Meeting of the Federal Open Market Committee Meeting
May 17, 1994

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 17, 1994, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Forrestal
Mr. Jordan
Mr. Kelley
Mr. LaWare
Mr. Lindsey
Mr. Parry
Ms. Phillips

Messrs. Hoenig, Keehn, and Melzer, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

Ms. Minehan, First Vice President, Federal Reserve Bank of Boston

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

Messrs. Goodfriend, Lindsey, Promisel, Simpson, Stockton, and Ms. Tschinkel, Associate Economists

Ms. Lovett, Manager for Domestic Operations, System Open Market Account
Mr. Fisher, Manager for Foreign Operations, System Open Market Account

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

Mr. Madigan, Associate Director, Division of Monetary Affairs, Board of Governors
Ms. Johnson, Assistant Director, Division of International Finance
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Bennett, Ms. Browne, Messrs. Davis, Lang, Rolnick, Rosenblum, and Scheld, Senior Vice Presidents, Federal Reserve Banks of New York, Boston, Kansas City, Philadelphia, Minneapolis, Dallas, and Chicago respectively
Mr. Judd and Ms. White, Vice Presidents, Federal Reserve Banks of San Francisco and New York respectively
Messrs. Altig and Coughlin, Assistant Vice Presidents, Federal Reserve Banks of Cleveland and St. Louis respectively

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CHAIRMAN GREENSPAN. Would somebody like to open the meeting by making a motion to approve the minutes?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. I'll call on Peter Fisher for a report on foreign currency operations. Peter.

MR. FISHER. Thank you. [Statement--see Appendix]

CHAIRMAN GREENSPAN. Questions for Peter?

MR. BROADDUS. Peter, you mentioned communication. Most of the research I've seen suggests that intervention like this, if it has an effect, it's mainly by way of communicating future likely policy actions. With that in mind, what do you think the prospects for the dollar would be if we did not follow through at this point with pretty strong policy actions?

MR. FISHER. The dollar would trade off.

MR. BROADDUS. Significant downside risk or--

MR. FISHER. It's very hard to put a number on that. Let me start by saying that if the Committee does something in the range of what the market is expecting, I'm not sure the dollar will move up very abruptly. I think it will tend to pip up and pip down a little bit as has happened with previous actions of the Committee. I think inaction by the Committee could have a downside risk to the dollar. The market is fairly neutral at this point. In the interbank sense, its position is such that inaction could result in significant dollar sales.

MR. JORDAN. This is really a follow-up question. A coordinated intervention like the one in which we participated on May 4 carries with it the message that there was communication taking place about fundamentals. Everybody knows there was intervention with coordination. Can you share with us what the nature of that communication was among the central banks and ministries of finance, and whether the market correctly perceived what that communication was about?

MR. FISHER. I think that the morning of May 4 began with President Tietmeyer's release of his statement that they did not have an interest in seeing the mark overvalued against the dollar. One consultation in which I was engaged was a discussion of the nature of the dollar's reaction to the mark and that it seemed to move awfully quickly and without regard to where people thought interest rates were going in each of the countries. The nature of the disturbance in the exchange market was the focus of my discussions with most of the other countries that I consulted with--I consulted with my counterparts in the G-7 central banks and a few others. When I say "disturbed" market conditions, I'm referring to April 29 when very seasoned professionals were unable to get business done, unable to get phones picked up, and where the exchange market was not responding to fundamentals in the sense of the direction of interest rates being pretty well laid out for them and they seemed to get caught in other backwashes in the market.

MR. TRUMAN. President Jordan, just to amplify on what Peter said, since you referred to the finance ministries, the principal consultations initially were between us and the Treasury Department, and between the Chairman and President Tietmeyer on the day before his statement. These consultations were followed up by some discussions about whether the Bundesbank felt it was appropriate to join in a coordinated operation. It was only on the morning of May 4 that there were any additional consultations with the Japanese along with the other central banks.

MR. JORDAN. I assume that market participants don't know the magnitude of the intervention. I don't know how well they can guess at those things, but when I saw the amount that the Germans did and a statement by Mr. Issing, I read that as a lack of enthusiasm for the business.

MR. TRUMAN. Well, I guess that's right, but I can tell you that the Bundesbank Directorate did discuss this operation. Whether Mr. Issing was present at that discussion I do not know. But both Mr. Tietmeyer's statement--the excerpts from his speech, which were deliberately released early--and the size of the Bundesbank operation were discussed by the Bundesbank Directorate.

CHAIRMAN GREENSPAN. Let me just add that I've had a number of conversations with Mr. Tietmeyer.

MR. JORDAN. There was a press commentary after the May 4 action--I don't remember its precise contents--but people in the Treasury and in the Administration more generally supposedly viewed the action as an alternative to domestic monetary policy actions.

CHAIRMAN GREENSPAN. The issue never came up, at least not in my conversations. Governor Lindsey.

MR. LINDSEY. Peter, given what the Chairman just said, which I agree with, and given what you said--that even if our policy moves along the lines of market expectations, there's not going to be upward movement in the dollar--that opens the question as to what is next and means that we may have another run on the dollar. How long do you expect the latest intervention to hold? I suppose the intervention last August bought us 9 or 10 months. I assume the second intervention will buy something less than 9 or 10 months. Do we have any ammunition left?

MR. FISHER. With regard to the risk for the dollar going forward, I would again focus on the dollar/yen exchange rate. I think the operation and the action of the Bundesbank last week and whatever the Committee does in the realm of the expected, if I can put it that way, will tend to stabilize the dollar/mark rate. I don't see any big downward potential in the dollar/mark rate on its own terms. The yen, though, will be the locus of attention particularly in the run-up to the G-7 Summit this summer. That puts us back in the political context, and whether the Administration maintains its current formulation or reverses I think is a bigger risk for the dollar. However, if the dollar can get through the G-7 Summit roughly at its current level against the yen, then I may be sticking my head way out but I would see slightly greater odds for dollar strength thereafter than dollar weakness.

MR. LINDSEY. Does the potential reversion, which hopefully we won't have, that you mentioned involve foreign policy issues or does that include monetary policy statements?

MR. FISHER. I'm not quite reading you. The monetary policy by the Administration or--

MR. LINDSEY. Yes, in other words dollar bashing being foreign exchange statements, how about Fed bashing being monetary policy statements. If there were a recurrence of the former, would that be harmful?

MR. FISHER. That will tend to disturb the foreign exchange market. I think one of the very helpful official statements on May 4 was that by Mr. Altman to the effect that he had no argument with the Fed over interest rates. That really came on the heels of the Tietmeyer comment; that was a very useful setting for the operation. So obviously, yes, if some of that Administration enthusiasm for the current Fed policy were lost, that would tend to be destabilizing to the dollar.

MR. LINDSEY. How about Congressional statements?

MR. FISHER. I think they are more expected by the foreign exchange market than Administration statements; they may be in the same vein but I don't think they have the same effect.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Peter, I have a variation on Al Broaddus's question. As you know, the Europeans have been somewhat concerned about the effect of our actions on their long-term rates. Does the market anticipate or do you yourself think that if we were to take an action today that it would have an upward effect on European rates or have their actions sufficiently decoupled their rates from ours?

MR. FISHER. Well, if the history of the last three or four months is my guide, I'd have to say I would expect an impact on their long end. It's hard to imagine there won't be some such impact. I think, though, that we have seen more decoupling in this period--between the last meeting and now--than we saw in previous periods. So, in that sense I can be modestly hopeful that there would not be a negative impact on their long end. I think the Bundesbank's actions last week are probably going to be the most helpful in that regard. After the moves in mid-April had tended to squeeze out expectations of rate reductions, they have been put back in with last week's action and that may help decouple European rates.

CHAIRMAN GREENSPAN. Okay, any further questions? If not, would somebody like to move to ratify the actions of the Foreign Desk since the last meeting?

SPEAKER(?). So move.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Joan Lovett.

MS. LOVETT. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Joan? Jerry.

MR. JORDAN. Before February when we started to announce our actions, it was standard practice in the daily program to protest a federal funds rate move away from the intended rate, maybe sometimes going against what you saw as the reserve needs of the current maintenance period. Since February we've announced our decisions three times, but in monitoring the Call over the eight weeks since the March meeting there were at least a couple of occasions where it appeared that you still needed to protest a rate to indicate that policy had not changed even in the absence of an announcement. It sounded like the Street still thinks that there is a possibility that we could change the funds target without announcing the change and therefore your daily program still has to account for that. Is that right? And what would help to clarify the situation for you?

MS. LOVETT. Well, I think that what really is at stake is that while we have announced the changes that we have made, the market still sees itself as always looking for when we're going to make a change in the future. On occasions when they think we will or we should, they move the funds rate up immediately in the morning well before any kind of an announcement by the Committee would be likely. And the rate sits there until we demonstrate something to the contrary. And so on a couple of occasions where the market thought the data were such that perhaps there was going to be an action in coming days, they moved the funds rate up to reflect that possibility. Part of the theory that seems to be at work there is that if people really believe that the Fed will move, for some it means buying cheap funds relative to what they will be later. Moving the funds rate also is a way of testing the Fed to see what its stance is. And so even though we recently have announced our policy actions, what we respond to is the market moving ahead of our announcement of Fed policy actions. I think that's always going to happen.

MR. JORDAN. Are there still people out there who think we might change the intervention level on the funds rate without an announcement?

MS. LOVETT. Yes, there are some people who still think that's a possibility; it hasn't been ruled out because we have mentioned that these announcements have not necessarily been for all time. I think the market tends to set up for itself a series of time points. It looks for announcements on the discount rate now within a certain period of time in the morning, policy announcements any time after that, but always the possibility of something being signaled ahead of the announcement. Even if that is not forthcoming, there are circumstances when they move the funds rate ahead of the Fed. For example, on the day of the employment data release on Friday, May 6, most people didn't think that the Fed would take action that day, but they still moved the funds rate up on the theory that perhaps the Federal Reserve would do something on the following Monday. And thus the constellation of where the funds rate would be over the balance of the period suggested that it was worth pushing the rate up.

MR. JORDAN. If they've come to believe that all increases in the funds rate will be accompanied by an announcement, then the absence of an announcement would seem to lessen the need to protest. A protest action would occur if you saw a need to drain reserves but you felt you had to add reserves because the funds rate was too high. Shouldn't the absence of an announcement, which would indicate that the funds rate target has not changed, have the same effect as your protest move? When you do your protest move you're going to have to wind up taking more back out than you otherwise would.

MS. LOVETT. Well, I guess it's really their anticipatory moves that we're talking about; it's not the actual Fed moves; it's the market anticipating the Fed moves before they occur.

MR. JORDAN. Well, what's the difference between our failure to issue a press release and a protest action by the Desk?

MS. LOVETT. Perhaps with the passage of time, as people become accustomed to our new disclosure practices, those anticipatory moves will not require our protest actions. But we're always going to have anticipatory moves; I think that's a given. How the market would view our absence from protesting I think would require more experience with our new disclosure practices. I don't think there's enough experience with them now for the market to be confident that, had we stayed out when they pushed the funds rate a point higher, we were not paving the way for the Committee. We're not in the position to pave the way for the Committee.

MR. KOHN. The day before the March FOMC meeting nobody expected us to change policy that day or to announce a change that day but funds were still high.

MS. LOVETT. Right.

MR. KOHN. And if we had not gone in, that would have looked as if the decision somehow had been made ahead of the meeting.

MS. LOVETT. Or that we were trying to get the market ready for it--to pave the way for a decision. I think that there just has not been enough experience with the announcements for people to feel comfortable in terms of what the timing of those announcements is and so forth.

MR. JORDAN. I would hope that over time one of the benefits of announcing would be the leeway to allow the funds rate to move on a daily basis over a little wider range without worrying about an incorrect perception of current policy.

CHAIRMAN GREENSPAN. That's one of the advantages of announcing.

MS. LOVETT. Yes.

MR. LINDSEY. Joan, just a quick question. What is your estimate of the Treasury balance shortfall?

MS. LOVETT. Well, relative to our expectations on the April tax collection themselves, we fell short by $12 billion. And if we take April and May combined there was a big catchup in early May.

MR. LINDSEY. Yes.

MS. LOVETT. They only fell short by about $9 billion. We had forecast an increase in the April tax take of something in the neighborhood of 25 percent over the level a year ago and it appears to be coming in between 5 and 10 percent above. Everyone seems to have had those same kinds of overestimates, so people are still trying to find out if there will be some offsets in June or whether in fact all these adjustments were made last year and people really did get ahead of the change in their tax liabilities.

CHAIRMAN GREENSPAN. If there are no further questions, would somebody like to move to ratify the actions of the Desk since the last meeting?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection. Let's now move on to Messrs. Truman and Prell.

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

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

CHAIRMAN GREENSPAN. Questions for either gentleman?

MR. PARRY. Mike, I have a question about the inflation numbers: Last year at this time we had an unpleasant inflation surprise. This year it seems, if you look at the year-over-year comparisons at least, that the consumer inflation numbers are coming in somewhat below the forecast. Part of that is probably due to recent changes in the seasonal factors for the CPI, but that probably is not a complete explanation; I don't think it is. Is there some perspective as far as that development is concerned that ought to be brought into this discussion? I know you cited the 6-month inflation rates and they don't look quite as favorable.

MR. PRELL. Well, clearly, I was trying to suggest that for someone who wanted to look for evidence that things were not going so well. We do still regard these longer trends in the indexes as quite relevant to gauging the behavior or the direction of inflation. Last year, to be sure, the spurt that we saw was, it appears now, considerably a matter of seasonal adjustment problems. Looking back now, things don't appear quite so bad. Our recent experience has been a shade better than we anticipated a few months ago. The very latest data aren't any better than anticipated. If there has been some good news recently, it's been on the labor cost side. The employment cost index in the first quarter was considerably lower than we had anticipated, and in our view that sets the world right in a sense. As you know, we had wondered a bit about why ECI increases had leveled out last year in the face of unemployment rates considerably higher than they are now, the substantial reduction in the current inflation, and to some degree in shorter-run inflation expectations. So, we give some credence to those numbers and it has led us to trim a little off our wage forecast or our total compensation forecast on the benefits side going forward. And so we are reasonably comfortable that, if the economy follows the path we're talking about, the inflation trend will remain stable to perhaps a shade lower. But I did want to highlight some risks and certainly to underscore our view that the room to maneuver here in terms of faster growth than we're projecting seems to us rather limited, if one really is concerned about inflation.

MR. PARRY. Did you say that the very latest data are in accord with expectations?

MR. PRELL. Current CPI.

MR. PARRY. Well, the thing I'm thinking about is that the 2.4 percent change in the total CPI over the past 12 months and the 2.7 or 2.8 percent change in the core rate over the same period are a little better than expectations.

MR. PRELL. Yes, for the total over recent months, we're doing somewhat better.

MR. PARRY. Okay.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mike, you indicated that you thought there might be some significant revision in the first-quarter GDP number when we get the revision. Will that be at the end of this month?

MR. PRELL. Yes.

MR. LAWARE. Would you share that with us?

MR. PRELL. Well, I can address this on two levels. One is simply the arithmetic of plugging in the actual data that are now available in place of the assumptions that the BEA had made. And this is primarily data that have changed on inventories, retail sales, and construction. On net, those numbers would seem to chop a good percentage point off of the 2.6 percent GDP growth rate that was estimated initially. Now, we're anticipating that some of the incoming data, particularly on trade, perhaps will come in better than BEA had assumed. And ultimately, perhaps on the next round of revisions when there are some further changes, for example, in construction, we may get closer to the 2.6 percent. So, notionally, in framing this forecast we've been thinking that GDP in the first quarter was probably a little less than the 2.6 percent, probably 2 percent plus rather than what the incoming data just mechanically would suggest. And then we made an estimate of, in essence, the best change for the second quarter, and that's what gives us an estimate of something over 3 percent for the first half.

MR. LAWARE. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. There has been a fair amount of discussion about capacity--how much of it we have left before we have inflationary pressures--and about the growth potential of the economy. Most of these estimates, particularly the growth potential, can change with seemingly small changes in assumptions, like labor force participation rates, productivity increases, and that sort of thing. I presume that you are thinking of a capacity growth rate of maybe 2-1/2 percent or maybe 2-1/2 to 3 percent. Do you have a view as to whether we're likely to be on the high end of a range like that or on the low end, given the recent trends in labor participation and what appears to be fairly strong capital spending, especially equipment spending?

MR. PRELL. Our working assumption is that, in the near term, potential output growth is about 2-1/2 percent. I think one might take a more optimistic view of the underlying productivity trend--assign more of the increase we've seen over the past few years to perhaps sustainable underlying trend growth, as opposed to the normal cyclical component. But we think that's going out on a limb a bit at this point. We've already assumed a considerable pickup in trend productivity growth from what we were experiencing prior to the 1990s. On the labor force side, we haven't seen much lift yet in labor force participation and the population trends are very hard to read. It's conceivable that the trend in labor force growth isn't even quite so strong as we've anticipated, which is not robust by historical standards. We feel that the 2-1/2 percent potential is a reasonable working assumption. We don't advocate that the Committee take that number as gospel and make its policies on that assumption and close its eyes to the incoming evidence. But we think that's a reasonable estimate for now.

I must say that, for example, in a recent Business Week article there was much talk about how the world was changing in terms of productivity growth, and I think high-tech investment is one of the elements in that story. In quantitative terms, the net investment from that kind of equipment isn't very large because it's rather short-lived; it turns over relatively rapidly. So the capital stock in that sense isn't growing very rapidly. But if you believe that it is affording firms the opportunity to reorganize in major ways the way they do things and is really creating disproportionate efficiences in a sense, then I think you can make a case for stronger growth. The other thing I found puzzling in that article was that it said because of all of this, one needn't worry so much about inflation. And the key argument it made was that if there were pressures, firms would just ship production abroad. Well, that's a rather puzzling argument. It says basically that you can avoid inflation by sucking in imports, but that doesn't really enhance domestic economic growth in the GDP sense. So, I think there's some loose thinking behind some of the more optimistic stories.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. First, to follow-up on Bob Parry's question about the inflation statistics, the first four months of 1993 were initially reported as averaging 4.3 percent. We use a thing that we call the median CPI as an alternative to the CPI less food and energy to try to monitor what these numbers are telling us as the year unfolds. We were getting 3.6 percent for those first four months versus the official 4.3 percent. Now that they've revised the seasonals, they're reporting the first four months of last year at 3.4 percent; that brought it back close to where we were. For the first four months of this year, we're getting 2.9 versus the 2.3 percent.

So as an exercise as to what the seasonals did, I had the staff apply last year's seasonal factors to the first four months of this year, and that would have produced a 3.1 percent rate for those months, the same range as where the median is. That tells me that .8 would have to be redistributed over the subsequent eight months of the year if we were still operating with the last year's seasonals. Now, I don't know whether the new seasonals are truth or not, but I do know that other things the same in the raw component, the final eight months of the year will have a higher inflation rate, and I don't know which months the seasonals stole from. But it biases me toward saying that it's more likely for higher inflation numbers to get reported rather than lower from this point.

MR. PRELL. Well, President Jordan, let me just say that we have no reason to think that this hasn't been a distinct improvement in the seasonal adjustment.

MR. JORDAN. Right, I don't disagree; it's closer to the median, though.

MR. PRELL. Well, actually, the median generally has been running very close to the regular core inflation number over the past year. They are almost identical on a 12-month basis. But the key here is that I don't see on technical grounds a reason to be very concerned at this point that, in essence, the recent data have been overstating the degree of deceleration and that we're going to get a vast surprise later on simply because the adjustment in the seasonal factors has been overdone. The methods seem to us to be reasonable: We consulted with them during the process of their revisions, and don't believe that they really are missing significant residual seasonalities.

MR. JORDAN. Well, I think that the median and the so-called "core" track very well, within a couple of tenths, most of the time and furthermore over longer periods of time the median and the actual CPI come out to be virtually identical, but the median for these four months currently is running 2.9, and I have more confidence in that than I do in the 2.3 that was reported for the first four months because the core is 2.7 for those months.

MR. PRELL. Yes, but that's splitting hairs in terms of the measurement accuracy.

MR. JORDAN. Well, not quite because remember last year we got the dip in the latter months of year as initially reported; those got revised, too. If the median is telling the truth and we have had four months of 2.3 and it's really going to average out 2.9 over the year, then it's going to have to be running a few months up in the range of 3.3 to 3.4. We just have to expect that that's the way the numbers will work out. This is not saying what's right or wrong but that this is the way the statistics were kept.

The other question is about the Greenbook. I try hard to assess what I think about the economy versus what the Greenbook says and use the latter as a starting point to understand the logic of how policy plays into the numbers that you provide us with. And I have gotten sort of comfortable with the familiar reversion pattern that whatever happens--the surprises in the fourth-quarter of 1993 and the fourth-quarter of 1992 were on the up side but we had a weak first half of last year--there's a tendency for real output to revert over some period or horizon to some idea of potential capacity. And that goes in both directions; it's symmetrical. The CPI projections tend to revert to something under 3 percent out there someplace, so that gives us nominal. As I read this Greenbook the logic of the policy linkages seemed to be clear, but I want your response on two things. One, am I getting it right? Second, where is the vulnerability? That is, increases in short-term interest rates hold down, you say, bond and equity prices which in turn influence real output, namely investment spending including residential and nonresidential investment spending. And as people see the effects of that long rate on output, that influences inflation expectations as the economy converges on potential, and that finally influences what actual CPI inflation turns out to be. So is that a correct characterization of the linkages and, if so, where is it vulnerable?

MR. PRELL. Well, I think it's pretty close with the minor exception that I would suggest that, in terms of the inflation forecast, the behavior that we're predicting is not simply a function of expectations but also of our judgment that the output path producing the unemployment rate and capacity utilization rates leaves a modest amount of slack in the system. So that force is tending to tamp down wage and price increases. In terms of the risks in this outlook, they are so numerous and disparate that it's hard to know where to begin. That isn't particularly different from any other forecast. This may be one of the reasons why the markets seem so unsettled and volatile; and like many other forecasters we have a hard time, in light of the dramatic reversal of the bond market, judging where the equilibrium may be. The market movements have been very fast and very large, and judging what the impact will be as we move forward several months or quarters is a very tricky business.

As I suggested, there are considerable differences of opinion among private forecasters and we think they mirror some of these uncertainties. On the one hand, there is a view that we are in the midst of what will be a dramatic and very well sustained capital spending boom that will interact in some sense on the trade side where we will be very competitive. In that view, as these foreign economies pick up, we will see tremendous increases in exports, and this kind of lift will provide the income to support a healthy rate of consumer spending right on through 1995. On the other side, there are those who are beginning to find some hints of weakness here and there; they think the higher rates that we have, assuming they are sustained, will have an even more serious damping effect on the housing sector and that consumer demand will be damped not only by that but also by the effects of the tax increases beyond what we had anticipated. They see that saving is already at a low level, that we've already seen increases in debt and probably will have more ahead, so consumers may feel more constrained down the road. And certainly even with the recent better news there are those who are skeptical about how quickly the foreign economies will come on and thus what kind of impetus we'll be getting in the next few quarters from a diminished drag on the trade side. So that's sort of a range of some of the thinking that I see, and there certainly are elements of risks in those directions in our view.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. My question has been answered.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mike, in the same vein as Jerry's question, it seems to me that much of the overall profile of the projection depends on the idea that the recent run-up in long rates is going to restrain the economy in the future. In that context--I know you think that most of the recent increase has been real--I would be interested in knowing particularly with regard to the 30-year Treasury bond rate, which is currently about 7-1/2 percent, roughly how much of that you think is real.

MR. PRELL. Well, if I take the base as last October's low when the rate was about 5.8 percent, that's an increase of some 170 basis points, if I've done my arithmetic correctly. I would judge that more than half of that is real. That's a seat of the pants judgment and I can't point to any clear-cut analytical support for it. I certainly see nothing in changes in inflation forecasts going out the short distance for which most professional forecasters' results are available; and nothing in the household surveys indicates that the longer-range inflation expectations have risen dramatically. Looking at stock market behavior and trying to intuit something about what may have happened to the real returns that are built in there, I see a significant element that must have been real as opposed to inflation.

MR. BROADDUS. I'm just trying to pin it down a little more.

MR. PRELL. In looking at the behavior in the housing market, as limited as the evidence is at this point, people have not on the evidence dismissed these higher rates as being simply a reflection of higher inflation in terms of what they might expect for their wages or for house prices going forward. We wouldn't have seen as much effect as we have perhaps if there really had been that kind of inflammation of inflation expectations.

MR. BROADDUS. But would you say that currently, taking the 30-year bond rate, that maybe 4 percentage points of it is real? Am I doing my arithmetic right?

MR. PRELL. Well, looking out over a 5- to 10-year span, I guess I would be more comfortable asserting that market expectations would be on the order of 4 percent inflation. They could be a little lower, but that would leave the real rate a little lower than it has been.

MR. KOHN. The backward-looking survey indicators contained in the financial indicators package put real rates at 3 to 4 percent.

MR. BROADDUS. Wouldn't 4 percent be on the high side historically for the longest real rate? That's really what I'm trying to get at.

MR. KOHN. Yes, except for the 1980s; the rate is about where it was for much of the 1950s and 1960s.

MR. BROADDUS. But by longer-term standards, it would be quite high I think. I tried to figure that out in the current--

MR. PRELL. Indeed, that's one of the reasons, given our assumption that there will be at least mild fiscal restraint and that inflation expectations will be going down, I think there is a discernible downside risk to our bond yield forecast; we have it really not getting much below 7 percent by the latter half of 1995.

CHAIRMAN GREENSPAN. Further questions for the gentlemen? If not, would somebody like to start the Committee discussion?

MR. HOENIG. Thank you, Mr. Chairman. Our District continues to be healthy. Housing has remained very strong, although many now expect that perhaps some slowing will come with higher interest rates. Manufacturing continues to improve. Our auto plants are still producing at very high levels. The energy area remains mixed but natural gas activity is still good. Farm income may be hurt a little by some fall in cattle prices, but grain prices should be good, and therefore income should be reasonably good overall. An executive with one of the larger rail lines in our region that goes to the West told me that activity has never been this high. Not just whole shipments to fill backlogs but intermodal transportation volumes are at record highs, and shippers are increasing their prices and the increases are sticking.

The banking industry has not been this strong in our District in three decades. Our classified asset levels are as low as they've been since the data have been collected. We had the lowest number of banks losing money since the '70s, and earnings are above 1.3 percent on assets. Loan-to-asset ratios have risen from a low of about 48 to over 50 percent. Loan demand, judging from what bankers tell us, is picking up. There is this issue that was mentioned earlier with some interest rate rises--the FASB rule and what it might do to the banks and their level of activity. That has not been a major concern to date. Capital ratios at our banks are averaging over 8-1/2 percent. So things are generally good in the region.

As far as the national outlook, we have differences with the Greenbook in some individual areas, but overall we are fundamentally in line with the Greenbook growth projections. We do have a little higher inflation projected than does the Greenbook, partly because of basic natural rate of unemployment issues and those sorts of things. Other than that we're in line with the Greenbook. That concludes my comments.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. In terms of the District, the underlying level of activity, which of course has been strong, just continues to gain momentum. The auto industry, for example, which directly and indirectly so dominates our area, continues to exceed our earlier expectations. Second-quarter production schedules were set at 12 percent over last year, and since retail inventories are at relatively low levels, even if there is a fall-off in sales this ought not to affect the production schedules. The third quarter at this point seems a long way off; nonetheless, the early expectations are that the production levels will be up very substantially over last year. And, of course, the third quarter is normally a very slow quarter. While the April auto sales were down a bit from the first-quarter level, some of that reduction results from the shortage of the better selling models. Production capacity constraints really are getting to be an increasing problem. In this environment, the steel business continues to be excellent; the raw production side of the industry is operating essentially flat out. And it's more than just autos. The appliance business is also very strong, as is the demand for other housing-related steel products. There is, though, a little capacity available in the finishing end of the steel business, and the majors will be increasing their purchases of semi-finished steel products from foreign sources to fill out that available capacity. An activity that I haven't mentioned in years because it's been so absolutely moribund is the rail car manufacturing business. There also has been a decided pickup in demand as the fleet has gotten a lot older. While people in the industry do not expect that deliveries will be quite as high as some of the published reports that you've seen, nonetheless, we are told that shipments of 35,000 to 40,000 cars annually over the next few years seem reasonable. Not surprisingly, prices of rail cars are being increased this year, and there is a more substantial price increase scheduled for next year.

The heavy-duty truck business has been even stronger since the last meeting. The Class 8 sales forecast has been raised again, this time to 195,000 units, and the sales level will be constrained by capacity limitations as will the sales of medium-size trucks. GM, for example, would like to add a third shift to one of their medium truck production facilities, but they just can't get the qualified workers. Offsetting this somewhat, retail sales so far in May are reported to be a little slower than earlier in the year, but I think this is a comparative issue, not one of weakness in market conditions. Sales of some items, such as home appliances, continue at a very fast pace. A very large retailer told me the other day that their sales of appliances, for example, in April were 25 percent over the sales level of last year.

In the ag sector, so far the planting has been going well. Corn and soybean acreage is expected to be up this year, and both the corn and soybean plantings, as of last week at least, were well ahead of the normal schedules. It is, of course, a long, long way to harvest. Nonetheless, we are off to a good start with what are regarded as generally good moisture conditions. Sales of ag equipment are well ahead of last year, with sales of large tractors some 18 percent higher than last year; and last year was, in a comparative sense, quite strong.

All of this strength certainly gives a very positive tone to the District, but I do think there are some worrisome signs on the pricing front. In the steel business, I've mentioned at a past meeting or two that there is a $10 a ton price increase scheduled for July 1, and at this point virtually everybody expects that to stick. In addition, the majors are adjusting discounts and pricing for extras, which will have the effect of raising steel prices by about another 2 percent. Aluminum manufacturers are reducing their production to firm up the prices. Admittedly the latter are at low levels, but the reduced production levels nonetheless have resulted in higher prices, and I am told that the Russians are cooperating with this effort. One very large user of aluminum told me the other day that they are forecasting about a 17 percent increase in the price they will pay for aluminum next year. Many other manufacturers report an upward shift in the cost of their raw material and component purchases. By no means is this a dramatic shift, but it indicates just a different attitude and a different tone out there than has been the case in the past. Some, of course, are finding ways to pass these increases through in the form of higher prices for their products. For example, although their heavy truck prices won't be increased this year, one very large manufacturer is planning a pretty significant price increase next year. Of course, retail auto prices are being increased as we go along here. Despite all this, so far there does not seem to be any upward pressure on the wage front. Though everybody we talk to says there is a shortage of qualified labor, so far at least it has not resulted in higher wage rates; but I just wonder how long that can continue to hold.

With regard to the national economy, our numbers are essentially in line with those of the Board staff. I do think that at this point the risks, both in terms of growth and inflation, are on the up side.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Thank you, Mr. Chairman. Part of the Twelfth District continues to show very strong growth. Outside of California, the growth of employment between March 1993 and March 1994 was 3.3 percent. And over that period three states--Nevada, Idaho, and Utah--ranked first, second, and third in the nation in terms of job growth, and Arizona ranked seventh. In the Pacific Northwest, we see economic growth that is best characterized as being pretty solid, but at a less spectacular pace than in the other states that I mentioned. I might note that I had an opportunity to meet with the head of a major construction company based in Oregon; he's been in the business for 30 years and he said this is the strongest period that he has ever seen. His biggest client is Intel, and they have a huge project going on in Albuquerque, another one likely to start soon in Arizona, and another one in Oregon itself. One of the interesting things is that these projects are not all for the Pentium chip. As a matter of fact, they're building plants for the next generation--which are still in the design phase. But in any case, these are major projects.

Hawaii's economy remains weak and the job losses continue in that state. On a mildly positive note, though, the visitor count seems to be up from what it was a year ago. California appears to have hit the bottom of its long down cycle, but the current pace of activity seems to be improving very slowly. If you look at the California employment data--and they seem to be revised very frequently--they show a trough in December but job growth between December and April is up only 1/2 percent at an annual rate. Other broad-based measures such as state tax revenues, retail sales, and personal income show basically no trend. I'd say the only area in California where there are convincing signs of significant improvement is real estate and other construction. Existing home sales, housing permits, and nonresidential construction awards all improved very significantly during the last two quarters compared with the same levels in early 1993.

Turning to the national economy, our policy assumptions are very similar to those in the Greenbook, and we come to similar conclusions about what is likely to happen in the economy. However, we do seem to have a somewhat different view on the responsiveness of the economy to interest rates. In our model, that responsiveness appears to be a little larger. Consequently we have a little weaker economy in the second half of this year, and next year we have a little stronger growth because we have long-term rates coming down a bit more than in the Greenbook. With regard to inflation, with the small amount of unused capacity in the economy, we do not see the prospect for improvement in inflation from this point on, and we certainly don't rule out the possibility that the inflation numbers could begin to look even worse in 1995. Thank you.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. I've been reporting for several meetings that the tone in our District is pretty positive and nothing has changed. I've been in this business for about 20 years now, and I would have to say that I can't remember a time when the anecdotal information we hear in our District was any stronger than it is now. There are very few weak spots--that we hear about anyway. I think it's fair to say that most people that we talk to are broadly optimistic about prospects for the near term, at least for growth of jobs. A lot of noteworthy things have happened but I guess the single most noteworthy development in our region recently has been the enormous improvement in commercial real estate activity. Activity in this sector appears to be increasing sharply. I don't think there has been a great deal of actual new construction yet, but vacancy rates are declining, prices are rising, rents are rising, and markets seem to be tightening in a number of our communities. Just a couple of examples: The Raleigh-Durham market in North Carolina was described at our last board meeting as being as tight as it has been in about a decade, and it has been a pretty good market through this whole period. We also are hearing a number of reports that things are improving in this sector here around Washington. We get reports that the northern Virginia, D.C., and the Baltimore/Washington corridor markets are tightening, rents are up, prices are rising at least to some extent, and that of course was one of the worst situations in the country. More broadly, we're told that there is substantial domestic and international investment demand for commercial real estate properties in our region despite the recent backup in long-term rates. So the news on the real estate front is bullish in our area, and that's refreshing because it wasn't very long ago that people were talking about a 15-year real estate depression in this part of the country.

Elsewhere, we are still hearing, as I reported earlier, a lot of anecdotal comments suggesting increased concern about the outlook for prices and inflation. I think it's fair to say that these concerns are not restricted to bankers and financial people. When our small business and agriculture advisory committee met a few weeks back, we polled them on their inflation expectations and the vast majority expect some worsening in that situation. They see the economy strengthening; they see labor markets tightening; they didn't use the term shortages of skilled labor but they said there were shortages of "good" labor. And they talked about tightening in a number of other markets. So a clear majority of these people are expecting inflation pressures to rise, and I think that's the general attitude not just in that group but across my region broadly. So that's the District situation.

As far as the national outlook is concerned, as I understand it, the staff is now assuming that the funds rate is going to rise to about the 4-1/2 percent level sometime around fall, and that an increase of that magnitude will be sufficient to hold the growth of real GDP to about 2-1/2 percent at an annual rate in the second half of this year and through 1995 and also keep the core rate of inflation at about 3 percent over that period. Now, moderate GDP growth like this might not be a great outlook in all circumstances, but my feeling is that it wouldn't be a bad outcome right now, given where we are and what is happening. After all, it would follow a year of solid growth in which we have moved much closer to full employment. I think it would lay a nice foundation for sustained growth out beyond the projection period. We don't talk about this too much at non-Humphrey-Hawkins meetings, but there may even be a little further progress toward our longer-term price stability goal. But I have to say that I'm concerned about what I see as the generally accommodative policy we've followed up to this point. I still think that may give us more thrust in both real GDP growth and nominal GDP growth, at least through the end of 1994, than the Greenbook envisions. And I don't think it's by any means assured that a 4-1/2 percent funds rate is going to get us the relatively moderate inflation and real growth that the Greenbook is projecting for next year. In short, it seems to me that there are substantial upside risks in these projections on both the real side and the inflation side, and we need to give the upside risks some careful weight when we discuss policy later in the meeting.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Thank you, Mr. Chairman. Conditions in the Sixth District are also very, very good and the expansion is pretty broadly based and relatively balanced. Let me just tick off some of the sectors of the economy. In the retail sector, sales did taper off a little in April although the activity in recent months has exceeded retailers' expectations by a sizable margin. Many of them are planning to add to their inventories. Auto sales are still quite strong in most parts of the District. The interesting thing to me is that the dealers are expecting continuing growth, although at a somewhat more moderate rate, in this area through the rest of this year and into next year. Tourism, as I've reported before, is a source of considerable strength in the region. There has been a fall-off in European travelers but that's being taken up by domestic travelers and also by people from the Caribbean and Latin America. I won't say anything about the casino gambling again because we all know about that. I'm going to bet that it will continue!

On the production side, our survey in April for industrial production suggests that there has been some leveling off in output. But the expectations for future activity are above those seen at this time last year. There was some effect on production from the Teamsters strike, so that cut down activity a little, and suppliers to the automobile sector are running at near capacity in the District. Textiles, particularly in the household area and apparel fabrics, also are sources of strength. The only weakness on the production side is in defense and aerospace.

On the real estate side, sales of single-family homes remain quite strong throughout the District. Many realtors are reporting that the recent increases in mortgage rates have actually spurred buying on the part of people who were sitting on the fence, as it were. Inventories of homes remain quite tight in many areas, and realtors are reporting increases in prices as well. Builders are reporting strong increases in the number of homes under construction, although speculative activity is practically nonexistent. Traffic through the subdivisions is quite heavy, and that's in contrast to the assertion in a letter that I read this morning that you received, Mr. Chairman.

On the multifamily side, markets continue to improve, too. Building permits were up 50 percent over a year ago in the first quarter. Nonresidential real estate is also doing better. Commercial real estate agents are more positive now about future activity than they have been in a long time. On the financial side in the states, budgetary pressures that were in existence a while ago have practically disappeared due to the new growth.

On the price side, in contrast to some of the comments I've heard today, we're finding that price pressures are practically nonexistent, with the exception of construction and perhaps a little bit now in textiles. Lumber prices have stabilized in the last few months, but the costs of other building materials have increased and we are also seeing some wage pressures for skilled labor in the construction industry. Wage pressures are basically fairly quiet in other sectors. Retailers are telling us that intense competition is keeping a lid on prices.

In the banking sector, I would echo what Tom Hoenig said, in that banking in our District is quite strong; loan demand is up, particularly in the consumer sector. So, Mr. Chairman, I think that is probably as positive a report as I've been able to make in quite a long time. It's hard to find any weaknesses in our area.

With respect to the national economy, I must say that I've been impressed by the strength of the data we've gotten since we last met, notwithstanding the lower-than-expected first quarter. I had at the last meeting tended to downplay the rather bullish expectations for growth in our forecast, but I've become a little more convinced that the upsurge in the fourth quarter may continue to play out for a little while longer. So, our forecast for GDP is somewhat stronger for 1994, fourth quarter over fourth quarter, although we do show a deceleration in 1995. Also, we don't see inflation reaching a peak until 1995. I won't go into the various differences in the forecast and I wouldn't want to make too much of the differences because while our forecast does differ from the Greenbook in the near term, the forecasts converge in 1995. What I think comes out of both of those forecasts as far as I'm concerned is that some additional move in policy as contemplated in the Greenbook probably is needed and in time will cause inflation to moderate. Thank you.

CHAIRMAN GREENSPAN. First Vice President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. Things are clearly in recovery mode in New England. Payroll employment has grown for the region as a whole in each of the last three months and jobs overall are about 2 percent above a year ago. This improvement is broad-based. With the sole exception of durable goods manufacturing, all major industry categories had more jobs than a year ago. On a geographic basis, only Connecticut continues to show job losses. The New England unemployment rate declined for the third straight month to 5.6 percent, well below the rate for the nation as a whole. Other indicators are also positive; average weekly hours in manufacturing reached a new post-recession high, help wanted advertising rose in March, and per capita income growth of 3.7 percent exceeded the national pace slightly. All this good news should not obscure the fact that the region as a whole has gained back only about a quarter to a third of the ground lost during the recession, no matter what data are used to measure progress, although one could question whether we want to go back to the late 1980s in terms of how heated up things were in New England. Companies continue to report that competition is very keen and that their own quality and efficiency improvements are the primary determinants of survival, not rising overall demand. There's no rising tide to carry them all to prosperity. On the other hand, there doesn't seem to be any remaining undertow either.

Several contacts, including some on our board, complained that the Fed is raising interest rates just as the economy finally shows some signs of life. In response to our questions, however, a number indicated that they were seeing attempts by suppliers to increase prices, but these attempts were being resisted. Retailers saw strong growth in March but a fall-off more recently. Cautious optimism may be the best way to express the New England viewpoint almost across the board.

On the national scene, we too believe that growth will be somewhat stronger than projected by the Greenbook. We've been impressed by the degree of tightening in labor markets recently, but on the other hand our projections of the NAIRU are at the low end of the range that seems to be used by Board staff, and we are a little more optimistic about potential GDP growth. While our sense of the components of the picture varies from those in the Greenbook, we do agree with projections of low inflation, at least in the near term.

CHAIRMAN GREENSPAN. Thank you. President McTeer.

MR. MCTEER. The economy in the Eleventh District continues to grow moderately, about in line with the national growth rate, possibly a little weaker. Our expansion is broadly based, with the exception of energy and defense-related sectors. Construction in particular is very strong; it moves from strong to booming in some areas that are benefiting from relocations from other parts of the country. Median prices of existing houses are up 6 to 10 percent depending on what market one is talking about. Construction is going on all around me, and my house is the only one that I know of that has not gone up in estimated value. I just got that in the mail.

SPEAKER(?). Maybe it's because of the residents!

MR. MCTEER. It's a big mystery. The gains in nonresidential construction are also significant, matching those in housing. Retail, warehouse, and industrial buildings are strong throughout the District. Even commercial property is beginning to rise in price, although there is still a lot of excess commercial property in the major metropolitan areas, including an old Reserve Bank building in Dallas that is still on the market.

As I've indicated, we are benefiting a good bit from relocations. We are benefiting from being in what we refer to as the low-wage, low-cost center of the North American free trade area now. We've been asking our directors and Beigebook contacts questions about pressures on prices and wages for some time. We are getting some indications that price pressures are beginning to appear, and some wage pressures have been mentioned. This is the first time since 1985 that people in our area are mentioning upward pressure on wages.

I don't really have anything of value to add about the national economy except that it seems a lot stronger than the first-quarter GDP numbers would indicate, especially the real final sales number. Then the April retail sales number brings to mind a Richard Pryor comment, "Who are you going to believe, me or your own lying eyes?" There seems to be a conflict between those numbers and the feel of the economy out there.

When I talk to people about policy, there seems to be a difference of opinion on whether we're ahead of the curve, too far ahead of the curve, or behind the curve. There's more uniformity of opinion, though, that we need to do what we're going to do quickly and get it behind us. I often hear that we're creating uncertainty with small steps, and they urge us to do what we need to do. As a matter of fact, last week we had a vote in our board meeting on a discount rate recommendation. dissented from the vote, but even he said whatever you do don't do it piecemeal. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The District continues clearly to be a part of the Northeast--its growth trend is positive but somewhat slower than the nation. Manufacturing continues to grow, but the pace of growth has flattened out some. The bookings for the future also have gone up rather substantially but that too seems to be flattening out. I suspect it may have to do with some capacity constraints. A major railroader in our District reports what others have said in the railroad business: they're operating flat out. They can't get cars fast enough to ship the goods. Residential construction has made a good-sized rebound, although I think some of that is clearly seasonal. Once that part is out, I think we will have moderate growth. Nonresidential construction is mixed. Some areas are still dead and likely to be that way for some time. Other areas are beginning to show some signs that there will be additional construction, probably more so next year than this year. Retail sales clearly have picked up. The automobile business is strong, and it's clearly a seller's market at this point except for a few lines. Bankers, who heretofore have not seen a whole lot of growth in commercial lending, are now reporting modestly rising demand. Business loans, both to finance inventory accumulation as well as capital equipment, and consumer and real estate lending continue to pick up. In our labor markets the rate of unemployment for the District as a whole is about the same as for the nation, although it varies quite widely around a relatively small District. However, the growth in new jobs has been on the sluggish side despite the improvement in the economy. Consequently, wage pressures are well contained. On the price side, there clearly is a desire and a wish to raise some prices, but I'm still hearing mostly that it's very difficult to make those increases stick.

As far as the national economy goes, I don't have a lot to add. I think at this point in an expansion the risks tend to be for faster growth rather than slower growth. Perhaps it's just my own District and the influence that that has, but my sense is that the odds pretty strongly favor moderate growth and that there is not a lot more upside risk to the economy than downside risk.

On monetary policy, because the District is improving but not as fast as the nation, the increasing interest rates and our actions have been more justifiable on a national basis than a District basis. I am running into what has just been echoed across the table: Do what you have to do and get it out of the way so that we can get this uncertainty behind us.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. The District economy continues to be very healthy. The only exception to that is the energy sector, which of course is not very large in the District; otherwise, things continue to do very well. I think people are becoming increasingly optimistic, and that's starting from, at this point, a fairly optimistic base. A few anecdotes, some of which I've reported before, which I think are interesting and relevant: I've heard a number of reports over the last several months about lean inventories, with the clear implication that people expect some attempt to step up production and build inventories over the next several months. I would expect that to occur. Continued reports about labor shortages, particularly of skilled labor in many markets, do not seem to have translated into a broad-based increase in wage pressures, although in the Twin Cities market it does appear that wage increases--this is from the panel that we work with in trying to plan our own compensation--turned out to be larger in 1993 than those that had been planned. Exactly what was going on there I don't know, although we face a pretty tight labor market.

On the banking side, there are reports of increases in loan demand and some preliminary indications that banks are starting to bid a little more aggressively for funds through small time deposits--something we haven't seen for quite some time. As far as pricing and price pressures go, it's very hard to find any broad-based indications of acceleration of inflation, but what I am hearing is that discounts are diminishing and the frequency of sales is diminishing. It's very hard to quantify, but that does seem to be occurring.

With regard to the national economy, I must say the logic of the Greenbook forecast does appeal to me. It seems to me that the increase in interest rates, particularly in long rates, may work as that forecast envisions, that is, growth in real GDP will slow once again--whether it occurs in the third quarter or somewhat later remains to be seen. That may succeed in stabilizing the rate of inflation about where it has been. Although I must observe that in the last couple of expansions--coming out of the 1980-82 recession and the 1973-75 recession--once the economy built up momentum, those expansions seemed to go on longer and to be stronger than we, certainly, had anticipated. Now, some of that may be the fact that, of course, the momentum is not independent of the policies we pursued; and maybe we just reacted too late. But at least a naive reading of those expansions suggests to me that once the economy starts to develop some momentum, that tends to go on for a while.

Some numbers that I was looking at raise questions in my mind about what we might be able to say about the inflation outlook. These numbers suggest, though I guess it's a little too early to even call this analysis, that the relationship between labor market conditions and the performance of wages or compensation seems to have deteriorated in the early 1980s--around 1983 and 1984--and hasn't been reestablished. This suggests that we can't conclude very much from labor market conditions and what that might imply for wage pressures. Similarly, there seems to be deterioration in the relationship between utilization rates and consumer prices that occurred about the same time. I don't take much comfort from that; it raises uncertainty in my mind, if nothing else, about the price outlook, and it forces me to rely a little more on my intuition. My instincts at this point are that the risks of inflation certainly are on the up side, particularly because we're not indifferent to errors in that direction. In other words, we're not terribly concerned if we undershoot inflation. We might be a lot more concerned if we overshoot.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. Our District is performing in a fashion much more similar to the Seventh District than the Third District. It's a pattern of fairly uniform strengths that are getting stronger. The ag sector is looking forward to a third very good year overall. It's early to tell whether they will meet that expectation, but they've had two good years and there certainly is a lot of optimism in the ag sector and the ag banks. In processed foods especially, capacity is up a lot. One county on the western side of Ohio reports an increase of 7 million "layers" in the past year--turkey processing plants. That means a lot of new capacity.

Motor vehicle plants are going flat out, and a lot of them are running above what would be sustainable long-run capacity. But a lot of new capital spending is occurring, a very significant amount by the major manufacturers. That is adding a lot of optimism to people's assessment of the current situation. Capital goods overall are booming; and the return of the machine tool industry, notably the higher value, high-tech end, is especially encouraging to people in such major communities as Lexington, Cincinnati, and Pittsburgh; all are reporting that the high-tech firms are doing quite well. The one sector that I would note where there is consistent weakness and talk about layoffs or cutting back is health care. We have some very large health care operations in the District, and they continue to be pessimistic.

I might note a couple of anecdotal things that need to be paid attention to going forward. One is the continued strike at Allegheny Ludlum Steel; they've been on strike since before Easter. This is a governance kind of issue: Management is saying that they are going to see this through and tends to talk in terms of months rather than days or weeks before it is settled. It's important nationally because they provide the stainless components for the exhaust systems for General Motors. There is no alternative domestically at this time. General Motors has indicated that they are now preparing to go to Japanese stainless steel by month end if they can get it. The other alternative would be to go to carbon steel components and promise buyers that they will subsequently recall the vehicles and put in the stainless components. GM says that they are not going to shut down production based on this labor stoppage. The other thing that stainless steel is critical for is transformers and electric power operations. There are no alternative sources. So, Allegheny Ludlum has--

CHAIRMAN GREENSPAN. There used to be a big stainless high alloy industry in this country, but it has evaporated.

MR. JORDAN. Yes, and it's a tough one for us, and it's adding a degree of pessimism to the Pittsburgh area especially. The other more or less anecdotal report relates to residential housing. What we are hearing in the District is that the problem is not the cost or availability of funds but the cost and availability of building materials. The Ohio Trade Council Union has become a developer of medium- and low-income housing and complains about escalating costs of production and that is what he sees as the source of inflation, not the cost of funds.

Turning to the national economy, my reading is certainly influenced by conditions in the District. It's not a question of encountering any kind of head winds; rather, it's the buildup of tail winds that I think is of increasing concern. I no longer feel that it's a case of simply backing further off the accelerator but that we may have to start contemplating tapping on the brakes fairly soon. I don't know where neutral is, but I think that we are well shy of a neutral policy and getting there may not be enough. The Greenbook projections depend critically in my assessment on the deceleration of nominal GDP growth. It's the nominal spending where I have my concerns rather than the decomposition of that into its real and price components. In 1992 we had growth of over 6-1/2 percent for the full four-quarter period and that was more than had been expected. There was some deceleration in 1993, even with the robust fourth quarter, thanks to the weakness in the first half of the year, but growth for the year still was 5-1/2 percent. Growth this year is looking like another 5 to 5-1/2 percent. But for the forecast to work, it is important for nominal GDP to decelerate to under 4-1/2 percent in the next 18 months. I don't see what will make that happen. I have no confidence that the kind of policy assumptions in the Greenbook or the linkage of working through long-term bond yields are going to produce that deceleration of nominal GDP. The way I now tend to think about where we are is not that we are entering the fourth year of the expansion, but rather that we are someplace in the first year of a classic expansion. As it looks to me, the period of about 2 or 2-1/2 years after the end of the Gulf War was one of economic restructuring in a lot of sectors and a lot of regions. The talk about it being an anemic recovery was because it wasn't a recovery, in a sense, but rather a period of restructuring. Some time during the course of last year we entered into what would be more of a classical recovery from recession. If that interpretation is right, then we should be thinking in terms of a year to six quarters of 5 to 6 percent real GDP growth. Yet, most of us are saying that we don't see that the economy has the capacity to handle that many quarters with 5 or 6 percent real

GDP growth without way overshooting. If that's an accurate assessment of where we are, then monetary policy is well behind the curve.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. The national economy continues to expand rapidly and its momentum appears, at least to me, to be building. Industrial production, for example, grew at a 5.4 percent annual rate for the four months ending in April, faster than the 4.6 percent rise in 1993. Payroll employment rose at a 2.7 percent rate in the four months ending in April, following a 1.9 percent rate of increase in 1993. The unemployment rate fell about a full percentage point over the past year when comparable methods are used to measure it. Despite efforts by businesses to build inventory in the first quarter of this year, the inventory-to-sales ratio fell sharply as sales boomed.

In the Eighth District, economic activity has also expanded rapidly in recent months. Many firms report expansions, additions to payrolls, and increases in sales. The District continues to grow faster than the nation as a whole, as best we can determine. For example, during the past quarter nonagricultural employment increased in all District states by a significantly larger percentage than the national average, namely by 7-1/2 percent at an annual rate versus 2.1 percent nationally. Increases in employment are occurring in nearly every major manufacturing and nonmanufacturing sector. District reports reveal that the Eighth District's expansion is spreading to parts of the District such as southern Illinois that had until recently been sluggish. Particularly noteworthy developments are occurring in the transportation sector. Increases in auto production, which Tom Hoenig and Si Keehn have mentioned, are expected to boost auto employment in St. Louis to the highest level since 1989. Commercial aircraft orders also are rising considerably. The District's real estate sector remains strong as evidenced by double-digit increases in building permits and continuing anecdotal reports that homes available for sale are in short supply. Relatively strong loan demand, especially by businesses, is also indicative of the strength of the Eighth District's economy.

The momentum of the economic expansion, as I mentioned before, seems to me to be building. I am not comfortable with the Greenbook outlook that nominal and real GDP are poised to slow down in the second half of this year. Such a slowing appears to be based on a cutback in interest-sensitive sectors, especially housing. Housing affordability, even with today's mortgage rates, in my view is very favorable. And reports at last week's Business Roundtable meeting expressed strong doubts that interest rate increases are retarding spending to any degree at all or are likely to do so in the near future.

The continuing strong performance of the District and national economies reinforces my concerns about the inflation outlook. In the Eighth District the prospects for increased cost and price pressures have been boosted by low-levels of farm inventories and new houses for sale, and more broadly by substantial job growth and relatively low unemployment rates. Nationally, both consumer and producer price increases have accelerated over the past seven months from their pace over the previous five months. In addition, inflationary expectations have increased as well, which is reflected in declines in both bond prices and the foreign exchange value of the dollar since our last meeting.

CHAIRMAN GREENSPAN. Governor Kelley.

GOVERNOR KELLEY. Thank you, Mr. Chairman. I'm essentially the same place I was in March, so I'll try to be a little brief today. We have moved policy considerably, three times now, which I think has been entirely appropriate. The reason that I feel particularly comfortable with that comes largely from the fact that I think interest rates were too accommodative for present conditions and needed to be changed. And probably we haven't completely eliminated that yet and we do have a little more to go. Consequently, I would expect to support a policy move action in the second half of this meeting.

My comfort doesn't primarily arise from an especially high level of concern that we are near full capacity and on the cusp of some type of an inflationary flashpoint. I certainly do recognize that there's considerable strength out there and we get confirmation of that from the consistent reports--and I'm sure they're correct--from around the Districts that there is a good deal of momentum. Consequently, there surely is the possibility that the economy could overheat. But I think there's reason for at least a bit of skepticism that that is going to happen. A brief recitation, if I may; I did this the last time we were here and most of these things have been referred to in one form or other already this morning. I won't talk further about interest rates; we know how much they've gone up. Their restrictive impact is just beginning to be felt. Mike Prell made reference to housing in particular. Second, one factor that I think is important that we haven't talked about much is the impact of unit labor costs. We've done very well in that regard recently. In fact, it has been getting meaningfully lower now for some four straight years. Staff tells me that in the case of the unit labor cost index, which has been decreasing substantially and consistently, that that impacts the economy with a six-quarter lag. This means that we've got a lot more favorable impact to come from the restraint that is already in place.

On the productivity side, we've recently been looking at a 2 percent increase. Staff has raised its estimate of trend to 1-1/2 percent, but if I understand correctly, they are only expecting 1 percent over the remaining part of the forecast period. All the private sector conversations I've had suggest that we might continue to do quite well in that regard rather than fall back. If that turns out to be the case, it does two things for us, obviously. First of all, it holds down cost pressures; and secondly, it extends the amount of capacity that the economy has available before it gets itself into difficulty.

In the area of consumer spending, we've talked before about the very high level of debt that was built up through the 1980s; that plateaued for a while but did not come down, and now it has begun to rise again. This leaves me with a considerable question in my mind as to how long the legs under consumer expenditures may be. Indeed, if they're very long, I would worry about that a lot because we're in a new territory now in terms of consumer debt. Not unrelated to that is the fact that autos have been a part of the push so far and that probably has approximately peaked. We've talked about foreign economies; I won't go into that any more but their weakness impacts on us here. And then, of course, fiscal policy continues to be mildly contractionary, at least over the rest of the forecast period.

All in all, I have considerable confidence that there's a lot of underlying strength in the economy, a lot of good solid momentum, and that things look very favorable. I believe that the economy can keep growing despite whatever constraints are out there and that our recent policy actions as well as those restraints give us good prospects for keeping inflation well in check. Thank you.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The Second District's economy appears to be advancing at a rather nice pace this spring. Preliminary March reports indicate that establishment job growth was strong in most sectors of the economy. Tax receipts suggest that personal income grew at a reasonable pace. Retail sales surpassed the optimistic expectations of the merchants, with actually some problems in April because inventory levels are lower than the merchants would like them to be. The commercial real estate market is showing considerable signs of revival except in the lower part of Manhattan Island. The anecdotal information for April and the first part of May suggest that this growth is continuing. And consumer price inflation is quite subdued in the District. There is something of a malaise around the financial services industry because of the difficult markets in the first four months of the year and because of some concerns about individual firms and problems related to them--for example, the case of Kidder Peabody and the death of Lazard and then the New York Times article on Sunday regarding what would appear to be some questionable relationships among firms in the municipal finance area.

On the national level, we differ somewhat from the Greenbook in having a little slower growth in the second quarter and a little higher growth in the second half of the year, but the net result is that we are just 0.1 percent above for the Q4 to Q4 period. We also have a slowdown in 1995 to 2.4 percent growth in GDP, which is just about where the Greenbook is. However, we're not quite as optimistic about the CPI. We've got it up 3.1 percent whereas the Greenbook has it up 2.8 percent. I would not be very satisfied with an upturn in inflation as something that we would anticipate. So that raises the question of what really is going on in the economy and what if anything the Federal Reserve can do about it. We think that growth has to be slowed down because we think that, certainly by the end of the year, potential GDP will be fully used up. We will be at or very close to the NAIRU and at the use of manufacturing capacity that has historically given rise to cost and therefore price pressures. One of the things that those who don't want to find inflation, especially among journalists, are looking to is the possibility that the capacity availability outside the United States will help us avoid inflation. We looked at that quite carefully and find very little solace there.

In the area of interest rates, one of the things that's most difficult to forecast--and it has been discussed by Mike Prell both in the Greenbook and in his oral presentation and then by various members of the Committee this morning--is to try to figure out just how much the policy that we have put in place so far and its effect on medium- and longer-term interest rates will slow the economy down. In the very sensitive areas of, say, the 7- to 10-year maturities, it's difficult to figure out exactly what has caused that increase in interest rates, but we've done a rather large amount of work on the relationship between the Treasury market and therefore interest rates in general and mortgage-backed securities; Joan Lovett referred to that rather briefly in her presentation. But quite clearly, as interest rates go up and the duration of any mortgage portfolio increases, the hedging requirement moves out the yield curve. And we think that has a fair amount to do with the considerable increases in interest rates in the 7- to 10-year area, especially in the 10-year note itself. If that is so, it means that we've got a closer linkage than we have had historically between short-term interest rates that the Fed directly can control and the medium- and longer-term rates that have a rather direct effect on the interest-sensitive sectors. I think all of us would have to agree that we are not quite sure exactly how that will play out in the future.

Another area that we find has to be looked at very closely is the attitudes and therefore the likely spending habits of the consumer. The consumer is a good deal more confident than he or she was a couple of months ago. But it's very difficult to find out exactly what they are so confident about except that the increase in employment would seem to have lowered the anxiety level about losing jobs. Still, one hears enough about layoffs especially in the white collar sector to wonder how consumer confidence that is a large part of all of our economic forecasts, and which Governor Kelley discussed very well I thought, is going to affect the future. So we're in a situation I think where we have policy actions that need to be taken, but it seems to me that at this particular time the question marks are rather larger than usual--although as Mike Prell pointed out, all economic forecasts have question marks--and therefore make decisions on policy that much more difficult.

CHAIRMAN GREENSPAN. Thank you. Governor LaWare.

MR. LAWARE. I've grown considerably less comfortable since the last meeting with the consensus view that we have a solid economic expansion under way. Not only was the announced GDP growth rate in the first quarter way below staff expectations, but staff now expects a further downward revision of the 2.6 percent number that was announced. That, combined with recent statistics on auto sales and production, industrial production, retail sales, and a modest reversal of consumer expectations, has convinced me that the psychological tone of the economy is very fragile. I attribute that fragility to job security anxiety, fueled by continued corporate re-engineering with the accompanying layoffs combined with worries about household cash flow, debt levels, and impending changes in the health care system and its costs. Nonetheless, the reduction in slack in the economy certainly feeds my concern that there remains some prospect for growth well in excess of potential, and I expect that further absorption of slack will come from the export sector. As U.S. products become more competitive because of dollar rates, technical improvements, higher quality, and the recovery of European and Canadian economies as well as a higher level of growth in Mexico, the growth in exports will exceed staff expectations and stimulate a higher growth rate than in the Greenbook forecast.

All in all, I believe that events already in train will tend to heal the fragile psychology of the economy, all of which suggests that additional restraint may be in order.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you. It appears that the strength of the expansion is deeper and wider than we have seen previously, based on some of the comments made here today. This is partially due I suspect to job creation and acceptance by employees of moves to different jobs--thus more churning in the labor market. Confidence continues to be reasonably strong both on the business side and on the consumer side even in the face of a slowdown in the first-quarter GDP. Credit demand has increased and the U.S. economy appears to be adapting better to changes than our competitors--such changes as technology, labor conditions, balance sheet adjustments, and so on. I find myself with an analysis very similar to Mike Kelley's and John LaWare's in that I see this strength as sustainable and don't see a runaway growth outlook. We still have an environment of re-engineering and emphasis on cost savings and productivity. This question of job quality I think is continuing to put pressure on income levels generally. We're also not through the downsizing of the defense industry. The deficit is going to continue to limit fiscal policy initiatives. The low saving rate that we have seen I think is going to limit long-term investment opportunities. The capital market volatility and stock and bond price declines do increase the cost of capital. The volatility itself raises the cost of capital, and the wealth effects that are felt by individuals may start to be seen in reduced consumption and investment.

On the inflation front, as we've heard in some discussion around the table, the recent history is quite good. I do think that there are vulnerabilities, for example in commodity prices including oil. And although farmers are optimistic at planting time, that's when they're the most optimistic. That seems to be a universal truth in the ag community. But we do have low carryovers, so this is a fragile time going into this planting season.

One thing that hasn't been mentioned as much was the faster increases in the producer price index in the first quarter of this year. Although the April report was better, the index is still up about 9 percent on an annual basis for 1994. We still have health costs as an uncertainty, and the strength of the economy generally I think is increasing the chances that inflation could start to heat up.

I think both the appearance and the actuality of the stronger economy coupled with the realization that there are checks on this growth are feeding some of the uncertainty that is reflected in the wide range of forecasts for GDP, inflation, capacity constraints, and interest rates. We see a little more diversity of opinion than we ordinarily do on the forecast front, and this is feeding into the capital markets. They remain volatile and fragile. I think we're still facing a continuation of the sorting out process that was begun in February. At that time many people were on the same side of the market and positioned for more of the same--slow growth, with long-term interest rates expected to come down, and inflation expected to be under control. So when the jolts hit the market we saw more of an effect than might have been anticipated. Those jolts, of course, were precipitated by the initial Fed tightening but also were supported by reports of stronger growth more generally. People were having to fully assess whether or not real rates should be higher. Then, of course, we have domestic political uncertainties, Japanese trade pressures, China, Korea, one can go on.

Traders also have very short time horizons and they tend to think in terms of up or down, and neutral was really throwing them a curve. That, I think, enhanced the uncertainty in the markets. This portfolio unwinding that we've been going through is not an instantaneous process because the portfolios are complex. We also are faced with internal firm risk management constraints. The markets are efficient but they're not complete. As Bill McDonough mentioned, there has to be a searching for hedge opportunities as people seek to unwind. We have seen some market liquidity constraints as near substitutes have been sought and traders are trying to reduce exposures.

In sum, I don't think the turmoil is over. And in terms of the risks generally, while some people seem to think that they are more on the up side, I see some countervailing forces to those upside risks that are feeding the fragility and the uncertainty.

CHAIRMAN GREENSPAN. Thank you. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, what struck me most at the table today was the talk of inflation. I've heard more on that than I've heard in all the meetings I've attended in 2-1/2 years. That was a surprise to me. I don't think that the concern we have in the analysis is really on the demand side. I think the staff is right on target. We have moderately expanding demand. We have what would otherwise be robust demand being checked this year by fiscal policy contraction, by a rising yield curve, and by a deteriorating international situation. That's moderate. What we don't know, really, is what is happening on the aggregate supply side. Governor Kelley mentioned a very, very positive scenario, one in which productivity is improving as a result of substitution of capital for labor over the past few years. If he's right, then we have room for a very extended expansion. And, Mike, you have a surprising ally in my former colleague, Jim Medoff--I don't think we've ever agreed in the past--who sent me from the Center of National Policy an analysis of the normalized help wanted index against the unemployment rate. He concludes that the NAIRU is more like 5-1/2 percent because of the changes you've mentioned. I think that assumes that it is positive technical change that has driven the substitution of capital for labor. If, on the other hand, what has caused this substitution is a rise in the relative cost of labor to capital because labor is more expensive, perhaps because of government mandates or what have you, then really what we've had is a supply shock. And that may explain why I hear so much talk about inflation here in spite of the fact that the help wanted index is at the same level as it was at the depths of the 1982 recession. That surprised me; no one is demanding labor, yet we're hearing about inflation all the time.

We're going to have to see, and fortunately this is not the meeting where we are going to find out whether we have to go to something more restrictive. I think that President Jordan was right on target. The thing that we have forgotten is that during an expansion the mix in nominal GDP between inflation and real growth tends to worsen. In the Greenbook forecast, it's not worsening; it's staying at about 50/50. That probably isn't going to happen. If Governor Kelley is right, maybe it can last for a while longer; but history says otherwise and my bet is that in three months or six months we're not going to be talking about neutrality. But fortunately we can wait for three to six months for that to change.

CHAIRMAN GREENSPAN. Thank you, Governor, and that brings us to our coffee break. Let's take five, seven minutes.

[Coffee break]

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

CHAIRMAN GREENSPAN. Questions for Don?

MR. MELZER. Don, I just wanted to ask about the April tax payments and whether you think there is any peculiar behavior occurring that may be depressing M1 in the short run. A year ago we had a similar experience but you didn't mention that in terms of--

MR. KOHN. It's hard to parse this, President Melzer. In fact, April tax payments were up considerably from last year while last year they were low relative to the year before. It is true that this year's payments were less than we and everyone else had expected. So it's a little difficult to know exactly what seasonals were built in. Before we got this surge in early May, it looked as if the shortfall was bigger, and the low level of tax payments in April was one of the factors we were citing as a reason why M1 might have been slow in April because people hadn't built up their balances in order to pay taxes. That explanation didn't seem to have as much weight after the extra billions came in in early May and the tax receipts over the April-May period looked as if they were about 10 percent higher than last year. There might still be something in there since M1 growth this year is still low relative to its growth before the last year. It's very difficult to know what seasonals are implicitly calling for.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Don, I read the Bluebook as saying a 4-1/2 percent funds rate is neutral and here's an attempt to produce that kind of policy stance. All of your commentary was in terms of the "C" versus "D" alternatives, a 1/4 point versus a 1/2 point increase. You didn't discuss the pros and cons of going immediately to 4-1/2 percent, assuming that that is a neutral policy stance, nor did you discuss the possibility that 4-1/2 percent is too low rather than too high. A lot of your remarks were in terms of: "Well, we're not sure it's 4-1/2 percent; it might be 4-1/4 percent and there's even a possibility it might be 5, 5-1/2 or 6 percent." Even if we went to 4-1/2 percent immediately, or in the next six months, and if there were no movement at all in bond yields, no effect at all, you'd still have 300 basis points between the funds rate and long rates. What historical experience would lead you to believe that a 300 basis points upward slope in the yield curve is a neutral monetary policy?

MR. KOHN. Well, a couple of points. First, as between the 4 and 4-1/4 percent, I had assumed that those were the two options on the table. To be sure, moving eventually by more can't be ruled out--75 basis points or even more. I tried, but perhaps it didn't come through in my remarks, to raise the issue that 4-1/4 percent certainly might not be enough; and I expressed some concern that we not get stuck calling this neutral and therefore find it hard to rise beyond that. I agree that the Committee certainly needs to keep its options open--that 4, 4-1/4, even 4-1/2 percent may not be sufficient.

As to the slope of the yield curve, I think that's been a sometime thing in predicting economic activity. The yield curve was extraordinarily steeply sloped for several years in this current expansion before the expansion seemed finally to have gotten under way in a self-sustaining sense. It's certainly true that the markets have built into this spread more tightening than the staff forecast. I think it's a question of judgment as to where the implied economic strength is. Moreover, in judging the yield curve one has to take account of uncertainties and liquidity premiums. With all the uncertainty and higher volatility, some of the level of long-term rates is reflecting liquidity premiums, not necessarily expected movements in funds rates. But I don't disagree with the the overall thrust of your comment, which is that 4 or 4-1/4 or even 4-1/2 percent may not be high enough. I think Mike came to the same conclusion.

CHAIRMAN GREENSPAN. If there are no further questions, why don't I begin? One of the interesting aspects of this whole period has been the extraordinarily parallel pattern of movement between dollar-denominated long-term rates and the deutschemark and the whole series of other currencies, despite the fact that there are no very persuasive reasons why all of these rates should be fundamentally coupled. You have to ask yourself under what conditions you get a coupling of rates for noneconomic reasons, or for reasons other than the basic type we usually see.

The answer essentially lies in the notion, at least in my hypothesis, that if there is a risk premium out there which is generic, its impact will tend to be relatively the same depending not on what currency is involved but whether there is uncertainty about long-term commitments in financial markets and price stability in the markets. If we hypothesize that there has been a very significant increase in international portfolio holdings of many currencies, then if you get a major element of uncertainty--for example, if I'm a portfolio manager and I have long commitments in U.S. Treasuries on the expectation that prices are going to go up, and the markets go against me--what has happened is that my whole sense that "I know what it's doing" has collapsed. And the tendency, whenever uncertainty of that nature arises, is for human beings to disengage from whatever they're doing, to pull back. And pulling back in the U.S. Treasury market means going from 10-, 15-, and 30-year issues into the short end of the market, tilting the yield curve back up. But it also presupposes that any element of speculative uncertainty which exists in the holdings of long-term deutschemark relative to short-term deutschemark also induces an adjustment by sales of longer-term securities and purchases of shorter-term. This adjustment obviously can spill over into all sorts of portfolio holdings, provided there's a large amount of communication.

It is just very difficult to know why it is that U.S. dollar-denominated issues have so dominated the markets, and indeed why we at the central bank, by tightening, have obviously dislodged a lot of positions while creating a concept which is analogous to a generic risk premium that explains not the intercurrency movements but the movements from speculative positions--that is, from longer-end price-sensitive positions back to the shorter end. It also explains in part the nature of the financial bubble that we obviously have run into. This is a very interesting phenomenon because what we see is a very large increase in implied volatility in the long end of the market coming off the options, but only a very modest increase in the yield spreads of a number of the different types of instruments we use to measure credit risk. We've gotten a very small rise in the rate on six-month commercial paper over six-month Treasury bills; BAA corporate yield increases have been very small relative to U.S. Treasuries during all of this period. Junk bond yield spreads are not moving up, which is another way of saying that the concerns about the economy as such are not being undermined by all of this financial instability. What we come up against here is that there is a great deal of uncertainty and a lot of nervousness. And indeed some of it is purposeful on our part because if we are going to pierce the bubble, the only way we're going to pierce it is essentially to create a degree of uncertainty.

The issue of uncertainty as being helpful or unhelpful is really not clear-cut. We experienced periods of relative certainty in the latter part of 1993 which everybody just looked at as though the markets had no downside price risks; everyone was committed. The yield spreads were very marginal, and indeed they had all been coming down dramatically from the 1987 peaks after the stock market crash, and there was an element of euphoria that really gripped the markets. You could see that in huge increases in mutual funds, both stock and bond funds. In fact, what we were dealing with largely was a situation in which there was very little uncertainty. That clearly was a very unhappy state of affairs; the mere fact that uncertainty did not exist was not a good; it clearly was a bad. And our endeavor to break that pattern, which we had to do even though it turned out to be a much bigger problem than we suspected, was a very purposeful endeavor to create a degree of uncertainty and readjust holdings from weak hands into firmer hands as far as speculative securities are concerned. As a consequence we have taken a very significant amount of air out of the bubble. We had discussions in this Committee not on the desirability of raising rates and tightening the markets because the economy needed it--I think that was a universal view--but there have been differences here about how much the financial system could take before its tensile strength broke. And I think what we have reached in conclusion at this particular point is the defusion of a good part of the bubble. I think there's still a lot of bubble around; we have not completely eliminated it. Nonetheless, we have the capability I would say at this stage to move more strongly than we usually do without the risk of cracking the system.

I think the economy is probably stronger than we suspect, partly for reasons that I raised back in February; the inventory situation just strikes me as too tranquil, and before this is all over I think we've got to get something moving on the inventory side. Look at the lead times on deliveries of materials; they've just moved up modestly. Slowdowns in promised deliveries have clearly moved up and that's far more than an issue of the weather in the month of February. So there are the makings here of stronger inventory changes than I think we recognize.

The most interesting aspect of the economic outlook as I see it is that this far into the recovery--and it's almost immaterial whether or not you take Jerry's view that in effect we're only in the first year of the recovery--the actual inflation rates, wage rates, and the like are lower than one would ordinarily expect. This raises the question, which I've raised in earlier meetings, as to whether the lack of financial tinder is a relevant consideration here in holding inflation back. The truth of the matter is that it almost doesn't matter, because as Gary Stern said--and I think quite legitimately--we may not know what the future looks like but we do know at this particular stage, with the relative lack of imbalances that exist in the economy, that the chances of overdoing a tightening of monetary policy and creating a cascading down in economic activity are really not very large. If we overdo it, what we will do is push economic activity farther out. The chances of our breaking the back of the economy at this point--with inventory levels as low as they are, capital goods markets still with significant momentum, and the orders as strong as they are--have to be pretty low. The obvious problem is that errors on allowing inflation to take hold, even if the data raise questions as to whether it will, involve another type of risk altogether. As a central bank we obviously can't take that kind of risk.

The sentiment of the Board of Governors, as you probably know, is to move the discount rate, as nearly all the Reserve Banks have requested, by 50 basis points today. And the implicit view of the Governors is to request of the Committee that we allow all of the increase to pass through. There is a balance of concerns as to how we should state that, but if we are going to act, I do think we should indicate that we are taking out a substantial part of the degree of accommodation that existed through the 1993 period. But I'd leave open the issue of any further moves; while we may pause for markets to interpret that, we ought to make adequate leeway to move should events require that we do so. My own impression is that we probably will not have to move before the next meeting if we do 50 basis points now.

I find it unlikely that we are near the end of this pattern, but I do think we are now becoming more data dependent. There really are two credible economic scenarios that we have to keep in mind. One is something quite similar to the Greenbook forecast and, if that scenario evolves, the inflationary pressures on the system will come down. If it doesn't evolve, if we still have momentum in the system, I think the pressures are going to pick up on us to move--not immediately, but sooner rather than later. The crucial issue as far as I'm concerned, however, even though it's not a critical matter in the forecast, is to watch what's happening to the financial system--what's happening to bank loans, to credit extensions, to the degree of financial tinder that is either not moving or moving. We need to be very careful about this very large risk premium that exists in the financial markets, which basically says that this bubble is a bigger one than we had anticipated. We've caused a good part of it to dissipate, maybe even most of it, but it's very obvious from the implied volatility numbers we're getting out of the options that these markets are not about to simmer down very quickly.

So, I merely have put the issue out on the table. I have a particular view, were we to move 50 basis points, on whether we should go symmetric or asymmetric. My preference is symmetric, but frankly I don't think it means very much because if the economy accelerates we'll be holding special Committee discussions, with or without symmetry in the directive language. My own inclination would be to go symmetric at this stage, but I don't feel very strongly about it. With that I open this issue up.

MR. FORRESTAL. Mr. Chairman, as you know, I've been a proponent of gradualism, but I believe we're at the point where we need to take more aggressive actions. I think the gradualistic approach may have created some uncertainty in the market. I've heard some of the same comments as were reported earlier. People have suggested that if we are going to do something, we ought to take strong action. So, I'm really supportive of that action. I think there is considerable momentum in the economy. Our forecast, as I indicated earlier, is for stronger growth than the Greenbook forecast, and even building in 50 basis points we see the inflation numbers in 1995 as unacceptable. So, I think that there ought to be a 50 basis point pass-through to the market, and I would prefer a symmetric directive as well.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I, too, would support a 50 basis point move and I prefer a symmetric directive. I must admit I'm not convinced at this point that our gradual approach was the wrong one, and it still may serve us well in the future. But I do think 50 basis points is appropriate at this time. The other point I'd like to make is that I hope any public statement we make doesn't convey either the impression that we are likely to do anything in the near term or that we are likely to rest on our oars for a while. I think that--

CHAIRMAN GREENSPAN. Excuse me, I'll just read you a very preliminary draft.

MS. MINEHAN. Which you just happen to have!

CHAIRMAN GREENSPAN. I just happen to have it here! This implies that we move on both the discount rate and the funds rate. "These actions, combined with the three adjustments initiated earlier this year by the FOMC, substantially remove the degree of monetary accommodation which prevailed throughout 1993. As always, the Federal Reserve will continue to monitor developments in the economy and financial markets to judge the appropriate stance of monetary policy." I think that captures where we want to be.

MR. PARRY. Good.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Alan, I would endorse what you recommended. I'd like to briefly state my reasons. First of all, as you know I've viewed the stance of monetary policy as having been very accommodative for some time, which I think will lay the basis for an acceleration in inflation. Over the last three years, for example, our net open market purchases of government securities have totaled over $100 billion, which is a staggering number. This expansion in base money has fostered a tremendous increase in liquidity, with the narrow money stock, M1, increasing by one third over this period. Secondly, I don't think we've gained credibility in financial and foreign exchange markets with respect to our resolve to contain inflationary pressures, let alone achieving or moving further toward price stability. With respect to the risk of overdoing it, I would agree with what you said. One of the things I looked at in that connection is the prevailing forward rate structure, which is cited in the Greenbook; it anticipates about 150 basis points of increase in short-term rates before the end of the year. So, as I say, I don't think this move is overdoing it. In fact, if we don't keep up with sustained increases in market interest rates, I think we run the risk of a policy that continues to be accommodative and will simply increase the inflationary pressures down the road.

With respect to the statement that you read, I would be concerned about anything that was interpreted as our having reached neutrality, because I don't think we really know. I'm a little concerned that maybe those words--I don't have an alternative suggestion--too strongly suggest that we've reached a neutral stance. I just don't know what that is.

CHAIRMAN GREENSPAN. Neither do we. President Broaddus.

MR. BROADDUS. Needless to say, I support your proposal enthusiastically, but I share Tom Melzer's feelings. When I heard the statement I had the same kind of feelings that you had, Tom--that it may tend to suggest that we've reached a plateau or reached neutrality. Maybe we can work on it a little bit. Also, along those lines, I don't have really strong feelings about the language of the directive, but I think a symmetric directive would tend to create the impression that we have reached a plateau. So, while I would accept a symmetric directive, I have a preference for an asymmetric directive.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support a 1/2 point increase, the symmetric directive, and I like the draft statement the way it is.

CHAIRMAN GREENSPAN. First Vice President Minehan.

MS. MINEHAN. I agree with President Boehne. We support the 50 basis points; we support the symmetric directive, and the wording of the statement.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I support the proposal in its entirety. I am a little concerned--somebody mentioned this earlier--about the comments we get from time to time that we ought to take whatever actions we're going to take and then pause. I don't think the statement gives the impression that we're necessarily locking ourselves into that for any extended period of time. I guess what I'm concerned about is a view in the markets now, and I don't know why it should arise now, that we are more clairvoyant than we are--that we somehow know where we're going and when we're going to stop. And I think we ought to be careful and try not to convey that impression.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. I endorse the proposed moves, both of them. The economic case continues to exist for this move and I think we do have a window of opportunity for making it. I support symmetric language. I am a little concerned about the statement giving the impression that we are satisfied or that this pause may run a while, although I can't think of a better way of saying it. That's the only concern I have, Mr. Chairman.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Well, Mr. Chairman, I certainly support the proposal. The only question I have is a technical one. Is this a single announcement today and is it going to be announced by you or announced by the Committee or--

CHAIRMAN GREENSPAN. It's going to be announced as a part of the discount rate announcement. In other words, there's no need to make two separate announcements.

MR. KEEHN. Okay.

CHAIRMAN GREENSPAN. It's not by me; it will be by Joe Coyne. Governor LaWare.

MR. LAWARE. Mr. Chairman, I'm very pleased to support your recommendation, and I think the elegance of the language permits the interpretation that was intended--that we may still be probing, that we are not sure that we are at neutrality, that we have taken a significant step forward, but we're not at all committed to standing pat. I just think the language is beautifully composed.

MR. MELZER. One suggestion, I'm sorry to butt in, but maybe the phrase "significantly reduces" rather than "substantially removes." I don't know whether that--

CHAIRMAN GREENSPAN. We played with that. I think it's a tricky issue and I'm trying to avoid--if we ever tried to write a communique around this table we would be here for a good six months! President McTeer.

MR. MCTEER. I support your recommendation.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I also support your recommendation. It seems to me that it is appropriate to go ahead and make our statement in the market, and I think this proposal would do so. When we started this series of moves of 25 basis points, we talked about the notion that when we think the series of moves should come to an end we should so signal. I don't think--

CHAIRMAN GREENSPAN. It was at the point when we thought that the structure of the financial markets could take more.

MS. PHILLIPS. Right, right.

CHAIRMAN GREENSPAN. At the very beginning we were concerned that we would be hitting the markets too hard.

MS. PHILLIPS. I don't know whether we're at neutrality or not. There is an argument that we may well be at neutrality because we may be getting more of a kick from our tightening actions as a result of the increase in long-term rates. So, in any case, I support your recommendation.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Your initial remarks I think are very important. We can learn a fair amount if we think more about what's going on with relative yields. Normally when we think about a relative move it's either by quality spreads, by currency denomination, or by maturity. At one time I studied the behavior of interest rates in periods of crisis atmosphere relating to an international event: Suez, the Bay of Pigs Cuban missile crisis, the Yom Kippur War, Iraq in 1990, and so on. The yield curve always steepens very sharply as portfolio managers shorten their horizons. As the uncertainty dissipates the yield curve flattens. That's quite different from the cyclical behavior of the yield curve as an expansion matures. I think that we're closer to conditions of 1978 than we are to some other historical episodes. In April 1978 President Carter said that there was no danger that excess demand would spill over and raise prices just when the latter were about to explode. And through 1974, 1975, and 1976, as you recall, the economy was fairly tranquil; wages were fairly well behaved. Some of this started to change a little in 1977, but nobody saw it coming. At least I certainly didn't. The Administration had misread the situation in 1978 because they looked at things like wages; they looked at a lot of things and said there was no problem with inflation, and they were wrong. They never saw it coming. And I'm concerned that we may be wrong again. It struck me in the go-around earlier that at least some of you looking at the world from inside the beltway--Governors Kelley, LaWare, and Phillips --have a different feel of the economy than what I sense from the other twelve of us. Certainly I thought this was a marked difference, and I'm not sure quite what to make of that.

I'm not troubled with the idea of saying we're at neutral and we're on hold. If a very powerful move had to be made, we would act anyway. None of us is going to know in advance whether any 25 basis point difference is significant or not, whether it's to 4-1/4 or 4-1/2 or 4-3/4 percent. But to me it's quite different to say we're at 4-1/2 percent and we think that it's just as likely the next move is down as up sometime out in the future. Being neutral implies an equal probability that the next move will be down as up; we never know this. If this group walks out of here today saying we're at 4-1/4 percent and most people's commentary is, as it has been after the last couple of meetings, that we've got more to go, I would find that troubling.

I would much rather if everybody walked out and said we're at 4-1/4 percent and we don't know whether the next move will be down or up. To me that's a lot different than the majority of people responding in the weeks ahead, as we get queries about this, saying: "Well, we're not quite at neutral; we've got more to go." That adds uncertainty to the bond market that I don't view as constructive. I would rather have a stronger statement that we don't know when we're going to move again and if we do, it might be down or up. If people are not comfortable with that 4-1/4 percent, let's go to 4-1/2 percent and do a full point on the discount rate. I'd rather do more than less.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. I support the 50 basis point increase in the funds rate and the symmetric directive. I think it is going to be seen as a very powerful action by the marketplace both inside the United States and out. I do think that we have to make a statement. There will be people whose only view of the world is based on their own trading positions who will be disappointed by our not saying the word of God is that this is it for some extended period of time. We can't say that and shouldn't say that, but I think we should be aware that it is not a sure thing that this action plus the statement, which I think makes a great deal of sense, will necessarily stabilize the financial markets. I hope it does, and it probably will after a couple of days, but it need not happen in the hour or two or even a day or so after the meeting. I believe it will be very well received outside the United States where attitudes are to a substantial degree affected or influenced by our fellow central bankers. The Chairman was at the last BIS meeting and, if I may say so, did an unusually good job of explaining the U.S. position, and I don't think anybody who attended that meeting will have any doubt that this is a very firm, decisive action. And I think we will be very much applauded by our fellow central bankers in many of the countries around the world.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I support the recommendation and I would particularly like to associate myself with Governor LaWare's comments about the elegance and appropriateness of the statement that you proposed.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I support the statement, Mr. Chairman. I think we will be coming back. I thought President Jordan made a very good point, and probably nine days ago I was about where he is. But I think this is the right move for right now and I don't know if I can pick any number where I could go out and say that the probabilities of moving up or down are equal. There's a level of uncertainty about the economy and about the financial markets that causes me to express some uncertainty about my interest rate objective. I think the statement is very well written, and I support it.

MR. BERNARD. I'll be reading from page 15 of the Bluebook. "In the implementation of policy for the immediate future, the Committee seeks to increase somewhat the existing degree of pressure on reserve positions, taking account of a possible increase in the discount rate. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration of economic, financial, and monetary developments, slightly greater reserve restraint or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with modest growth in M2 and M3 over coming months."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Broaddus	Yes
President Forrestal	Yes
President Jordan	Yes
Governor Kelley	Yes
Governor LaWare	Yes
Governor Lindsey	Yes
President Parry	Yes
Governor Phillips	Yes

CHAIRMAN GREENSPAN. The next meeting is on July 5 and 6, the Humphrey-Hawkins meeting. This meeting is adjourned.

END OF MEETING