

Meeting of the Federal Open Market Committee

October 2, 1990

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, October 2, 1990, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Boehne
Mr. Boykin
Mr. Hoskins
Mr. Kelley
Mr. LaWare
Mr. Mullins
Ms. Seger
Mr. Stern

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

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

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

Messrs. J. Davis, R. Davis, Lang, Lindsey, Promisel, Rosenblum, Siegman, Simpson, and Stockton, 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. Ettin, Deputy Director, Division of Research and
Statistics, Board of Governors
Mr. Slifman, Associate Director, Division of Research
and Statistics, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of
Monetary Affairs, Board of Governors

Messrs. Broaddus, T. Davis, Scheld, and Ms. Tschinkel,
Senior Vice Presidents, Federal Reserve Banks of
Richmond, Kansas City, Chicago, and Atlanta,
respectively

Messrs. Judd, McNees, and Miller, Vice Presidents,
Federal Reserve Banks of San Francisco, Boston,
and Minneapolis; respectively

Mr. Belongia, Assistant Vice President, Federal Reserve
Bank of St. Louis

Ms. Ann Marie Meulendyke, Manager, Open Market
Operations, Federal Reserve Bank of New York

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CHAIRMAN GREENSPAN. Good morning, everyone. Would somebody kindly move the minutes of the last FOMC meeting?

MS. SEGER. I'll move.

CHAIRMAN GREENSPAN. Is there a second? Without objection. Mr. Cross, would you bring us up to date on foreign operations?

MR. CROSS. Yes, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Mr. Cross?

MR. BOEHNE. Sam, could you elaborate some on your comments about the dollar being less of a safe haven, which certainly has been true in this latest Middle East crisis? Do you see that as something that has been evolving over time and the Middle East situation brought it to a head? Or do you see it as something that is more transitory? What are your thoughts on it?

MR. CROSS. Well, it's very hard to be sure. It may be that over time as other currencies tend to be more widely used and as other markets tend to be further developed one might expect some lessening of the uniqueness of the dollar. Also, we now have a situation in Europe where for the first time the political differences and uncertainties that existed before aren't there, which may have meant that on this occasion there was more willingness to use some of these other currencies because they don't see the same kinds of political East/West problems as before. It could be for any number of reasons. But it's certainly true that the traders we talk to tell us that the old timers who work for them were all taking positions that assumed there would be a lot more movement into the dollar than happened. As I say, it could be having a significant effect in the kind of cautionary attitudes [unintelligible]. We also detect that a lot of people are very hesitant to be very short of the dollar in these circumstances because they think if there is overt military hostility the likelihood is very high that the dollar would pop up. So, quite often recently on Fridays we see evidence that there's a lot of settling of the books--that people don't like to go home for the weekend very short of dollars because they fear that if some really serious hostilities were to break out they could find themselves suffering very, very large costs.

CHAIRMAN GREENSPAN. Other questions for Sam?

VICE CHAIRMAN CORRIGAN. I'll make a comment in the context of Ed Boehne's question. In this immediate setting I think it is also true that concern abroad about financial fragility--or whatever you want to call it--in the United States and in U.S. financial institutions unquestionably has been a factor in the timeframe of the last month or so. It's impossible to quantify that, but there's no question in my mind that that's a factor.

MR. CROSS. Well, that's true. I certainly should have mentioned that factor. There is hesitation about U.S. institutions.

CHAIRMAN GREENSPAN. Extending on Sam's remarks, I think there really is something fundamentally different about a confrontation where there is the possibility of a whole country or countries going under from a coup or some instability and the currency could conceivably--with a very low probability that's still not zero--become worthless. And that probability did exist with the East/West confrontations for Europe and for Japan. This confrontation doesn't have that characteristic. In other words, there's no credible judgment that one can reach that says this thing will be wiped out. I think we saw that reaction in Saudi Arabia where there was this huge run [unintelligible] just moved as though it was the old dollar because that type of threat was there. So it may be that while this confrontation has negative effects on Europe and Japan they really are quite limited. And this war effect is very new to them. The real test will be if the dollar doesn't do terribly much if there is a war, which is not all that inconceivable assuming that we can--

MR. CROSS. What we also have heard a lot is that instead of movement from one currency to another currency there has been a surge of movement to liquidity in many places. So this tends to be a greater shift to liquidity than to a currency.

MR. LAWARE. Sam, at the other end of the spectrum, what set of circumstances might create a run on the dollar?

MR. CROSS. One can think of any number of possibilities. Certainly, one concern is the fact that the Japanese industries are holding something on the order of \$250 billion or so that would be largely unhedged. And because of what may happen here that could cause them to get frightened and to start running for cover fast. Or, as I was indicating in my comments, there are factors in Japan that could lead to a desire to shift a lot more funds [to yen] for their own reasons. One could envisage all kinds of scenarios that could cause the dollar to start moving down very, very, rapidly, with a lot of investors all around trying to get out.

MR. LAWARE. Thank you.

MR. CROSS. It's a real danger.

CHAIRMAN GREENSPAN. Any further questions for Sam? If not, I'd just like to take a few minutes to review what occurred at the G-7 meeting relative to the issues to be discussed today. Those of you who have seen the communique know that a crucial paragraph on monetary policy brings forth the issue of, as they put it, "that the rise in the price of oil associated with the Gulf crisis poses two risks: a risk of inflation and a risk of lower economic growth." The original draft that had been worked up by the deputies actually was skewed more toward inflation problems and had much less in the way of the issue of recession. But [unintelligible] and Mr. Brady both pushed for a symmetrical statement --or more exactly a statement that encompassed both even though [unintelligible] also involved income policies and a whole slew of other things, which were supported by no one. Interestingly, however, the following sentence in the communique was crafted by _____, which seems to contradict the basic endeavor to get balance between inflation and growth, and it reads: "The Ministers and Governors consider that stability-oriented monetary policies and sound fiscal policies constitute the correct policy

response." The interesting aspect of all of this is that the participants who were most strongly concerned about the inflation impact of the Gulf affair were the , both of whom in the previous G-7 meeting had lectured the group on being careful not to let the inflation genie out of the bottle because of all the difficulties they were having stuffing it back in. And I thought it was quite interesting the extent to which they basically were not pushing for anything other than stability and clearly were acting against any form of accommodation. My sense is that the other members of the G-7 were essentially all in the area of stability. I heard very little in the way of--at least in the table discussions--"interest rates should move up." In side conversations with some of the Germans I did get the impression that concern about the major increase in German government deficits was going to cause some upward pressure on monetary policy driven largely from the market side. But that concern did not get expressed in the underlying discussion that evolved among the various participants. I would suspect at this stage that pretty much everyone recognizes that if there is a credible budget agreement here, we will ease. I didn't get too much in the way of concern about that, although I would suspect that if we embarked upon significant ease without a budget agreement, we would. To the extent that these people ever express disapproval in anything stronger than moving an eyelash, we would get a double eyelash effect or something like that. But the notion of stability in the context of individual adjustments was really enforced by the fact that there was no criticism, for example, of the Japanese [3/4] percentage point rise in the discount rate on the grounds that that was required to maintain what they perceived to be a basically stable policy.

There was not too much conversation on exchange rates. There was a general belief that a weak dollar would be undesirable. And that was implicit in the communique, following up on the previous G-7 meeting's communique which had indicated that the yen was exceptionally weak, in language suggesting that the yen had reached a broadly acceptable range without specifying against which [currencies]. The general view of the group, even though it was not explicitly stated, was that dollar stability--in fact, general stability--was desired, although

suggested that it might not be all that bad if the yen did actually firm somewhat relative to the other currencies. But that was not a general view and that did not, of course, find its way into the communique. I got the impression indirectly by the way he responded to the editing of the communique that Mr. Brady basically was not in favor of significant weakening of the dollar. He made several statements suggesting that, but he made no pronouncements; it was sort of half sentences. But he was clearly not desirous of driving the dollar down and probably would be uncomfortable if that in fact happened. The French at the meeting and the Japanese in public speeches requested that there be exploration of "a more stable international monetary system" as they put it. And the G-7 basically agreed that some looking at the process was authorized, although I sensed no enthusiasm for the process on the grounds that no one was thinking that anything useful would come out of it. But because a study and not an action paper was requested nobody particularly fought against it.

With respect to intervention, generally nobody wanted to discuss anything about ranges; nobody even wanted to discuss

contingent intervention. As a practical matter, while it may have been discussed peripherally, there was less talk about concerted intervention even in the abstract than at any time since I've attended those meetings. I would say in general that it wasn't a particularly dynamic meeting, in part I think because there has been a change in the participants. Considering the background of all the things that were going on, it was remarkably quiet and pretty much described by the communique. There were no sub rosa discussions and no implied programs that are not in the communique. And there is nothing much I can report that was not in the newspapers. Does anybody have any questions or anything they want to comment on?

MR. FORRESTAL. Was there any discussion about the possibility of recession in the United States and the potential spillover into other countries?

CHAIRMAN GREENSPAN. Yes. There was general discussion of that in the context of the monetary policy issue. I might say that there is a high degree of awareness about what is going on in the American economy and concern about it. But as far as I can tell it's a limited concern, though clearly there.

MR. FORRESTAL. Could I just follow with one other question? I've seen some press reports recently that the [Delors] proposal, the parallel currency, is getting noisier.

CHAIRMAN GREENSPAN. The hardened ECU?

MR. FORRESTAL. Yes. I understand that it's getting more support than it did when he proposed it originally. Was there any discussion or do you have any sense that this is gaining any momentum?

CHAIRMAN GREENSPAN. Well, the discussion wasn't at the G-7 meeting but a couple of weeks earlier at the Basle meeting of the G-10 governors. It was clear that the European part of the group had just come from Rome where they had had a fairly extended discussion, which sort of pushed back the [Delors] plan slightly. I got the impression that the interest in the hardened ECU was not that everyone had all of a sudden looked at this and said "Gee, what a terrific idea." I think what happened was that the finance ministers finally had gotten the message that when you have the type of monetary policy integration contemplated in the Delors plan a substantial loss of financial sovereignty is involved. So it wasn't the hardened ECU theme that created the problem; it turned out to be the vehicle that enabled some of the governments to back off from their commitments by saying "Isn't this interesting? Let's look at that." But I would suggest if there hadn't been a major plan they would have found something else.

MR. FORRESTAL. I take it that it's your sense that our trading partners will be following a fairly restrictive monetary policy for the foreseeable future?

CHAIRMAN GREENSPAN. Well, I think that's certainly true on the part of the Germans. It is going to be true on the part of the Brits and the Canadians until they begin to see more weakness in their economies. And as Sam had mentioned this morning, Mr. Hashimoto is already talking about what was effectively turning monetary policy around. I'm not clear what that means. As of the G-7 meeting, one

had the impression that they would remain firm, although there was no discussion of a further rise in their discount rate. But, certainly, there was no indication of the type of reversal that was even remotely implicit in Hashimoto's remarks yesterday.

MR. FORRESTAL. Thank you.

CHAIRMAN GREENSPAN. Is there nothing else on this? We don't need anything to ratify [any transactions] since, fortunately, I assume nothing was done.

MR. CROSS. No, there is no need for any action.

CHAIRMAN GREENSPAN. Peter Sternlight.

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

CHAIRMAN GREENSPAN. Questions?

MR. HOSKINS. Peter, I've been on the call on occasion and I've watched the market tend to focus more and more on the funds rate as the measure of our policy. To an extent, at least based on your report, we are beginning to alter our program so as not to indicate that we made an easing [move]. In other words, we had to add [reserves] and we didn't do it because the market might have reacted.

MR. STERNLIGHT. Right.

MR. HOSKINS. The question to you is: Are you comfortable with that or would you be more comfortable with more flexibility around the funds rate? And if you would [prefer the latter], do you have any ideas on how we can get that without disturbing the market?

MR. STERNLIGHT. Well, we have been uncomfortable for a year or more--two or three years maybe, going back since the October 1987 stock market decline--with the extent to which we give a lot of attention to the funds rate rather than feeling that we have some element of flexibility where we would aim at a borrowing gap and have a rough expectation about the funds rate but where there was room for the funds rate to vary some around that. I think what has put us in the kind of box that we're in now is a weakening of the relationship between borrowings and the funds rate spread over the discount rate. I wish there were greater flexibility so that the market could accept our doing things when the funds rate is a bit to the easy or firm side of what they think is the central point without their getting all that excited about the policy implications of our actions. I think it would take some kind of public statement to get the market off its fixation [on the funds rate]. And even then, it's going to be hard to do because the market is always reaching for something to guide itself. And unless we can put something else out there--and I'm not sure what else we have now to substitute for the current security blanket--

MR. HOSKINS. Well, I don't either. That's why I asked you.

MR. PARRY. But if it were explained that there would be greater fluctuations in the funds rate, do you think that's something they could live with?

MR. STERNLIGHT. Yes, I think that could help.

MR. PARRY. It will?

MR. STERNLIGHT. No, I think that would be--

MR. HOSKINS. That would take a public statement.

CHAIRMAN GREENSPAN. I don't know, really. When we say more volatility around something, of course, they'll be looking at the something. Unless there is literally another instrument that we can employ, even in part, with some credibility, merely allowing the funds rate to fluctuate doesn't help us all that much because they will all be competing on who knows what the central tendency is on the funds rate. What we really need is another instrument--some mechanism that captures the degree of tightness in the system better than the funds rate itself.

MR. BLACK. We need some kind of reserve measure tied to M2, but there's no way--

CHAIRMAN GREENSPAN. [Unintelligible] goes off in the wrong direction.

MR. BLACK. Our present structure was set up to target M1, which then ceased to be a good indicator. We have all this institutional set-up in effect and it's not useful.

CHAIRMAN GREENSPAN. Yes. In fact, I'm going to come back to that issue a little later because we've been giving a lot of thought to that structure not only in this context but also in the context of reserve requirements, which were originally set up on an M1 targeting basis.

MR. BLACK. Very cleverly done, too.

CHAIRMAN GREENSPAN. The way they set it up, I thought it would have been terrific if it had worked.

MR. BLACK. I thought it was great at the time, but I didn't know what was going to happen to M1.

MR. KOHN. Mr. Chairman, if I could add to this for a second. I think--we'll see whether [Peter] agrees--that things became even tighter after that Thanksgiving problem we had but loosened up a bit recently. I think the problem in the last few weeks has been one of extraordinarily volatile expectations that we were going to ease, perhaps momentarily. And if we're not doing what the market expects us to be doing, that's always going to be a problem for the Desk. And there's also a greater disconnection between the funds rate and the underlying reserve conditions. I wonder, without being able to prove it, whether that isn't partly a function of the problems with the way these banks are changing their operations to some extent in the money markets. That creates another set of problems for the Desk. So, I think we've had some pretty unusual circumstances over the last three maintenance periods.

MR. STERNLIGHT. Yes.

MR. KOHN. But in general, my sense is that we've loosened a bit over the last few months relative to where we were right after Thanksgiving.

MR. STERNLIGHT. Maybe so. There was a day recently that we were able to provide some reserves--I think it was through multiday RPs--and funds were [trading] a hair under 6 percent and that was accepted by the market. They thought there was a big reserve need and they didn't think anything of it on that occasion. But at the moment I'm more conscious of the occasions when we felt our hands [were tied] because of the expectations of an imminent easing that Don referred to, and we didn't move lest they misinterpret our--

MR. BLACK. Peter, does anybody think we've tightened any because we went above our expected--?

MR. STERNLIGHT. No, I do not think so.

MR. BLACK. I haven't seen any indication of it; I just wondered if you had.

MR. PARRY. I'd like to pursue a little more your views on the consequences of passage of the budget compromise. If the compromise is passed and signed, you feel that that probably would produce a rally in the long-term end of the market? Is that correct?

MR. STERNLIGHT. I think it would be a positive. I would not expect a big rally because there's still that concern about inflation.

MR. PARRY. That, and you said the consequence, if we then followed that with an easing move, would be that long-term rates would probably [unintelligible] and not move up. Is that what you're thinking?

MR. STERNLIGHT. In that context I would not expect the long end to move up; right.

CHAIRMAN GREENSPAN. Further questions for Peter? Martha Seger.

MS. SEGER. I'm just sitting here listening to Peter and Don talk about this fed funds fixation and the problems [that creates]. Are you sort of making the case for prompt release of our minutes? Maybe that would fix it so we could tell people what we're doing rather than make them try to read it from entrails.

MR. KOHN. I wasn't trying to make that case, no. I'm not sure that would help them in terms of trying to guess what we're going to do tomorrow, which is really what it's all about--not what we did yesterday.

MS. SEGER. It would still give them more guidance than they now get where they just really are flying by the seat of their pants.

MR. BOEHNE. I'm not sure, Martha, that it makes the case to release the minutes. It makes the case simply to say what the fed funds target is, much the way we say what the discount rate is. I think the minutes are so ambiguous that they don't tell you very much.

But if we say the target is an 8 percent funds rate, people know what an 8 percent funds rate is just like they know what a 7 percent discount rate is.

MS. SEGER. Maybe the Greenbook--

MR. BOEHNE. If there's a case in all of this, that's the case. I don't see it on the minutes side.

MS. SEGER. Well, I think we need to give them some more guidance so they don't have to hang on every basis point change [in the funds rate] and try to equate that with a policy move.

MR. MULLINS. Would there be a benefit in going to a range from our point estimate? Or would that just--

MR. STERNLIGHT. Well, I like to think of what we have as a range anyway. But the market would immediately put the rate in the middle of the range and if they're looking for--

CHAIRMAN GREENSPAN. They'll be looking for the central point of that range.

MR. STERNLIGHT. If they are looking for ease, then anything to the lower side of that range will make them begin to think it's the first step on the easing side; conversely, if they are looking for tightening.

MR. PARRY. But it would make your job easier to use a range?

MR. STERNLIGHT. I tend to think of it as a range anyway, but the market doesn't.

MR. BLACK. You are in the [minority]. Of all the observers you're one of the few who really think that. Don't virtually all observers think of it as a target?

CHAIRMAN GREENSPAN. In principle, you either have an interest rate or a non-interest rate [target]. The trouble is in trying to finesse all this; it doesn't work.

MR. BLACK. You have to be able to predict--

CHAIRMAN GREENSPAN. Either we have to say interest rates don't matter and we basically are targeting some financial variable or structure of variables or we target an interest rate. And then we're always going to find somebody who's seeking the central point of whatever range we contemplate. I don't know what we do about that, but it's not satisfactory; that's for sure.

VICE CHAIRMAN CORRIGAN. You're absolutely right. As long as there are legions of very, very well paid people out there whose livelihood depends upon their ability to understand every nuance in Mr. Sternlight's activities, we're stuck with it.

CHAIRMAN GREENSPAN. Are you suggesting something about creating some more [un]employment?

VICE CHAIRMAN CORRIGAN. Actually, that would do it!

CHAIRMAN GREENSPAN. [Unintelligible.]

VICE CHAIRMAN CORRIGAN. It's true, though, that there are literally thousands of people all over the world who do only that.

MS. SEGER. [That's] why we need to tell them what we're doing.

VICE CHAIRMAN CORRIGAN. I don't think it would change it.

MR. SYRON. They have to find something to look for.

MR. MELZER. Right. They'd be looking for [something].

VICE CHAIRMAN CORRIGAN. No matter what we did, unless we really went the whole distance by going through some kind of a quantity as opposed to a rate--

CHAIRMAN GREENSPAN. Or lock in a mechanical [approach]--

VICE CHAIRMAN CORRIGAN. But even that--. If you go back to the period in 1980 and 1981 where we really did, at least for a period of time, [target] the money supply range, we had pandemonium every Thursday afternoon when the money supply figures were published. And that gets very frustrating. But I must say it's pretty darn hard to figure out how to avoid it.

MR. BOEHNE. If we say, for example, what the funds rate is, then they will try to figure out what it is we look at when we are about to change the funds rate.

SPEAKER(?). Yes.

MR. BOEHNE. And if we release that, then they'll go back-- it's an impossible situation.

CHAIRMAN GREENSPAN. Jerry suggests a significant part of the gross national product is value added from [Fed watchers].

MR. SYRON. Nationwide.

MR. FORRESTAL. He has a new instrument. They can all come back and work for Don.

CHAIRMAN GREENSPAN. Further questions for Peter? If not, may I have a motion to ratify the Desk's actions since the last meeting?

VICE CHAIRMAN CORRIGAN. So move.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Mr. Prell.

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

CHAIRMAN GREENSPAN. Questions for Mr. Prell?

MR. SYRON. Mike, I know a lot of this is because of the oil issue, but I have one technical and one substantive question. The technical question: Is the big [drop] that we see in the first quarter of 1991 in the CPI because of what you already have anticipated on the excise tax?

MR. PRELL. That is part of the first-quarter effect. Of course, with the timing of the gasoline tax that has been proposed, that means we'll get something before the end of the year.

MR. SYRON. My other question relates to your forecast of two mildly negative quarters but then quite a bounceback. I know that it's completely [impossible] for anyone to forecast what's going to happen in the Middle East, but I just wonder how likely your forecast is from a much more qualitative point of view. Perhaps I'm factoring too much into this for how likely I think the credit crunch is and how much momentum I think this downturn could cumulate once we get into it, particularly on the consumer confidence side. That may or may not be offset by the assumption you had to make about when oil prices would change that.

MR. PRELL. I'm pleased that you said we had to make that assumption because, obviously, there was some degree of arbitrariness to that, and we hope that this is a plausible baseline. We feel somewhat optimistic--but [unintelligible] I think to highlight the kind of policy issues you confront. Basically, that rebound does follow fairly naturally from the improvement in real disposable income that would result from this kind of decline in oil prices. History suggests that oil price shocks of the sort we have had do tend to disturb consumers, and [thus] we see very sharp drops in confidence. The previous large drops were in somewhat similar circumstances. Unless the economy really follows through with a significantly negative performance, one might expect confidence to improve somewhat. We certainly see downside risks here because of the credit situation, but we think we've built in some allowance for that in an informal way. But should quality spreads widen dramatically, should lenders really pull in their horns more sharply than we sense they are, that would certainly be a drag on business spending. We've assumed that inventories will be kept in very tight check over the coming months; that's one of the reasons for the weakness in production in the forecast. We don't have a buildup [in inventories]; they keep production lines running. So, that positions us for a nice rebound in production as soon as that underlying demand picks up. But as we enter into a period of such weakness, there are a number of variables that could turn more negative than we have [projected]. It's possible too that we will skate through this without any cumulative decline.

MR. SYRON. Is there an historical analog for a disturbance causing this kind of muted downturn but then bouncing back this quickly?

MR. PRELL. Well, I guess one would have to reach pretty far back to find any example. This is a supply shock. The supply shocks

that come to mind occurred in 1973, which was a period when other things also tended to exacerbate recessionary pressures, and again in the 1979-80 period when we had a recession with an oil price shock. But the magnitudes differ and the general circumstances differ. I think one couldn't simply appeal to historical precedent to justify this forecast.

MR. SYRON. Thank you.

MR. PARRY. You mentioned the conservative inventory policy here, but basically it isn't much of a cycle in inventories. Do you feel very confident about that? Typically, one expects some buildup of excess inventories, which are subsequently run off, and then some increased production as the economy picks up. We go through these cycles in real GNP. But in truth, these inventories are really pretty [consistently] at very low levels; that may be a potential source for some greater cyclicalities than was in the forecast.

MR. PRELL. Well, as I suggested, we've assumed that businesses do move their inventories very consistently with sales in this period ahead. Our sense is that in recent years, given the kind of inventory management practices that have evolved, the pattern really does support that kind of assumption about their behavior. One can already see an awareness on the part of businessmen that there may be weak sales in the months ahead. We have anecdotal reports of retailers ordering very cautiously for the fall. Basically, we are looking for the production adjustment to happen very rapidly and that's when our recession is occurring.

MR. PARRY. Okay.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Mike, my question is about your relatively quick drop--from my point of view--in the inflation rate out in 1992. My question focuses on a couple of observations. One is that ex food and energy, the trend has been upward in the last couple of years; and I'm wondering what you think is going to put the squeeze back on inflation. The second has to do with potential GNP. If the oil price doubles, or under the other assumption increases by 50 percent, that must have some impact on the potential GNP that you've built in, which means that you have lower growth for the real economy but you also have lower potential GNP. I'd like you to sort that out for me.

MR. PRELL. On the latter point, we really haven't done anything exotic in the assumptions about potential GNP. You're quite right that the shift in the relative price of energy could affect the productivity of the capital stock; it could have an effect on the level of potential GNP. If oil prices stayed very high, one would have to be concerned about some effect. I can't state the magnitude; perhaps Dave has something to contribute on that point. Basically, though--assuming there isn't a major contraction of supply that is permanent, so to speak, going out through 1992--I think our forecast follows quite naturally from the assumption we made about oil prices, the projection we made for the dollar, and our anticipated increase in slack in the economy. We have a 6-1/2 percent unemployment rate. We think that is high enough and the slowness of growth per period great enough that we should see some downward pressure on real wages. We

anticipate that import prices will be rising fairly rapidly in the near term, but as a result of our dollar path [the rise] will be decelerating and thus that will be a helpful factor in the deceleration [of overall inflation] by 1992. And we have a favorable trend relative to overall inflation and energy prices as we go out through 1992. So, the cumulation of these things puts [inflation] back into the low 4 percent area during 1992.

MR. HOSKINS. Thank you.

MR. PRELL. Dave.

MR. STOCKTON. On the potential outlook question, I'd say that given our basic forecast, which is just sort of a continuation of a modest rise in the relative price of energy--abstracting from this temporary rise--that we're not expecting any significant scrapping of the capital stock. And that is the principal way in which the potential output falls in the short run. Obviously, if [energy] were to be maintained at that higher relative price, there would be greater scrapping of the capital stock and greater substitution away from energy that would [lead] to a reduction of potential output.

MR. PRELL. This is a complex question--one we really want to look at in the weeks ahead. As we noted in the Greenbook, one still has to be very tentative about one's assumptions on potential GNP. And we've yet to address that in that broader production framework.

CHAIRMAN GREENSPAN. When you look at the GNP data rebased to 1987, you tend to get lower growth rates [unintelligible], of course, slower productivity. And when you take a look at the potential, the question is: Are you going to be viewing it solely in the context of 1982 dollars or in 1987 dollars, which I assume is the base that will be emerging relatively soon? And that base is .1 or .2 less, as I recall, on a systematic basis.

MR. PRELL. Well, that's just one more of the uncertainties. And, of course, if and when there are revisions of the data, that will alter the sectoral distribution of value added as the result of the repricing of computers and so on. And that could alter one's impressions of what has been going on in productivity performance.

MR. HOSKINS. Let me just follow up on--

CHAIRMAN GREENSPAN. President Guffey.

MR. HOSKINS. I'm sorry.

CHAIRMAN GREENSPAN. Roger.

MR. GUFFEY. Looking at the forecast, Mike, it appears to me that a good deal of emphasis was put on the net export sector. You have it coming back fairly quickly. What kind of assurances do you have, given the uncertainty of the Middle East problem, that that's really going to come about? You have it coming back very quickly, it seems to me.

MR. TRUMAN. There are really three factors there. The answer is that we can't give you too many assurances, obviously, for

the reason that you cited: We have the same [uncertain] oil situation here. There are some short-term effects built in, which cause this low that's going to look like [unintelligible]. As a short-term factor, we took account of the fact that we're not going to ship any more grain to Iraq right away but that the grain will go somewhere else as we get into 1991. So, that tends to give you a short-term decline that magnifies the bounceback. Then in the fourth quarter to the first quarter, with the negative growth in the United States, imports are held down. So that gives you an arithmetic effect as far as net exports are concerned. Then, as we get further out into the forecast, the lower dollar that has come about over the last year tends to give a boost to exports as well as to hold down imports. The growth assumption that's in here has been marked down somewhat from recent forecasts; it was marked down last time and it was marked down this time consistent with the effects that we have in the U.S. economy. And we have quite slow growth built in, as the Chairman mentioned earlier, for Canada and the United Kingdom, for example; we have negative growth in those two countries. On the other hand, we have some resumption of growth next year, especially in Canada. So, that does give a boost in that direction. We also have a somewhat rosier outlook--or let me say a less negative outlook--for Latin America in 1991, which gives us a boost to [exports]. Those are the big factors.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I'm back on my housing kick. If I'm reading this page correctly, you are estimating housing starts for this present calendar year at 1.2 million, going down to 1.15 million next year, with this present quarter actually being the low quarter--although the next quarter is going to be about the same. It surprises me that we see this downturn ending so quickly--unless you're a lot more optimistic than I am about the credit situation, which, obviously, you are.

MR. PRELL. I suspect so. But that doesn't mean that we're expecting things to return to the kind of situation we had three or four years ago. I must say that on the mortgage side, as opposed to the construction side, we still don't see signs of any great addition to effective demand in that market. But I think the construction credit side will continue to be a touchy situation for a while longer. As you know, we have assumed that there would be some gradual improvement in access to credit by builders who have decent projects to propose. But the key here is that we're looking primarily to the weakness in real income over the next couple of quarters to be the major drag on housing demand. And as that situation improves, we expect some people to come back into the market and provide some lift to housing demand. The level to which we go back is still a relatively low level of overall housing activity; it certainly does not go beyond what one might think the longer-run demographics would suggest should be the basic level of housing demand. So, we don't think we have a very aggressive forecast here as we look out to 1991.

CHAIRMAN GREENSPAN. Do you have a number that you use for sort of gross extinctions--in other words, the equivalent of the age of stock in the passenger car market--from the housing stock? There is a figure that is basically the net extinctions, which is related to the total number of operable housing units and the total number of--

MR. PRELL. Well, the figures that we've built into our thinking would involve about 400,000 units a year to replace dilapidated or demolished units and meet the second-home demand. If you add that to the demographic trend, we estimate that the basic housing start level ought to be somewhere at 1-1/4 to 1-1/2 million units--maybe toward the lower end, if you want to be conservative.

CHAIRMAN GREENSPAN. So we're at the point where the vacancy rate increase is negligible and the housing starts number is following with the demographics?

MR. PRELL. Well, we are sort of building into this forecast the notion that we're going to absorb some excess supply at this point. That's one moderating influence in the growth of starts over the next couple of years.

SPEAKER(?). That's just residential, right?

MR. PRELL. That's right.

CHAIRMAN GREENSPAN. Yes.

MS. SEGER. Mike, how about this heavy flow of horrible publicity about real estate problems, such as the latest Newsweek cover story. If you [don't] own a house, it seems to me you'd get a slight case of cold feet about buying one because it practically guarantees a big loss on your investment, whereas a few years ago practically everyone--especially around this area--who stepped into the housing market expected to make a killing.

CHAIRMAN GREENSPAN. Can I just add to that?

MS. SEGER. Isn't that right?

CHAIRMAN GREENSPAN. The equivalent Newsweek cover at the top of the market was exactly at the top of the market. And then we got a signal that maybe--

MS. SEGER. Yes, a bleeding signal.

MR. PRELL. I think we've been pointing for some time to the altered psychology of this market. The investment motive for buying a home in many areas of the country is not very strong at this point. There are still areas where prices are reasonably firm. On the whole, though, the picture is certainly one of a flattening out of prices for both new and existing homes. It looks much like the kind of rate of increase or stability that we saw in the last recession. But interest rates are anticipated to be a bit lower. They're at the low end of the range we've seen in the past decade or more. And there is some basic underlying demand. Now, houses might get smaller. We've seen a lot of moving-up-the-scale by homebuilders in recent years and perhaps if there's some moderation in demand for shelter, it will take the form in part of less extravagant houses. But at some point we're going to have this pressure to house this population. While we may have doubling up and so on for a while, I think there is some underlying support here.

CHAIRMAN GREENSPAN. But Governor Seger is right. It could just as easily go to a million annual rate for a quarter or two and still be consistent with--

MR. PRELL. It could go even lower than that. It's a small sector. It has some side effects but it would take a very deep plunge relative to our forecast to have a major effect in altering the outlook.

MS. SEGER. It's small, but it involves a lot of small business people who write their Congressmen.

MR. PRELL. Well, you're moving into another sphere. I guess you could say that might--

MS. SEGER. I'm not; it makes no sense here.

MR. PRELL. That might [hint] at some offset in terms of fiscal policy.

MS. SEGER. Thank you.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. Mike, I was interested in the general tenor of your presentation, which was: "We are projecting two consecutive negative quarters but we don't really believe it very much."

MR. PRELL. That's a slight variation of what I tried to say.

MR. MULLINS. There are no hard data to support it.

MR. PRELL. We can't see it yet.

MR. MULLINS. True, you talked about new orders, which looked fairly depressing. Also, you could make the point, which you made, that the purchasing managers index would be rather consistent with your forecast, it seems to me. As for consumer spending, August--the first post-oil-shock month--didn't look too great and some of the third quarter will be [what happened in] July. But again, the auto sales really are holding up even in September. Yet the forecast has been lowered for the fourth quarter by 1-1/2 percent and for the first quarter [of 1991] by a little over 1-1/2 percent based upon apparently no hard data supportive of it. What did you see that fed into such dramatic changes, despite the fact that the hard data didn't really compel you to do it?

MR. PRELL. Well, as I noted, there were several [factors]. One of the biggest single considerations was the significantly higher level of oil prices that we have in the fourth quarter and in the first quarter of next year, which is going to squeeze the real purchasing power of households by a significant degree.

MR. MULLINS. So, if we reduce the oil [price] forecast to where it was in the August Greenbook that would account for most of the--

MR. PRELL. That would account for at least the majority of it; I wouldn't say it would account for all of it in a [strict] mechanical translation. We thought there were other factors in the environment too. The general inflation trend looks a bit worse and the excise tax hit also implies somewhat greater inflation in the near term and still further erosion of real income. We also looked at the credit market developments and at least intuitively judged that there is more restraint being imposed there than we might have anticipated in our previous forecast. We try to take into account the anecdotal information. I mentioned that as something that certainly has looked negative and I think it would be silly for us to ignore that totally.

MR. MULLINS. Do you see hard evidence of the credit market constraint?

MR. PRELL. Hard evidence? Well, obviously, the trends are visible. The lending practices surveys that we pick up aren't that up-to-the-minute, but the recent survey showed a slight widening of quality spreads in the bond market. Very clearly something that has impressed us is the turmoil in the banking sector. That is something we can't yet document in terms of its effect on their lending, but it seems to us to suggest some significant further constraint on them.

MR. MULLINS. May I ask a related question on the [projection]? We have now gone through six quarters with GNP growth averaging a little over 1 percent. And capacity utilization, it seems to me, hasn't come down that much. We have talked about why unemployment hasn't gone up so much--because of the participation rates. What's your view? Is this about what you'd expect: a 2 percent drop in capacity utilization?

MR. PRELL. We have had some reasonable increases in industrial production thus far this year. Indeed, there is something of a tension between the industrial production numbers and the GNP numbers over the course of this year. The relative movement is pushing the limits of what one might have expected. But the natural consequence of that is that we don't have capacity utilization coming down a great deal. I don't have an answer for this. These are somewhat independent data sets and they sometimes do diverge. They are also both subject to revision. And where the truth lies, I can't say with any certainty.

MR. MULLINS. Could one explanation be something analogous to what happened in the labor market, in the sense that the labor force hasn't grown as rapidly as we expected? Perhaps the capital stock has not been growing, in fact.

MR. PRELL. Well, in a sense this is a mechanical calculation. All the variation in capacity utilization essentially comes from the variation in industrial production. We don't measure capacity month-by-month. I guess one might say that there hasn't been anything very obviously strange about the relationship of capacity utilization to price behavior this year. Materials prices have not been collapsing; the PPI for finished goods has not been collapsing. This doesn't suggest that capacity utilization really has been falling dramatically. So, I don't see any indication that we've been led astray by these numbers.

MR. MULLINS. Thank you.

CHAIRMAN GREENSPAN. Further questions for Mr. Prell? President Hoskins, didn't you have a question?

MR. HOSKINS. I was just going to follow up on your comment, but it's so far removed now that I don't think we ought to put Mike back on the rack to torture him more on that.

MR. PRELL. I could use a couple more inches!

MR. HOSKINS. If I listened to your comments correctly, [the implication] was that if we do have a slowing in real GNP and potential GNP is also slowing, we're running off a gap or slack model and the 6-1/2 percent unemployment isn't going to buy us the same reduction in inflation. That was the only point I was trying to make. But it isn't [unintelligible] and nobody knows.

MR. PRELL. Well, the point we tried to make is that if potential GNP is growing more slowly, one has to lower one's sights on what kind of GNP growth we can have and achieve a given degree of slack. That, I think, is the cutting edge on this issue.

MR. ANGELL. Mike, following up on David Mullins' questions in regard to the fourth quarter: I note that you have nominal GNP at 2.6 percent for that quarter. If my memory serves me correctly, we hardly had any quarters in the 1981-1982 recession that had nominal GNP that low. That 2.6 percent is an extremely low nominal number. I wondered: How does V2 on a one-quarter lag basis look with 2.6 percent? We really have a fair idea, don't we Don, as to where M2 might be in the third quarter relative to the second quarter? We could put that to bed and then take this number [and determine] what kind of a V2 change we would have.

MR. KOHN. For the fourth quarter?

MR. ANGELL. Yes.

MR. KOHN. We have a minus 2 percent velocity. Now, we wrestled with this issue, and we tried to address it at least in a sentence or two in the Bluebook. Obviously, we did not have a comparable slowdown in money to accompany the slowdown in nominal GNP. Just from a modeling perspective, we find that the models are driven by consumption, and nominal consumption remains quite high. A lot of that is prices--oil and whatnot--and it's not real. But nominal spending--dollars flowing through--remains quite high, and that should help to support M2. From a more theoretical perspective, the notion is that holdings and increases in holdings of M2 are related in some sense to notions of permanent income and longer-term trends. So, we wouldn't ordinarily expect money demand to react very sharply contemporaneously to slowdowns in nominal GNP. It would work through in the sense that it averages through in a slower path in nominal GNP over time. That's how we tried to square this circle. We really don't expect a comparable slowdown in M2 for those reasons.

MR. PRELL. Governor Angell, I might just note that the relatively low deflator we have gotten for the fourth quarter--

MR. ANGELL. I noticed that.

MR. PRELL. --is something of an artifact of our assumption about oil prices, the oil import pattern, and how fast those prices of imported oil flow through to finished products, and so on. The fact that we had a big bulge in the oil price gives us this temporary dip, which is then reversed in the first quarter. That isn't to say we don't have a pattern of slower nominal GNP growth over this quarter and the next; but it is still a relatively low number.

MR. ANGELL. But on the nominal [GNP] there's also a rather significant move back from what looks like a 1990 nominal of about 5 percent. That's not for the [calendar] year, but for the Q2-to-Q2 period; then it looks as though it goes from 5 percent nominal to 7 percent nominal. But I don't think it needs any more elaboration.

CHAIRMAN GREENSPAN. Any further questions for Mike? If not, would somebody like to start the Committee discussion?

MR. FORRESTAL. I will start off, Mr. Chairman. I would have to say that the business and consumer attitudes we have found in the Sixth District since our last meeting suggest a quite fragile economic outlook. The people that I've talked to in the past several weeks have become increasingly negative, with just a few exceptions. We have been looking with interest at the oil sector, the energy sector on the Louisiana coast, expecting that perhaps the higher oil prices might have given rise to some greater interest in investment in that sector. But we have been told by our contacts in the industry that there is just too much uncertainty about the price of oil in the future. So, they're not ready to embark at this point on any significant added investment.

The only bright spots that I can find in our economy are for the most part in the export-producing industries. The industries that are competing with imports are still shrinking, and that's particularly true in the apparel area. Retailers in the district are anticipating substantial caution on the part of consumers, which I think is certainly justified. Interestingly, they're delaying orders for Christmas merchandise; they think that manufacturers will need to clear out goods at lower prices later on. I'm not sure that their bet is quite good on that score since manufacturers' inventories are quite lean. So, it's hard to tell how their strategy will finally come out.

Now, what I've been talking about is really a reflection of attitudes and anecdotal information. The hard data that we get from the July numbers suggest that the District is doing fairly well in comparison to the rest of the country. In the month of July, for example, unemployment fell just a little, which moved the rate a bit closer to the national average. But we did get hard data for August for the state of Florida and that suggested that there is going to be a significant increase in the rate of unemployment for the month of August.

Picking up on what Mike said about the credit crunch, the business contacts that we have are reporting increasingly stringent credit policies at banks. While I'm not in a position to say that good projects are not finding financing, the atmosphere created by the

documentation that is being required is producing a cautionary effect. So, the anecdotal information in the District is quite negative.

As we look at the national economy, our forecast is similar to the one in the Greenbook, although we don't actually show declines in the fourth and first quarters. Our services consumption sector is certainly not strong, but it's not as weak as that shown in the Greenbook and that keeps our GNP from turning negative. Also, our investment spending forecast is not quite as soft. Now, having said that about the Atlanta staff forecast, I want to throw in a caveat and say that I suspect that our forecast is not incorporating the anecdotal evidence that I've talked about but rather is using the hard numbers. So the errors, if any, in our forecast are likely to be on the down side. I think the oil shock came at a time when business confidence was already quite low, and that has caused projects which might have seemed a little doubtful to be put on the shelf. There are pressures on businesses to reduce expenses and that could quickly lead to reductions in both output and employment.

The other issue that is a concern is the weakness in the banking system. Unfortunately, the media attention to this problem is certainly not helping. And it's in the banking sector as well as the real estate sector, Martha. So, I think the financial sector difficulties are probably adding to the tax-like impacts of the oil shock. In these circumstances, it seems to me that one could easily come up with a negative judgment about the national economy. And that is my judgment; I find myself turning quite negative.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, at present it's really not clear what impact the developments in the Middle East are having on the Twelfth District economy. On the one hand, there are anecdotal reports that do suggest a considerably less optimistic attitude by business leaders in the District, and we've also seen some slowing in retail sales. We do a survey of business leaders asking them whether they expect recession in the next 12 months, and in the most recent survey 40 percent of the survey respondents said they do expect a recession. That represents a change from only 4 percent several weeks ago. That to us was a rather significant change. While the attitudes of most of these respondents have changed considerably, when we then asked them whether they actually had made changes in their business plans, we found that a number are taking an increasingly cautious attitude toward investment and operating costs, but the vast majority really have not changed their plans at this point. When we talk to retailers, we find that quite a few have experienced either slower sales or actual decreases in sales of nondurable goods in August and early September. These are not published data; these are just reports from individuals. At the same time, however, the recent published data don't show very much in the way of weakness. Employment, for example, showed some improvement in July and August over what was a bit of a sluggish performance in the second quarter. Employment levels in August were 3.2 percent higher than a year ago. That compares to 1.6 percent for the rest of the nation, so it's a very strong performance.

As for real estate, although this number has a little problem with it, real estate loans--single-family and home equity loans--have

continued to expand at a rate of 22.7 percent in the past year. If you look at the monthly seasonally adjusted increases in the past seven months, they have ranged between 13 percent and 45 percent. I must admit that some of that is due to the bank restructurings, because S&Ls are becoming a less significant factor, particularly in the state of California and also in Arizona. But even stripping that out, there is underlying strength in real estate loans in single-family and home equity loans in the Twelfth District.

If I can turn to the national outlook for the moment, the basic path of the Greenbook forecast certainly seems plausible to us. We expect one or two extremely weak--and I guess they could be negative--quarters. We would say that is primarily resulting from the oil shock. We then would expect that to be followed by a pickup of growth in the first half of next year. I think one of the primary sources of strength is going to be in the net export area, resulting from the 15 percent decline in the trade-weighted value of the dollar in the past year. We also expect, using the Greenbook's assumptions with regard to oil prices later on in the period, that consumer spending should pick up in 1991. Inflation certainly is going to be higher next year--probably somewhat over 5 percent, as indicated in the Greenbook. Inflation will be fueled not only by higher oil prices, but we ought to keep in mind also the impact of the decline in the value of the dollar, and more importantly, underlying wage pressures. The unemployment rate at its current level suggests that, even without the oil shock, the economy would have been straining at its capacity to produce in the months ahead and that that would have been a further impetus to strong underlying price pressures.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. This is obviously a very volatile and highly uncertain period and any economic forecast is going to be subject to an unusual degree of uncertainty. At the same time, I think we have to avoid overemphasizing these uncertainties. To me the main thing that has changed is that we have this oil problem in the Middle East and we don't know how that is going to affect the price of oil. Given the kind of assumptions that the staff has made about what will happen to the price of oil, I believe their forecast is a very plausible one and I think the economic projections make sense. I would guess that the odds of error are about equal in both directions. The key feature of the forecast to me is not so much that a recession is predicted, but that the recession the staff is projecting is relatively shallow and brief. And when you think about recessions that we've had in the past, they have almost always been preceded by some kind of overheating of the economy: inventories have been bloated to some extent, usually inflation has accelerated rapidly, and interest rates generally have risen rapidly. But those conditions really don't exist for the most part today. So again, I think the staff's projection is pretty well on target. I make this point because I think it implies that the policy approach that we take ought to be cautious and measured, like the one that we have been taking in recent years. I don't think there's any cause for panic now even though we obviously need to be alert to what is going to happen in the Middle East.

So far as our District economy is concerned, usually I don't see anything that's all that different, but I come out with a little different view than Bob Forrestal did. I don't think the Beigebook

report reflects conditions as well as what we've heard since then because our most recent anecdotal information suggests that economic activity is still growing for the most part, but at very slow rates. The sharp slowing that we had been reporting early in the year seems to have subsided. The main weak point in our area, as is true I guess in most other places, is certainly commercial building. We have some major problems in the Baltimore-Washington-Norfolk corridor. It looks as if we increasingly will have to deal with the kind of real estate problems that some other parts of the country have been through. Apart from that particular situation, however, I would describe the activity in our area as still growing, but at a very, very modest pace.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Thank you, Mr. Chairman. In a District context, there really is very little recent specific data that will give a meaningful indication as to where the economy is going. Everybody is in a state of suspended animation--waiting to see how some of these major uncertainties will work out. But I agree with Mike that there's a considerable dichotomy between the sentiment out there and the underlying facts. On balance, though, I think the District economy is continuing to show further moderation. We're still doing a bit better than other parts of the country, but I think the growth rate is coming down.

Despite that, I'm quite surprised, really, that some of the basic businesses are better than I might have expected. The steel business, for example, continues to be strong; and as the year has gone forward it really has shown improvement. They started this year expecting shipments of about 80 to 81 million tons; that number has come up and we're close enough to the end of the year that 84 million tons looks like a very safe [bet by the] fourth quarter. Order books are basically full; there are some orders being delayed but no outright cancellations that I'm aware of. Meanwhile, though, those in the steel business are trying to raise prices where they can and when they can, and to some extent the increases are sticking. The construction business in the Midwest has finally hit the air pocket that others have experienced. The August numbers, both residential and nonresidential, showed declines--not perhaps as significant as in other parts of the country--but they were down, and that's the first time we've experienced that. General attitudes of those in the construction business are, understandably, quite pessimistic.

In the auto sector, sales expectations certainly are being reduced. The third-quarter number for cars and light trucks together came in at 14.6 million. The fourth-quarter number is now down to 14.2 million and that brings 1990 down to 14.3 million; there has been a steady erosion as we've gone through the year. For 1991, at least at the company I talk to, they are expecting 14 million at this point; but they have brought that down from 14.3 million the last time I talked to them and from 14.9 million the time before that. So, it clearly has been coming down. In the September numbers that Mike referred to, fleet sales apparently had an impact both on the first, but maybe most particularly, the second 10-day period of September; those sales were moved forward a little earlier than is normally the case to deal with production schedules. The fourth-quarter production schedules for the auto companies are higher than last year, but last

year was a comparatively low period. Clearly, the production risks are on the down side which, of course, is exactly what happened in the third quarter. They had a very big production increase scheduled for the third quarter and they reduced that right through that period. As an aside, the heavy duty truck business has been and continues to be very, very soft. The news out of that area is bad.

The agricultural sector continues to be strong. Another week or so of this good weather and crop production is just going to be excellent. Farm income, despite low commodity prices, is going to be "pretty good," which means really very good. There is some uncertainty and the budget resolution adds to that uncertainty. As a consequence, the agricultural equipment business seems to have plateaued. And as the major manufacturers look forward to next year, they think it's possible that equipment sales have plateaued and that 1991 will not be as good as 1990, and that's the first time in 2-1/2 years that we've had that comparison.

On the price side, I must say as I talk to a lot of people around the District, that they are using opportunities to raise prices where they can. Many of them felt they got burned the last time around on this energy issue and this time rather than waiting and putting through more major increases on an annual basis they are trying to add a little here and a little there whenever they have an opportunity. Whether the competitive conditions are going to permit that remains to be seen.

What to me is the most worrisome is this attitudinal issue. While the current level of activity seems to be pretty good and there is certainly no evidence of accelerating deterioration, most businesses are worried about a recession. And many of the CEOs that I talk to are running their businesses as if we are going to get into a recession. They are looking at their plans for 1991 very carefully. They are trying to curtail capital spending where they can. The risk, of course, is that this could become a self-fulfilling prophecy and we could experience something of a downturn as a result. Therefore, Mike's forecast looks entirely reasonable from our perspective. Because of that and given the budget resolution and the other caveats, with respect to policy I think we need to be alert to the opportunity to respond to potential weakness.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Thank you, Mr. Chairman. As far as the First District goes, the situation is not very ambiguous. Activity has clearly slackened and it is becoming softer--with a lot of variation, of course, sector by sector. In the real estate sector, of course, we are seeing some adjustment in prices. Residential prices on average are down about 15 percent; condominium prices are down 40 to 60 percent depending on where they are; and commercial rental rates are down about 33 percent. Consistent with that, 90 percent of the banking assets in the District are now in institutions that we have rated either currently or prospectively as 3s, 4s, and 5s, and about 55 percent are in institutions that are 4s and 5s. As you talk to people, it is interesting that in many ways it seems that businesses are gloomier the closer they are to the consumer. Sales of white goods and appliances generally are quite poor and are poorer than we expected, even given the housing cycle. Car sales have been bad but

not really awful, with essentially mixed changes as they have been nationally and fewer sales of small trucks. Talking to [retailers in] different types of apparel stores, what we found--and I suppose this isn't unexpected--is that the discounters are doing significantly better than traditional upstairs stores, but even they are finding an enormous amount of price sensitivity. Real specials when they run them--I talked to a representative after they had an extraordinary special--will bring people in, but on a day-to-day basis people won't come in. And, one interesting thing that some of the people who run these discount chains tell me is that they obviously are keeping their inventories very lean, but they have the perception that the people they buy from also are keeping inventories lean and that's one reason they are not expecting a terribly good Christmas season. They think they may not see the surplus of goods coming into them that they have seen in earlier periods. Interestingly--I'm not sure it means an awful lot except noise--consumer confidence bounced up in the region from 28 to 37. [Laughter.]

With our manufacturers, the outlook is somewhat more mixed. Computers are quite weak, even including their export sector; that is a relatively recent change. But I will say--maybe this is consistent with what Mike was talking about regarding expectations on the new IBM systems--that people who produce fabricated metal boxes that the computers go in say that they are doing reasonably well and that they are expecting pretty good orders further down the line. Manufacturers of longer lead time products that utilize manufacturers [unintelligible], such as those who produce power systems and locomotives, are still doing reasonably well.

The credit issue continues to be very, very difficult. There is an enormous amount of nervousness about this and, as other people have said, it's a daily story in the newspapers and on the talk radio shows, which is kind of an ultimate index of these things. Some significant tightening is probably appropriate in home equity line conditions by banks. And we have seen some businesses that really are very substantial in size actually cutting back their capital spending or being more cautious on capital spending because of a concern about how much more debt they want to take on. They are becoming very, very worried just about the environment and the attention that is being paid to different quality paper. In that regard, mutual funds that we talk to are very, very nervous about all types of bank paper and a lot of them have cut back on it. And we're seeing substantial outflows from junk bond funds, which again I suppose is what one might expect.

As far as the national outlook goes, we're pretty much in agreement with the Greenbook, although we have this question of whether we will get as much of a snapback as quickly. But again, I think that is a slightly different perception on the credit side. I would say that with respect to that one issue, which we think might cause some cumulation of this [slowdown], there really is a lot of nervousness about the financial fragility question. Looking at the latest two examination reports on shared national credits and highly leveraged transactions, the increases in classifications in those areas are just very, very substantial. So the concern I would have, even if we get into what should be a relatively mild downturn precipitated by a supply interruption, is that that could cause significant problems for some of these institutions, which will

further tighten the credit situation and may expand a slowdown beyond one induced by a supply constraint.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. As for the District, I would say activity in terms of what we can measure is still slowing; I would guess we're probably bouncing along around zero right now in the District. One relatively bright spot, at least through June 30th, is the banking area. For the first six months of the year, we're showing at small banks in the District return on assets of 1 percent, return on equity of 12 to 12-1/2 percent, and really no significant buildup in nonperforming loans. Now, I don't think that's going to hold up necessarily through the balance of the year, but that sector so far looks pretty decent. In terms of the numbers on the large reporting banks, there's not a lot of credit being extended but my sense is that that's somewhat of a mutual thing. I think there's just a sort of paralysis. Dick, you mentioned this too: I'm not sure borrowers, even if the credit is available, are all that anxious to borrow in this environment.

I had a dramatic example of something we have heard about from a number of people this morning. I was in a couple of areas in our District last week where geographically the economy is really doing quite well, not only statistically but also if you talk to people they say business is going well. But their attitude is much more negative than the reality of what they're dealing with. I think that pervades people's actions in the conduct of day-to-day business.

The other feeling I get is that there's not a lot of sense that monetary policy is somehow at fault. In other words, I'm not getting accosted by people saying: "You guys have really screwed up; you really ought to be doing something differently." I'm just not picking that up. Perhaps the corollary to that is that there is a general malaise out there, a lot of uncertainty, paralysis--however you want to describe it. I'm not sure we have it in our power to snap the economy out of it. And maybe yesterday's stock market reaction--and I realize this is just temporary--gives us some insight into the influence the Middle East situation has on expectations and this malaise that has set in: the slightest whiff of some resolution there really had a very positive, temporary, impact on attitudes.

Turning to the national situation, I personally would not be surprised to see one or two negative quarters, and I wouldn't really have any quibble with what Mike has projected. We look at monetary policy from perhaps a somewhat different perspective than Mike, but I think we're saying essentially the same thing. Our assessment is that the current course of policy is unlikely to exacerbate whatever recessionary pressures exist. I think there is some sense--and I mentioned this a meeting or two ago--that some people might criticize the Fed for being too tight. And yet if you look at the latest three months--whether you look at reserves, the base, narrow money, or broad money--compared to the prior 12 months, there really has been no tightening of monetary policy on that basis. In fact, some of the measures suggest somewhat of an easing. Anyway, my view is that we have built a tremendous [foundation], or whatever you want to call it. We have wrung out a tremendous amount of excess liquidity over the last three years that had been built up from monetary stimulus or

whatever in the mid-1980s. And if we can just come through this next period here with a reasonably good monetary policy still intact-- probably a combination of good luck and good policy--the prospects for making significant progress on inflation down the road are really pretty good, I think.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. For some time I have commented on reasonably good economic conditions in the District and I think by objective measures that is still the case: The economy is continuing to expand at least modestly. Of course, every generalization has holes in it and, as Si Keehn reported, farm implement sales clearly have leveled off--and they had been quite strong in the spring in our District. Agricultural conditions in general are very good, but there are remaining pockets of drought, so there obviously are ongoing problems in those areas. The construction sector has weakened in some locations. Having said that, and having reported that I think by objective measures the District economy is expanding, like a lot of other people who have commented I think what has changed recently are attitudes, which clearly have deteriorated significantly. There's a good deal of concern out there; we're even picking up some questions about the status of the large money center banks, which is a topic that doesn't come up very often in our District. But there is some concern about that. Attitudes clearly have worsened as a generalization, but there are exceptions. I happened to be in a meeting with the treasurers of many of the corporations based in the Twin Cities and they almost universally reported business as strong. Now, these companies tend to have very large international exposure, not just selling abroad but operating abroad. So, they're not saying the U.S. economy is strong per se. But they are reporting that business for the most part is strong. There were a couple of exceptions; but in general I was surprised by the tenor of their remarks and the comfort they seem to have, at least looking at their businesses worldwide.

In regard to the national economic outlook, I don't disagree much with the Greenbook forecast. Our own model has us avoiding a recession, although we have a continuation of three or four more quarters of very slightly positive real growth. But we can also calculate probabilities of recession with the model, and clearly the probabilities have gone up relative to those calculated prior to the previous FOMC meeting. I think that's just a statement of how the risks have shifted; that clearly argues that there are greater downside risks for the real economy. Unfortunately, the inflation numbers, as Mike commented, also have been disappointing irrespective of food and energy prices. And our model doesn't provide much comfort on the longer-term inflation outlook either. So, I see risks sitting out there in both directions. It's not a pleasant outlook to contemplate, obviously.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, the economy in the Dallas District seems to reflect many of the national trends, but overall we may be doing just slightly better than the nation now. The picture is quite mixed, however, and virtually all segments of the region's economy are growing more slowly than earlier in the year. The higher energy

prices help fewer people and hurt more people in our District than was the case years ago. So, the net impact is less certain. Residential construction activity has shown a modest pickup from the extremely depressed levels of the last several years, but nonresidential construction is flatter now, with the exception of the Houston area. Retail sales have shown some very slim gains in recent months. The refining petro-chemical business has held up relatively well lately. Other areas of manufacturing have been somewhat weak. We did meet with our advisory council on small business and agriculture a few weeks ago. Our agricultural conditions seem to have improved, certainly in recent weeks. Outside of the issue of credit availability, which incidentally is not a new issue with us, the economy may be doing considerably better than it had been over the past several years of meeting with that group.

Looking at the national economy, I have no real disagreement with the staff's Greenbook forecast. Intuitively, I wonder if the third quarter will be quite as strong as they're indicating, but I would not have a great quarrel with it. We don't see any evidence that we're heading into a cumulative downturn. As a matter of fact, as I look at Mike's forecast and think about that outcome, it would not be a bad result, if it could actually be accomplished. It seems to me that the assumption is that a steady monetary policy would accomplish that result. So, in spite of all the uncertainties and concerns, I would tend to pay a bit more attention to the inflation picture rather than [to the possibility of] the economy slipping over too far.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The District economic indicators are generally weak and, as elsewhere, business and consumer confidence is low and I think deteriorating. Employment is falling in the District; manufacturing is slumping; construction is off; retail sales fell in August and the first part of September; and bank lending is declining. And at the anecdotal level, there is more concern on the part of the ordinary public and the business community about the soundness of banks. It's hard to measure, but I think it's there and I think it's growing. I'm also hearing anecdotal evidence about the slowing payments of accounts receivables. Again, it's hard to measure, but they seem to have slowed a good bit. One businessman told me at a meeting that he doesn't even hear "the check is in the mail" anymore; people just say that the money isn't coming, which I think is a major change.

At the national level, I think the risks are on the down side. My hunch is that we're facing a recession that will be more pronounced than contemplated in the Greenbook. I think business and consumer confidence are likely to get worse and the stresses and the cracks in the financial system are likely to weigh more substantially on aggregate demand during the coming months than is built into the forecast.

We talk about a cumulative downturn and we say we don't see the evidence for a cumulative downturn. I think we're probably looking for the kind of evidence that was typical of recessions that we had when the economy was more dominated by manufacturing. We tend to look at sales and orders and inventories and that sort of thing. We have a different kind of economy and I think the cumulative

downturn may have a different kind of anatomy this time. We had a demand side softening of the economy coming into the summer. The economy had slowed a good bit. Then on top of that we had the supply shock, which has caused it to slow more. Now we have the financial fragilities. And it seems to me that that's the cumulative set of forces that will take us into a recession rather than having business people misjudging sales, seeing their inventories build up, and then cutting back on their orders. I think we're in a different kind of economy. It's important for us to resist inflation in this kind of environment and to reduce inflation over time; but it's also important to buy some insurance against too deep a slump in economic activity where we would then find ourselves in a situation--if the economy starts to get away from us--in which we're forced to ease too rapidly in a very short period of time. I think we've bought a lot of credibility in recent years by trying to stay ahead of the economic curve, and I think we should continue that approach to policy even in the face of the uncertainties that we're experiencing at the moment.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. In terms of the national economy first, I think the forecast that Mike and his colleagues have put on the table is as good a forecast as you're going to get right now. Our own bank forecast is very similar in all of its major elements to Mike's forecast. But having said that, I think the point Mike made at the outset and that several others have made is very important: There really is a sharp dichotomy between attitudes and expectations versus what we see in the economic statistics and what those hard economic statistics would suggest in terms of a forecast. And I think there is a danger in that environment of the classic self-fulfilling prophecy.

There have been several comments made about the financial fragility aspects of that. Let me just add a couple of insights in that area. First of all, part of what we're seeing in banking, broadly defined, is also being seen in other countries. There is a similar situation at least in many respects in Japan and, while it's not widely talked about, there are symptoms of the same kind of conditions beginning to develop even in the London clearing banks because of asset quality problems and overextension of real estate loans and so on. So, while the problem to date has received a lot more attention in the United States, it is not one that is in all of its dimensions unique to the United States. It has secular elements to it, especially in this country, in terms of even greater questions in the marketplace as to how these institutions are going to generate the earnings that they need not only to raise capital but also to maintain reasonable rates of return for shareholders. But right now there clearly is a very, very pronounced cyclical element surrounding this issue of credit quality concerns.

Looking at that from the vantage point of the major money center banks, there are three areas: the LDC loans, the HLT loans, and the real estate loans. Right now what we see is a clustering of weighted classified asset ratios in the money center banks in New York. For the institutions that have been the subject of a lot of this recent attention, those weighted classified asset ratios are now in the range of below 20 percent, which is not great but certainly should be manageable. I would say right now that by far the greatest risk of further deterioration in asset quality is in the real estate

area. The LDC situation, if anything, is better, especially after all the chargeoffs that were taken for Argentina. The exposures in that area essentially now are in four big countries: Mexico, Venezuela, Brazil, and Argentina--not that the others are totally insignificant; but of those countries two are in pretty good shape. The HLT situation, while laden with uncertainties, again I would judge as manageable. But the big, big question is on the real estate side. Even if, as I think, the situation right now is better than a lot of the market scuttlebutt would have it, it's certainly not as good as we'd like to see it. And it's very important to recognize that if you just take those seven institutions, you're talking about banking assets of about \$700 billion, which is something like a quarter or a third of domestic banking assets. And with only one or maybe two exceptions, for the foreseeable future the growth in assets in these institutions is going to be very, very restrained because of capital considerations, leaving aside whatever judgments one might want to make about credit screening and those types of things. I think it's also important to keep in mind that the foreign banks, especially Japanese banks, that have been a very important source of the net growth of credit in the United States are not going to be a source of that kind of growth in the future, at least in the foreseeable future. Again, I'm leaving aside what we mean when we talk about credit crunches. I think we have a situation in which a very large number of institutions, both foreign and domestic, are simply not in a position to be doing a lot of lending because of de facto constraints, and appropriate constraints, coming from the capital side. But at the moment my assessment still would be that the situation, while not pretty, is certainly not as difficult as some of these reports would indicate.

I should also say in the area of financial fragility that while the spotlight at the moment is on the banks, it should also be kept in mind that the securities houses and the insurance companies are by no means exempt from these problems. Indeed, I would stipulate that some of the potential sources of vulnerability in the securities industry could be even more acute than some of the ones in banking, even though that is not a subject of great conversation at the moment.

Against that backdrop, a question that keeps running through my mind is: Why are attitudes so sour? Now, presumably everybody is looking at the same numbers that we're looking at. What is it that has produced this very, very substantial deterioration in attitudes and expectations? It seems to me that there are at least three or four factors at work here. One is that I do detect, even among the most aggressive businessmen, a recognition now that inflation has proven to be much more stubborn than we expected and than they expected. There was a time when we talked about inflation that a lot of people would say to us "You're fighting the last war." They don't say that anymore. I think there is a recognition that the core inflation rate has not gone down and probably has crept up. So, that's a factor. I think the budget process, leaving aside what you think are the results in terms of numbers, has taken a major toll in terms of expectations or attitudes. On Wall Street and on Main Street that has been viewed as a farce and I think in its own way has clearly undercut attitudes and expectations. Again, no matter what you think of the program itself, which I actually think is pretty decent, we're still staring at this incredibly massive deficit for next year. You can dress it up any way you want, but I think that number has been a

shock to people as well. The third factor that I think is very, very important in terms of this souring of attitudes and expectations has been a decline in asset values. For the typical household it really has struck right in the breadbasket because between stocks and houses there has been a very sharp psychological adjustment if not a real adjustment. One of the things that sharply distinguishes this period from other periods that we've gone through in the past is the fact that asset values at the level of both the household and the corporate sector are declining in many cases. Some of that, of course, especially in real estate, is a result of the excesses that went before. Nevertheless, it is there.

I also think that there are renewed and heightened concerns, even among people who don't normally think about this question, about the reliability of our external sources of finance. All these news reports about the Japanese pulling back and other things are catching the attention of people who normally don't even give those types of issues a second thought. In a way, Sam's earlier comments about the exchange rate are a manifestation of that. So, you take all of that and superimpose the Middle East on top of it and the conclusion I come to is that we shouldn't be terribly surprised that expectations and attitudes are as sour as they are. When you put it all together, it seems to me that what we have right now that is different from most of our earlier experience is either the reality or the danger of a significant element of illiquidity and/or credit rationing beginning to manifest itself in asset markets, especially real estate. And that does seem to me to carry with it some dangers that are quite different from some of the things that we've had to deal with in the past. Indeed, I would be concerned that any further or more widespread illiquidity, again especially in real estate markets, could very well be the thing that tips some of these expectational factors into more underlying behavioral factors.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. With respect to the District itself, the economy continues to grow moderately and there are mixed results in individual industries or economic areas of activity. In the energy sector, for example, the higher oil prices have pushed up the rig count modestly. For example, in August the count was 282 in the District and in September 301. However, that followed a drop in the rig count from July to August. But it has come back and, as has been stated around this table before, the question is whether or not there is enough equipment and skilled labor to meet the demand. The last and important part of that equation is whether or not there are enough lenders out there willing to finance oil speculation exploration. Having been burned in past years, I'm not sure that that kind of financing will come from District banks. Whether it will come from Boston's probably is not very clear either!

With regard to the agricultural sector, farmers have put in the bin the largest wheat crop since 1982. The corn and soybean crop look very good, with some concern about the bean crop being nipped with a little early frost. But with regard to the wheat crop, given the lack of exports to Iraq that has already been mentioned and the projection of restricted or lower levels of exports to the Soviet Union, the reaction in the market is simply to [unintelligible] the big harvest. The lower exports and less demand clearly have dropped

the price of those commodities substantially. In the livestock industry, on the other hand, both hogs and cattle are going great guns, particularly with the prospect for cheaper feed in the future.

As for automobile assembly activity in the District, auto makers continue to shut lines down or to shut down entire assembly factories. For example, in Oklahoma City a plant will go down a full week in October and in Kansas City a Ford plant will shut down a week or two weeks, depending upon their order levels. As a result, it's off and on. There isn't much lost income when those auto workers are not working, however, because of the arrangements under the auto contracts. So, it's really not a matter of cutting their purchasing power but rather a question of how much they're actually working and what kind of orders they're getting for particular automobiles or trucks. On the other hand, in the aircraft industry, which was mentioned this morning by Mike--and Wichita is a big player in this--the billings for 1990 and 1991 are projected to be about 30 percent higher than last year, year-over-year. So, that industry is still clicking along very well. With regard to construction, activity is up rather significantly over year-ago levels: about 30 percent in nonresidential and 5 to 7 percent in residential.

So all in all, the District, although not booming by any stretch of the imagination, is doing as well as or better than the nation. And that is important with regard to the outlook in the sense that a lot of people I talk to say "Well, we're doing pretty well, but I think we're in a recession." When you press them on why they believe we're in a recession they say they watch the news or read the newspapers and given what's happening in the Middle East they simply think that times are [not] as good as they otherwise would have been. But there's no real evidence that we're in a recession.

With regard to the national economy, we go through the same exercise that the staff here does with regard to projections and with basically the same assumptions. One thing we did not build in this month was the fiscal restraint that would take place with regard to a \$35 billion budget agreement. Even with that, we're a little less optimistic than the staff in the sense that we would project an additional quarter of flat growth--not negative, not positive, but flat--in the second quarter of 1991. Otherwise, it looks very similar. But given the uncertainties that are out there, I don't think one can put a lot of faith in the long-run projection. There are too many uncertainties. As a result, it seems to me we probably should be doing nothing.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. First on the national outlook, I don't have a lot of problem with Mike's forecast. But there is a very large error band around forecasts, and as the Chairman indicated last week to the business economists, that error band is increasing, not getting smaller, certainly relative to 20 years ago. That error band is a couple of percentage points either way. So, I'm not so worried about the forecast as I am about our perceived response to it. As several people already mentioned, we had an oil price shock; that was a real shock. There's not much we can do to increase output because of that. We have had a wealth loss and I don't think that calls for much of a response by us. Some of the other concerns, of course, relate to our

ability to fine tune in some sense. I don't think we have a very good record on being able to pick out when the appropriate time is to increase the rate of growth in money and when the appropriate time is to shut it down. Nor do I think the evidence from the academic community, at least as they judge policy in terms of the importance of expectations, supports our doing anything other than providing a stable monetary policy. I would judge stability by the rates of growth in M2, and we've had a pretty stable rate of growth for three years as Tom Melzer mentioned. And with Don's numbers--they are coming up--it looks like we're going to be fairly close to that number of the last three years. So, I think the problem now is not making an error to signal the markets, essentially the currency and bond markets, that we're running a risk of making some of the mistakes that we did in the past--that is overdoing it in the face of a potential recession. So, I think we need to find some way to [provide] some certainty or at least not increase the instability about the future. I suppose one could make an argument for tightening policy as a way to send a signal. I'll save that for later.

Let me talk about the District. The Fourth District is doing generally better than the nation, but not a lot better. As just one example, our employment in manufacturing in the last year has been flat while the nation's has declined about 2 percent. Our unemployment rates, after tilting up in the second quarter in Ohio and Pennsylvania, now are back at 5.3 and 4.8 percent respectively. So, the level of activity is holding up pretty well. Capital goods producers, which we have a [unintelligible], are still filling their order books, but they are less optimistic. One turnaround has been in heavy duty truck activity; the orders there are starting to revive. Also, the export side, which has been a strength for us, still seems to be strong but we're beginning to get some signs of a softening there. We recently talked to an economist at one particular construction machinery company who indicated that they had experienced a very sharp falloff [in demand] for construction machinery worldwide starting in August. So, there are some signs that the economy has softened, but as far as the numbers go, in general the Fourth District seems to be holding up okay.

In terms of attitudes, they are very similar to what people have indicated around the table. I went through the District last week on a bunch of road trips and when I talked to individuals they always seemed to have a good reason why their business was doing okay. Everyone had his or her own peculiar reason--we just got lucky or we got this order that will take us out through the second quarter of next year. But there is this pervasive view of impending disaster out there. I think there is some tightening in terms of cost control within the larger firms because of that, even though their order books haven't shifted much. Overall, I don't think the District has changed much other than in terms of the attitudinal caution because of the oil price shock.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I have just a couple of comments about two industries I've been following closely in the last several months. One is autos. Quite a bit has been made of the fact that deliveries in August and September have looked pretty healthy, and that has been used as an indicator of consumer spending not falling into a sewer

someplace. What I picked up from some analysts within the industry were two things: (1) that the seasonals are atrocious because the auto industry no longer has the regular seasonal swings that it used to, so that applying the seasonal factors that we do doesn't make a lot of sense; and (2) that the auto sales and these deliveries statistics really were distorted this time. Si alluded to it, but didn't expand on it. They were distorted by fleet deliveries, but these are fleet sales that are controlled by the auto companies themselves, primarily to car rental agencies. All of the Big Three own car rental agencies and they use deliveries to them to sort of cook the books, if you want to say that. They can more or less determine what kind of sales statistics they want to report by getting either more orders placed or fewer orders placed for their car rental subs. And there was an exceptional amount of that done in September for a couple of big reasons. One is that they simply didn't have enough orders coming from the traditional sources--purchases by folks like you and me--to get their assembly plants cranked up. They needed to get more strength in orders, so they chose to provide it in that way. Also, there is this continued push in the industry for market penetration. There's a real horse race out there. It's as if nobody wants to blink and no one wants to cut back and run the risk of cutting their market share statistics still more. So, they are really trying to hold their production up. Then there are the rating agencies--Moody's and Standard and Poors--and those folks are really checking carefully on the Big Three these days with threats of downgrading their debt obligations. Apparently important factors considered are production and market share as an indication of future viability. So, that's another factor entering in. Anyway, I was warned by two different people that these statistics should not be taken at face value at all. Also, I got an interesting statistic on showroom traffic, which would be the kind the consumer would usually think of; it has dropped substantially to about 15 percent below a year ago. And what they call the closure rate, or the number of deals that are actually closed as a percentage of the individuals they deal with, has dropped by 20 percent just in August. It was pointed out to me too that inventories are building and that the auto inventories themselves are probably about 4 days above normal and that truck inventories are getting up to about 20 days more than the dealers would like to have.

Another industry that I was probing Mike on is homebuilding, because I've been talking to a lot of homebuilders in the last couple of months, and there really is a problem out there. The financing situation is getting more and more attention; it started out as an S&L problem in the form of limits on loans to a single borrower but now it has spread way beyond that. We are hearing of more and more homebuilders failing and closing their businesses or liquidating, etc. Small business groups in general, I think, are showing a lot of nervousness. They seem very negative. Retailers who are in the small business category seem to be very cautious about their Christmas orders. Again, as Bob Boykin said, small businesses always have gripes about getting credit, but I've never heard them as loud as they are this time because now they're talking about having had credit but then the lines were cut. So, this is a little different from lack of availability initially. And these credit availability problems are way beyond small business. Again, we're hearing it from businesses of all sizes and in many different industries.

So, I wouldn't be surprised to see the couple of negative quarters that are shown in the Greenbook. I guess what I would be surprised to see is the kind of snapback next year that the staff is assuming. I'd like to see it but, frankly, I doubt that it will happen.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, let me focus for just a moment on the budget deal that was struck this past weekend. It seems to me that the basic dilemma we have been struggling with for months now has been intensifying recently; even before the oil shock, the economy was having some problems. We have a perception that we are going to weaken substantially, largely driven by the oil situation. But even before that I was disappointed in the level of economic activity--in the second quarter, for instance. In the case of the financial system, we know there is a lot of pressure there and a great deal of credit stringency in the banking system that is playing back into the real economy. Taken by themselves, these kinds of factors would push one in the direction of easing. On the other hand, the inflation situation seems to look worse, again driven by the oil situation. But even before that occurred there was precious little progress being made; maybe there was some deterioration. So, there's a concern that [higher prices] are becoming embedded, which would lead one in the direction of firming.

So, what we needed was a way to break out of the impasse. And we now have a fiscal deal. I imagine everybody would define the ideal fiscal deal differently, but this one I'm sure is not it. I would hope that it's a new genre in the shabby history of budget deals; I would hope that this one is going to turn out to be firmer and to have less smoke and mirrors in it than those we've had in the past. We don't know that much about it yet, but it looks that way. I've been trying to find more reports on the teeth that may be in the enforcement part of this and I haven't found very much yet. But there is some evidence that there are teeth in it and that's encouraging. It is a multiyear commitment, which I think we all felt was very important. And I think it has a good configuration to it: it's about the right size early on and then grows as it goes down the line. Could it be another snow job? Oh, sure it could! We could turn out to be as disappointed as we've been in the past. But if it works, I don't think it needs to be all that it is cracked up to be in order for it to do a lot for us. It could go far toward restoring our fiscal health; it could help the saving rate a lot. It would by definition, I guess, help the saving rate a lot. It should help investment a lot, which I think is the absolute key to the future of this country's economy. In the area of reducing inflation, it would seem to me that there is the possibility of more progress available here than in anything that we could do at this point through monetary policy by cooling excess demand and providing relative strength to the dollar. In general, we've all been talking about the malaise in attitude that we have around the country and I think it could go a long way to [reversing] that. Again, I don't think it has to be as good as it's touted to be in order to be highly beneficial. If it's not passed, we're quite likely to be due for a very painful trip through the wringer. If that should occur, I think the Fed is probably just going to have to look to the long-term best interests of the country and kind of let the short term fall out as it may. But if

it's passed, it can only help--and perhaps can help a great deal. The question is: How much? Keeping in mind the fact that we're still going to have very large deficits to be dealt with for the next couple of years at the minimum, I think that if it's passed, we should be looking for appropriate ways to support it.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. I generally agree with the staff's forecast. I think we're facing a stalled out economy that is likely to dip for a quarter or two into negative territory. I'm a little less optimistic, as a number of people are, on the [prospects for a] consumer-led pickup in 1991. First, that assumes oil prices are going down as the major impetus; we'll see what happens there. I also worry more about further erosion of consumer confidence, given the fragility of the banking system, new taxes both on the [state] and federal levels, continued real estate value problems, and also just the experience of a recession. People haven't seen one in 8 years and many of them were not adults at that time. I also would sign on to what most people have said about attitudes. I would just make one additional point. President Corrigan mentioned asset values falling. I think we also have to take into account the fact that debt ratios of individuals and firms are relatively high. And with the economy slowing, a lot of them are facing the prospect of servicing debt. Before, there was an easy way out: you could sell the house at a higher price or you could split up the firm and sell [parts of] it off. I think it's not a cheery prospect facing those constraints and living with them; there is some sense that the good times are gone in a lot of markets.

I'm also a little less optimistic on the export side, due primarily to concern about the growth of foreign economies. It seems to me that when you see the stock index in Japan go from 39,000 to 22,000 that is not bullish. Germany also has had a reduction of 30 percent in stock prices pretty recently. I'm concerned about the oil impact in eastern Europe. Obviously, Canada and the United Kingdom are not in great shape, but the dollar should help. I would just perhaps be a little less optimistic overall on the pickup. We also don't see the momentum to a downturn; we don't see a free fall. I think Ed is exactly right: the world has changed in some sense, and maybe we will not see the typical inventory cycles of the past. Instead of seeing a momentum to the downturn, we have seen a ratcheting down, it seems to me. We had a near-term growth path of 1 to 1-1/2 percent and it was disrupted by the oil price shock.

I also agree with Mike Kelley on the budget deal. I think it is contractionary. While it is an embarrassing spectacle to see one of these made like sausages into law--and this one isn't law yet either--it does have some real taxes and some real cuts in it. Mike Kelley mentioned the enforcement agreements. What they have in this in effect are little decentralized Gramm-Rudman sequester constraints by categories of spending: defense, domestic spending, and the like. And if more is spent than the budget allows on those categories, in 15 days you go into a sequester. And by the way, those detailed Gramm-Rudman constraints last for a couple of years and then go back to more macro constraints. And on entitlements and revenue bills there is a constraint that they must be pay-as-you-go or there is sequestration. So, I am encouraged by the discipline they have tried to build in; even the rough discipline of Gramm-Rudman, I think, has been

beneficial. I wonder if we would have had even this without that. By the way, I think the markets responded positively to the budget deal, although they were lucky to have a day in which oil prices came down! [Laughter.]

On the inflation side, I agree that no real progress is apparent. I continue to believe that the right approach is a stable monetary policy and I think we should see slack opening up. I think that's essentially what we should do; about all we can do is to maintain a moderately restrictive stance. I also continue to think that we're not in the 1970s scenario and that if we do [maintain that stance] there is little realistic danger that the oil price shock will get generalized into inflationary expectations, especially given the state of the economy.

My real concern continues to be the credit markets. It's not at all clear to me that we are maintaining a constant stance. It seems to me that with the slower projected growth in economic activity and constant short rates, it's hard to avoid a conclusion that monetary conditions may have tightened. The budget deal at the margin is more contractionary than we projected in the Greenbook. And even though a couple of people have mentioned that the monetary aggregates are back on their growth paths, that's due almost exclusively to the growth in two components--currency and money market funds. The core components of money continue to creep along and that has been going on for seven months. From the beginning of 1990 through the third quarter, savings deposits have grown at $3/4$ of a percent annually; small time deposits have grown at $3/4$ percent; large time deposits have contracted by 8 percent; other checkable deposits have contracted by $1/2$ of a percent; money market deposit accounts have grown at $4-1/4$ percent, but that growth was mainly in February and March; and demand deposits have rebounded $2-1/2$ percent. So, the reason M2 and M3 are back on track is because of the rapid growth in currency--much of it for export, which I think is not much related to economic activity--and money market funds. Money market funds this year have grown at 12 and 22 percent for the two categories. Again, I think the increase in money market funds is not responding to increased economic activity nor is it likely to engender greater growth. It's responding to problems in the stock market. At the margin it does increase credit, but it increases credit to a specific segment of the economy: investment-grade institutions, and the Treasury and commercial paper markets. Indeed, the SEC has a rule out, as you may know, to restrict investment of money funds in below A1/T1 paper. Now, to be honest about it, it's really not fair to cut out a couple of categories. But it does seem to me that when you look at the recent reaction of money market funds--and we can understand what's going on in currency and the consistency of all the other core money categories and the persistence of this very slow growth at well below our lower range--that there is a concern that money is growing more slowly than we projected and endorsed.

The final point I would make in this vein, which has been made by a number of other people, is something new in the condition of the banking system. There have been well publicized concerns about the FDIC fund, which is projected to be \$10 billion at the end of the year and then perhaps go into single digits. Insurance fees on banks have increased from 8 basis points to $19-1/2$ basis points in a little

over a year and the prospect is that they will go higher as will the capital ratio.

CHAIRMAN GREENSPAN. It's 23 basis points in the budget--

MR. MULLINS. It's 23 basis points in the budget deal, which brings in \$4 billion over 5 years. This is not what we talked about earlier in the summer; it's not [the limits on] loans to one borrower; it's not examiners' zeal. It is a lot of big losses in a lot of institutions. Commercial real estate problems are evident throughout the banking system. Community banks, small regionals, large regionals and money center banks all have significant investments in commercial real estate. I think we will have several more quarters of bad news while the accounting reality catches up with these institutions. More generally, I think we're in for a protracted period of retrenchment in the banking industry both to deal with the asset quality problems to build capital, as Jerry mentioned, and also to figure out how to be profitable in the new world. I think all this has translated into higher funding costs for banks, lower stock prices, and bank debt yields at junk bond levels. And it seems to me inescapable that these sorts of pressures in the banking industry have shrunk or restricted credit. Specifically, I would be concerned that they have limited credit to a very large portion of the economy, those small businesses and large businesses that are not investment grade. I'm less concerned about the investment grade institutions; they have the public market to go to. It's difficult to make a case that the rest of the economy has an easily accessible alternative source of funds. I look at insurance companies; they're not doing so well. One can see some of the impact on finance companies. But if we do have this contraction in the banking industry, it certainly has to have tightened conditions for a major portion of the industry.

So, I think we're currently facing a stalled out economy, which is projected to dip into negative territory. What concerns me on top of that is the increasingly tight credit market conditions. With the lags in the process, I think we do have a risk of turning a mild downturn into a fairly ugly situation. I agree with Dick Syron that herein lies the potential for a cumulative deterioration. I'm more concerned about this problem this time than last time--first because the economy has weakened; secondly, because the core components of money don't seem to be picking up; and finally, and most importantly, because the pressure on the banking industry seems to have tightened and the tourniquet has been turned an extra notch. I would still believe in a stable policy. I'm just concerned that what we are getting is one which is more constrained than what we projected, endorsed, and would like.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I won't presume on the Committee to try to restate or recite all of my views at this point. You have all heard my concerns about the fragility of the financial system. Perhaps I can shorten my remarks by simply associating myself strongly with both Ed Boehne's statement and Jerry Corrigan's statement. In addition, I think that the banks are really scared and have become super cautious. I think bankers are demoralized. I've been talking to a lot of bankers in all parts of the country over the last several weeks and I have never seen them [exhibit] a lower sense of optimism and

bewilderment as to where to go from here. And that will make the credit crunch worse in the future than it is at present, particularly if there are signs that the economy actually is going into a period of recession. Perhaps under those conditions, the momentum in a downturn might be very surprising and might cause the recession to last longer and go deeper.

I have to say that, being a cynic, I believe that the budget deal is a sham and a delusion. If you had walked across the Sahara Desert without a canteen, you would think the water in Boston Harbor was [potable]. [Laughter.] And yet, in thinking or contemplating any move toward ease as a result of the perceived window that we have here because the markets have reacted favorably to this budget agreement, I worry about the dollar because we have an environment of rising interest rates elsewhere in the world against the contrast of perhaps lower rates here and a softer economy, which is less inviting to investors. Yet I think a case might be made that perhaps at least some modest move toward ease has already been discounted in the exchange value of the dollar. So, I'm concerned that perhaps this is the time to make a very slight move toward a bit more accommodation.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. There really has not been any money shock that has synchronized all the sectors of the economy and there is no inventory correction cycle underway. This is not a recession as generally defined. Never before have we had a recession in which monetary policy eased 12 months prior to what somebody says was the likely high point. I don't agree that June was, but somebody thinks it was. It clearly is a synchronized slowdown in the U.S. economy, but it is more in the nature of an event related to buildings and real estate and, consequently, banks and thrifts. We have to be careful if we really want to be forward looking, not to look backward at the real economy. If you are trying to be forward-looking, that's always a disaster; you can't get ahead by looking backward.

Now, I think there are some considerable risks, but those risks are in the years out ahead, not in the 6 months ahead of us. The considerable risk is that we will go through this slowdown event and end up with inflation at a rate of 6 or 7 percent and end up with a set of easings that tips the dollar loose. I do agree with the analysis of Sam Cross that there still is a safe-haven effect on the dollar. The considerable risk is that we will throw the monetary policy tool away before we have the ability to use it. I would not enjoy being in a situation of a declining dollar with all that means for future inflation. That could then mean that inflation doesn't peak in the third and fourth quarters of 1990; the peak might be out there further ahead. So, it seems to me that the exchange value of the dollar is a real restraint on us, but I don't see any reason to admit that to anyone outside this room. But I would hate to see us get into a position where we no longer have any potential to do it because we have a spread of 300 or 400 basis points between the Treasury bill rate and the 30-year Treasury. It seems to me that under those circumstances then, the fears that people have about downward risks certainly would be justified. So, I think there is considerable risk. I do believe the U.S. economy has a lot of recuperative ability. [Unintelligible]--and I'm not able to tell as well as David is how each of the parts go--but if monetary policy is

reasonably steady and stable, then I think the adjustment mechanisms can take place and can take place in an environment in which we get some of these corrections made. I must admit that when I first came on board I was pleased that we had engaged in monetary policy actions that I think avoided a recession in 1986. But looking back on it, I have a feeling that what has happened in Boston and in New England and elsewhere would not have been carried to such excesses, if we had let a correction take place a little earlier. So, I'm just urging caution.

CHAIRMAN GREENSPAN. We're running late, as I'm sure you're all aware, so we do have coffee out there which I hope is not too chilled. And lunch is not that far away. So, let's make the coffee break a bit shorter than usual and then reconvene.

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

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

CHAIRMAN GREENSPAN. Questions for Mr. Kohn?

MR. HOSKINS. Back to David's comments about the components of the aggregates: Instead of looking into that aspect, let's look at [velocity]. You put a memo out in June, I think, saying that there might have been a shift in M2 velocity. If that were the case, isn't the [recent] resumption of growth inconsistent with that? Wouldn't you expect lower growth rates?

MR. KOHN. Well, I think we're still seeing that velocity shift. That is, if you look at the resumption of growth that we've had on a quarterly average basis, we're still seeing in the third quarter a quarterly average growth of only 3 percent even with the last two months being strong. And that's about 2-1/2 percentage points less than the model was predicting for the nominal GNP we think we have gotten. We have growth in the fourth quarter projected at about 4-3/4 percent on a quarterly average basis; it's 4 percent month-over-month. And even that, I think, is close to 2 points less than the model predicted. So, yes, there has been some pickup in M2 growth, but certainly if it slows down to the 4 percent pace, that's still consistent with the velocity shifts we thought we were getting before. We have about 4-1/2 percent for the year and that's a 1-1/2 percent shift over the year, which is not completely out of line with past history though on the outer edge of it. So, I don't think the pattern really contradicts what we were talking about at midyear; it may be a little stronger, probably impelled by these uncertainty factors. I think the underlying shifts are still there. Governor Mullins remarked about the deposit components still being weak, and that was part of the picture. [Banks] didn't need to make loans; they didn't need deposits; they weren't going to compete for funds and I think that's still true.

MR. PARRY. Don, the three alternatives you talked about are different from what was in the Bluebook, right?

MR. KOHN. Slightly, in the sense that as I thought about the sort of--

MR. PARRY. Is there no analytic support at all--something that might suggest that the inflation problem is severe and should be dealt with?

MR. KOHN. For the tightening alternative, "C"?

MR. PARRY. Yes.

MR. KOHN. I think there is some support for it. If you thought it was sufficiently severe, my feeling was--I think I used the word "practical" as I presented these--

MR. PARRY. That doesn't sound very economic.

MR. KOHN. Under the circumstances of a tightening fiscal policy and widely expressed concerns about credit conditions, my feeling was that an alternative C was in the Bluebook but I didn't see expending a lot of the Committee's time on it so close to lunch.

MR. BLACK. You took time to add an "A+" though.

MR. KOHN. No, the easiest alternative I had was exactly the same as this--an "A minus/B".

SPEAKER(?). That's right.

MR. FORRESTAL. Don, you may have said this, but I missed it if you did. If we did alternative A in one step, 50 basis points, what do you think would happen to long-term rates?

MR. KOHN. I think they'd go down. Peter, I think, may disagree. The market is not expecting that, but in a situation in which the economy is seen to be very weak and fiscal policy is moving toward restraint, whether it's enough or not, I think long-term rates would go down. They wouldn't go down by anywhere near the 50 basis points, though. It would be a restrained reaction. And if the dollar fell and if the incoming data in the subsequent couple of months didn't confirm the economic weakness [unintelligible], then bond rates would end up two months from now higher than they are right now.

SPEAKER(?). Absolutely.

MR. STERN. I'd like to follow up on Lee's question. In the M2 forecast for the fourth quarter, have you included anything for this flight to liquidity? Or is it based pretty much on the way you think velocity is deviating from--

MR. KOHN. We have a little, but slowing down. This is not a war forecast or something like that. We have conditions settling down somewhat, but still we have allowed a little for the flight to liquidity. Though we still have this velocity shift going on, it's not as much as we had in the third quarter; we have much less in the fourth quarter in a settling down kind of process.

MR. SYRON. Ted, can I ask you--this is slightly different than what you assumed--what your view is on the pressure on the dollar under "A" and then "A prime," if we part with the assumption that something is done on the budget deficit?

MR. TRUMAN. Which one is which?

MR. SYRON. "A" is the traditional "A". "A prime" is "A minus/B," I guess.

MR. TRUMAN. Well, I think you would get a reaction with "A," quite pronounced, if you get it all done at once. With the two-step process the way Don described, you might get a reaction with the second step, depending on what the circumstances were at that time. As Sam said earlier and Don suggested, I think there is something built into the market at this time. Sam, you may want to comment again in light of what has been said. We probably would get some adjustment. In some sense there was an adjustment yesterday, essentially anticipatory. The exchange market came back a little today; I think the adjustment may have been overdone.

MR. CROSS. Certainly, you'd likely get a reaction if there were the larger move. On the more moderate one, I think the markets are expecting it but there might still be a reaction, even though they are expecting it and have built it into their thinking, on the grounds that it would sort of confirm it. Basically, I think the general attitude toward the dollar is negative and that kind of easing would tend to confirm that the Committee may be going in that direction. So, you could get a reaction even on the smaller move.

MR. SYRON. Could I ask your degree of nervousness about a cumulative decline on either of these things?

MR. TRUMAN. Falling out of bed?

MR. CROSS. There certainly is that possibility. And if it happens this quickly and spreads through all the other markets and has all these effects on interest rates and the stock market and everything else, then we have a real mess on our hands. It's impossible to assess how big the possibility of that is. But the market's view toward the dollar is generally negative. So, there is some susceptibility--some fertile ground to see something starting as a movement down, which could then lead to a lot of efforts to get out and protect the dollar. That is a serious possibility.

MR. ANGELL. Sam, what would be the odds of the dollar engaging in a significant downward move if we stand pat on policy--that is, take the third alternative?

MR. CROSS. Well, the dollar has been stable for the past few weeks, basically, except for the strange things going on with the yen.

MR. ANGELL. So, we could be somewhat encouraged to believe that it might be stable or even slightly strong again?

MR. CROSS. Well, as I say, if you cut away from all of these things, as far as we can tell the general sentiment toward the dollar is negative. Markets are talking about moving further toward 150 on

the mark and toward 130+ on the yen. So, that is the sort of framework we are dealing with. After having heard the statements of the Chairman and various other things that have gone on, the markets certainly would not be surprised to see the middle option move tied in with action on the budget. That is probably the general expectation of most people out there.

MR. MELZER. How is the long end behaving today?

MR. KOHN. It's up a little, but not much.

MR. GUFFEY. We talk about the prospects for the longer end and the dollar if we ease. Do you have any concern, given all the commentary that has taken place with respect to the fragility of the banking sector, that if we were to do anything before the budget is really set in concrete that it would be misinterpreted? Maybe misinterpreted is not the right word. Rather, would it be thought that we reacted to the fragility of the banking system and as a result would that propel the market into greater negativism and [unintelligible]?

MR. KOHN. As I indicated in my briefing, I think an action before the budget is at least more wrapped up than it is now would be a little confusing to the markets. They wouldn't know whether you were responding to fiscal policy or to credit market conditions and that sort of thing. Under those circumstances, I would advocate that the Chairman look for an opportunity to explain that and explain what was propelling the Committee and give the reasons why you did it. I think that would be important, especially if it were separated from the fiscal policy response.

CHAIRMAN GREENSPAN. Further questions for Don? If not, let me start off by giving you as quick a review as I can on the budget plan. I realize the inclination of John LaWare and I sympathize with it, but having looked at this I'm inclined to believe that the degree of criticism is a bit overdone. However, I might add that the fact that it is a bit overdone may make it difficult to get it passed on Friday because there is a lot of "real stuff" in here. Let me define what I mean by real stuff. I would say that any program that requires a majority of both houses of the Congress and a Presidential signature to be reversed would be defined as being enforced. If you go down the list of all the various items that they have agreed to--though I must tell you there is a disproportionate amount of tax and tax-type stuff in there, much more than I would prefer--it does have the characteristic of enforceability. The consequence of that is that \$500 billion is not a number which I would argue has no smoke and mirrors. My view of \$500 billion is that it has always had some smoke and mirrors in it no matter what; it's a question of how much. If we get a reconciliation bill and an affirmation of what David Mullins calls the "mini Gramm-Rudman," they've actually come up with something that is a lot better than anything they have done before.

There are a few holes in the system which can break through between the budget resolution on Friday and the actual 13 or 12 individual budget items that have to be, according to the reconciliation instructions, on the floors in the House and Senate and in place by October 19th. But I don't think they are very large. In other words, once you lock in the reconciliation on the floor in both

houses, given fairly rigid instructions to the various committees within each house as I understand it, the leeway is not all that considerable. There is some fudging possible, for example, in the agriculture committees where they can take the \$13 billion and knock off a couple [billion]. I don't think that can be done in any of the other ones in any realistic way. No I take it back. There is one other, but it is not very important. You can't do it, for example, in the civil service lump sum; that's specific and that's it. The postal affairs item is one that's in there. In any event, there are a number of items in which there can be slippages between the reconciliation and the final passage, but I don't think enough to make all that much difference. The probability of passage is fairly high in the Senate but a very close call in the House. The markets responded positively to it and to the anticipation of it, but as David said, they were lucky that they ended up with the oil price decline. Sometimes luck is not always bad! I would think that the consequences of that deal being voted down on Friday would be very adverse in the markets. There would be disillusionment the likes of which would be very large. And even though it's the Administration's position that they may need more than one vote to get it put in place--in other words, lose it and then come back at it--I'm not all that certain. I think that if they lose it, unless they lose it by just a handful of votes, it's going to be final.

There's not much to say on the Middle East issue with the exception that it's fairly clear that the futures markets have fairly persuasively forecast some form of war. We have \$35 oil when in fact production has pretty much closed the gap on what has been lost. And inevitably, consumption has to be down 1/2 million barrels a day at these prices. The supply/demand balance is not all that different from what it was before the invasion of Kuwait. What we're looking at is a large number of refineries around the world that are concerned about being shut down because of inadequate crude or bidding in the market for inventories that already exist. What we have is not a flow/price effect, but basically an inventory adjustment/price effect. There's no knowing where that number will go because there's nothing that one can readily evaluate with respect to price changes under those conditions. I think there's enough of that buying to hold the price up for a while. The forward markets are discounted \$10 to \$13 a barrel. And there I think we are looking at a bimodal distribution in which part of the forward market reflects a war that actually happened--loss of the Iraqi/Kuwait oil but also some Saudi oil--and the other part is the expectation of a war where nothing is destroyed or there is no war and everyone goes back to production. If they go back to production, prices will fall below \$20 a barrel in this environment. This is not a market in which it is going to go back to \$21 and stay. This is a market which has an over-inventory, high production levels, and an awful lot of cheating out there which no one yet has figured out. I cannot believe that Libya is producing at where it says it is; it's not the way they behave. As a consequence, what we have is a highly uncertain situation. When we were here the last time, we were discussing when and if war might break out. I think it's still the case that lots of materials are moving across the ocean to Saudi Arabia. We're obviously not positioned; if we were, all that stuff wouldn't be coming. So, we are not ripe yet for an ultimate confrontation on either side. It's only when we get to that point that the issue will be enjoined and resolved or there will be military confrontation. But that's weeks away, maybe well into

November. What we're likely to get is a heating up to a point where it's going to go either way and probably will get resolved within six weeks after that, hopefully. In fact, I think the odds of peace have gone up rather than down in the last two or three weeks.

So, we have that large uncertainty out there. In the interim, we have all the issues that everyone here has been discussing. I do think the evidence clearly suggests that we have a credit implosion going on. We can see it all over the place. I don't know whether the word "crunch" is a relevant notion, but everything is really being pulled back. Commercial banks, on the basis of restrictive capital requirements and fear of not being able to meet the requirements, are pulling back. Asset quality results are giving them some concern. And while I don't know how to read it, I think that Ed Boehne is right in the sense that what's happening here is some sort of pressure. I may change my mind in three or four days, but I still think we're in a situation in which there are forecasts of thunderstorms and everyone is saying well the thunder has occurred and the lightning has occurred and it's raining, but nobody has stuck his hand out the window. And at the moment it isn't raining. The point is, as best I can judge, that the third-quarter GNP figures in the Greenbook are not phony. I think they are relatively hard numbers. They can get revised down; they are being put down more and more but the economy has not yet slipped into a recession. Now, that may change next week, but I think it's important to distinguish between forecast and history.

In any event, we have some really significant pressures out there. And at this point what strikes me as our major concern is that if we're going to maintain a semblance of monetary stability in an environment in which credit pressures are tightening the market, then I think we have to find some mechanism to ease. We probably should ease at some point, really, to offset the credit crunch--with or without a budget deal. But what I would recommend at this particular stage, in the context of all of this, is that we go asymmetric toward ease today with an understanding that if the budget resolution passes we go down 25 basis points, say, on Monday, but stay asymmetric. There is still a possibility, although I think the odds are falling very sharply, that the budget deal--although it can't fall apart after the reconciliation--can get muddied in a certain sense. I would hesitate to go more than 25 basis points on the budget resolution itself because it's not the ultimate final deal, although it is most of it. And I think it would be appropriate to respond to that. In that context, I would just stay asymmetric, and if the economic data look very poor on Friday, it might be desirable--especially if the budget deal finally makes it--to go down again, although I'm not sure that that would be the appropriate response. But what I would suggest at this particular point is to presume that under certain contingencies we would move. If there is an area of uncertainty about the events as they emerge, it would probably be desirable to have a telephone conference. In fact, this is a very touchy period and if there's any uncertainty or questions about what is actually happening, I think it would be appropriate for us to have a conference. At lunch we will be discussing an additional action that the Board is currently contemplating, which is the reserve requirement issue that I mentioned to you previously. It is not supposed to involve interest rate effects, but does have an anti-credit crunch implication if the Board does decide to move in that direction. So, in light of the fact that

the credit pressures have picked up, if anything, in the degree of stringency and--having looked at the plot of retail M2 excluding the elements that you suggest--that monetary growth clearly is pretty slow, I would agree with the way you put it, David: that we are tighter than we had intended. So, in the context of a budget agreement and this stringency, I would think it appropriate to take the types of actions under the various contingencies I have outlined, and I throw that on the table as a recommendation for discussion.

MR. GUFFEY. May I have a clarification, Mr. Chairman? Are you talking about Friday or are you talking about early the following week?

CHAIRMAN GREENSPAN. Not Friday, no.

MR. GUFFEY. Okay.

CHAIRMAN GREENSPAN. Probably Monday, I would assume.

MS. SEGER. I think it's a holiday.

CHAIRMAN GREENSPAN. It is?

MR. SYRON. Columbus Day.

MR. BLACK. It's not a holiday for financial markets, though it is a bank holiday.

CHAIRMAN GREENSPAN. It's a bank holiday?

MR. ANGELL. For the Federal Reserve and commercial banks it's a scheduled holiday.

MR. BLACK. But the securities market will be open.

CHAIRMAN GREENSPAN. How do you implement monetary policy when the banks are closed?

MR. BOEHNE. You wait until Tuesday! [Laughter.]

MR. MELZER. May I ask a question on the luncheon discussion? If you decide to do that, how do you think that will play? Will that be perceived as some sort of an easing in policy or will it be perceived as a technical matter?

CHAIRMAN GREENSPAN. You're talking about the reserve requirements?

MR. MELZER. Yes.

CHAIRMAN GREENSPAN. Well, we hope it's perceived as a technical issue. But it is a non-interest rate easing effect in the same sense that if you reduce taxes on commercial banks, some of it goes through into increased loan availability. How much depends on what the incidence is. I don't think it will be perceived as an easing.

MR. KEEHN. What might the timing of that be, assuming you go through with it?

CHAIRMAN GREENSPAN. I would say sooner rather than later. We haven't quite decided.

MR. KEEHN. Fairly near term?

CHAIRMAN GREENSPAN. Yes, I would assume so. In fact, how that is perceived will be dependent on the words that Joe Coyne puts out with the action! The purpose of that is to emphasize it as a technical issue, which it is. It's basically something that we have been discussing; as you can see, that memorandum has been on the Board's agenda for quite a long while.

MR. HOSKINS. I have a question. If this problem with banking is a kind of nonprice rationing, I don't see how lowering prices at the banks is going to help a lot in terms of availability of credit.

CHAIRMAN GREENSPAN. Are you talking about the reserve requirements?

MR. HOSKINS. No, more generally about lowering interest rates. If [banks] are tightening their standards and they don't want to make real estate loans, then lowering rates 1/2 point probably isn't going to change them.

MR. SYRON. It will improve their earnings.

CHAIRMAN GREENSPAN. I disagree with Mr. Hoskins. Basically, if you're a commercial bank and you're concerned with your capital, you pull back; and the method by which you pull back is an asset rationing that opens up your margins. In other words, the way you ration essentially is either through increases in price or through asset quality. To the extent that you're opening up, if the federal funds rate moves down, you may bring the level of loan rates down. That's the tradeoff. So in that sense, it does make credit available.

MR. HOSKINS. Well, we can discuss it some other time. I can see the reserve requirement effect a little better and, by the way, I would be in favor of something like that because it is a direct tax. You do increase capital almost instantly for them; that's clear. What's not so clear to me is whether you increase demand for loans when you lower the funds rate and all loan rates go down.

CHAIRMAN GREENSPAN. You don't increase demand, you increase supply.

MR. HOSKINS. Or you'll increase supply if bankers are not rationing on the basis of price but on the basis of credit quality.

CHAIRMAN GREENSPAN. No, but credit quality and price are interchangeable in anybody's portfolio. [Unintelligible] if you tell me I'm making a loan at 12 percent and I think the borrower is a deadbeat, I would say I want 30 percent; that's the same credit restraint.

MR. KEEHN. Could I ask an operational question to be sure I have this clear? You're suggesting that we ease early next week, say, Tuesday. Is the purpose of that easing to respond to the tightening that has taken place in the market?

CHAIRMAN GREENSPAN. No, that's in response to the budget resolution passing.

MR. KEEHN. That was the question. Are you then suggesting we would ease 25 basis points near term before that?

CHAIRMAN GREENSPAN. No, no action prior to Tuesday. I think if we did it sooner, it would be very confusing.

MR. LAWARE. But you are suggesting a second 25 basis point [move] when the budget agreement is wrapped up?

CHAIRMAN GREENSPAN. After the budget agreement is wrapped up.

MR. KEEHN. That would be after the 13 individual appropriations have been done and the situation clarifies?

CHAIRMAN GREENSPAN. Yes.

MR. PARRY. And this is primarily in response to the credit conditions?

CHAIRMAN GREENSPAN. No, it's a combination of both the budget agreement and credit conditions. If the budget issue were not on the table, I would still argue for the easing of 25 basis points. I'm just saying on combining the two, it depends on how the budget agreement--

MR. PARRY. Because there's more weakness than that imparted by the supply shock? If, as I thought was stated, most of the weakness was a result of this supply shock, there's nothing we can do about that really.

CHAIRMAN GREENSPAN. Oh no, it's more weakness than that. I would say that the appropriate policy under the oil price supply shock is to do what we were doing before--to try in a sense to maintain the same money supply growth pattern we would have had prior to the oil shock, absorbing a lower level of physical activity and a slightly higher level of inflation largely because we can't avoid either of those two. I would say that the appropriate action is essentially to be where we were. It's not to be accommodative; it's not to try to stop the rise in prices, because we can't.

MR. PARRY. Well, one can do something about the inflation to some extent.

CHAIRMAN GREENSPAN. What I'm trying to say is that there are two types of inflation. One is the oil price pass-through. The other is whether it embodies itself in the wage structure. It's the second that we have to be very careful to avoid.

MR. PARRY. That's right.

CHAIRMAN GREENSPAN. If we believe that the oil price goes up and the [unintelligible] comes down and there's no wage effect, it's a complete washout. There is no way to keep the [higher] price in there unless it embodies itself in some nonprice cost, in other words wage costs, cost of capital, or something.

MR. PARRY. I guess I see the tradeoffs perhaps somewhat differently. You are computing the Greenbook's forecast of what is likely to happen to the oil price but the Greenbook's forecast of interest rates is constant. If you had interest rates declining--

CHAIRMAN GREENSPAN. I'm not using the Greenbook forecast. I frankly think that if we take Mike at his word, this one is a real problem. But I would say that I see no reason for us to change the policy patterns that we had in effect as of July. Basically, the targets that we constructed for the money supply should not change as a consequence of the Middle East crisis. That's what I think should govern what we're doing. If we do that, in my judgment we do not accommodate the inflation process.

MR. BLACK. Mr. Chairman, if you would favor this move without the budget agreement because of economic considerations, wouldn't it be wiser to link it more to those economic considerations so we don't have this precedent of having acted because fiscal policy has acted? I think that could set a precedent for us in the future that--

CHAIRMAN GREENSPAN. That may be, but the number of budget agreements that we're going to see making a precedent is going to be so few that--

MR. BLACK. You have a point there. You still stressed it in the context of a longer-term objective of trying to control inflation, given that the aggregates have picked up some, but a lot of that pickup may be fictitious. It seems to me that under those circumstances maybe a little lower interest rate is compatible with keeping the money supply running at the rate we had in mind all along, and couching it in those terms--

MR. MULLINS. Make it economic not political.

MR. BLACK. Yes, that's essentially what I'm saying.

CHAIRMAN GREENSPAN. I don't disagree with that, but the issue basically is that I don't see how we can get around not responding to a real budget agreement. This is a real budget agreement. There is no question that there is a significant absorption of purchasing power coming out of the system. No one has ever seen a joint monetary policy/fiscal policy switch pulled off, and I don't think we're going to see it here. But I do think that there's a general expectation [of an easing response], which we'll have great difficulty getting around, at least on the verbiage side. Let me put it this way: If I had the impression right at this stage that the economy was strongly inflationary, I think the argument we would make is that we should do nothing unless that budget agreement were making the economy go through the roof. That's not where we stand. I would argue for some ease, as indeed I have, because of the credit stringency issue over the last several months. If anything, what

evidence we have suggests that that stringency has gotten worse in recent weeks.

MR. BLACK. But I would still express that in terms of reiterating our long-term objectives.

CHAIRMAN GREENSPAN. Oh yes, absolutely.

MR. BLACK. This is perfectly compatible with that and it's not throwing in the towel [on inflation]; that's what we're concerned about.

CHAIRMAN GREENSPAN. I think it is important for us to emphasize that we have set target ranges for the money supply. If growth veers outside of them the Committee would then act [accordingly], and I think that anything we do in the next six months had better keep monetary growth well within those ranges or we're going to accommodate this oil price thing. And then I think we're going to be in the soup.

MR. BLACK. All I'm saying is let's make that a part of the statement. I think most of us would agree that that is the way we want to do it.

CHAIRMAN GREENSPAN. I think that's right. That's acceptable to me.

MR. BLACK. It's hard to know, really, what funds rate level to pick out of thin air that will give us the rate of growth we want in the aggregates. I was cheered by the pickup in M2, but when you examine it you wonder if that isn't part fictitious.

CHAIRMAN GREENSPAN. Yes. I think that a small part of it does show up, but David is right: it's in M1 and money market mutual funds.

MR. BLACK. To me, if in fact M2 is really still relatively weak, then this easing is perfectly compatible with the policy that aims toward price stability. But if M2 for some reason or other strengthened a great deal beyond what we think, then--

CHAIRMAN GREENSPAN. Let me put it this way, Bob. If M2 were at the upper edges of its range at this stage, I would feel very uncomfortable. And my judgment is that David is right. One has to be careful about taking out individual components; when you look at a price index and say without this, this, and this--

MR. ANGELL. We don't know how to read M2, and certainly we don't know how to read it disaggregated. That's nonsense.

CHAIRMAN GREENSPAN. Are you arguing that the money market mutual funds are not in this basic thing?

MR. ANGELL. I'm arguing that we do not have sufficient knowledge about where the increased liquidity is located or whether or not being located one place versus another place makes a difference.

CHAIRMAN GREENSPAN. But we do know the motives for the accumulation [unintelligible] assets.

MR. ANGELL. But we do not know that the motive for holding the assets is what affects behavior.

CHAIRMAN GREENSPAN. I would say, basically, that if you know the motive for holding it, you know what the behavior is; that's the definition. We know the currency--

MR. ANGELL. But does anybody believe that if someone has \$40,000 in a money market mutual fund that he is less apt to buy an automobile than if he had the \$40,000 in--

CHAIRMAN GREENSPAN. Yes. If he just moved it out of the stock market, I would say the answer is yes.

MS. SEGER. Because they're scared to death of the stock market.

MR. ANGELL. But when the stocks were sold, someone bought the stocks. There's no use going on. I'm not going to be convinced! [Laughter.]

MR. HOSKINS. Don, what is the relationship between the changes in the components of M2 that you can discover and spending in the economy?

CHAIRMAN GREENSPAN. I don't want to make a point of this, and I don't think David wanted to make a point of it, but I think it's not an irrelevant consideration to try to disaggregate on occasion. Even if we don't disaggregate, we still get moderate growth. Go ahead.

MR. KOHN. I think I'll stay out of it! [Laughter.] Obviously, we aggregate these things; they work better that way.

SPEAKER(?). Good choice.

CHAIRMAN GREENSPAN. I'm ready to answer particular questions, but I do think we ought to get going on the policy discussion.

MR. SYRON. Just a specific question, Mr. Chairman. I have a lot of sympathy with what you suggest. The specific question has to do with timing. You would envision next Tuesday. Would you also envision, without putting too fine a point on it--I know this is an action by the Board--the reserve requirement action being announced around the same time?

CHAIRMAN GREENSPAN. It could be or it could be earlier.

MR. BLACK. I'd feel a little better if I knew how that reserve requirement matter worked out.

VICE CHAIRMAN CORRIGAN. I got confused about a different disaggregation problem. The thrust of your suggestion, Mr. Chairman,

was that next Tuesday you would envision, in an almost automatic fashion, an adjustment of 25 basis points in the funds rate?

CHAIRMAN GREENSPAN. If the budget resolution passes.

VICE CHAIRMAN CORRIGAN. I'm just trying to clarify the two steps here. You have said, assuming this budget resolution gets passed in the Congress, that on Tuesday of next week there would be a 25 basis point adjustment in the federal funds rate. You then stipulated that there might be another?

CHAIRMAN GREENSPAN. Yes. At that point we would stay asymmetric toward ease.

VICE CHAIRMAN CORRIGAN. Okay.

CHAIRMAN GREENSPAN. And we would contemplate another move if the economic data and/or the budget deal suggest that.

MR. GUFFEY. Mr. Chairman, given that you're thinking about moving on Tuesday after a holiday on Monday, we won't know then how the markets will react to the budget resolution being passed. Would you consider--

CHAIRMAN GREENSPAN. The stock market will be open on Monday. And we don't do anything until 11:30 a.m., so the markets will already be open on Tuesday--

MR. GUFFEY. Well, 24 hours can make a difference in the way the market reacts to digesting what happens on Friday. That is my point. And I would delay [our move].

CHAIRMAN GREENSPAN. Until Wednesday?

MR. GUFFEY. Yes. Also, it complicates the Desk's problems, being the last day of the reserve period.

MR. STERNLIGHT. That wouldn't be a problem; that would be the middle of the two-week reserve period.

MR. GUFFEY. Oh, that's right. Okay. I'd just like to see how the market reacts to the budget activity before we go forward and complicate matters if it is a negative reaction.

MR. SYRON. But the budget action this week--excuse me--is a binding decision, right?

SPEAKER(?). That's correct.

CHAIRMAN GREENSPAN. It is a decision that is about 80 percent bound, maybe more than that, if my recollection is correct. Theoretically, it's 100 percent binding, but I think as long as we have Bobby Byrd and Jamie Whitten up there--

MR. BLACK. Is this change in the reserve requirements going to have any real impact?

MR. MELZER. What will it do to the growth rate? Can you calculate an effective growth rate of reserves?

MR. KOHN. We would make a shift adjustment for this, so all our published data [would reflect that]. Traditionally, whenever we publish reserve requirements, as St. Louis does for its monetary base requirements, we would make a shift adjustment. In dollar terms it would drop the monetary base.

CHAIRMAN GREENSPAN. Can I get the discussion started? Bob Forrestal has the floor.

MR. FORRESTAL. Oh, I was going to ask a question. I don't want to prolong this either so I'll quickly ask the question and then make my comments. Suppose they don't pass the budget resolution, when do we face sequestration?

CHAIRMAN GREENSPAN. Well, that's an interesting question. Theoretically it is supposed to be effective--well, they are going to vote Friday night so I guess it's Tuesday morning.

MR. FORRESTAL. Tuesday morning. If we face sequestration and it's real and they don't change it, then the contractionary force in the economy is even greater.

CHAIRMAN GREENSPAN. Are you going to believe that that sequestration is real for the first 24 hours? I wouldn't.

MR. FORRESTAL. I don't know; that's a judgment call. My point is that I think we need to be prepared for that contingency.

CHAIRMAN GREENSPAN. Well, I would be very hesitant to move upon the sequestration, which is readily reversible by a majority of the Congress and the President, especially given the size of the sequestration we're looking at; it's not credible. So, I'd be a little careful.

MR. FORRESTAL. Well, if you want to get the [policy] discussion going, let me say that I agree with your prescription. As I said at the meeting last time, I think that there is greater weakness in the economy than the forecast suggests. And I think that weakness was already present at mid-summer before the Iraqi invasion of Kuwait. So, I think it would have been appropriate to ease at that time, and I think the argument for easing at this point is even greater. In the interest of time, I won't go into the whole litany of reasons why I think that. Suffice it to say that I have two points. I think that we have established a great deal of credibility. We can continue to use that credibility, but I think it's time to use it and to exercise leadership. And I think that'll be understood. The thing that appeals to me about the 25 basis point move is that we can test the market a little as well and see what the reaction is before we move to the second step. If we had a sharp drop in the dollar or a runup on the long end of the maturity spectrum, we'd know that. So, I agree with what you're prescribing.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. My preference would probably be alternative B, asymmetric toward ease. If I were voting I wouldn't dissent against the 25 basis point move downward. In any case, I'd be very sensitive to growth of the aggregates--sensitive to their heralding a possible slowdown and a decline in market rates, and thus pegging the funds rate at too high a level. So, I can identify with the general sensitivity that you have. I'd like to make three other comments very quickly. One, I agree with what Bob Black was saying. I'd much rather see the rationale here being made in the context of what's happening in the economy--expectations with respect to how that may affect our performance against monetary aggregates and so forth as opposed to [the budget issue]. I'm just thinking back to how the unintended credit tightening rationale played in July; and if we can put [our action] in a broader context of the economy and our broader goals, I think we'd be better off. Secondly, I'm very goosey about tying too much to budget deals, particularly if there are two steps in that. My assumption has always been that that is a political position more than an economic position. I understand why we're there and I don't--

CHAIRMAN GREENSPAN. But it's not inconsistent; it's a little consistent with--

MR. MELZER. No, I understand. But, again, in an economic context I might have some questions as to the extent of the response that would be necessary. My only point is this: If we make one adjustment that's perceived to be in connection with that, that might be quite enough. If we make another one, the perception might be that we're following right along. I don't think people will necessarily distinguish between the budget deal and fiscal restraint, and there's a lot more fiscal restraint promised down the road. And I'd hate to see us get into a linkage where we sort of condition people to think that there is always going to be a monetary policy offset.

CHAIRMAN GREENSPAN. I honestly don't think that's--

MR. MELZER. Okay. Well, I just wanted to express that concern. And then finally, I really don't know about the adjustment in reserve requirements, but I'm sure you are weighing it in the context of everything else you have in mind. As you know, people have been taught to think in terms of the three tools of monetary policy. And I'm not sure how that would play, particularly in conjunction with the two contemplated easings.

CHAIRMAN GREENSPAN. Why don't we discuss that at lunch?

MR. MELZER. That's fine; that's a concern I have that I don't know how to accommodate.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Well, I would agree with the program with all these different components. The reason is that I'm not upset with [unintelligible] there is in the Greenbook that we need to do something about inflation in sort of a [unintelligible]. But I don't think we're going to get it--and [this reflects] my own degree of nervousness about the financial markets--without doing something. As I look at this, I think the reserve requirement part is important. I

look at the reserve requirement part as having something to do with bank earnings and the longer-term threat to [the viability of] the financial system. I look at the 25 basis points that will be done early next week as something that is in return for what is--when you assign probability to it--a significant degree of fiscal restraint.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. I would absolutely agree with your proposal as to both timing and methodology, which I would gather is alternative B as Don verbally described it, with asymmetric language now and an assumption that we may move next week with a continuation of asymmetric language.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the price level consequences of the oil shock are my greatest concern, and I would hope that we would take actions to make sure that those price level consequences don't get embedded in underlying inflation. And I think the inflationary pressures were significant even before the oil shock. It seems to me that the best way to deal with this situation would be to have an unchanged funds rate. So, I would support that alternative, whatever it is--"B," or "B-A", or whatever.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. I agree with the decision that Tom Melzer has expressed and I also agree with what Bob Parry has suggested. Monetary policy does its job best when it looks at the price level. And this is not a monetary event in terms of its cause and it is not a good precedent to have a linkup with fiscal policy. It really is the worst form of fine tuning because it is being made on the basis of the real economy and then it is linked up with fiscal policy. And it has the potential of being 50 basis points, so I cannot support this policy action.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support your proposition.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I support your proposition with one caveat. I am still quite worried about the exchange rate creating problems for us. So, I would urge that after doing the first step we go quite slowly and test the waters before being committed irrevocably in any sense to the second step.

CHAIRMAN GREENSPAN. Well, the way things are working, I would suspect that if we get to the first step, we should have a telephone conference to evaluate how that step went because we can't project a sequence of events that is at all complex through to the next FOMC meeting. I just don't think we know how to do that.

VICE CHAIRMAN CORRIGAN. A lot could happen.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I certainly support an easing move, basically because of the spreading weakness in the economy that I think was apparent even before August 2nd, the credit crunch situation, and the fragility of the financial system that doesn't seem to be getting better. My preference would be for something called maybe "A*," which would be an immediate 25 basis point cut reflecting those concerns, to be followed by another 25, which would be the reward to the boys on the Hill for doing the budget.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Well, I have some sympathy with the concerns that have been expressed about the real economy. Unfortunately, I have the impression that we're losing sight of the inflation situation as we do that. As I said before, I think there are equivalent risks here. In that environment, I would favor stability in policy. And as I look at the alternatives, something like the growth of M2 that we would get under "B" would be acceptable to me. I could even imagine going a bit beyond that--that is, trying to make sure that growth in M2 didn't fall below the 4 percent or so anticipated in "B," which would then involve some slight easing. But I have the sense here that we're talking about going beyond that for reasons that I don't find very compelling. Those have to do with the composition of M2, and/or real estate problems that are long-term, and inventory problems that we certainly aren't going to solve with policy actions taken here today. So, I must say that I'm uncomfortable with where we seem to be headed.

CHAIRMAN GREENSPAN. What would you do?

MR. STERN. I'd be willing to contemplate an asymmetric directive and even a 1/4 point move in the funds rate depending on what happens on Friday--the economic data, and how the aggregates are looking and so forth. But I think I would want to stop there.

CHAIRMAN GREENSPAN. I would certainly say, assuming that is done, that we would go back to the Committee. So, you have another shot at it in the sense that, as far as I'm concerned, it is not a self-evident process. We would evaluate how that move went--

MR. HOSKINS. There's one problem. If we go back into a Committee meeting and then we come out with asymmetric language again, I think a lot of people don't like to dissent around asymmetric language.

CHAIRMAN GREENSPAN. No, that's not what I'm getting at. I'm talking about a basic discussion of what the actual response was. Jerry is raising a crucial question. If we all of a sudden find that the dollar is loose on the down side, we'd be crazy to move again. My suspicion is that the members of this Committee will evaluate what has happened pretty much the same way. Each of us is going to be looking at the same data. I don't contemplate that as a particular problem, frankly. President Boykin.

MR. BOYKIN. Well, Mr. Chairman, as much as I would like to support what you're recommending, I have some difficulty doing it. I guess to me the Greenbook forecast looks a little more realistic than it does to others. I'm afraid we might lose sight of the inflation situation. I'm more concerned that the timing would be premature by

several weeks if we did make a move. It seems to me that the last 1/4 point move was tied to the credit situation. And I have to confess I don't fully understand--we'll discuss it at lunch--but if you do the reserve requirement change, it's to address that. That seems to me at least a nod in that direction. So, if that is a nod, I would want to wait a while longer and let the economic data come through before doing what is being contemplated. So, I would not favor it.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Well, I favor your recommendation, Mr. Chairman, but I regret deeply that it will look like an endorsement of this non-agreement, which I cynically still have great doubts about.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. I support your suggestion, Mr. Chairman.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, this is a time when we have to be extremely cautious, as everybody has suggested here. We have had recent increases in the core rate of inflation; we have weakness in the dollar and complete uncertainty as to how this budget package is going to play. The more I look at it the more it bothers me. For example, I don't know whether the public is going to [react] the same way. And there is this nervousness in the bond market, which made me lean initially toward doing nothing on the federal funds rate. But to me changing the federal funds rate is not really a change in policy; it's a change in policy if we really are trying to do something with a rate of growth in the aggregates. And you have satisfied me that your intention is to try to keep to what I think is an appropriate target. So, I don't think that's a change in policy. The market, however, is going to look at it as a change in policy, and that's why I suggested earlier that we couch it in terms of not having abandoned our long-run target, but just as a way of implementing what we want to do.

CHAIRMAN GREENSPAN. I agree with that.

MR. BLACK. So, I would go along with it. It wouldn't have been my first choice, but you're probably more right than I was when I got here. As to this second step, I sure would agree with Jerry Corrigan--as you did and I think everybody has--that we want to look at that one very closely. But to the extent that we can disabuse the market of the notion that we really have changed the thrust of our policy every time the federal funds rate jumps a little--

CHAIRMAN GREENSPAN. No, I would say that we have a specific operational problem that we have to find a way of resolving. Just to be locked in on the federal funds rate is to me simplistic monetary policy; it doesn't work.

MR. BLACK. As I've said before, it's a modern day version of the real bills doctrine. We set a particular rate and the market gets all the money it wants at that rate. The only way we have to encourage it to take more is to lower that rate, or the only way to discourage it is to raise the rate, which is what we had under the real bills doctrine. And I don't like the initiative for the

generation of the money supply to come from the market. It ought to be supply determined rather than demand determined since the long-term velocity of M2 looks like a pretty stable function to me now. So, I've always endorsed that. I don't have the answer, as I indicated earlier. We just don't have any reserve measure that can be expected to control M2, so I don't know what the alternative is. And I am very frustrated over that.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. I was going to give the case for alternative C that Don didn't have time to give. Given what's on the table here, I think I better address the issue.

MR. KOHN. I'll talk to you after the presentation; save it up for next time.

MR. HOSKINS. I think there is a danger of our losing sight of what the fundamental job of a central bank is, which, of course, is to bring down inflation over time. And this is the kind of period when I think we typically have lost sight of that in the past, so I'm very cautious about any wavering at this point in time. Monetary growth is returning to the 4 to 5 percent range. I think our growth ranges are rather wide. I dissented in February because I didn't want [M2] to get to 6 percent this year; I wanted us to keep the rate of growth around 4 to 5 percent. So, I would not be happy to see M2 surge up to that level. I don't think we have the credibility that some people around the table think we have, though of course that's debatable; I think we have to earn it yet. But with respect to policy moves, I'm very concerned about the reaction in the marketplace--that they might see us as tossing in the towel on inflation. So, I do think that the explanation that you give--and I would prefer to link this motion if it carries to the economy and M2--needs to be done carefully. Again, I didn't want to tie it continuously to the credit crunch because then we're locking ourselves in. As the banking system gets weaker, which I think is a structural problem over time and not a cyclical problem, we'll be tying ourselves to something like that.

CHAIRMAN GREENSPAN. When we talk about credit stringency here, hopefully you're referring to a sort of supply-side effect of restraint in the context of weakening demand. In a sense if we're trying to maintain a steady supply and the markets are tightening up independently of what we are doing--at, say, an 8 percent funds rate--I think this is a classic case of what's wrong with [focusing policy on] an 8 percent funds rate or some other fixed funds rate.

MR. HOSKINS. Well, I would agree if I could see a little more clearly that that was happening. If, as I think Don suggested, we begin to see some real weakness in M2, then we would recognize this as a severe credit related problem. I don't see that yet, and that's why I'm having a little trouble right now.

CHAIRMAN GREENSPAN. That's very internal.

MR. HOSKINS. My preference, of course, contrary to popular opinion, would be not to raise rates at this point, but to stay where we are. I would agree pretty much with [others on] this side of the

table that 50 basis points is a lot to do. I'm uncomfortable doing that for the reasons I've suggested.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. I support the proposal. I also agree that the best way to deal with this situation is to try to keep a stable policy. I think that's what we should do and about all we can do. And that's what this proposal seeks to do. I also agree that it's useful to get the market attuned to a little more flexibility in the fed funds rate and to get market participants to think some about the difference between the monetary policy stance and a specific interest rate. I also think the timing is right. Given the lags in the process, if we wait much longer, we run the risk of this credit situation producing some real damage six months from now and turning a mild downturn into something that could be more severe. The dollar is a concern. Looking at the alternatives, the alternatives are perhaps not too kind to the dollar as well, if we were to have a more severe downturn and trouble in the banking system. So, I don't see any easy way out for the dollar, given the situation we face. In terms of the size of the move, the long-bond market has come down about 40 basis points and I think following that roughly in magnitude would be consistent with a stable policy of monetary restraint.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Mr. Chairman, I would prefer to delay the 1/4 point [move] until there is something more concrete to support it in the economic data than what we're looking at now. I don't see that we would be creating a greater supply, given the credit crunch, simply by dropping the rate 1/4 or even 1/2 point. It's rather like pushing on a string. As a result, I'd wait until either one or two things happened: until either the economic data suggested that it's appropriate to ease or until the budget agreement itself is actually put together with some certainty. Now, that may be three weeks; that may not be until the 19th of October. It's October 2 now, so that's about 2-1/2 weeks away.

CHAIRMAN GREENSPAN. Let me rephrase my proposal in the form of a voting proposal. I would recommend alternative B asymmetric toward ease, with the presumption that if the budget resolution passes both houses there would be a 25 basis point decline [in the funds rate objective] on Tuesday morning or Wednesday or sometime around then. Implicit in the proposal is that I'd like to remain asymmetric toward ease but--and this is something of a change from what I indicated earlier because I'm sensing different views in the Committee--that's as far as I would go. It would merely be an asymmetric position with no presumption of a [further] move. And if events materialized in the usual manner, in the way they have not under an asymmetric directive since the last FOMC meeting, what I would suggest is that it has the same status of that. That is, under the same conditions we would move and there would be no implication of further action or the necessity of automatic action either as a consequence of an October 19th budget agreement or anything else. Obviously, if the economic data all of a sudden turn sharply adverse, that would trigger it; that's the type of thing I would use. So, that's the proposal that I would put on the table and request that we get a vote on.

MR. LAWARE. Excuse me, are you suggesting that whatever second move might happen would be subject to a [conference] call?

CHAIRMAN GREENSPAN. Well, there will be a call in any event to evaluate the first move, assuming that we have one, to get some judgment [on the reaction]. But that has nothing to do with the--

MR. HOSKINS. There's no implied second move.

CHAIRMAN GREENSPAN. There's no implied second move.

MR. SYRON. No automaticity.

CHAIRMAN GREENSPAN. There's no automaticity; that's correct.

VICE CHAIRMAN CORRIGAN. Just one other point: As I listened, Mr. Chairman, I thought there was a lot of wisdom in the suggestion that several people made about not tying this unduly to the budget resolution in your public statements. The more I think about that, the more I think it would be embarrassing.

CHAIRMAN GREENSPAN. No, I would say that the budget agreement would not be a relevant reason to move were it not for the fact that there was a weak economy. One can basically say that in the context of squeezing down the deficit, there is a little more reason but the fundamental reason is the economy and not the [budget] agreement.

MR. ANGELL. Could we just be asymmetric and then see what happens in the marketplace after the budget deal and then you simply would have the authority [to call for a move]? Or do you feel you'd be in a position of saying yes or no?

CHAIRMAN GREENSPAN. Well, are you saying: Suppose something happens, would I feel obligated to request the Desk to move even if I thought at that point that it was a mistake because of some events that had occurred?

MR. ANGELL. Yes.

CHAIRMAN GREENSPAN. Well, that's a good question. I would accept that.

MR. ANGELL. Okay, in other words we will have asymmetric language and it will be simply the Chairman's judgment.

CHAIRMAN GREENSPAN. Yes, that's my inclination, as I've indicated, if [the legislation] passes and nothing else of significance happens to prevent action. But I grant you that if there's some adverse market response or if something peculiar happens, it might not be desirable to move. At that point, however, I think it would be appropriate to have a telephone conference to discuss why. But my inclination would be in that direction.

MR. ANGELL. But it's sort of like what we had in July?

CHAIRMAN GREENSPAN. Exactly.

MR. ANGELL. Okay. That's my point.

CHAIRMAN GREENSPAN. Any further comments?

MR. BLACK. One thing to bear in mind is that the employment report comes out on Friday and that's significant.

CHAIRMAN GREENSPAN. Let me be very specific. This is an asymmetric directive. Asymmetric directives are not automatic by their very nature. However, I do suggest to you that if the Congress passes the budget bill, I would intend to implement the easing. It is conceivable that other events concurrent to that may make that unwise. That's as far as I'm going.

MR. BOEHNE. Let's hurry up and vote.

CHAIRMAN GREENSPAN. Please.

MR. BERNARD. The language would be: "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. Taking account of progress toward price stability, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, slightly greater reserve restraint might or somewhat lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with growth of M2 and M3 over the period from September through December at annual rates of about 4 and 2 percent respectively. 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 persistently outside a range of 6 to 10 percent."

MR. ANGELL. Mr. Chairman, in light of our abilities on the funds rate, I wonder whether it would be a little more accurate to pull that range in a bit. The 400 basis points--

CHAIRMAN GREENSPAN. We've raised this issue before.

MR. ANGELL. Okay.

CHAIRMAN GREENSPAN. I would suggest the following: May I ask Don Kohn to submit a recommendation to this Committee on that question, because we've been doing this for long time?

MR. ANGELL. Yes.

CHAIRMAN GREENSPAN. I agree with you that we probably [unintelligible], but let's not muddy this.

MR. PARRY. We could discuss it over breakfast.

SPEAKER(?). We'll be here at breakfast.

CHAIRMAN GREENSPAN. Okay, we're voting on the directive now. Please call the roll.

MR. BERNARD.

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|------------------------|-----|
| Chairman Greenspan | Yes |
| Vice Chairman Corrigan | Yes |
| Governor Angell | No |
| President Boehne | Yes |
| President Boykin | No |
| President Hoskins | No |
| Governor Kelley | Yes |
| Governor LaWare | Yes |
| Governor Mullins | Yes |
| Governor Seger | No |
| President Stern | Yes |

CHAIRMAN GREENSPAN. Let us have lunch.

END OF MEETING