubtful that we would be able to get it up to the bottom of the range in any case, unless we did a very pronounced easing of policy. I am willing to accept lower than intended growth, certainly, in preference to easing policy at this time. As far as the directive is concerned, I would suggest that we tilt slightly toward firming and keep an asymmetric directive that would enable us to firm even more, if circumstances required. As for the various clauses that the staff has indicated in the Bluebook, I would stress the indications of inflationary pressures and general business activity the most and downgrade the dollar. Also, I would keep that sentence in the directive that would allow for greater M2 and M3 growth--that we would tolerate that if it occurred.

CHAIRMAN GREENSPAN. I would like to raise a point with respect to that. This directive goes through a very short period of time. And I'd raise the question as to whether or not it is really an operational directive at all, because by the time this is actually something that is likely to happen, we are beyond the period which we are focusing on, with respect to policy in any event. That's at least my view; I don't know how the rest of you read that.

MR. JOHNSON. Sounds like a good case for early release.

MR. BOEHNE. I'm sorry, Mr. Chairman, I guess I don't understand the point that you are making.

CHAIRMAN GREENSPAN. Well, I am referring to the sentence "Somewhat faster growth in the broader aggregates would be acceptable in the absence of indications of worsening price pressures and substantial weakness in the dollar, given the shortfall of these aggregates from their annual averages." What I am basically saying is that we are not going to learn a great deal more about what those aggregates are doing between now and the termination of the time frame to which this directive applies. So, I am not quite certain whether the directive has any operational significance because of the shortness of the time frame.

MR. MORRIS. [Unintelligible] with respect to the aggregates, not interest rates.

CHAIRMAN GREENSPAN. Oh, no, no. Just the aggregates.

MR. MELZER. I read that, at one point, to mean the opposite of what it is intended to mean. I think it could be interpreted that way. If you were worried about the slow growth, you might actually encourage--

MR. STERN. It seems to me, if anything, that is certainly too open-ended the way it is currently written.

CHAIRMAN GREENSPAN. That is all I meant. President Parry.

MR. PARRY. Mr. Chairman, I believe a strong case can be made for alternative C and I would characterize that, at least in terms of anticipated effects on interest rates, as being a small move. In July, several Committee members expressed the view that a tighter policy would be necessary in the coming months and I think developments since then strengthen that view. Most data released since our last meeting suggest that the economy and inflationary pressures are picking up. Inflation in the first half was over 4 percent and real growth was at a very strong 3-1/2 percent rate. Data that we have seen so far on economic activity in July--particularly employment data, retail sales, industrial production--indicate that the economy remains strong in the current quarter. Given that it takes a long time for our actions to affect inflation, I believe we should make a policy adjustment. If we delay much longer, until inflation has really gained momentum, more severe action will be required to bring inflation under control. For those reasons I would support the adoption of alternative C as presented by the staff.

CHAIRMAN GREENSPAN. $700 million on borrowings.

MR. PARRY. $700 million.

CHAIRMAN GREENSPAN. President Morris.

MR. MORRIS. Well, Mr. Chairman, I would support Mr. Corrigan's formulation of a modest tightening--a $600 million borrowing level. I think that we might need to move further in the event we get a period of pronounced weakness in the dollar. There has been so much talk in the foreign exchange market about the inevitability of a further leg down in the dollar that that seems to be the conventional wisdom. For that reason, this recent weakness in the dollar has the potential, I think, of generating a test of the earlier lows; that's just potential; I am not forecasting that. If that should turn out to be the case, we probably would have to make another move prior to the next meeting. But I think the evidence of greater strength in the economy would certainly support a modest move at this time of the sort that Mr. Corrigan outlined.

MR. ANGELL. It seems to me that we need to remind ourselves that these minutes will be published six weeks from now, around the time of the next meeting. It just seems to me that we ought to be somewhat careful about making asymmetric statements when there is this much uncertainty. I think the real question is what do we do, not the question of symmetric or asymmetric. I would prefer a symmetric "B". Now, that puts me at the far end of those who have been speaking so far. I do believe that the monetary aggregate growth paths are quite different from those we had in the period that led to the price pressures we are now seeing; and I think it is a mistake for us to react with the monetary aggregates behaving in this nice 2 to 4 percent growth range, which might very well be the right path for the long run. Yet, as you anticipated, Mr. Chairman, and I would agree with you, we do have this change in velocity. It would be a mistake for us, then, to go to $600 million on borrowing, because $600 million will certainly be a vote for a lower monetary growth path. The members of the Committee know that I have not favored returning the monetary growth paths back to within our target ranges for the year; I have favored coming in below the ranges. But, just as a year ago, we were undoubtedly somewhat careless in not recognizing the 15 percent monetary growth path when we made that discount rate change last August, I think it could be just as much a mistake for us to move now before we see the need. I am prepared to make adjustments as might be needed if commodity prices and the exchange value of the dollar were to move in such a direction as to make inflation and our worst fears realized. I would want to move at that point, but I am not willing to take a hard position now for minutes to be published six weeks from now based upon our feelings.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, I would favor alternative B. I would favor basically no change from current policy, and I say that because I guess I am not totally convinced that the economy is going to be quite as strong as perhaps some others believe. I question that inflation is a problem at this point. Granted, when you determine or realize it is a problem, you are pretty far down the road, so that a certain amount of anticipation is desirable. But, given the fact that the interval between this meeting and the September meeting is pretty short compared to some of the intervals, and that the need for a policy shift is less than convincing--to me, at least--I would stick with alternative B, the $500 million borrowing assumption. Rather than being symmetrical, though, I would have a sentence in there that would allow a little tightening by the Desk, if that should become necessary.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, I would be in agreement with the position that Jerry Corrigan laid out. For reasons that have been well stated, it certainly seems to me that the economic opportunities at this point are on the upside and not on the downside. On the inflationary pressures, though admittedly far from conclusive, we may be going through something of a bubble here. Nonetheless, the signs are there and I do think it is appropriate that we begin to move against that. I find the aggregates' performance this year to have been erratic. They may emerge on a more predictable basis, but as yet I don't see the evidence of that. Therefore, I find the alternatives, in terms of aggregate growth rates, to be a little awkward. Accordingly, I would prefer to deal with the borrowing level and, given the circumstances, I think a borrowing level between "A" and "B", namely, $600 million, would be appropriate. In terms of the wording of the directive, I would be in favor of "would" for [greater] restraint and "might" for lesser restraint. And I do think that this sentence on the next page [of the Bluebook] does, at least preliminarily, convey the reverse meaning. I think we might fiddle with the language on that to get a more appropriate wording.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. As Bob Parry indicated, Mr. Chairman, a number of us at the last meeting thought that we were probably going to have to let interest rates rise over the next 12 to 18 months if we were going to prevent this underlying rate of inflation from accelerating. And it seems to me that this expectation is even more likely now, in view of the information that we have had since then. At the same time, I am not exactly sure when it will be appropriate for us to take that action; but I believe that it will probably be sooner than I would have thought at the time of the last meeting. I am also well aware that the history of the System has been that, generally, we have not moved fast enough against inflation. So, I tend to try to compensate for that. Despite that, since there is a good deal of uncertainty out there, I believe the best case for now is to stick with alternative B. I would make it asymmetrical with the "would" on the tightening side and the "might" on the other. I think the Board staff's statement with regards to the "as well as" clause does suggest that it would be helpful to shift that around to deemphasize the borrowing side; as for the weakness of the dollar, that may deserve some further thought. I think there is also another argument: that we ought to put restraint of the business expansion high on that list if we are going to change the list around. And I would not put in that sentence on the undershoot of the aggregates at all. And I say this with the sneaking suspicion that later on down the road, I am going to look back and say, "I wish I had been where Jerry Corrigan and those others were".

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. Basically, I am for no change, as I said earlier. I believe that we are in a period of sectoral catchup and the monetary growth is very subdued at the present time. So, I would like to keep it at alternative B with a $500 million borrowing target and I would do two changes: 1) I would upgrade the importance of inflation, and maybe give it sole prominence in the first sentence; and 2) I would downgrade the dollar, as Presidents Forrestal and Black mentioned earlier. We are way above the lows that the dollar reached earlier, and to say that we want to react now to weakness in the dollar would probably be inappropriate.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Well, as I suggested earlier, I think that the principal risk we are likely to face, over time, is higher inflation. The key question in my mind is one of timing. I don't have the sense that the inflation problem is a _fait accompli_. On the other hand, I don't think we can afford to sit back and wait until it is obvious, for reasons mentioned earlier about the cost of undoing it once it is in place. Balancing those two considerations, I am not prepared to go as far as alternative C, but I do view something between "B" and "C" as perhaps a positive, helpful, preemptive strike at this point in time. That entails, in my judgment, relatively little risk to the economic outlook; also, if it turns out that we were wrong, it would not be terribly difficult to undo. And from that perspective, I think it merits consideration as well.

CHAIRMAN GREENSPAN. Is that $600 million?

MR. STERN. Right around there, yes.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I'm in favor of no change, which is alternative B, $500 million borrowing target, for three main reasons. One is, as I think Governor Angell emphasized, the uncertainties that we are facing. Another reason is that there aren't that many weeks between this meeting and the next FOMC meeting; we have another chance, very soon, to look at things and change our approach, based on additional readings of the economy. The third reason is that I just don't see that the economy is currently boiling. The forecast certainly does look pretty good; but, again, I question whether or not we're going to see the hit from the trade turnaround in the way that many are expecting. So, for those reasons, I would like to propose keeping reserve pressures as they are. And, in the statement, I would deemphasize the impact of the dollar on what we are doing. Also, I don't want to tilt the directive.

CHAIRMAN GREENSPAN. First Vice President Hendricks.

MR. HENDRICKS. We see a further acceleration in prices this year and next, and believe that the risk is on the upside. Therefore, I believe it's reasonable, at this point, to increase the pressure on bank reserves by moving toward the "C" path. I'm not particularly picking the C alternative, but favor a $600 million borrowing objective.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I definitely would put the priorities on the side of worrying about inflation as opposed to the recovery. I would favor "B" with a tilt toward tightening. I could certainly accept a $600 borrowing target, although I'm not voting, so I don't need to accept it. I'd feel particularly strongly about moving if I felt that we were sort of maintaining a 6-1/2 to 6-3/4 percent funds rate against a very strong demand for reserves. Now, as you pointed out before, Mr. Chairman, on the velocity argument, maybe we won't see that. We're certainly not maintaining a lower funds rate than would otherwise prevail through rapid reserve injection here; but that's where I come out. I would be inclined to leave language in there about the dollar. I think if we lost control of the dollar on the downside, we could kick off that whole cycle that we dealt with just a couple of months ago; and I'd be very sensitive to weakness in the dollar in the language.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. I would prefer staying with "B", largely for the reasons I outlined a few minutes ago. I think that the underlying trends are going to tend to damp both the inflation that is showing up and also, perhaps, the robustness of the expansion that we're in. However, I do recognize the short-term tendencies toward some inflationary movement here. So, I would also like to see the language be asymmetric in the direction of tightening.

CHAIRMAN GREENSPAN. What do you want [on borrowing], alternative B?

MR. KELLEY. I would stay with "B", the $500 million.

MR. JOHNSON. I guess I see some firming signals and, as I said, a little more upside risk than I did before. But, a lot of the early warning signals--some of the financial market signals--are not showing us as strong a concern as they did at our last meeting. So, I'm a little reluctant to see us stick our neck out too far. I guess I'm somewhere around alternative B with asymmetric language to give us the option of a potential tightening if we see firmer signs. But, sort of like Wayne, I'm not sure I want to commit myself to anything on instinct; I've got to have a little more evidence. When people read the minutes in six weeks, they'll look at what was going on when we made those decisions. The thing that has happened since the last meeting is that the real economy is showing more firmness, but that's about all I see right now. Maybe we'll be ready for a tightening move later, but for now I favor alternative B, with asymmetric language. I am for deemphasizing the dollar a little because, as I said earlier, I see it somewhat influenced by the oil price; and I'm not sure that the declining oil price, which might send the dollar down, is something we should be worried about. The dollar declined significantly, consistent with the decline in oil prices in 1986, and we saw inflationary expectations break in the face of that; we tried to resist the dollar's downward move; it certainly wouldn't have been a resistance against inflationary expectations. I'd like to avoid that kind of a problem. I think the dollar is still an important issue, but I think it depends on what's influencing it. So, I would rather highlight inflationary expectations and just leave the dollar as a proxy for that.

CHAIRMAN GREENSPAN. $500 million?

MR. JOHNSON. Yes, $500 million, with asymmetric language.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. A good deal of comment has already been made about the growth--that it's perhaps a bit stronger than we were expecting last month. But, I would just note that if you believe the forecast, and I think virtually everybody agrees with the Greenbook, you're only looking at 2-3/4 percent growth in the third and fourth quarters. That doesn't seem to me to be overly expansive. And, there is considerable uncertainty as to the inflation outlook, at least in my mind. To be sure, prices are quite likely to be up, but as a result of feeding through on import prices; and I'm not at all sure that a bit tighter monetary policy is an appropriate prescription under those circumstances. As a result, I would favor "B", with $500 million borrowing, until some additional evidence comes along. I would note, in that respect, for those who believe that the aggregates are important and that there is some informational content in them, that they're growing at a very nominal rate now. As a result, to further tighten at this point, in anticipation of some higher prices, seems to me to be inappropriate. So I would go for "B" with a $500 million borrowing level until some more information surfaces that would lead us away from that. Lastly, I would prefer to leave the language with respect to the dollar in the directive because, in my view, monetary policy has to act against a depreciation in the dollar that becomes fast, no matter what the cause. And, as a result, I would leave it in, and I would even leave it at a fairly high level of visibility in the directive.

CHAIRMAN GREENSPAN. Thank you. If we averaged everybody, we'd get a different result than if we averaged the voting members by themselves. I don't know if this is a typical result of this type of activity.

MR. ANGELL. The people who don't vote don't have to be responsible.

CHAIRMAN GREENSPAN. I'll put that on the record. It's fairly obvious that this is a unanimous vote for alternative B, and I would read it as a mild--maybe slightly more than mild--majority for a tilt in the language. There is some desire to move inflation and business expansion up in the language and the dollar down. The average borrowing requirement amongst the voting members is a shade under $550 million. For those of you who are keeping score, I'd opt for "B" with $600 million and a definite tilt. Basically, my own view is that the risk of snuffing out this expansion at this stage with mild tightening is extraordinarily small. My view is not so much that we know a great deal about what's going to happen in the fourth quarter and beyond. I just find it rather difficult to perceive a set of forces which can bring this expansion down when you have the following: lead times in the delivery of materials and investment goods as short as we have now, which presupposes that the markets are basically tight on inventories; clear evidence of an expanding capital investment market; and, in effect, pretty much a full adjustment in consumer expenditures [unintelligible] I think we are likely to get as a result of the income adjustments from the tax bill and other elements. I do not believe that this is strictly a [unintelligible] trade issue myself, but I think there is more to it than the trade balances that are emerging. And when you begin to see order impacts in some of the basic raw materials, such as in steel and aluminum, and the extraordinary behavior of the textile industry, which is surprising even with all the restrictions, I wouldn't join my colleagues here who consider this a set of very uncertain things. I think what is uncertain is how it materializes; but, I've seen this before, and this doesn't look uncertain to me. I may eat those words in six weeks, but it has a tone to it which I, frankly, find not really inflationary yet; there is no evidence in the wage data that I see. In any event, that's the way that I come out; and that's the way I read everybody else. I guess we can structure some language which I suspect would pretty much grasp the issue. Let me describe it. On the operational paragraph, it would read: "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions." As you know, we can either put this in terms of "somewhat greater reserve restraint" or "slightly greater reserve restraint". As I listened to the discussion, I read it as "somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable depending on indications of inflationary pressures, the strength of the business expansion, behavior of the aggregates, and developments in the foreign exchange market. I don't know whether or not that would be acceptable or whether anyone would suggest some rephrasing. I think I was capturing what I heard, but I will accept revisions.

MR. ANGELL. I wasn't quite certain what the vote was in regard to the dollar's position. I would be among those who would like to leave the dollar as being an important indicator, somewhat more prominent. But I may be out-voted, I'm not sure.

CHAIRMAN GREENSPAN. Frankly, it's a close vote.

MR. STERN. I agree with Wayne, in part because when this directive is published it would seem to me to be an awkward time to have downplayed the dollar if the dollar continues to do what it has been doing the last three or four days. I don't think you gain much.

MR. BOEHNE. I agree with that, Mr. Chairman. I don't think we ought to downplay it. We may be feeling more comfortable about the dollar just now, but it wouldn't take very much for us to find ourselves in a very uncomfortable position. And six weeks from now it will be more attention-getting if we change the emphasis than if we leave it alone.

MR. HELLER. Let me speak on the other side. I don't think we're writing here for the press release only; we're talking about the operational paragraph. If we have the dollar right up front, as soon as we get the kind of weakness that we are getting now, if sustained for another day or two, it could be seen as an indication that we have to tighten monetary policy. And that is not what the majority, at least of the voting members, was agreeing to. So, I agree with the Chairman in moving the dollar to a lower position. Let me note that it still is in the same sentence. We haven't split it into two sentences, as we have done many times before. So, it's a very modest downgrading; it's just the order in which we are reading it rather than a cardinal distinction.

CHAIRMAN GREENSPAN. Can I ask a question? We had the strength of the business expansion at the bottom of the list the last time. As I read it, there's a fairly strong consensus to move that up. Would there be any objection to moving that as #2 after inflationary pressures?

SEVERAL. That would be good.

CHAIRMAN GREENSPAN. So the question really gets down to two things: the relative positioning of the foreign exchange markets and the behavior of the aggregates "as well as" phrase. If we move the business expansion issue up, I would be willing to leave the sentence the same as it was the last time.

MR. BOEHNE. That makes a lot of sense.

MR. MORRIS. I agree.

CHAIRMAN GREENSPAN. Is there agreement on that? On the issue of the M2 and M3 growth rates, which were 5 and 5-1/2 percent, there were some suggestions of going to 5 to 6 percent in this context, which would be reasonable as far as not wanting to be splitting M2 and M3 apart. As I read the data and alternative B, I would assume that we might want to say through the September period--that this approach is expected to be consistent with growth in M2 and M3 over the period from June through September at annual rates of around 5 to 6 percent.

MR. ANGELL. I would really favor making that broader and going 3 to 6 percent. It seems to me that you could have a circumstance in which the aggregates were growing at 3 percent and, for other reasons, you still might want to tighten.

CHAIRMAN GREENSPAN. One of the problems is that it's such a short time frame that that issue can be difficult to implement. Does anyone else have views on this?

MR. HELLER. As long as we don't read a move to 3 to 6 percent as an indication that we are aiming for 4-1/2 percent, or something like that, and that is where the policy should be directed.

CHAIRMAN GREENSPAN. I thought that maybe the 5 to 6 percent was really a forecast of what is likely to happen, irrespective of monetary policy.

MR. ANGELL. I guess I'd want to hear Don Kohn's comments on that.

MR. KOHN. Well, our best guess was that under alternative "B" we'd have M2 growth of 5 percent and M3 growth of 5-1/2 percent; but, as you well know, there is a wide range of error around that. As I said in my briefing and the Bluebook, that presumes that money and income grow a little more closely together than they have over the last couple of quarters. That could fall short; I can't rule out that possibility. The question is whether you would want to react; but with the aggregates after the "as well as" clause at the end of the sentence, I'm not sure how strong any reaction would be, in any case.

MR. ANGELL. How about going to 4 to 6 percent then? It just seems to me that 5 to 6 percent is so narrow.

CHAIRMAN GREENSPAN. Let me ask another question. In your judgment, what is the average lead time between monetary policy and the aggregates.

MR. KOHN. Well, it's several months, clearly; as I think I indicated, whatever we do now will have its principal impact in the fourth quarter. But it is also true that this goes the other way a little: that is, whether incoming data that suggested the aggregates were running outside a range of 5 to 6 percent or 4 to 6 percent should have any influence on a proposal that Mr. Sternlight might make on the borrowing objective is not quite the same as saying you're actually going to have the effect. You can react and then assume that your effect would be somewhere down the road.

CHAIRMAN GREENSPAN. Let me ask you this. Does anybody object to 6 percent as the upper limit? Are there any objections to 4 percent on the downside?

VICE CHAIRMAN CORRIGAN. I wouldn't object. I would just offer a historical caution, for what it's worth. I think we have to be a little bit careful about jiggling around these quarterly objectives at mid-quarterly meetings, especially when we are so near the end of the quarter. It can convey something more than I think we had in mind.

MR. JOHNSON. I'd like to second what Jerry says.

VICE CHAIRMAN CORRIGAN. I think it's better to leave them close to where they were at mid-quarter.

MR. JOHNSON. I agree with Wayne's point that it is likely that they could come in there. I would want to change the whole language in terms of clarifying what we are saying if we go to 4 to 6 percent. I would want to make clear that though we're assuming no change in policy, the aggregates may come in in the 4 to 6 percent range. But that's not what it could imply. So, I'd rather just leave it alone.

CHAIRMAN GREENSPAN. Leave it alone, meaning what?

MR. ANGELL. You're going to leave it at 5 to 7-1/2 percent?

MR. JOHNSON. Well, 5 to 6 percent may be okay.

MR. ANGELL. If we're changing the top one, why is there any harm in changing the bottom one?

MR. GUFFEY. The alternative is to state it in terms of about 5 percent for both.

MR. ANGELL. About 5 percent would be fine.

CHAIRMAN GREENSPAN. Would 5 percent be acceptable to everybody? What's the general view on that next sentence?

MR. STERN(?). Take it out.

CHAIRMAN GREENSPAN. The general view is for just dropping it. Anybody object to that? Strongly? That leaves us with the funds rate.

VICE CHAIRMAN CORRIGAN & MR. BOEHNE. Keep it the same.

MR. ANGELL. 4 to 8 percent.

MR. HELLER. I think that this is something we should consider sometime in the future. That 4 to 8 percent is such a barn door; it's very wide. At some future time we may want to narrow that down a little.

MR. JOHNSON. That has always been the range used in the past, just to convey within the reserve target--

MR. HELLER. Wrong direction.

CHAIRMAN GREENSPAN. If you narrowed it, you are really saying that you're targeting--

MR. ANGELL. --the federal funds rate. I think it would be the wrong signal, in light of the 1976 experience.

CHAIRMAN GREENSPAN. Let me just ask, we haven't quite got to the borrowing target--

MR. ANGELL. I thought there were seven votes for five hundred; that was the way I counted.

MR. HELLER. $525 million.

CHAIRMAN GREENSPAN. I don't like people who are good at arithmetic. $525 million?

MR. ANGELL. I don't think anybody will know it's $525 million; you don't tell anybody.

CHAIRMAN GREENSPAN. Well, you know something, I don't know the answer to the question. The point being that I don't know what the convention is here--whether you average these things, which you can, or whether you take the majority. What has been the convention?

VICE CHAIRMAN CORRIGAN. The convention, I think, Mr. Chairman, is that you do not average that.

CHAIRMAN GREENSPAN. If you don't average, then the figure is $500 million.

VICE CHAIRMAN CORRIGAN. The majority is--

MR. JOHNSON. That is going to lead to other [unintelligible]. If it turns out to be an average number, you're going to have people low-balling it until it clears the average.

MR. HELLER. $536 million is the average!

VICE CHAIRMAN CORRIGAN. I think it is hard to average it. One other thing that is done, in terms of trying to sense where the critical mass is, if I could put it that way, or where the Committee might stand, is that the Chairman has been known from time to time to ask people what their preferences are as opposed to what they could live with. In this particular case, you may have some shadings of opinion around those borrowing numbers, for example, based on the question of symmetry or tilt that would go with them--in other words, the "woulds" and the "mights". I, myself, certainly would not dissent, at this meeting, over the difference between $600 million and $500 million in the context in which there was some tilt along the lines that Governor Johnson has suggested. So, you do have some play; but I don't think that most members of the Committee would be comfortable with averaging the borrowings. I think that can get to be quite awkward when there are larger differences, as there may be, than the difference between $500 million and $600 million.

MR. MORRIS. You also have the authority, of course, to call a telephone conference meeting to reconsider the borrowing level in the event, say, we get extreme weakness in the dollar, which I think is a possibility.

MR. ANGELL. We already have that in the tilt of the directive, anyway. That is, you can go firmer, based upon developments, without calling a Committee--

MR. HELLER. If you start out with a base of $600 million and then you have the language with the tilt, it gives you a very different environment than if you start with a base of $500 million and have the tilt in. $500 million with a tilt in it gets you right to the range where everybody may well want to be--in the $520 to $550 million range, or whatever--while $600 million with a tilt in it would get you a lot closer to--

MR. KELLEY. The tilt is worth $25 to $50 million dollars.

MR. BERNARD. In the operational paragraph, there's a problem that Mr. Cross and Mr. Truman pointed out on the factual portion of lines 24 to 26. The dollar, at least as of an hour ago, instead of having risen further, was unchanged. I don't know what the latest figure is, so that needs to be changed to make it factually correct.

MR. HELLER. Roughly unchanged.

MR. BERNARD. About unchanged.

MR. CROSS. It's, on balance, unchanged; it has been up and down.

MR. ANGELL. I think that would be appropriate. Change that.

CHAIRMAN GREENSPAN. I'd like it reread just to be certain.

MR. BERNARD. "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. Somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable depending on indications of inflationary pressures, the strength of the business expansion, developments in foreign exchange markets, and the behavior of the aggregates. This approach is expected to be consistent with growth in M2 and M3 over the period from June to September at an annual rate of around 5 percent. Growth in M1, while picking up from recent levels, is expected to remain well below its pace during 1986. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate consistently outside a range of 4 to 8 percent.

MR. KOHN. Excuse me, Mr. Chairman, I thought I heard the Committee express the view that they wanted to retain the "as well as" in front of the aggregates. Normand, just read--

CHAIRMAN GREENSPAN. Right.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Boehne	Yes
President Boykin	Yes
Governor Heller	Yes
Governor Johnson	Yes
President Keehn	Yes
Governor Kelley	Yes
Governor Seger	Yes
President Stern	Yes

CHAIRMAN GREENSPAN. As I read it, the next meeting is September 22. Thank you for your patience, ladies and gentlemen.

END OF MEETING