

Meeting of the Federal Open Market Committee
September 24, 1996

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, September 24, 1996 at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Jordan
Mr. Kelley
Mr. Lindsey
Mr. McTeer
Ms. Phillips
Ms. Rivlin
Mr. Stern
Ms. Yellen

Messrs. Broaddus, Gynn, Moskow, and Parry,
Alternate Members of the Federal Open Market
Committee

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

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

Messrs. Lang, Lindsey, Mishkin, Promisel,
Rosenblum, Siegman, Simpson, Sniderman, and
Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

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

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

Mr. Smith, Assistant Director, Division of
International Finance, Board of Governors 1/

1/ Attended portion of meeting relating to proposal to amend the
Authorization for Foreign Currency Operations.

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

Ms. Pianalto, First Vice President, Federal Reserve
Bank of Cleveland

Messrs. Beebe, Davis, Dewald, Eisenbeis, and
Hunter, Senior Vice Presidents, Federal Reserve
Banks of San Francisco, Kansas City, St. Louis,
Atlanta, and Chicago respectively

Messrs. Bentley, Hetzel, Ms. Krieger, and Mr.
Rosengren, Vice Presidents, Federal Reserve
Banks of New York, Richmond, New York, and
Boston respectively

Mr. Sullivan, Assistant Vice President, Federal
Reserve Bank of Chicago

Mr. Weber, Senior Research Officer, Federal Reserve
Bank of Minneapolis

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CHAIRMAN GREENSPAN. Would somebody like to move approval of the minutes? Bob, I know the San Francisco District is three hours behind us, but I think you are going to have to move their approval.

MR. PARRY. I would like to move! [Laughter]

CHAIRMAN GREENSPAN. Without objection, the minutes are approved. Peter Fisher.

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

CHAIRMAN GREENSPAN. Thank you. Questions for Peter? Governor Lindsey.

MR. LINDSEY. Concerning the French budget, it appears that the French got from here to there with asset sales. Of course, the budget is a very flexible document, but one would think that asset sales would be a little suspect by the terms of Maastricht. Why is the European Monetary Union going to bless this?

MR. TRUMAN. It remains an issue under Maastricht, and I think the answer is politics. It's not settled yet, but it appears to be headed that way.

MR. FISHER. To put the market's reaction in a nutshell, I think the market is focusing on the question of whether the politicians can pull a rabbit out of the hat. Maybe they can. Having a commission in Brussels bless the French budget is one aspect of how the politicians may be able to do that. The markets are not going to underestimate the ability of the politicians. Those who are positioning in the expectation that EMU will implode fear that the politicians may pull a rabbit out of a hat and when they see something like that happening, they back up and reassess the question of speculating against the EMU.

MR. LINDSEY. So, the markets are saying that the triumph of politics over economics is a good thing?

MR. FISHER. In the short run, it may work that way. The market practitioners are concerned that they could lose a lot of money if they underestimate the politics.

CHAIRMAN GREENSPAN. The real question is the outlook for the EMU. If one thinks the EMU is going to fail, one would expect the deutsche mark to rally very sharply. If one expects the EMU to hold together, for whatever reason--all the countries may be running 5 percent deficits but they may still decide to come together--that means the deutsche mark is going to be put into a structure that will inhibit its strength, which is what the EMU will do. So, what is really involved is a practical judgment about the prospects for the EMU, not whether it is good or bad, I don't think the market is going to be judging whether it is good or bad. They may in fact view it as phoney as a four dollar bill--an American four dollar bill.
[Laughter]

MR. TRUMAN. The question, Governor Lindsey, is whether we are talking about high politics or grass root politics and that is another source of uncertainty. The high politics may bring it about. The question is whether the grass root politics will follow the high politics.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. I believe also that there are a couple of recent events that make one rather more inclined to think that the politicians are taking a fairly sensible line. The last time we were together, there was a real question by most observers as to whether the leading countries would allow the Maastricht criteria to be fiddled. You may say that this interesting and creative budgetary fix by the French is a bit of a fiddle, but I would note that Chancellor Kohl on the occasion of President Tietmeyer's 65th birthday made a very strong speech in favor of Maastricht and the need to observe its criteria very carefully. He was followed by President Chirac who supported him. In addition, there was a very significant event last weekend when the Germans took a position that I think is very rational. The big risk is not that EMU may not take place; it would appear now that it will. The question is what happens after it does. The key to that is what Finance Minister Waigel has brought forth. It is called a stability pact, and last weekend in Dublin the finance ministers and central bankers met and endorsed this stability pact. That is a very significant development. They still have to decide whether the punishment for violating the fiscal rules after EMU will be automatic and just how it will work, but the agreement in principle is quite significant.

CHAIRMAN GREENSPAN. It is, but if you take an asset sale that is one-half percent of GDP and consider that appropriate, the fudging potential involved in the stability pact is quite considerable. So, a lot of future relationships are at stake. I agree that these last two events imply that EMU is going to happen. The question is about some of the crucial issues that the Germans specifically are very concerned about, especially a fudged or temporary 3 percent Maastricht followed by erosion. The Germans have made very strong statements on this issue, and the question is whether the agreements are in fact going to back up those words. I would say that the evidence, as Governor Lindsey suggests, does raise some questions.

VICE CHAIRMAN MCDONOUGH. Yes, it raises questions. However, before these recent developments, the overwhelming expectation was that if EMU happened, it would be followed by something that simply would not work. The whole notion of trying to use monetary unity to create political unity has never succeeded anywhere. Now, it looks as if they are doing some things that at least make disaster not as predictable as it seemed to be until recently.

CHAIRMAN GREENSPAN. They are cutting down the sharp edges of the adjustment costs. Governor Rivlin.

MS. RIVLIN. Just based on our own experience, I suspect they will have long wrangles in the context of the stability pact about what counts and what does not. It isn't until you have budget sanctions that you even have to face up to those questions. It is

possible that European markets are simply not very sophisticated about budgets yet, and that what counts and what does not is something on which they have not really focused.

CHAIRMAN GREENSPAN. Budget accounting basically.

RIVLIN. Yes. We have worried about this for a while, but they have not.

VICE CHAIRMAN MCDONOUGH. That is a very good point.

CHAIRMAN GREENSPAN. Even with our fairly specific unified budget principles, there is an awful lot of fudging that goes on in the process.

MS. RIVLIN. We had to make rules about asset sales.

CHAIRMAN GREENSPAN. Any further questions?

MR. TRUMAN. What is involved in the French budget is not actually an asset sale, but a somewhat complicated takeover of pension obligations in return for cash. It is a kind of asset sale. Economists would call it an asset sale; I'm not sure accountants would.

CHAIRMAN GREENSPAN. We call it an asset sale. [Laughter]

VICE CHAIRMAN MCDONOUGH. It is an asset sale a la francaise! [Laughter]

CHAIRMAN GREENSPAN. Any further questions? If not, would someone like to move for a vote to approve the domestic operations?

VICE CHAIRMAN MCDONOUGH. I move their approval.

CHAIRMAN GREENSPAN. Thank you. Without objection. Mr. Prell.

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

CHAIRMAN GREENSPAN. Any questions? President Parry.

MR. PARRY. Mike, the information coming from the employment data may be somewhat clearer than you have suggested in the sense that, while admittedly the unemployment rate number is questionable and the labor force has been very volatile with large declines, the nonfarm payroll message is very consistently strong and seems fairly reliable. In addition, I have a feeling that we are going to have upward revisions in that area. We have had such revisions in the last couple of years because the survey does not take into account, as well as it should, hiring by new businesses. There was a big upward adjustment when the last revision was made, and I would expect to see another. So, although I agree with your point about the ambiguity surrounding many of the numbers that have come out in recent weeks, when it comes to the production side, particularly employment, it seems to me that we do have very consistent strength.

MR. PRELL. I don't think I can comment very productively on your point about what future revisions may show. We do not have a basis for a judgment about whether the allowances that the BLS makes in blowing up their samples for new firms and other statistical problems are on target this time or not. To be sure, there have been sizable revisions at times in the past. On the broader point, as I tried to suggest, we certainly do see evidence that hiring has continued to be quite robust, probably outstripping the trend increase in labor force growth. However, I am not sure how much that tells us about things going forward. It may be in essence that this reflects the strong production gains that we have seen recently rather than the anticipation of much more rapid growth in business than we have projected. I think the indicators of business sentiment that we have suggest that firms are anticipating growth, but not necessarily growth that differs greatly from what we are forecasting. It is a risk, and certainly this is a part of the picture where households that have enjoyed very sizable income gains recently, and probably are continuing to do so in September, add a certain buoyancy in the economy that is visible in consumer sentiment. That is probably a response to the very favorable labor market environment.

CHAIRMAN GREENSPAN. Any further questions? If not, would somebody like to start the roundtable? President McTeer.

MR. MCTEER. Economic growth in the Eleventh District has continued to run a little faster than the national average. In recent months, we have benefited from higher energy prices, the rebound in the Mexican economy, and strong warehouse construction activity following the deregulation of trucking. The Texas rig count has risen 22 percent so far this year, with the result that business and consumer sentiment is quite high in Houston and Midland. With the rebound in the Mexican economy, exports from Texas to Mexico were up 17 percent in real terms in the first half of 1996 and are back to levels that prevailed prior to the peso devaluation. Rail and truck traffic also has returned to predevaluation levels. Optimism along the border is slowly returning. Three months ago, only 10 percent of El Paso employers planned to hire additional workers; in a recent survey, more than 26 percent planned to hire new workers. Construction activity in the District is expected to remain strong, as falling vacancy rates and rising rents improve the anticipated returns on offices, warehouses, and retail space. Office and retail rents have been rising in recent months. In some markets, first class office space is about fully absorbed. Warehouse construction continues to be strong particularly in Houston, Dallas-Fort Worth, and El Paso. This construction activity has more than offset a very mild slowing in residential construction.

We continue to hear increased anecdotes about tight labor markets and rising pressure on wages, and we hear more rumblings that the higher labor costs will have to be passed on in higher prices at some point in the future. But so far, there is little anecdotal evidence of widespread price increases. At both our board of directors meeting and the meeting of our advisory council on small business and agriculture, there were frequent mentions of shortages of a wide variety of workers and of wage boosts that were considerable in some instances. In some but not all cases, prices have been increased, with rising wages as the justification.

Regarding the national economy, I agree with the broad outline of the near-term outlook in the Greenbook. Some signs of slowing have begun to show up and growth more in line with the economy's long-run potential seems more likely than was the case at the time of our August meeting. The risks, however, appear to be on the up side for both growth and inflationary pressures. If anything, the risks have risen over the past several weeks, but I continue to feel that we may be worrying too much about sizable employment growth and low unemployment rates when prices themselves and leading indicators of final prices, such as prices of commodities and metals, including gold, are behaving so well.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. I first want to comment on Bob Parry's point about the nonfarm payroll numbers because those revisions go in both directions as we have seen. Currently, the BLS is using a plug of 140,000 per month for jobs created in new business startups. In 1990, they were using 80,000 per month. They subsequently decided that the number should be negative and wound up revising the employment data down. By the nature of those plugs, they are always going to miss the turning points. At some point, there is going to be a big revision in the opposite direction, just like last year's upward revision.

Turning to the national economy, we got a copy of the August survey of the National Federation of Independent Business, which was also mentioned in some of the material we received from the Board staff last night. I noted with interest that an expansion high 27 percent of the firms said that they have been increasing their compensation, and yet there was a decline in the percentage that said they were going to be raising their prices and an increase in the number saying that their earnings were improving. That says to me that productivity is really quite good. Plans for capital spending rose 4 percentage points, so at least from that sample of a very large number of small businesses, the productivity explanation of developments in compensation is being verified.

On the strike situation, people in the District are very pleased with the outcome of the Ford contract and they generally do not expect GM to take a strike. But the answers were not entirely consistent on that point. We have talked to the large auto supplier companies who say the UAW's concern is not GM workers; it is UAW workers. GM wants to sell some of their parts operations. The UAW wants a say in who buys those parts operations because the union wants them to remain UAW plants under the new owners. If that is agreed to, the UAW may go along with GM's outsourcing intentions. The issue is not going to come down to compensation, and the big companies that we have talked to say that they do not expect a strike.

In the District, we have had a number of meetings in the last few weeks with directors, advisory councils, and bankers. We asked them about the kinds of capital spending they had seen and business plans for the future. We asked in particular whether business firms were trying mainly to increase capacity or trying to increase productivity. Most said that capital spending would continue to expand but at a slower pace through 1997 compared with what we have seen in the past three or four years, and it would be almost entirely

for the purpose of improving productivity. I have only a few stories about firms that are actually increasing their capacity. One director reported that the paper processing equipment now being installed uses 50 percent less labor than the equipment it is replacing. Since the capacity of paper producing operations is growing, there has been some softness in prices, but he said the really extraordinary efficiency of this new equipment is what is driving the industry's investment decisions.

We asked firms about compensation increases and whether in their judgment, or that of other firms they talked to, the increases were warranted on the basis of productivity improvements or whether they were seeing pressure on earnings and/or pressure for higher prices. We did not hear any stories about higher prices. We did hear some stories about pressure on earnings, but basically our contacts were saying that they were not going to be passing along higher labor costs or attempting to raise prices for the foreseeable future. We did hear some reports that it is now easier to find people at the entry level than it was earlier, especially in Kentucky and Indiana where it had been very difficult. One of the directors from western Pennsylvania simply said that business there was in the doldrums. Steel and oil executives tell us that their production capacity is rising faster than demand, and they expect downward pressure on prices. Basically, they said the investment in steel producing facilities in the last couple of years is starting to come on stream now and will continue doing so out into 1997. Accordingly, with foreign competition also increasing, they expect more difficulty in just holding the level of steel prices.

We have continued to hear stories about rising delinquencies, late payments, bankruptcy filings, and therefore more charge-offs in the banking industry. One report that I found interesting for an area that is so heavily influenced by motor vehicles is that there is an ample supply of tool and die makers. This is not usual for our part of the country in the sixth year of an expansion. The reason given is that investment in computerized design and manufacturing technology is making these people easy to find. One very large auto parts company said that they are now producing the same truck parts with 20 percent fewer hours than in 1994. Productivity improvements at their plants have been averaging 5 to 7 percent per year, and they expect that to continue.

Let me turn to the Greenbook and the national economy. It seems to me that there are at least four views about monetary policy in the current situation that are all respectable views even if not equally probable. Of course, there could be some combination of these four views. One is that the current stance of monetary policy is such that in the future we are going to see an acceleration in the growth of final demand. But because of capacity constraints, however one wants to think about that, the growth in output or aggregate supply cannot increase along with aggregate demand, and therefore we will get higher prices. That is why at the last meeting I was so disturbed by the upward revision in the nominal GDP projections through 1997. That revision has now been reversed in part, so my concern from that source has been relieved. A second view is that the stance of monetary policy is not going to produce an acceleration of growth in aggregate demand, but growth in aggregate supply will slow toward an annual rate of about 2 percent because of capacity constraints. That assumes

productivity and labor market conditions similar to those in the current Greenbook. Therefore, inflationary pressures are going to increase modestly in this view, but they will still increase. A third position is that the current stance of monetary policy is going to lead to a slowing in the growth of nominal spending and in aggregate supply or potential output at a more or less parallel rate. Therefore, inflation will continue at about the same rate; we simply do not make any progress in reducing inflation. The fourth position would be that nominal spending growth is going to slow because of the current stance of monetary policy, but output growth is not going to slow as much because of the productivity improvements from the capital spending of the last four years--the introduction of new technologies, and all of that. Therefore, we will get less price pressure in the future. I think that those scenarios pretty much encompass the views of what we are hearing from Wall Street, from analysts, and other commentary about whether current policy is too tight or too easy.

CHAIRMAN GREENSPAN. President Broadus.

MR. BROADDUS. Economic activity in our District has continued to expand at a reasonably steady pace over the period since our last meeting. There does appear to have been some moderation in the rate of growth of household spending and also in residential construction activity in some parts of our region from their very strong pace in the first half of the year. But our latest regular survey of manufacturing indicates that factory activity rebounded very sharply in the latter part of the summer from its somewhat sluggish performance earlier in the summer. Shipments, new orders, employment, and the average workweek have all been rising in that sector. Also, as noted in our Beigebook report and picking up on a comment that Mike Prell made, commercial real estate activity clearly has strengthened through most of our region as vacancy rates have declined and rental rates have crept up. The improvement is not so apparent in the Washington metropolitan area, but it is very evident in the southern part of the District in particular.

Probably the most striking aspect of the recent regional information--and I suspect this is true around the country--is the persistent and increasingly widespread reports of very tight labor market conditions. We, too, had a meeting last week of our small business and agricultural advisory committee and all five small business representatives who attended reported some difficulty in attracting workers despite fairly sizable wage increases in some cases. We continue to get similar comments from the directors on all of our boards and in response to our periodic surveys. Recently and interestingly, there have been more complaints especially from construction firms and employment agencies about the difficulty of finding suitable unskilled and semi-skilled workers. There are people out there, but many of them have very little job experience and in some cases very little schooling. As a result, their productivity is quite low and firms are reluctant to hire them in light of the potential costs of doing so. Given this situation, some of our contacts have told us that local labor markets are really tighter in many cases than the already low state and local unemployment rates might suggest. One other indication of tight labor markets comes from state reports of withheld taxes; I think the latter are running higher in all of our states and jurisdictions than had been projected earlier in the year.

Finally, Hurricane Fran hit our region pretty hard. I remember looking at the radar weather report, and at one point the clouds were coterminous with the boundaries of my District. North Carolina was especially hard hit; the damage there is estimated somewhere in the neighborhood of \$3-1/2 billion and the majority of it, though not all by any means, was to private residences. Repairing that damage is going to spur activity in a local area that is already operating at a very high level of economic activity in relation to capacity.

I do not have a lot to say about the national picture beyond what I have been saying for the last couple of meetings and that already has been noted by Jerry and others. The Greenbook projection continues to reflect the view that monetary policy is now restrictive enough to foster a deceleration in real GDP growth to its long-term potential, and then to maintain such growth pretty much indefinitely. In this environment, core inflation moves up fairly modestly to about 3 percent in 1997 and holds there in 1998. Maybe this will happen, but my feeling is that it is hardly a sure thing, and I continue to think that there are significant upside risks on both the real side and the inflation side in the current projection period.

CHAIRMAN GREENSPAN. Mr. Gynn.

MR. GYNN. Thank you, Mr. Chairman. In my view, the recent economic data and anecdotal information show an economy that is operating at a healthy pace. In fact, coming off a surprisingly strong second quarter, GDP growth is averaging just under 3 percent on a year-over-year basis and is exceeding my earlier expectations. As others have observed, the growth is both broadly based and without serious imbalances. Job growth, which has gotten so much attention and discussion, underscores the strength of economic activity. Although labor shortages are not widespread in our District, I am hearing more complaints in recent weeks and months about both the quantity and the quality of available workers. Fortunately, investment spending seems to have kept capacity utilization within a reasonable range. The slowdown that I had expected in the pace of activity has been slower in coming and is still less obvious than I had anticipated. Some signs of slowdown, which we thought we saw in the data in earlier months, were either revised away or reversed. For example, after sorting through the mixed signals that Mike Prell reviewed on housing, it looks as though that sector has continued to be surprisingly strong and that has brought with it strong spending on consumer durables. The most recent data on retail sales may signal some slowing in consumer spending, but it seems to me that the underlying fundamentals of job and income growth provide a continuing source of strength. Our revised forecast for the remainder of 1996 and into 1997 is for a continuation of good growth but with some moderation. That moderation, again, is not coming as soon nor to the same degree as we had earlier forecast.

Despite the greater than expected pace of growth and the low rate of unemployment, price pressures appear to remain modest. While the special effects of the increases in energy and food prices are working their way through the price indices, economy-wide measures of prices remain low. At the same time, I am hearing more and more concerns anecdotally about wage pressures. Some business people I have talked to are actively weighing the costs and benefits of trying

to hire more qualified workers, and with that they seem to be developing a clear intention to try to pass through their higher costs by increasing their output prices. At the same time, we continue to hear stories of intense competition that limits price increases across almost all industries, sometimes causing price increases earlier in the year to be rolled back. Finally, in my conversations I continue to try to gauge expectations for both growth and inflation. While it is hard to find folks who want to argue that growth is too strong, the one plea I almost always get when I have serious and in-depth discussions is for a policy that optimizes the chance of keeping inflation at moderate levels. That is something that people would like to be able to take for granted in their decision-making and negotiations.

In the Southeast, we have continued to see growth at a moderate pace in August and September. Retail sales remain strong and, in fact, exceed last year's levels. Tourism, which is so important to our District and especially to Florida, has been somewhat mixed, but the outlook is mostly positive. Consumer confidence remains unchanged, while manufacturing continues to expand at a moderate pace. The declines in the apparel and textile sectors that I previously talked about at these meetings continue to show up. Part of that loss is being made up by the expansion of the auto industry in our region. Single-family home sales were mixed throughout the District, while builders noted that new home sales and construction remain healthy but flat. As Al Broaddus observed for his region, class A office space is in short supply in several of our markets, and we are beginning to see some speculative projects, notably in Florida and Atlanta. District bankers report moderately strong loan demand and some decline in credit quality. Payroll employment increased in June and July. Scattered reports of localized labor shortages are more common. Despite those, there are few signs of increasing wages and only spotty reports that the increases are affecting market prices. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, overall economic conditions in New England remain good. In particular, the regional unemployment rate in August was a full percentage point below the national rate. Initial unemployment claims have been falling and are approaching levels last seen in the 1980s. In thinking about this, we had a discussion about how our regional economy feels now versus how it felt in the late 1980s. Basically, the thinking is that the dynamism--or as some would phrase it, the frenzy--that characterized the New England economy in the late 1980s is not there now even though the unemployment numbers are approaching the levels of the late 1980s. Payroll employment expanded only 1 percent over the past year or at about half the national rate. Help-wanted advertising is about the same as a year ago and well below the levels of 10 years ago. The growth in average hourly earnings remains subdued, with increases for production workers only about 1.9 percent in New England over the past year compared with a national increase of more than 3 percent. However, the anecdotal reports are more positive than the statistics, and there is some speculation that the state employment numbers will be revised up when the benchmark revisions are done in early 1997. State tax receipts suggest greater strength than the employment data show.

The largest disconnect between statistics and anecdotes is in the manufacturing sector. Employment continues to drift down at New England manufacturers, but our informal contacts are generally very positive. Most report sales and orders comfortably above year-ago levels. Some report smaller increases than earlier in the year, but others see no evidence of any slowing. A great exception to this is the paper industry, which Jerry Jordan mentioned before. Manufacturing inventories are in good shape. Prices generally are flat and wage increases are in the 2-1/2 to 4 percent range. Most firms say they are not feeling wage pressures, but it depends on the kinds of employees they are looking for. Computer and software engineers are much in demand and can be had only if the employment package is sweetened with stock options and other incentives. Reports from the retail sector were also positive. Absent from the latest reports were the customary complaints about excess capacity and new competitors. Upscale products are doing especially well. Here, too, prices generally are flat, with a few increases of 1 to 2 percent reported. There are some recent articles that have suggested that changes in temporary help employment may be a leading indicator. If so, the reports from our contacts in this industry point to continued strength. Business continues to grow rapidly, wages are rising, and one contact reports that qualified workers in the technical and professional areas are able to demand wage increases of 5 to 10 percent over year-ago levels because they are in demand and because there is a wide range of options in terms of projects for them.

Turning to the national scene, we mostly agree with the Greenbook path for GDP, though I would question whether consumer spending will fall off quite as sharply as expected in the third quarter. However, that GDP path, given stable low unemployment rates through 1998, does not seem likely to result in such a stable level of inflation as is expected in the Greenbook. By anyone's estimate, labor markets are tight. The unemployment rate right now may not be 5.1 percent, but I do not think it is 5.4 percent, and I have some doubts about whether it will bounce back to 5.4 percent quickly. Such a bounceback seems to be what is needed to create the rather low CPI projections that are included in the Greenbook estimate. The inflation picture is also more than normally confused by BLS measurement changes. We have ignored those changes for the purpose of attempting to compare like numbers, which I know is futile, but they do appear to show an uptick of a slightly greater dimension than is reflected in the Greenbook numbers. The Greenbook forecast in some sense is an idyllic one, but the sense that I have is that we are using more than the normal amount of smoke and mirrors to create this idyll, and you should forgive that phrase, Mike. As I see it, this forecast is a very risky one. Growth may well be stronger, and even if it is not, the flow-through to inflation may well be more pronounced than is projected in the Greenbook.

Let me close by noting that our Bank, along with everybody else's, has normal rounds of meetings with outside groups. We had a group of academicians in the other day--Paul Samuelson, Jim Duesenberry, Marty Feldstein, Rudi Dornbusch, Bill Poole, and Ben Friedman--people who rarely agree about anything. But they were all in harmony on the subject of where monetary policy is right now. They all felt that it was a little too "not restrictive," let's put it that way, or a little too easy for the conditions as they saw them and in need of a bit of tightening. Of course, there was a lot of debate.

MR. KELLEY. Why don't you hire some decent help? [Laughter]

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, economic conditions in the Seventh District are quite similar to what I reported last time. Our regional economy is still operating at a very high level. The pace of the expansion has slowed somewhat from the first half of the year, but by less than had been expected. The housing sector has held up remarkably well in many areas of the District. Housing starts, permits, and home sales in the Midwest were all up sharply in July. Housing starts did come down a bit in August, but that retraced only a small part of the 16 percent July surge. Manufacturing activity in the District generally remains strong. Orders in the second quarter and the early part of the third quarter exceeded expectations in most core industries including light motor vehicles, construction machinery, metal working equipment, appliances, and steel. The second half of 1996 is still expected to be softer than the first half for most of these industries, but some of that expected softness seems to have been pushed out a quarter.

We have just received the Chicago Purchasing Managers survey for September, which I would caution is confidential until it is released to the public next Monday, September 30. The index will show overall activity expanding at a solid pace of 56.3. That is slightly slower than the robust pace suggested by the August survey, but the August level was significantly higher than in July. The prices-paid component, which has been indicating modest increases, surged in September to 59.3, and that is its highest level since August of 1995.

District retailer reports on sales activity for the first half of September ranged from flat to modest year-over-year gains. Sales over the Labor Day weekend were lower than expected, but one major national retailer in our District noted a sharp pickup in the week after Labor Day. Auto and light truck sales have been stronger than expected according to our contacts in the industry. Sales in the first half of September seemed to be tracking at a 15 to 15.1 million annual rate. This pace is consistent with the Greenbook's upward revised forecast for sales to average 15 million units in the third quarter. On the auto negotiations, I do not have much to add; Jerry Jordan already commented on this. I would mention that there are, of course, two sets of negotiations going on--those in the United States and those in Canada. Our assessment is that there is a much higher probability of a strike by the Canadian GM workers than by the U.S. workers. But because of the close relationship between the U.S. and Canadian plants, a strike in Canada, if it occurs, would eventually have a very serious impact on the U.S. economy.

On employment conditions generally, the news is still the same. Labor markets remain tight in the Seventh District. Payroll employment growth, however, has been slower than for the nation, perhaps reflecting some labor supply constraints in our District. Similar to what Al Broaddus reported, when our small business and agricultural advisory council met earlier this month, they voiced concern also about the difficulty of finding and keeping qualified workers, and this concern is shared by many in our District. It seemed to be most acute for entry-level jobs, particularly in retailing, but construction and factory workers are also reported to

be harder to find. Firms throughout the District have been increasing starting salaries and entry-level wages, often including signing bonuses, and doing more on-the-job training to deal with these labor shortages. One manufacturer reported raising its starting wage of \$7.50 an hour to \$10.00 to attract qualified workers.

trucking firm in the United States reported that his firm is now in the process of deciding how to respond to a 33 percent increase in truck driver compensation that was announced by the second largest trucking firm in the industry. That increase is scheduled to go into effect in February.

More generally on the price front, most firms indicate that it is still extremely difficult to get price increases through despite having to pay higher wages. However, we continue to get some scattered reports of rapidly rising prices. Building materials prices were reported to be increasing: Cement is being rationed and gypsum board is on allocation in some areas. Steel prices have increased but are still below a year ago. The October price hike may not hold, however, if added capacity comes on stream as expected. Trucking firms are imposing a fuel surcharge that translates into about a 2 percent increase in prices paid by their customers.

Turning to the national outlook, my assessment has not changed greatly since our last meeting. I still expect growth in aggregate demand to slow to a more modest pace late this year or early in 1997. However, I continue to believe that there is a danger that the moderation will have come too late. Resource utilization rates are already high enough to suggest gradual acceleration in core inflation, as reflected in the Greenbook after the adjustments for the BLS measurement changes. Moreover, growth seems likely to remain relatively strong for another quarter or two, which is likely to exacerbate this situation. The recent news on inflation, of course, has been favorable, but I am concerned that this will not continue. The further tightening of labor markets revealed by the most recent employment report combined with the anecdotal reports of labor scarcity that we have all heard suggest that we can expect to see wage increases in excess of productivity gains. Profit margins may shrink somewhat but ultimately, as Mike Prell said before, more rapid price increases are likely to be the result. The risks in the current situation are heavily on the side of increased inflation.

CHAIRMAN GREENSPAN. Thank you very much. President Parry.

MR. PARRY. Mr. Chairman, strong economic growth is continuing in the Twelfth District, although with some slowing in July from the very brisk second-quarter pace. The California economy has performed very well in recent months, with annualized payroll employment growth averaging 3.4 percent during May through August. Although Los Angeles county continues to be somewhat weak, other parts of southern California are gaining jobs and residents, with many of these coming from Los Angeles county. The Washington State economy has accelerated further in recent months, spurred by rapid manufacturing job growth associated primarily with the resurgence at Boeing. Payroll employment growth in most of the other District states is very strong, ranging from about 4 to 7 percent at an annual rate. Slight recent slowing is reflected in decelerated manufacturing employment growth in the District boom states of Nevada, Utah, Oregon, Arizona, and Idaho. The only exceptions to strong growth are Alaska

and Hawaii. Alaska's growth has been slow in 1996, and Hawaii has actually lost jobs in recent months. There are signs of increasing growth in average wages in several parts of the District. The increases have been large and accelerating in Nevada and Utah, which one would expect, and they have occurred in the construction and trade sectors in addition to manufacturing. Wage increases in other states mostly have been moderate. There are signs of a slight pickup in California, although from relatively low rates.

Turning to the national economy, production-side data, particularly employment as we discussed, have been quite strong lately. On their own, they portray a robust economy. However, on the spending side, consumption and retail sales have not been doing as well. When this information is incorporated into the recently revised nonstructural model that we now use in San Francisco to forecast current quarter output growth, it produces a growth rate of 2 percent in the third quarter. Combining this forecast with that from our structural model, we expect output growth in the 2 to 2-1/2 percent range in the second half of this year as well as in the first half of next year. This forecast assumes that the recent slowdown in consumption spending is temporary. If consumption spending fails to pick up, obviously output growth will be slower.

To my mind, however, the growth forecast is simply icing on a cake that already has greater wage and price inflation baked in. Even if growth comes in, say, 1/2 percentage point less in the second half of this year, we will still be left with a quite low unemployment rate of probably less than 5-1/2 percent. Based on this, we anticipate an acceleration of inflation on the order of 1/4 to 1/2 percentage point in a wide variety of price and compensation measures during 1997.

I realize that there is some uncertainty associated with this forecast. For instance, the coefficients of the underlying Phillips curve are associated with sizable standard errors. However, as far as I know, the Phillips curve is still the best model available to forecast inflation and our analysis suggests that the Phillips curve is basically on track. With unemployment clearly below the natural rate, wages are accelerating and price pressures are building.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. The Tenth District economy remains strong, and I do not have a lot to add to my previous reports. I would point out that our directors continue to report healthy business conditions throughout our District. Retail sales and home building appear to be holding up well in nearly all parts of the District. Manufacturing continues to operate at high levels of capacity; employment levels remain high; rail shipments by one of our major companies are up about 5 percent this quarter over an already strong second quarter. Crop producers are expecting a sharp boost in income as very large crop yields should be combined this year with good prices. So they are very optimistic. The cattle industry is showing some improvement as well, although ranchers are still losing some money and feeders are making just a little. Wage and price pressures appear to have increased in the District according to the anecdotal reports. In addition, price increases for replacement equipment and machinery parts are being reported to us somewhat more often as we go around the District. Having said that, when we shake

everything out in terms of the anecdotal evidence, our retailers are still feeling the pressure from rising costs, but we are not seeing a lot of it being passed on into higher prices at this stage.

On the national economy, I have no quarrel with the Greenbook forecast. We see the outlook much as it is being shown there, with all major sectors in relatively good shape. As pointed out in the Greenbook, methodology changes are serving to lower the CPI numbers, but when these numbers are adjusted and prepared on a consistent basis I agree with the projection that core CPI inflation will be trending up over the next two years. I think we have to be aware of that. I also have noticed, not only in our District but a little more widely on the basis of anecdotal reports, that there is a bit more of a speculative bent to the economy in terms of types of investments in land and in some of the asset areas. I believe we should at least take note of that at this stage. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The Philadelphia District economy is growing, but not booming, and attitudes are generally positive. Some labor markets are tight while others still have significant slack. There is some upward pressure on wages but downward pressure on benefit costs, especially health care costs. There are some examples of upward price pressures related to steel and plastic inputs. One also hears, of course, that prices are being raised indirectly. For example, fitness equipment suppliers are raising the minimum order required for free delivery. Some auto dealers are giving smaller discounts. Overall, however, price pressures are still subdued in the District, with businesses reporting strong competitive pressures that continue to make it difficult to pass along price increases; they also report better productivity gains than in the published data.

Turning to the nation, there is something for everyone, depending on what story one wants to tell, but not all is murky. Clearly, there is a risk of accelerating inflation because of an overheating economy. The risk, however, is more one of an upward creep in the rate of inflation than a breakout of inflation. Actual inflation rates are still remarkably subdued, and most of the pipeline indicators are quiescent as well. The case for a moderating pace of economic growth, while not completely convincing, is nonetheless substantial. We do a fairly good job of forecasting the direction of growth. We do less well forecasting the timing and magnitude of change. But the expansion of consumption appears to be slowing and the rate of GDP growth likely will be substantially less during the second half of 1996 than in the first half. There is a tension between data on the supply side of the economy and the demand side, which usually says something is going on in inventories. Labor markets are taut but final demand, notably consumption, is moderating. Although industrial production rose 1/2 percent in August, capacity utilization in manufacturing actually declined slightly, suggesting less risk of bottlenecks in production. Also, the rate of unemployment consistent with stable and low inflation rates has varied over the last several decades; it is not constant. Finally, monetary policy is broadly neutral. We almost surely will not have far to go whenever an adjustment is decided upon. In short, we still have time for watchful waiting, if we want to take advantage of it, without letting down our guard against escalating inflation.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. Labor markets are tight in the Eighth District according to most contacts. The average unemployment rate for Arkansas, Kentucky, Missouri, and Tennessee was 4.8 percent in July compared with the national rate of 5.4 percent for that month and 5.1 percent in August. A major hotel chain that is planning to hire about 2,000 workers in the St. Louis area in the coming year has held numerous job fairs and has established a toll free phone number to search for and aid applicants. District payroll employment growth, however, has slowed in recent months, but given other developments this may reflect a shortage of workers available to fill positions rather than a decline in labor demand. Michael Moskow mentioned something along these lines as well. McDonnell Douglas ended the strike with their machinists union during the intermeeting period. In the agreement, union workers will receive a 4 percent lump sum bonus this year on top of their normal cost of living increase plus a 2-1/2 percent wage increase next May. In addition, retirement benefits were increased more than 24 percent, from \$33 to \$41 dollars for each year of credited service. All told, this settlement represents a substantial increase in worker compensation. District retailers that we surveyed reported summer sales increases of up to about 5 percent over the same period last year. Auto sales, in contrast, were flat, but District automotive production is expected to enjoy a normal seasonal upswing in the third and fourth quarters and is projected to be up more than 22 percent for the year as a whole. Sales of new and existing homes are up in most parts of the District.

The national economy is coming off one of its best quarters in recent memory. The growth rate of GDP was so fast that it is easy to predict slower growth in the second half of the year. With nearly 1/2 million nonfarm payroll jobs created in the first two months of the current quarter, employment growth is more than double the trend pace of labor force growth, and that means further tightening of already tight labor markets. Many private-sector forecasts of a slowdown in real output growth in the second half of this year have been incorporating expectations of Fed action--action that has not yet materialized. Even if the economy does slow to a trend pace of growth over the remainder of the year, 1996 is going to be a big improvement over 1995 and in my view the downside risks for the real economy are quite low. The risks of more inflation, on the other hand, are all on the up side. The Board staff predicts faster increases in worker compensation. It is forecasting a rise in the employment cost index from 2.6 percent last year to 3.3 percent this year and 3.6 percent in 1997. In 1994 and 1995, CPI inflation was 2.6 and 2.7 percent, respectively. On a basis consistent with those figures, the Board staff now forecasts 3.4 percent CPI inflation for both the current year and 1997. Such developments are against the backdrop of money growth near the top end of the Committee's ranges, readily available credit, and a booming equity market.

In the absence of any reaction by this Committee in these circumstances, market participants may easily conclude that the "acceptable" rate of inflation has moved up. This would reinforce inflationary expectations and make our job tougher in the long run. We simply cannot afford not to react to the scenario laid out in our inflation forecast.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. By almost all objective measures, the economy in the Ninth District remains very healthy. Labor markets continue to be tight and, given the quality of new hires, businesses report spending increasing amounts on training new workers. Our District is one of those where the local measures of housing activity would be consistent with the surprisingly positive national statistics. Housing through most of the District has been better this year, whether we are talking about sales or new construction, than it was in both of the preceding two years and has continued to hold up as the year has progressed. This also turned out, somewhat surprisingly, to be a satisfactory summer tourism season even though it got off to a slow start. Despite these positive objective measures, business attitudes appear to be a bit on the cautious side at the moment based on our recent conversations. I am not exactly sure about the source of this disconnect. It may be that businessmen are in fact expecting the slowing that has been widely advertised for the second half, or it may be that they are influenced by their continuing inability to raise prices and the continuing virulence of competitive pressures.

With regard to the national economy, I certainly agree with the spirit of the Greenbook forecast, so I will make only a few comments. I think the economy is on solid footing. It appears that demand is moderating, but it is uncertain if this moderation is sufficient to relieve pressures on resources in a meaningful way. I share the concern that resource pressures will lead to a modest acceleration of inflation. We went back and looked in a little more detail than usual at the experience of the mid-1960s and the late 1980s. Those years involved long periods of labor market tightness that in our judgment were perhaps comparable to what we have been experiencing recently. What we saw was that those periods were associated eventually with an acceleration of inflation. Of course, what happened back then is not independent of the policies that were pursued, and we have to be careful about causality and all of that. Nevertheless, the data suggest the risk that more inflation is in train and that it will emerge eventually.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, the economy in the Second District continues to pick up, so the positive developments that I began to record two meetings ago for the District continue. Payroll employment in the private sector accelerated in July to annual growth rates of 1.2 to 1.5 percent in New York State, New Jersey, and New York City. In August, New Jersey increased its rate of gain to 2.1 percent. The real estate markets also reported renewed vigor. Permits for new home construction and contract awards for nonresidential construction rose sharply in July and continued a trend of favorable year-over-year comparisons. More recently, New York City and northern New Jersey realtors reported that sales of existing homes rose 8 to 10 percent in August and early September compared to the same period in 1995, and floor traffic, we are told, has remained heavy recently. Consumer spending has firmed. New York and New Jersey officials reported 5 percent gains in August retail sales tax collections, while New York City reported an 8 percent gain on a year-over-year basis. That rate of increase has risen steadily since

April, with no signs of softness, implying no pause in underlying consumer expenditures over the summer months. The securities industry is very healthy; one of the major firms reported a 39 percent gain in pre-tax profits for the third quarter, and we are hearing from the others that they will be reporting very good gains as well. In the inflation area, the news is very good, indeed. Consumer price inflation in the New York-northeastern New Jersey area was unchanged in August at 2.7 percent on a 12-month basis. That compares to a national gain of 2.9 percent. August is the fifth consecutive month in which the region's rate of inflation has been less than 3 percent.

At the national level, we agree with everyone that growth is clearly moderating from the 3.3 percent first-half pace. We share the sense of confusion caused by the divergence between the demand side and the supply side in the incoming data, but taking account of an inventory boost, we think that growth will be around 2 percent for this quarter. In comparing our forecast to that in the Greenbook and assuming the present monetary policy, we have real GDP growth slowing next year to 1.7 percent. The Greenbook has it slowing to 2.1 percent. We are slightly more optimistic on inflation. We have the core CPI creeping up and just touching 3 percent in the fourth quarter of next year. There is no question about the risk of more inflation if the rate of wage inflation continues to move up and the price discipline that we have seen does not persist. We have to be concerned about that risk. On the other hand, I think we have equal reason to believe that the inability of businesses to increase prices will continue, that the cost of benefits will remain a positive factor in holding down the rise in overall compensation costs, and that wage earners, including those with high-level jobs, will continue to prefer job security rather than wage increases. I believe that the conduct of the United Automobile Workers provides very important evidence in that direction. For quite a number of months, we have been accepting the risk that these phenomena will persist, that prices will continue to be well behaved because businesses can't raise them, and that wage earners will continue the behavior that they have shown for several years. As a result of our accepting that risk, and that is what it is, we have had the wonderful phenomenon of high growth and low inflation. That is a combination richly to be desired. Thank you.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. After reviewing my comments from the last meeting, I conclude that there has not been all that much change. We are still expecting moderate second-half growth, which would be a slowdown, of course, from the first half. The evidence on inflation that came in during the intermeeting period generally has been fairly benign, and I would point to the core indexes and to commodity prices in particular. I asked myself what, if anything, we know that is new since the last meeting. At best, it seems to me that the news is fairly marginal. On balance, the signs of the second-half slowdown appear to be a bit more solid, but not all that much. Consumer spending has slowed, but now we are seeing signs that it may be turning back up. Housing has been a bit difficult to read, given that the starts number for August was strong. We continue to think that we are poised for a slowdown in housing demand because of the backup in long-term interest rates, but housing has held up surprisingly well. Consumer credit seems to be slowing a bit, to a pace more in line with income growth, perhaps as consumers take

cognizance of increasing repayment requirements associated with higher debt levels. Nonresidential construction is showing mixed signs. Net exports appear to be a bit of a drag on the economy.

The areas of strength that we have talked about in the economy are still in evidence. The labor market is very strong; unemployment is low; consumer confidence is up, perhaps fed by the strength in employment. The manufacturing outlook seems stronger. Business fixed investment also is poised for substantial growth, perhaps not at a double-digit rate, but it remains a solid contributor to real growth. One bit of news relates to corporate profits. At our last session, there was a fair amount of discussion about whether they would hold up. They do appear to be holding up better than might have been anticipated if one were assuming that increases in wages would result in a profit squeeze unless firms were able to pass on the increases through higher prices.

So, while it appears that the signs of a slowdown are becoming a bit more evident in consumer spending and construction, there is still growth--just slower growth. The areas of strength that are prevalent in the economy should also prevent that slowdown from careening into negative growth.

A bit more monetary restraint is being provided by the markets since the last meeting, as evidenced by higher long-term rates, including mortgage rates. The stock market has actually recovered. That means that the cost of capital is down, and that argues for continued business investment. Banks are continuing to support growth with credit availability, and I might mention that banks are doing quite well. They are making money!

On the inflation front, the laws of gravity appear to be holding greater sway than the principles of economics. At some point, we have to expect that labor costs are going to feed through to prices. If they do not, either profits are being squeezed, which does not appear to be the case, or productivity must be improving, which may be the case. However, statistical analyses and data are not yet showing the improvement. There is considerable analysis of and comment on this inconsistency in academic papers and also in the press. The explanations tend to concentrate on the continued efforts to downsize business firms, lower health insurance costs--some of that improvement may be permanent--additions to industrial capacity and other fixed investments, the inability to pass on price increases, and perhaps a breakdown in inflation psychology. Consumers appear to be quite price conscious. If all this is true, there may even be some room for optimism on inflation, but it seems to me that this is pure conjecture and we really cannot dismiss the tightness in labor markets. Clearly, there is room for additional economic analysis of productivity. In sum, I think we are about where we were last month. We know more but the new information is marginal. We still appear to be on a sustainable growth path as we look for further confirmation of a slowdown. The inflation news has been better, but if economic history repeats itself, the risks are on the up side. So, we must continue to be alert to inflation pressures.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. The data that have become available since the August meeting have provided a quite interesting set of crosscurrents. On the one hand, the data indicate that growth has slowed much more sharply in the third quarter than I previously expected, moving down to a pace close to trend. Moreover, the apparent mix between final sales and inventory investment suggests a diminished prospect for above-trend growth in the period immediately ahead. On the other hand, the August employment reports suggest that labor markets have become even tighter, raising the danger of a still faster acceleration of wages and therefore increasing the risk of higher price inflation going forward even if growth has slowed to trend. Thus, the case for tightening to slow growth to trend has diminished in my judgment, while the case for tightening to counter inflationary utilization rates may have increased. Well, it never gets easy. At the same time, the August CPI and PPI reports challenge us with further evidence that core inflation continues to edge lower despite utilization rates that historically would already have been associated with rising inflation. Let me elaborate on these two issues, beginning with the prospects for growth.

While I am comfortable with the broad outline of the path for real GDP in the Greenbook forecast, I would have been a bit more aggressive in lowering my forecast for third-quarter growth. There were three significant reports since the last meeting that suggest slower growth: the August retail sales report, the July construction put-in-place report, and the July foreign trade report. Cathy, you mentioned earlier that you were concerned that consumer spending might be even stronger than in the Greenbook forecast. My concern would be quite different. I suspect that consumer spending is growing at least 1/2 percentage point more slowly in the current quarter than the Greenbook is projecting. So, I think the central tendency right now appears to be growth around trend, and I would even say there are about equal chances that third-quarter GDP growth will be below trend as above trend. While the details of one quarter are of little importance to our task here, the sharpness and widespread nature of the softening of demand in the third quarter might make us cautious about the timing of the tightening that still appears to be the most likely direction of policy going forward. I expect an increase of only 1 percent in final sales in the third quarter compared to 4 percent in the previous quarter. At the same time, production-side data--payroll employment, aggregate hours, and industrial production in particular--look stronger. The contrast between the softness in demand and the strength in employment and production is likely to be reconciled with strong third-quarter inventory growth consistent with the rapid inventory buildup reported for July. However, if the rebound in inventory investment leaves the third-quarter growth closer to 2-1/2 percent in the context of softening final sales, the prospect of slower fourth-quarter growth becomes still more persuasive.

I think the most important implication of the developments in the third quarter may be that the unexpectedly sharp slowing in the growth of final sales has made room for a rebound in inventory investment to a trend level, perhaps removing the danger that inventory building will sustain above-trend growth in coming quarters. My strong expectation is that we are in a temporary lull. Fundamentals do not suggest to me a serious likelihood that the expansion is tiring to the point of slipping into protracted below-trend growth. Indeed, I continue to expect that, with an unchanged

policy, growth will be near trend or slightly above in coming quarters. Nevertheless, the sharpness of the weakening in final sales in the third quarter adds a cautionary note to this forecast and provides the rationale for waiting for data to confirm the expected stabilization in final demand.

Second, utilization rates: The decline in the unemployment rate to 5.1 percent in August was another significant piece of data. It suggested that the labor market may have tightened in August from the 5-1/2 percent area over the last couple of years, to a 5 to 5-1/4 range in the period immediately ahead. There are good reasons to believe that the decline in the unemployment rate in August was exaggerated, for example, because of the late survey date. But there is also reason to believe that the above-trend growth over the first half has left a legacy of somewhat higher utilization rates going forward. The staff completely discounts the August decline in the unemployment rate as a statistical quirk and assumes that it will be reversed in coming months. As a result, they project the same 5.4 percent unemployment rate going forward as in their last forecast. The difference between a shade below 5-1/2 percent and a shade above 5 percent is a very important one to me. Personally, I might buy provisionally into a NAIRU as low as 5-1/2 percent. I do not buy into a NAIRU as low as 5 percent. As a result of the August employment report, there is more uncertainty about the degree of labor market tightness, and in my judgment the danger of higher inflation going forward is also somewhat greater now than earlier.

Third, a word on inflation performance: The 12-month inflation rate, as measured by the core CPI, declined to 2.6 percent in August, a tenth lower than in the previous four months, and it has declined nearly half a percentage point since the end of 1995. The 12-month core PPI inflation rate was 1.4 percent in August, close to half the pace at the end of last year. Not only has inflation not begun to rise, but by some measures it has continued to decline. While monetary policy should be forward-looking, the disparity between inflation performance and inflation forecasts looking backward might temper our aggressiveness in adjusting policy in response to forecasts of higher inflation, at least until inflation stabilizes.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Thank you, Mr. Chairman. In reviewing the data that have accumulated since our last meeting, I find myself in rough agreement with the Greenbook's assessment. The evidence clearly points to a reduction in the momentum in aggregate demand with a slackened pace of spending growth now likely in consumption, government spending, and residential investment during the current quarter. With the pace of final demand now moderating, the upside risks from inventory investment are also reduced. On balance, it seems likely that demand growth will revert toward trend in coming quarters, with the risks to that forecast roughly balanced.

The primary problem that confronts us is that labor markets are already tight, and during the assumed transition to trend growth slack is likely to diminish even further. We thus appear to be on course toward a landing that is ideal except for the fact that we are now poised to hover above the runway without actually touching down. [Laughter] Even if we agree with the Greenbook's argument that the

decline in the unemployment rate to 5.1 percent in August should not be interpreted literally, it does seem evident to me that the labor market has notched tighter. In this respect the unemployment data seem consistent with the anecdotal evidence. It is not uncommon to hear that it is now "impossible" to find qualified entry-level workers, whereas six months ago the word "difficult" would have been used more frequently. At a recent Dallas board meeting that I attended, one director described the pressures that an inability to hire entry-level workers was placing on supervisors who were forced to work overtime. He explained that quit rates were rising among his supervisors as a consequence. I think this is precisely the type of anecdote that one would expect to hear at the onset of an inflationary episode. If widespread pressures of this type emerge, it seems likely that firms eventually will be forced to bid up wages to retain workers and then pass through higher unit labor costs to prices. At the same time, though, the current episode has some unique features.

While the labor market is tight, job insecurity also seems alive and well. Real wage aspirations appear modest, and the bargaining power of workers is surprisingly low. Although there is upward pressure on entry-level wages, more senior workers and particularly those who have earned wage premia in the past, whether it is due to the power of their unions or the generous compensation policies of their employers, seem to be struggling to defend their jobs and to avoid sacrificing the perks they currently enjoy. I would also interpret the UAW negotiations as indicating that we have aging auto workers who are focused on securing their own benefits during their lifetimes but appear reconciled to accepting two-tier wage structures with less generous packages for new hires. Of course, we hear reports of continued upward pressure on wages in skilled technical jobs, but that should hardly surprise us because the wage differential associated with skill and education has been widening secularly since the late 1970s, most likely due to technological shifts in the workplace favoring skilled and disfavoring less educated workers. And, of course, while wage growth has accelerated, compensation growth has increased only moderately because companies have offset more rapid wage increases with greater health care cost containment. We may hypothesize that that favorable trend is about to conclude, but anecdotal reports suggest that corporations remain confident of their ability to achieve further cost savings.

In contrast to past expansions that have led to inflationary upticks, capacity utilization is not excessively strained. Delivery lags have not increased. The world economy is not in a synchronous boom. Firms still insist that it is impossible to pass along price increases, and the behavior of broad inflation measures remains consistent with that perception. The dramatic table in Part II of the Greenbook reveals no evidence of an intensification in inflationary pressures. Nor can we find evidence that compensation pressures are eroding earnings. The markup of prices over unit labor costs in the nonfinancial corporate sector, for example, has not been declining, and pressure on profit margins is a typical precursor of an inflationary outbreak. Further, we have yet to see any evidence of an uptick in inflationary expectations. I found it striking that when rumors surfaced that hinted at a higher chance of a Fed rate increase today, longer-term rates rose rather than fell. So, we may well be at a point where inflation is poised to rise, but if we are, I think we are still at an early stage of the inflationary spiral. The anomalous

behavior of inflation in the face of seemingly tight labor markets is, of course, leading virtually all economists to lower their estimates of NAIRU.

For all the reasons that I have given, I am sympathetic to the view that the world has changed. Nevertheless, let me conclude by saying that I would not want to carry such reasoning too far. First, an unemployment rate of 5.1 percent lies near the lower end of almost anyone's estimated NAIRU range. Second, whatever the NAIRU, the unemployment rate does have predictive power for changes in the inflation rate. The probability of an increase in inflation is clearly higher when labor market slack is lower. For that reason, I conclude that the risk of an increase in inflation has definitely risen, and I would characterize the economy as operating in an inflationary danger zone.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. The worried faces around this table, I think we should remind ourselves, are worrying about the best set of problems that we could think of having. Central bankers all around the world would wish for this set of statistics. I think that Mike Prell and some others, who have rightly emphasized the uncertainty and the difficulty of forecasting at this particular moment, have overdone it a bit. In fact, the developments of the intermeeting period, reinforcing those of the previous intermeeting period, have given us reason for some confidence in our sense of what is happening in the economy and in our ability to forecast reasonably well at least in the short run.

There were three things that we thought we knew. One was that the economy was growing strongly but that the expansion was likely to slow. The data are certainly consistent with that expected slowdown, especially on the consumer side, although it is not certain, as nothing is ever certain, that the slowdown will last. The labor markets have proved tighter than we thought, but tight labor markets are something we ought to want, generally speaking. We ought to want the incentives that tight labor markets create both for employers to be as efficient as possible and for employers and employees to focus on upgrading the skills of new and old workers. We need that badly.

Second, we thought we knew that wages would begin to creep up in the tight labor market, mitigating the long stagnation in wages that we have had. This has indeed begun to happen, raising the cost of labor despite the slower growth in the cost of benefits.

Third, we thought that these wage increases would begin to be passed along in price increases if the slowdown in the expansion did not begin to take the edge off the robustness of the economy in time to keep inflation under control. We thought the risk was clearly on the up side and that we should stand ready to move quickly to forestall price inflation if the economy proved more robust than we thought.

I said at the last meeting that we might not find the answers all that quickly, and the evidence around the table is that we have not. The behavior of prices has, as people have pointed out, been surprisingly good. It seems to me that we are still in the situation

we were in at the time of the last meeting of watching very carefully the potential for inflation. I agree with Governor Yellen that we are in a danger zone, but we have not seen higher inflation yet. We should be pleased, in fact, that things are turning out as well as they are and that we have understood the current situation as well as we have.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. I think I am well aware and I am certainly deeply respectful of the arguments that would say that inflation is likely to rise and that policy should move now or perhaps sooner than now to prevent it. Of course, this view is based, as we have been discussing, on two central facts--that the economy is very fully utilized and that compensation is increasing as a consequence. These conditions clearly exist.

I want no part of an inflationary rise. I am sure no one here does. But I also see a number of factors that have forced me to question whether such an event is inevitable, at least anytime soon or to a meaningful degree. We have been talking about all of the reasons in prior meetings and again this morning in some detail. I will not run through my laundry list; it is much the same as we have been discussing. I would say that on balance I just do not see the evidence that moves me away from the judgment that I have been making for some time. There continues to be, as has been discussed, no visible sign of rising price inflation yet. If anything, it is continuing to go down, as Governor Meyer pointed out. I think there are many tell-tale indicators, precursors, that would show that there are very few signs of inflation actually in the pipeline. Unit labor costs are down from 1995 and they are forecasted to go down further. Foreign inflation is benign. Inflationary expectations are flat. We see very little delivery tightness. Commodity prices are flat to down. Real interest rates are flat in a neutral zone. And it does appear that we are getting the slowing in GDP growth that I think we felt was essential to maintain a steady policy. We will see how that develops.

With all of this said, I think nonetheless that the risks are clearly on the high side, and I continue to sit very lightly in my chair. I did not arrive at this judgment easily, but I would say that I believe we should continue to give this thing a chance.

CHAIRMAN GREENSPAN. Finally, Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. Last night one of the TV news magazine shows had a story about people who won the mega bucks lotteries, millions of dollars, and ruined their lives. [Laughter] That was a popular thing to show since most of us lose in lotteries and maybe we should be grateful because losing helps us to get on with our lives. [Laughter] The TV show reminded me that we have been having a string of what appears to be good luck, although the people at this table all know it is the result of our skill at managing the economy! I would like to comment on the possibility that our luck may be running out.

First, it is clear that we are seeing definite acceleration in nominal wages. Second, it also seems clear that the acceleration

is not now being passed through to prices, and that is the best of all worlds. A question we have to face, one of the questions that Governor Meyer addressed, is whether this subdued inflation is going to persist along with sustained growth further out. I have done a back-of-the-envelope calculation. It takes 70 cents of extra spending per capita per day to increase economic growth 1 percent. Now, I use this example whenever a reporter asks me to comment on the economic outlook. I ask how much are you going to spend tomorrow, within 70 cents, and when they can't give me an answer I say that I can't tell them what economic growth is going to be next quarter. [Laughter] Without using the sophisticated analysis either of the Greenbook or that Governor Meyer presented, let me use some very unsophisticated math.

In the last four quarters, the economy has grown at a 2.7 percent annual rate. Indeed, the economy has grown at a 2.7 percent annual rate since the fourth quarter of 1991. So, I am going to use as my operating assumption that we are in a 2.7 percent economy, which I agree is probably above the sustainable pace at this point. Even if we make that assumption and if we assume that the staff forecast is right about the third quarter, then in the fourth quarter we are going to need a 1.7 percent rate of growth. If the Greenbook forecast is right about the third quarter and the fourth quarter, growth in the first quarter of next year will have to be at a 1.5 percent rate. In other words, just simple regression toward the mean, in addition to all the reasons that Governor Meyer noted, suggests that our luck on the real side may be about to run out, if we think of this lottery drawing as the number from the BEA. But who knows? They may deliver an extra B-2 bomber one of these quarters.

Similarly, we are running a risk that our luck is going to run out on the inflation side. In the last year, the monthly CPI increase has been .1 percent four times, .2 percent two times, .3 percent three times, and .4 percent three times. That is what inflation at an annual rate of just under 3 percent is all about. It is essentially a random number month to month on which apparently billions of dollars are being bet. But if we view it as a random number, the odds of our pulling a .4 percent number in either of the next two months run just a tad under 50 percent. That will be, judging from the recent reaction to the .1 percent increase, not a happy day. So, I think we have a chance of seeing our luck run out on the real side of the economy, including inflation.

But that is not where I am most worried. What worries me more is that our luck is about to run out in the financial markets because of what I would consider a gambler's curse: We have won this long, let us keep the money on the table. You can see early signs of this. It includes real estate appreciation in the Hamptons, Connecticut, and Manhattan. BMW and Mercedes both had their best summer in history in the United States. The IBES earnings expectations survey for 5-year projected earnings hit a 12-year high in August. It indicates that earnings are expected to grow at a rate of a little over 11-1/2 percent per year. Now, if we assume nominal GDP growth of 5-1/2 percent over the same period, this means that NIPA profits will rise from 10.7 percent of national income to 14.3 percent of national income in 2001. Readers of this transcript five years from now can check this fearless prediction: Profits will fall short of this expectation. Unfortunately, optimism is ripe in the markets.

Excessive optimism is also necessary to justify current levels of IPO activity and valuations of highly speculative stocks. While it is not so large as to exert undue pressure on the real side of the U.S. economy, this emerging bubble is nonetheless real. As a survivor of the so-called Massachusetts miracle to which Cathy Minehan referred earlier, I can attest that everyone enjoys an economic party. But the long-term costs of a bubble to the economy and society are potentially great. They include a reduction in the long-term saving rate, a seemingly random redistribution of wealth, and the diversion of scarce financial human capital into the acquisition of wealth. As in the United States in the late 1920s and Japan in the late 1980s, the case for a central bank ultimately to burst that bubble becomes overwhelming. I think it is far better that we do so while the bubble still resembles surface froth and before the bubble carries the economy to stratospheric heights. Whenever we do it, it is going to be painful, however.

In addition, there is an associated risk that we face every two or four years, and it is related to the bond market. The markets have built in an array of rather optimistic scenarios for the effect of the upcoming elections on the nation's health. The dominant view is characterized by a recent missive from Goldman Sachs which predicted a divided government: "Continued divided control of government in fact might provide the ripest political conditions for a fresh push toward mandatory spending program overhaul in the next Congressional term, which would have the clearest favorable ramifications for deficit control in the coming decade." A second equally optimistic view was provided by a friend of mine who straddles both the political and the financial markets. He predicted a Democratic takeover of Congress and said with regard to entitlements reform, "Look, their program of savage cuts becomes our saving the system and it will get enacted." In this regard packaging is all that matters. It is what we might call the Japanese business gift theory of politics.

In short, the markets now have built into them a very optimistic view of what is going to happen after November 5. They may be right no matter what happens. I think there are two reasons to differ. The first is polarization and the second is party parity. Any look at the political advertisements now running makes clear that the new Congress is going to be fairly polarized. I see two types of members: those who got there by accusing their opponents of wanting to throw granny out in the snow and those who survived by vociferously denying that they wanted to throw granny out in the snow. How is either going to enact Medicare or Social Security reform? Second, no matter which party controls Congress, the margin of control is likely to be a relative handful of seats. This creates a very interesting dynamic. The majority will be ill-inclined to take risks for fear of losing its status. The minority will be both hungry and embittered and quite unwilling to help the majority shoulder the responsibilities of governing. That is not an optimistic recipe. Now, it may be that the optimists in the bond market who believe these optimistic scenarios are right and that the people are going to send only statesmen to Capitol Hill, just like they have every two years. In this scenario we, the bond market, and the country have nothing to worry about. But if the optimists are wrong, then indeed not only our luck but that of the markets and of the economy has run out. Thank you.

CHAIRMAN GREENSPAN. On that note, we all can go for coffee.

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

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

CHAIRMAN GREENSPAN. Questions for Don? If not, let me get started. If we cut through the somewhat foggy data for the third quarter, I think that there are two important hard numbers that emerge. One is that no matter how we look at the numbers, it is very difficult to get around the fact that hourly wages and salaries are accelerating. We have no third-quarter data on fringe benefit costs, but as I indicated in the August meeting in support of the views of the Vice Chairman, I think that health cost increases are still on the way down and still basically holding down overall compensation costs. Wage pressures are unquestionably the result of the tightness in the labor markets that we have all seen, and that tightness by every indication has increased rather than decreased in recent months. It is conceivable that there are seasonal factor adjustment problems in the unemployment rate, and I do not doubt that that is the case. There is also a sampling variability issue, which is not to be dismissed very readily, in the household sample figure. But the initial claims and more specifically the insured unemployment numbers are not inconsistent with some tightening in labor markets in the last two or three months.

The second very important hard number may be somewhat less hard than usual and is one that Governor Phillips pointed to, namely that profit margins seem to be holding up in the third quarter. In any event, the evidence that they may be declining is not very persuasive. This means that the rise or acceleration in compensation has to show up as it has historically either in increasing prices or increasing productivity growth. I am talking about the third quarter, which is just about history at this stage. The performance on the price side, I think, is very impressive. You cannot find price increases of any significance in the core CPI, which went up .06 percent and not .1 percent in August, if you want to look at some numbers to disbelieve, and I must say that I do not entirely believe them. Data relating to underlying inflation in the pipeline, as I believe Governor Meyer pointed out, show nothing. The pickup that we are getting in the Chicago Purchasing Managers' Survey, as far as I can see, is in oil product prices, which show up across the board in those surveys, and we are seeing them elsewhere. I do not take the price data in the purchasing managers' surveys as very useful, largely because we have far better data for the actual commodities that are being purchased. The purchasing managers' data, I am almost certain, are coincident with the rise in oil product prices and futures.

The difficulty that one has with all of this is whether prices will remain generally stable. I must say that I do not expect the September CPI to be as benign because it will include the 10 percent excise tax for airlines, and it is likely that the 1-1/2 percent decline in apparel prices for August will be largely reversed. Those two factors in and of themselves can very readily turn the CPI around. I must admit that I would be quite surprised if we did not get a significant uptick in the core CPI in the September numbers.

The question we are dealing with is whether the price/profit-margin/wage pattern implies accelerated productivity. While it is difficult to make a judgment about whether the productivity numbers are improving, it is not difficult to make a judgment that the rate of increase in productivity is a lot higher than is shown by the conventional numbers. At the August meeting, I raised a question about the internal inconsistency between the manufacturing data and the changes in total nonfarm business productivity. Since that meeting, we have done a fairly extensive amount of statistical evaluation and have made some very interesting findings. The first is that if we disaggregate productivity in the nonfarm business sector into corporate and noncorporate, the corporate data are generally not bad, though one must make a judgment with respect to how one price-deflates the gross corporate product. Nonetheless, the figures that are derived are far more consistent with the anecdotal data that we see on a day-by-day basis in the press and that we hear when we talk to anybody in the corporate sector, namely that productivity growth is a lot stronger than the 1 percent or less that we have seen in the nonfarm business product data. In fact, the number for the last four quarters is 2.6 percent at an annual rate; since 1980, it is 1.6 to 1.7 percent, well above the nonfarm business product numbers. Indeed, when we separate out both the nominal and the real noncorporate nonfarm data, we find something quite startling in those data, namely that measured productivity growth in the noncorporate sector is negative and has had a negative trend since 1980. The reason for this obviously is the price factors that BEA uses. When we disaggregate the Gross Product Originating data to two-digit SIC industry detail for those industries that tend to be in the noncorporate sector, namely services, we get full confirmation. Taking the new GPO by industry data through 1994 just published by Commerce and applying hours data, we get productivity for total services, which is a fourth of gross business product, declining 1.4 percent per annum since 1990, health services declining at a rate of 2.7 percent for 1990 to 1994, legal services at a rate of 1.6 percent--that is a more credible number [Laughter]--and social services, which are a large sector, declining at an annual rate of 3.7 percent for 1990 to 1994.

This tells us that a large chunk of the productivity data in the nonfarm business product area makes no sense and is giving us a distorted view of the underlying productivity growth rate in the economy as a whole and a distinctly distorted view of underlying real costs. If we look at the data on the corporate sector, even presuming that the inflation rates in that sector are misestimated, we still get some very persuasive productivity numbers. For those who have been brought up believing that productivity rose quite substantially from 1960 through 1973 and then took a swoon, these data show that when we use income-based statistics to disaggregate the nonfarm business product data, which show a decline from a 3 percent annual rate in the 1960s to 1.1 percent now, virtually all of that decline in productivity growth shows up in the nonfarm, noncorporate area. Productivity in that sector rose at a 5 percent annual rate from 1960 through 1973 and has been negative on average since then. The annual rise in productivity in the corporate sector went from 2.2 percent during the pre-1973 period to 1.7 percent since then. In other words, the tremendous contraction in productivity, which all of our data show, is partially phoney.

The result of all of this is that if we look at the underlying cost structure and adjust for the bias in service prices, which is obviously the source of this problem, we get an increase in real gross product for the noncorporate sector, an increase in productivity, and the numbers all make sense, assuming that the overall price index comes out lower than implied by the published data. If we look at the current structure of costs, hourly compensation for the corporate sector and probably for the whole economy is going up 3-1/2 percent per annum. If output per hour for the overall economy is going up 1-1/2 percent, which seems a lot more likely than the reported numbers, unit labor costs would be rising 2 percent. Multiplying unit labor costs by .7 percent, the general proportion of labor costs in total costs, results in a contribution to total costs of 1.4 percent from the rise in the compensation of employees. Other costs are going down: Indirect business taxes per unit of output are moving lower as are net interest costs. In the most recent period, these declines average about 1/2 percent, so growth in underlying total unit costs is somewhere in the area of 1 percent. This explains why profit margins are large and holding, and it explains why price pressures are nowhere near as high as we would ordinarily expect them to be at this stage of the business cycle in the context of laggard productivity growth.

The question that one must ask in all of this is how to explain the extraordinary behavior of prices when wage increases are very clearly accelerating. The answer is that we can explain it only if productivity is indeed rising a lot faster than our statistics indicate. If we look at the total cost structure, I grant that at this stage it is virtually impossible to make a judgment as to whether productivity growth is accelerating, but it is not difficult to make a judgment that underlying unit costs are rising at a very marginal rate. The evidence that we see of declining unit labor costs in manufacturing is a little dubious because the hours in the personnel services area that are used in manufacturing are not adjusted in those data. But even with those adjustments, manufacturing, which is a big chunk of the corporate sector and indeed probably far more representative of what is going on in the real world than some of the service areas in the noncorporate sector, is showing a cost structure even more benign than the total for all corporations.

If this analysis is in fact correct, it is important for us to take a look at what it implies about the current performance of the economy and the underlying inflationary forces. While the probability is still better than 50/50 that we will not get through this period without the very strong pressure on wages overcoming the productivity advances and engendering a much higher rate of expansion in total unit costs, I think the probabilities are falling. Indeed, there is a not inconceivable probability that we could get through this period into the early months of next year without moving policy. The reasons are as follows.

One, as Governor Meyer said and as I implied in the August meeting, the inventory data appear to be moving around. We know that the July change in constant dollars is at almost a \$50 billion annual rate. The August figure is substantially less. We know that from the numbers for motor vehicles, but we are also picking it up in some other indications for August inventories. One stems from a method for estimating inventories on the basis of industrial production that is

not too bad a predictor of inventories before they are published. Another comes from a model based on C&I loans and some judgment with respect to how commercial paper issuance relates to the financing of inventories. That also shows a somewhat lower rate of August inventory accumulation but a higher rate in September. The problem here is not that we are getting an excessive buildup of inventories. Even with a fairly substantial expansion of inventories--and the rate of inventory investment is now up significantly from where it was in the second quarter--we would need a long period of this type of inventory investment to get an inventory overhang. It is not that. I suspect that inventory-sales ratios are still not very high even at the end of September. The issue is that the level of output is being driven by higher inventory investment. As a number of you have mentioned, that takes some of the pressure off the fourth quarter and the first quarter of next year. The issue is not whether inventory accumulation is voluntary or involuntary; it is just that it is there. If it is there, it affects the arithmetic of the growth in GDP.

Secondly, while the August retail sales figures may be dubious, I do not think the revisions going back into June and July are. They show a significant slowing, which as best we can judge is also occurring in September. Mike Moskow points out that motor vehicle sales for the first half of this month are at a seasonally adjusted annual rate of 15.1 million. We get the same number here and that is a significant decline from the August level. Part of that may well be fleet sales, but it strikes me in looking at the distribution between fleet and retail sales, which is roughly a PCE/producers durable equipment split, that part of the motor vehicle number is clearly in the retail sales area. We also received a set of weekly chain-store sales data this morning. If the data are to be believed, the September seasonally adjusted numbers are well under the August numbers. Now, I am a little suspicious of the way those numbers run, largely because they have not been that reliable in the past. But they give some indication that, at this stage, we are not getting a pickup in consumer expenditures despite the fact that the consumer confidence numbers are quite strong. The Conference Board number circulated this morning was down just a small fraction; the Michigan Survey looks strong; the ABC numbers look strong; and capital gains and the wealth effect are strong. Yet, with all of that in the background, where are the sales? Now, one can readily argue that the dip in sales is only temporary and sales will come back, and that is a credible forecast. It also might be that consumer credit, which has been growing less rapidly and getting increasingly tight, is finally beginning to affect the consumer data. I think it is important to differentiate between current reporting and forecasting. Current reports, as best I see the numbers, are not yet showing the pickup that is implied in the Greenbook. It may very well occur. We know from the past that these numbers fluctuate a great deal. But for the moment, it is one thing to forecast and it is another to report.

Nonetheless, for a number of reasons that were discussed earlier, I continue to believe that the probability of our having to move, though declining, is still above 50 percent. The first and most important reason is clearly that the labor markets are getting increasingly tight. It may be that we will have the good fortune to find that some of the recent wage data are an aberration, but again that is a forecast. The information that we have today suggests that these markets are very tight, and I am not aware of any evidence of a

letup. The orders patterns at capital goods establishments are quite robust. The so-called adjusted real orders figures that we calculate to try to get a short-term forecast of industrial production are quite firm. I do not know of any evidence that says that industrial production is easing. The reason production is this strong is the buildup in inventories. That is where the impetus essentially is coming from.

Housing starts, home sales, and the like are higher than we would have expected at this stage. We have to be a little careful in our assessment, however. As Mike Prell pointed out, a good part of the increase in starts in August reflects a sharp rundown of the permits backlog. This suggests that the permits come first, the starts come second, and there have been indications that permits are weakening, although not as much as I would have expected. I think this is partly because, if we disaggregate home sales, it is becoming apparent that home sales financed by adjustable rate mortgages are becoming a more prominent element in the housing market. Clearly, as interest rates rise, adjustable rate home financing goes up. While cash sales still account for a small part of the total, they do not seem to be doing much. So, the fixed-rate mortgage is not as potent a force in reducing home sales as it used to be in periods when mortgage rates were rising.

I mentioned previously that consumer confidence is very high. The survey data are showing no signs of deterioration. The stock market, needless to say, is going on its merry way. It strikes me that we have to be very much aware of certain key data as they come out in the weeks ahead. I think the data relating to the whole insured unemployment system, which show as I said no signs of simmering down, are crucial to our assessment. We have to be aware of the possibility, as I mentioned at the July and August meetings, that if we begin to see signs of some pressures on the product side of the economy, in intermediate goods prices, and evidence of tightening delivery schedules--the usual types of developments that suggest that the economy is beginning to run not only into labor market tightness but production facility tightness--we can probably expect that inventory investment in safety stocks is going to rise and rise significantly. At this point, even though the current rate of inventory investment is a lot higher than it was in the first half of the year, it does not imply any pronounced increase in inventory-sales ratios. In the past, we have seen such an increase. If that begins to show up, it will be indicating a very strong economic boom superimposed on the expansion that we already have. At the moment, no evidence in any of the data that we look at suggests that. If we start to see profit margins erode, it will tell us that productivity gains, which have been supporting profit margins, are probably easing and that price pressures are probably going to start to show through. That to me would be a very important signal that the inflationary dangers are increasing unacceptably rapidly.

I recognize that there is a stock market bubble problem at this point, and I agree with Governor Lindsey that this is a problem that we should keep an eye on. We have very great difficulty in monetary policy when we confront stock market bubbles. That is because, to the extent that we are successful in keeping product price inflation down, history tells us that price-earnings ratios under those conditions go through the roof. What is really needed to keep

stock market bubbles from occurring is a lot of product price inflation, which historically has tended to undercut stock markets almost everywhere. There is a clear tradeoff. If monetary policy succeeds in one, it fails in the other. Now, unless we have the capability of playing in between and managing to know exactly when to push a little here and to pull a little there, it is not obvious to me that there is a simple set of monetary policy solutions that deflate the bubble. We do have the possibility of raising major concerns by increasing margin requirements. I guarantee that if you want to get rid of the bubble, whatever it is, that will do it. My concern is that I am not sure what else it will do. But there are other ways that one can contemplate.

This leads, as far as I am concerned, to very much the same policy discussion that we had in August. If there are indeed accelerating inflationary pressures, 25 basis points "ain't going to do it." A 25 basis point change used to be a mere indistinguishable tick in interest rate charts to which no one ever paid much attention. Despite the possibility that the markets may assume, if we were to move 25 basis points, that that would be it, I do not believe it. Nobody is going to believe that 25 basis points will accomplish anything. The minimum adjustment needed to have any effect is 50 to 75 basis points. We could have moved 25 basis points in August, as I indicated then, if previous policy had been on a tightening path. But a move then, and I must say now, would be a reversal in trend and would imply in my judgment that it eventually would have to total at least 50 basis points, probably more, and I am sure that the latter would be priced into the markets fairly quickly. This expectation of further action unfortunately requires us in my view to be more cautious than we would like to be if we were dealing with a wholly symmetrical approach to monetary policy.

I would like, if we can possibly do it and as I indicated in August, to avoid our moving up just as the rate of increase in GDP starts to come down. We are only a week away from the fourth quarter. I do not know about the rest of you, but my recollection is that whenever we are at the peak of intense demand pressures, we never are able to identify the peak at that point in time. It is only in retrospect that we identify it. So, we have to be careful about distinguishing between history and forecasts. My general impression is that the probability of a peak at this stage, as I said, is less than 50/50 but growing and that we may not need to move prior to the end of this year. We may not need to move as we get into 1997 if the economy starts to look as it did in 1995. That is not an inconceivable development as we look at the data that we have at this stage. There is no evidence that the economy is about to slip into recession. But there is at least a not unreasonable possibility that the pressures on labor markets as well as on the economy generally could ease enough to reduce the current set of pressures.

Having said all that, I fully acknowledge that we have a very tight labor market situation at this stage. I think identifying the current situation as an inflationary zone, as some have argued, is a proper judgment at this point. But it is a zone, not a breakthrough, and I would therefore conclude and hope, as I did last time, that we can stay at "B," no change, but also if we make that decision that we can retain an asymmetric directive pending our examination of the data as they evolve in the weeks ahead.

VICE CHAIRMAN MCDONOUGH. Governor Lindsey has a question.

CHAIRMAN GREENSPAN. You have a question?

MR. LINDSEY. Just a question, yes, about the productivity numbers. President Jordan mentioned that there is a plug in the employment statistics to cover changes in employment associated with business starts. That would all be in the noncorporate sector. How do we know that overstatements of employment in the noncorporate sector are not an explanation for the productivity statistics?

CHAIRMAN GREENSPAN. Because we have a separate set of numbers for double checking the household numbers. While the household numbers as you well know do not conform to the payroll numbers month by month, it really is quite extraordinary how close those two wholly independent sets of employment data come out over time. It requires some major changes in assumptions with respect to the distribution of employment between corporate and noncorporate to undercut the conclusions that these data seem to produce. The conclusions may be affected at the margin, but if you looked at these data and asked "what if," you would have to make bizarre assumptions about the distribution of corporate and noncorporate hours to make this problem disappear. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I support your recommendation for a "B" asymmetric directive. I believe that was the proper judgment to be made in July; it was the proper judgment in August; and it is the proper judgment now. In fact, developments since the last meeting make me even more convinced that this is the correct conclusion. So, I support your recommendation because I support the substance.

A series of developments not directly in the economic and monetary policy area has transpired since our last meeting. Without going into the details, because we are painfully familiar with those developments, I think this is an appropriate time for the leadership of the Federal Reserve, the 7 governors and the 12 Reserve Bank presidents, to support a common judgment as recommended by the Chairman. The debate in the earlier part of the meeting was very complete and it certainly gave everybody an opportunity to express his or her views. So, at this stage we are able to say that we have heard one another and the Chairman, whose views, I believe, clearly reflect a majority opinion. So, this might be a very good time to indicate that the leadership of the Federal Reserve is capable of pulling together. In my view, that would be of great immediate benefit to the people who work for us, whose morale certainly has been adversely affected to a serious extent recently. I think that it would have considerable merit in the eyes of the American public, whom we ultimately serve, when the minutes of this meeting come out on Friday, November 15. So, for reasons that are easy for me because I agree with the substance, but also for reasons that have to do with a collective responsibility of leadership, I support your position.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. This is going to be a little more difficult given what the Vice Chairman just said, but I would like to indicate that I think there are a number of different arguments that can be put

forward to make the case for raising rates, and I am going to argue in favor of doing that.

My first and foremost concern involves the level of resource utilization in the economy. The economy has been operating at a level somewhat above its long-term potential for some time now. While I expect growth to slow, and I certainly indicated that is our forecast, I do not think that the slowdown will lead to a reduction in the gap between actual and potential output. Indeed, the gap could well grow larger over the next few quarters. At a minimum, it is safe to say that I do not see any reduction in inflationary pressures in the near term. At this time, inflationary pressures are being masked by certain favorable developments, most notably the marked slowdown in the growth rate of health care costs. In my view, we should be using this opportunity to lock in lower rates of inflation instead of using it to put off needed action on interest rates.

Finally, we have talked at times about the level of the real funds rate. While this rate does not appear to be low by historical standards, the data suggest that we are in a period of relatively high investment demand and perhaps a supply-driven expansion that implies higher equilibrium real interest rates. In view of these considerations, I believe it would be prudent to raise interest rates 25 basis points at this meeting. This may not be the last increase we will need unless the economy slows down more than I anticipate. Thank you.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I support the Chairman and his recommendation.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I support your recommendation. I was fascinated by your discussion of the productivity trends and the analysis that was done. I hope that this will be written up and that you will share it with the members of the Committee. I look forward to reading it.

CHAIRMAN GREENSPAN. We will do so. President Jordan.

MR. JORDAN. I support your recommendation.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, I recognize that there are cogent arguments on both sides of this difficult policy issue. But after sorting it all out, the basic message for me is the one contained in the Greenbook projection--that labor markets are currently tight enough to put continuing upward pressure on wages, which may eventually feed into prices. This is certainly consistent with what we are seeing in our District. I agree with the staff's projection that if there is no change in policy, it is highly likely that we will see at least a moderate increase in inflation. My own view is that the risk of error in that projection is skewed to the up side. So, for me that certainly constitutes an inflation danger zone. In this situation, I agree with Bob Parry. I continue to believe that the Committee should act promptly and firmly to reduce these risks and

to hold the line on inflation. Building on one of your comments, my own concern is that if we wait to see profit margins declining, I do not know where that will put us in the cycle or how much we would be behind the curve. So, I would agree with Bob in favoring a tightening of policy today. I certainly agree with you that when we do move, 1/2 point is the right dose.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. This is a tough period, and I have some sympathy for what President McDonough had to say. But I do think that a healthy discussion of where we all are should not be divisive or problematic to our staffs. In fact, I think the worst message that we could send would be to stop doing that at these meetings because people will ultimately know about it.

I don't think there is a question at this point about whether GDP growth will slow; the question is how much. Larry Lindsey asked about my comment about consumers. As you mentioned, Mr. Chairman, there is some reason to wonder about the August retail sales data. I do not have anywhere near as much perspective on September sales as you do. But given the employment data, given the level of consumer confidence, given the rise in the stock market, given the lack of real visible restraint on interest-sensitive sectors and particularly the housing markets, I think there is some risk about how far GDP is going to slow. The next question, to the extent that it does slow, is whether that slowing will be sufficient to restrain inflation.

You mentioned the growth in wage pressures. It is clear that the relationship between tight labor markets and wage pressures that we think exists, does in fact exist. The question is what nexus exists between the increase in wages and the increase in overall prices and has that changed. It may be that profit margins will be squeezed, but I question, as I think you do, how long that would be allowed to happen in the atmosphere that all of us have seen--or heard of, anyway--in board rooms around the country. I do not think profit squeezes will be accepted for long. You talked about productivity, and I totally agree from what I know of it, which is a lot less than you know, that it is mismeasured. I see that as a hands-on operating person, which I have been through most of my career. I think productivity improvements in the service sector, of which we are a part, are vastly undermeasured. Be that as it may, the question is whether the increases that we have been seeing in productivity, whether we know what they are or not, will offset wage increases in the future. Now, with such tight labor markets, productivity improvements have to accelerate to offset the acceleration of wages. Whether this will happen seems doubtful because markets are tight and because we are starting to pick up more marginal workers than we were earlier. This whole question is confusing. I would assume that the impact of the kinds of things that go into technological diffusion and help increase productivity and cut costs may not be as significant going forward as they have been for some time. So, I would agree with you that when we begin to see squeezes on profit margins, that will

indicate the end of the trend where increasing productivity offsets increasing compensation costs.

I think the only place where we do disagree is in our degree of willingness to wait to see that happen. There is a willingness, on my part anyway, to move on the belief that wage pressures ultimately will not be damped by squeezes on profits and by productivity increases but rather will show through into final prices. I think the risks that that will happen need to be dealt with sooner rather than later and that in fact we may be behind the curve. It is true that our inaction over a period of months has allowed more growth to occur perhaps than would have otherwise, but if we are behind the curve and we continue to be, that does not augur well for growth going forward, given past history. In fact, once we experience an increase in inflation, we might have to move more than we would if we started to tighten policy now. Waiting might therefore have a more negative impact on growth than would a slight move now. So, I would go along with those who would increase rates at this point by either 25 or 50 basis points.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. I think there is considerable risk in waiting. The economy has enjoyed great benefits from this period of low and stable inflation, particularly given how expectations have been affected. I agree with what Don Kohn said earlier--namely, that we should not lose sight of the fact that the credibility of the central bank may have a very significant impact on price behavior right now. I have been here a good while, as have many people around this table, and I know how hard it was to earn that credibility. It took a long time, even beginning in the mid-1980s when significant progress had already been made in bringing inflation down. I really believe that it is a lot harder to gain and keep credibility than it is to give it away. It is not an issue as to whether the central bank is credible or not; it is not an ego issue. It is an issue with respect to the economy. If we are wrong with respect to our judgments on the risks of inflation, the costs to the economy are going to be higher down the road when we try to catch up with a moving train. If the central bank takes out insurance against anything, it ought to be against the risk of rising inflation, and I think this is the time to take out an insurance policy. So, I would favor an increase in the degree of reserve restraint.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. Mr. Chairman, I strongly support your recommendation both with respect to current monetary policy and with respect to asymmetry. I am intrigued, as others I think are, by your disaggregation of the productivity data because it provides us with at least a partial explanation of the mystery of why wages have been rising, profits have been holding, and price inflation has not been going up. I hope you will give us a chance to see all of this and work on it further. I still think it is appropriate to worry very strongly about inflation. If we get adverse information in the next few weeks, I think we should be prepared to reconsider.

CHAIRMAN GREENSPAN. Governor Kelley.

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

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I am uneasy about waiting. I think that cost pressures are building. I, like President Moskow, was fascinated by the productivity discussion and would like to see that analysis. If I were voting, I would say that I prefer to move now, but I would accept your recommendation.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I support your recommendation of "B" asymmetric.

CHAIRMAN GREENSPAN. President Gynn.

MR. GYNN. Mr. Chairman, I could support a decision not to change policy at this time, and if I had a vote this year, I would vote "yes." As Governor Rivlin noted in the earlier go-around, we can take great pride in the low inflation and the strong real activity that we have achieved. At previous meetings, I was among those who argued in favor of letting this thing play out. I think that has been the right thing to do.

Having said that, I have come to the view that a modest increase in our fed funds target rate is probably desirable now or sometime soon. In my view, we do need to continue to wonder about whether the hope for a slowdown over the rest of this year and into next year will materialize, at least to the degree that we expect it. Our previous forecast plainly suggested the need for such a slowdown. However, my concern is now rooted in the belief that the rate of growth that we have seen in recent quarters--unless we get a very substantial slowdown--combined with the recent pace of job creation, tight labor markets, and relatively high labor force participation are incompatible with stable inflation over the longer run. This raises a special concern that monetary policy may be accommodating those trends. The current stable inflation performance suggests to me that over the short run, policy may not be too expansionary. Nevertheless, few if any of our forecasts conclude that inflation will moderate under the current policy scenario. Indeed, most forecasts including my own suggest that inflation is most likely to stabilize at its present level or even accelerate slowly. I am convinced that the risks of inflation are now predominantly on the up side.

I believe with Tom Melzer that we currently have a unique opportunity to solidify the gains that we have made in recent years on limiting inflation. A growing number of us around this table and others outside the System are coming to the view that the risks of higher inflation, a small uptick at least, have increased. We have a chance to send a very credible and unambiguous signal to the economy and financial markets about our commitment to stem inflation and perhaps to bring it down further over time. The economy's current strength combined with the fact that markets have been expecting a policy adjustment for some time suggest to me that some change could be made at this time or sometime soon without causing either a large deceleration of real economic activity or a disruption to financial markets. Again, while I do not think the timing is critical, I think

the time is now or sometime very soon to move against the inflationary uptick that we are seeing. I clearly would prefer an asymmetrical directive if we decide to hold policy steady.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. My decision at this meeting is more difficult than at the past two meetings. Indeed, leading up to this meeting, I was feeling the pain associated with fence sitting, hoping the data would push me decisively in one direction or the other. No such luck. I believe that increases in utilization rates should in general be followed by increases in short-term interest rates. That is, procyclicality in short-term interest rates is one of the most important rules of prudent monetary policy. If the unemployment rate stabilizes near 5 percent and if the economy settles into trend growth, I expect I will be moved to support a tightening of monetary policy. I could make that case even today given the increased tightness of labor markets indicated in the August employment report and with fundamentals supporting trend growth ahead. I could make the case that, even here, a cautious step toward restraint would be prudent.

Nevertheless, Mr. Chairman, I am prepared to support your position for three reasons. First, there is a small risk that a tightening at this moment would be badly timed into a sharp slowing in GDP growth to below trend in the current quarter and the period immediately ahead. Second, the prospects of either higher productivity growth or some compression in above-normal markups going forward will give us some room to clarify both the prospects for growth and the degree to which labor markets have indeed tightened. Third, given the recently stable or even declining trend in core measures of inflation, failing to tighten today does not in my judgment leave us seriously behind the curve. That judgment is reinforced by the Taylor rule projections that, as Governor Yellen pointed out at the last meeting, suggest that monetary policy is appropriately positioned today in light of prevailing inflation and utilization rates.

I certainly respect the judgment of any colleagues on this Committee who would prefer a modest move toward tightening today. Nevertheless, I would second the wise counsel of the Vice Chair and encourage those on the Committee who believe as I do that the decision today is a close one and that either no change or a 25 basis point increase could be justified, to join me in supporting alternative B today.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. I was very struck with the group of prominent economists that Cathy Minehan assembled at her Bank. That is in part because I learned a lot of economics from the people in that group, and I do not think that they are at all unrepresentative of what I would consider mainstream academic thinking. I do think that moving today would be the academic thing to do. It would comport with history. It would comport with what our models tell us is going to happen down the road. But I also think that history and academic analysis tell us that we face an asymmetric loss function if we are wrong. We will pay a higher price if we are wrong in terms of more unemployed people in 1998 or 1999 or whenever

than if we were to move today. Because of the academic respectability of that argument, I would respectfully disagree with the Vice Chairman in this regard. I think that the motivations of the people here are very, very sound. I do not believe that we actually disagree. It is much more important that we pull together in public than around the table.

Having said that, Mr. Chairman, I believe that what you are proposing is more reflective of what I would call an entrepreneurial, hands-on approach. I think it is built frankly out of self-confidence and nimbleness, and you have earned the capacity to have self-confidence and to be a little more nimble in the conduct of policy. I will be supporting your recommendation based on what I think is a very well-earned reputation of success. Where I remain nervous relates to what is going to happen at 2:15 p.m. today, or whenever the magic hour may be. I think that the potential for seeing a wave of relief on the screens and the resulting reaction is going to be quite instructive as to our real long-term problem and the challenge facing this Committee.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I agree that it is a close call. At the broadest level, the performance of the economy has been favorable. It has been characterized by growth at or above trend and by low inflation. In recent months, it appears that the pace of the expansion and demand are slowing as anticipated and inflation has been quiescent. If I stopped there, it might be easy. Yet, I feel uncomfortable and I suspect that comes as no surprise. The bottom line is that I feel uncomfortable because of what I perceive is going on with resource utilization, particularly in the labor market, and what I think history tells us about the implications of that sooner or later for inflationary pressures. I would add that, should we get some acceleration of inflation, I believe that will bring with it some further disruptions and perhaps require a policy response that will jeopardize what has been a very favorable economic performance.

Before I came in here today, I was thinking a bit about the institutional issues that the Vice Chairman raised. But I have to say that I am not smart enough to know how things are going to play out on November 15 when the vote at this meeting is released. The bottom line, at least for me and I do not mean to be a purist about this, is the integrity of the process here. I continue to favor some policy tightening now, and I personally think a 1/4-point increase would be appropriate. You may be right that it is going to take more, but in my view it pays to be humble about our ability to forecast with accuracy in these circumstances, given the lags in policy and the uncertainty about the magnitude of the effects of policy. I conclude that a small response is appropriate at this juncture.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Thank you, Mr. Chairman. I can support your proposal to adopt an unchanged policy with an asymmetric directive and to continue to evaluate incoming data as it bears both on the degree of momentum in demand and the inflationary pressures latent in the current environment. But I find myself very close to the margin and would also have been quite willing to support an upward adjustment of 25 basis points today, had you proposed that. I can support your

proposal because, for the reasons that I outlined earlier and you explained in fascinating detail, this is an unusual episode. I believe we are still at quite an early stage of an inflationary uptick, if indeed this turns out to be one. I also agree that with demand moderating and current inflation stable or falling, we may end up deciding that it is unnecessary to move the funds rate upward.

But having said that, I believe that a very solid case can also be made for raising the federal funds rate at least modestly, by 25 basis points, on the grounds that the unemployment rate has notched down further, the decline in labor market slack is palpable, and the odds of a rise in the inflation rate have increased, whatever the level of the NAIRU and the associated level of those odds. I believe I am echoing Governor Meyer in saying that I favor a policy approach in which, absent clear contra-indications, our policy instrument would be routinely adjusted in response to changing pressures on resources and movements in actual inflation. I think such a response function operationalizes the precept that the Fed should ordinarily lean against the wind. A 25 basis point increase in the funds rate is a small move that entails only mild resistance to the forces that are threatening to blow the economy off course. In my mind, what goes up can also come down, and we risk an error if we make the hurdle for moving our policy instrument too high. I am concerned that a policy of maintaining short-term interest rates unchanged, in essence creating a flat LM curve in the face of spending or IS curve shocks, risks increasing the variability of real economic outcomes and decoupling the financial market mechanism and response that should be serving as an automatic stabilizer in the economy. I see the markets as doing their part in moving longer-term rates in response to economic news. But I think we can only count on those responses if our own responses are predictable and we are perceived as willing to play our part, too. My concern is that a failure to shift policy just modestly in response to shifting inflationary risks could undermine the assumptions on which the markets' own stabilizing responses are based.

CHAIRMAN GREENSPAN. Thank you. Would you read "B" asymmetric?

MR. BERNARD. The draft directive wording is on page 13 of the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth of M2 and M3 over coming months."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.	
Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Boehne	Yes
President Jordan	Yes

Governor Kelley	Yes
Governor Lindsey	Yes
President McTeer	Yes
Governor Meyer	Yes
Governor Phillips	Yes
Governor Rivlin	Yes
President Stern	No
Governor Yellen	Yes

CHAIRMAN GREENSPAN. We will now go on to the next item on the agenda.

MR. KOHN. Mr. Chairman?

CHAIRMAN GREENSPAN. Yes.

MR. KOHN. I have a procedural question. When would it be good to stop for lunch? [Laughter]

CHAIRMAN GREENSPAN. I had not looked at the clock but that is a very valid question!

MR. KOHN. It was Mike Prell's question and I agree with it. The members and staff could get their lunch and return to this room with it; it could be a break of about 5 minutes.

CHAIRMAN GREENSPAN. I will take it not as a suggestion but as a mandated response to somebody who knows. We will adjourn for lunch, but we will still be in the meeting when we return.

[Lunch break]

CHAIRMAN GREENSPAN. Peter Fisher has laid out what seems to be a reasonable proposal on the issue of our foreign currency investments. He is requesting that we replace the current 12-month maturity constraint on the investment of System foreign currency holdings with an 18-month duration constraint. Before you hold forth on your positions on this issue, are there questions on his memorandum that you want to direct to Peter? President Boehne.

MR. BOEHNE. I understand the issue of trying to get some of these holdings off the Bundesbank's balance sheet. What are our alternatives in terms of doing that? Is this proposal the only option? I can think of some theoretical alternatives, but I do not know whether they are worth much. For example, we could diversify into some short-term nongovernment securities instead of extending the maturities of our German government securities holdings. Or we could reduce our position in D-marks. I am just wondering if you have thought about other alternatives and what the pros and cons might be.

MR. FISHER. Certainly we have. We have not thought about reducing the D-mark position. That is, I take my responsibilities in the investment of our foreign currency reserves to be independent of their level. So, I am left with the task of taking a given quantity of deutsche marks and investing them. There are other avenues and other conversations the Committee can have about the desirable level of our foreign currency reserves. We have not looked at that. Once I take as given roughly the level of foreign currency reserves that we

have now or that we have had on average for the last five years, there are only a few alternatives that have any practicality. We already have about one-third of our reserves on the balance sheet of the Bank for International Settlements. I see that as a rather high number, although we could go higher. As a rule of thumb I was stopping at about one-third, but we could decide on a larger exposure to the BIS. We could, as in fact most central banks do, go into the commercial deposit market--the Eurodeposit market. In effect, the BIS is a veil for us. They are in the Eurodeposit market; we are not. We avoid, therefore, the rather time-consuming exercise of credit assessment. It is my sense, but it is a very strong one, that we would find rather awkward the process of making differential credit assessments among banks and taking commercial bank or commercial credit risks in the securities market and making relative assessments about the extent to which we should be exposed to or invest in individual private institutions. But that is really the only alternative that exists today.

Now, we have just begun to invest some of our reserves in the deutsche mark repo market, and I think there is some room for growth for us in that market in terms of our overall balance sheet. In my memo, you will see that I am worried about our promise to the Bundesbank that we would get off their balance sheet completely. What I am proposing here will reduce our D-mark balances at the Bundesbank to about one-third of our total D-mark reserves. Another third will be in the German government securities market either in the form of repos or direct investments, and about one-third will be in the BIS. It is my hope that the German repo market will grow and that we will be able to push the envelope a little more there than we have. But if we invest too much there, we will become a rather large piece of that market. So, the alternatives that seem realistic are rather uninspiring because they would involve taking on additional credit risks and the credit assessment process. We would face the prospect of pulling the plug on private entities if we became concerned about their creditworthiness.

MR. BOEHNE. What does extending the maturity of our foreign currency investments do in terms of exposing us to greater loss? This comes to mind because we have this issue of our surplus, and that gets us into potential foreign currency losses among other things,

MR. FISHER. It does nothing unless the Board changes the accounting rules, and we start marking the securities to market. We currently do not mark the securities value of the SOMA portfolio, the domestic portfolio, to market. We have not marked to market the securities value of the short-term foreign currency bonds that we hold now. There are some strong arguments in favor of marking them to market, but I am not persuaded by them. Indeed, I would be a vehement opponent of marking the securities to market, either the foreign or the domestic securities, out of a rather strong fear that, as the Account Manager, I would end up chasing my own tail as the balance sheet went up and down and I moved things around to change the duration of the portfolio. So, absent a change in the accounting rule, moving 15 percent of our deutsche mark holdings into a sub-portfolio of German government debt will have no appreciable impact on profits and losses. The huge impact will continue to be the monthly revaluation of the foreign currency holdings to translate them into dollar values.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Peter, I agree that we need to get our deutsche mark holdings off the Bundesbank balance sheet, and I would agree with that even if Maastricht had not put them on an euthanasia program. [Laughter] Eventually, you are going to be getting out of mark-denominated assets because there won't be D-mark assets. I think the issue of how much of our assets is in the form of foreign currencies has to be addressed sometime, but that is not the issue now. I also would be very concerned about the idea of buying private assets, although I think a few major central banks in the world do that.

MR. TRUMAN. If I could just interrupt, we could not buy any private assets other than bank deposits. We should have mentioned that in the memo. It may be useful to note as background that, before the Monetary Control Act, we could only hold our foreign currency balances in the form of bank deposits. The Monetary Control Act added government paper. So, the only private assets we may hold, as Peter has said, would be bank liabilities.

MR. JORDAN. I think that is something we need to preserve, and other central banks around the world would be wise to do the same. On the subject of duration, there are people around the table who know more than I do about it and how to use it appropriately. I understand that it has had a very profound and a very desirable effect on the balance sheets of commercial enterprises. It took a long time to bring that discipline into play. I remember a period in the 1980s when the question among bankers was, "Have you seen Sandy Rose's last article on duration in the American Banker?" The response was, "I hope so." [Laughter] If the concept is to bring discipline and to help in the evaluation of portfolios affected by interest rate swings, one uses duration as a tool to manage risk; one should not do things to manage duration. So, if we want to be comfortable about the way duration is used as opposed to what a maturity constraint would require, there should not be incentives to take actions for the purpose of influencing duration but rather to manage the changes in the valuation of the assets in the portfolio. I can imagine some scenarios where very dramatic changes in interest rates would influence duration and cause somebody to think that something would have to be done to readjust a portfolio's duration. We would not want to do that.

MR. FISHER. I would like to comment on that. After spending much of the last five years looking at the foibles of other central banks and their investment strategies and trying to make sure that we do not fall into some of those traps, I think there are two problems--you point to one of them--that can arise in using any kind of benchmark, particularly a duration target. One is the problem of too much discretion and the other is the problem of too little. On the potential problem of too much discretion, as the memo and the investment principles in the quarterly report make clear, we do not trade on interest rate expectations. We are going to design the benchmark and replicate it. Period; full stop.

The other problem is one of too little discretion: Are we going to design a benchmark that leads us to do goofy things, to churn the portfolio in order to maintain a perfect target duration? In designing what we might want to do, I tried to address that problem by

setting the 10-month duration target that I am telling the Committee I would intend to implement while permitting actual investments to vary over a very wide seven-week window on either side of that. Essentially, the portfolio can decay for an entire quarter without our having to do anything to address or move back toward a center point. If exogenous shocks occur in the market, my inclination--and I hope the investment principles we will be revising will make that clear--would be as apt to look at whether the benchmark itself, the 10-month target, should be revised as I would be to change our behavior. Over the last decade the single largest move in a five-year interest rate in Germany was about 250 basis points. The sub-portfolio that we have described in the memorandum has a 5-year duration target, so it is a rough proxy for that maturity. A 250 basis point move would translate into a change of about 2 weeks, perhaps a little more or a little less, in the average duration of a sub-portfolio targeted at 5 years, and that would translate in turn into a change of just a few days in the overall structure that I am proposing. The reason for having the wide latitude, if I may digress, between the 18-month ceiling I would like the Committee to set and the 10-month target is that there are a number of factors that could lead the duration of the portfolio to move away from my intention and that would be beyond my control as investment manager. The Germans are notorious for not holding regularly scheduled auctions. So, we are always subject to a big surprise, a big shock, as to when an auction takes place and its timing can move the duration quite a bit.

The other reason is that I very much want to separate the question of intervention and its size from the question of how the portfolio is managed and what kind of limit the Committee places on the Manager. If 50 percent of the portfolio were to be liquidated through intervention, there are different ways that could be done. We might liquidate everything at the short end; we might liquidate across the spectrum. That could swing the duration quite widely, and I would not want to have too short an overall limit placed on the portfolio that would in effect, because of intervention, lead to violations of the Authorization.

MR. JORDAN. Have you thought about how the Bundesbank might implement the eventual transition to the new euro?

MR. FISHER. I have begun to think about that. It has been my assumption that we would leave our deutsche mark holdings unchanged as they are transfigured into euros. And when that happens, we would then be a participant in the novel question of what the euro yield curve will be--whether, for example, German paper will determine long euro rates but French paper will determine the short rates. There is enough noise in how that will work out that I cannot see very clearly in my crystal ball. That is about as far as I have gotten.

VICE CHAIRMAN MCDONOUGH. Can I ask a follow-up question? I assume that whether our deutsche mark portfolio becomes a euro portfolio has to do with what we decide is the key intervention currency.

MR. FISHER. Yes.

VICE CHAIRMAN MCDONOUGH. The reason we are in deutsche marks is not because we love deutsche marks. It is because it is the right

intervention currency and therefore we sold our relatively small holdings of French francs, Swiss francs, pound sterling, and so on and put it all in deutsche marks. If we came to the conclusion over time that we would do all our intervention in euros, we should be completely in euros. Peter brought to the Committee the view that we will need euros but that we may also need some other currencies because parts of Europe may decide not to join the common currency. That would be a different matter, and we do not know how that will work out.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Peter, the word "euthanasia" has been used and I think it is appropriate. One of the options you did not address was to dispose of our DM holdings. President Jordan may be right in saying that this is not the time to consider that issue, but we need to decide at some point why we are still in this. Why do we still hold those large DM reserves? We have talked about getting rid of them since I have been here. We will have to get rid of them before 1999. We do not know how the euro is going to come into play. We do not know if we will want to intervene in euros. Why don't we take this opportunity to go to the Germans and say, look, let's really clean our books?

MR. FISHER. Our deutsche mark reserves will not disappear; they will be converted into euros. The euro will be a major reserve currency of the world even if it is subject to a great deal of volatility. It is my forecast that there will be some volatility, indeed quite a bit I would think, in the early years of the euro. And I believe that it would be in the interest of the U.S. monetary authorities to have some capacity to participate in reducing what I personally see as a rather significant risk of market disturbances. I am not suggesting any particular intervention or any particular type of intervention, but unilateral disarmament ahead of the event is not something that I would be urging on the Committee. But I want very much to separate these two questions, Governor Lindsey, if I can.

The question of how these reserves are managed and invested and how we stand as the prudent manager of what essentially is a public asset is different from the question of the level. In my six years of association with this question, whenever marginal improvements in the prudence with which we manage these reserves are brought to this table, the question of level is what comes back. I do not think the question of level ought to dictate the manner of the investment. We can have a debate about the level--

MR. LINDSEY. The reason is that the interest rate risk that you are discussing is trivial in comparison to the exchange rate risk, especially in the transition to the euro. That is why it comes back to you. But if we are going to consider this question another day, I am reassured. Let's consider it another day.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Just a follow-up, Peter. I want to make sure I understand the reason for your average duration proposal. Did you choose the 18-month duration because that leaves you within the bounds

of intervention amounts that we have done in the past? What is the reason for the 18 months if it does not relate to that?

MR. FISHER. If we just take the norm of historic interventions, we would not have to go out to 18 months in order for me to have a 10-month maturity duration target. But the day could come when the decision would be made to intervene using, say, half of our reserves, which would be three times the largest intervention amount used historically. The Committee has procedures for approving the amounts of intervention. I think this investment guidance I am seeking should be a separate issue and not become a constraint on future intervention. A much shorter duration, whether it is 15 months or 14 months rather than 18 months, is not the be-all end-all. But if you start squeezing and impose a shorter total duration and we were forced to intervene in very large amounts, I would run the risk of violating the authorized duration limit if I were to liquidate a great deal of our holdings at the short end. Let me just repeat that I propose setting a 10-month target, and I will not change that target without coming back to the Committee and soliciting your views on a change. So, the two things are separable in my mind.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. I want to pursue an issue that Ed Boehne brought up. Peter, I understood what you said about how we account for this, but regardless of the accounting, there is an economic exposure. Could you give us some idea of our exposure right now with the 12-month maturity limit, given how we typically invest our currency holdings under that limit, versus what the exposure would be if we went to a 10-month duration limit? What would be the actual increased economic exposure if we had, for example, an upward movement in German interest rates of 100 basis points? What would we stand to lose under this new scheme economically, assuming we had to liquidate our holdings right away, versus what we would have lost based on how we historically have invested our currency holdings, at least in recent times?

MR. FISHER. We have been spelling out some of the risks in the quarterly report that we have been sending you. The immediate answer that I have to your question is what I referred to in the memo. We did a simulation over an entire interest rate cycle and looked at what would happen if we were marking to market the entire portfolio, including deposits.

MR. MELZER. Yes, that is the question I am asking.

MR. FISHER. There was no quarter in which a deutsche mark portfolio structured as proposed would have had a net loss; that is, the capital value loss would have been exceeded by the earnings.

MR. MELZER. The interest earnings offset the capital losses?

MR. FISHER. Yes, over the last 10-year interest rate cycle. Moving 15 percent of our holdings as proposed implied a pickup over a normal investment cycle of about 20 or so basis points over the income produced by our current approach to investing. Now, I do not have immediately in mind an answer to your question in the way you structured it.

MR. MELZER. Okay.

VICE CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Peter, let me ask you a question to help further my education. I took two things out of the memo. One, you want to switch to an average duration limit as a way of measuring the overall liquidity of the portfolio. The second issue was more interesting and seemed to be the real question, i.e., whether there was a case for increasing average duration. You note that reserves are invested without price exposure and that liquidity is the primary objective. That would seem to suggest a low average duration. So, I need to understand what you buy by increasing the duration. Let me bring it down to the story about the 10-month versus the 18-month average duration; that was a good example. You started by saying you would like to have a 10-month average duration as the target, but you want to have 18 months as the limit and that is in case of the necessity for significant intervention. But that brings to a head the point because you implied in your discussion that, of course, we are going to sell only at the short end. You did not actually say that, but the implication was that you would sell from the short end of the portfolio. So, why are you holding long-term securities?

MR. FISHER. We tried to make clear several other points in the memo. First, I do not urge the Committee to adopt the 18-month duration limit solely for its liquidity measurement purposes. I think it is a replacement for the current 12-month maturity ceiling which was intended to limit both price risk and force a certain amount of liquidity into the portfolio. It has had some perverse effects. We are a major owner of very illiquid government bonds at the very short end of the German yield curve. If I continue to try to get off the Bundesbank's balance sheet without some increase in our duration, I am going to be buying more and more illiquidity in these short-dated cats and dogs of the German yield curve, which is contrary to the objective of wanting to be liquid. So, I will be buying less and less liquid paper. It is less liquid than buying securities "on the run" out of recent auctions and permitting them to decay and having a sub-portfolio spread evenly all along the yield curve. That is a bit of the background that I think changes the complexion of what you are pointing at.

I am also doing this because I feel a necessity to get off the Bundesbank's balance sheet. A decade ago we were entirely dependent on their balance sheet. Between 1/4 and 1/2 of the reserves of the German banking system were owned by us through the Bundesbank's balance sheet. We are down to a much smaller proportion in part because we have moved off the balance sheet and in part because the Berlin Wall came down and reserves expanded in the German banking system. That was a major shift. But I think we ought to recognize that the Bundesbank is in a very different position than we are. Let me just turn it around. A couple of months ago, when this Committee discussed the question of facilities for foreign central banks on our balance sheet, the Committee members expressed a great deal of reluctance, skepticism, and concern. We are going to come back and try to address these issues in a modified proposal. We currently maintain tens of billions of dollars of deutsche marks on the Bundesbank's balance sheet with zero liquidity cost. We can liquidate these at zero notice and contract their balance sheet at our whim.

Now, to put that in context, the need here is to get off their balance sheet. We have been rather slow in doing so, and they have been rather good natured about the tardiness of our response to their request. If I take that need as a given, I now have to look for a place to invest. I think a reasonable first step in how I diversify off their balance sheet is to invest in "on the run" German government securities or purchase them at auction, and build up a small sub-portfolio. So, it's a different mix of factors than I think we were--

MR. MEYER. I thought the compelling story was the German balance sheet, but some of the same issues come up when we talk about the liquidity of the SOMA portfolio.

MR. FISHER. They are similar.

MR. MEYER. The difference is that the way you buy differs from the way you sell, and that is really my question. You have the same situation domestically in that liquidations occur at the short end but buying occurs over a wide maturity range. I want to understand what you achieve by buying over a wider maturity span than you intend to sell.

MR. FISHER. I'm sorry; I meant to answer your question there as well. I do not mean to say that I will automatically liquidate only at the short end when there is a need to liquidate large amounts. Indeed, many central banks--the European central banks--discovered during the period of market tensions in the early 1990s that it is very efficient to repo out long-dated securities for immediate liquidity. That provides the luxury of selling those securities very slowly and gradually over time. That may be another source of liquidity. We will try to develop liquidation rules that may have an either/or flavor to them. We may liquidate significantly at the short end or we may repo out the long end and rebalance the portfolio more gradually. That is very much my intention because of the enhanced liquidity of holding the "on-the-run" German government securities. So, your point is very well taken.

MR. TRUMAN. There is one other factual point that it might be useful to note, and I think you referred to it in the memo, Peter. That is that one of the characteristics of the German money market is that they do not have a lot of short paper. That reflects a policy decision on the part of the Germans, and I might add a policy decision on the part of the Bundesbank. They are changing this a little. Therefore, the other side of their being good natured about this is that in some sense they themselves have not promoted the kinds of assets in the market that we could easily purchase. That is changing a little as I noted, and the Desk has taken advantage of that. Again, exactly how it will evolve in the context of the euro--leaving aside all of the other issues about the euro and the amount of euros we will get when the transition occurs--is unclear. My guess is that on balance we will be better rather than worse off because the Germans are the "least modern," if I may use that word, in terms of the kinds of government paper that they have on the market.

MR. FISHER. It would be my hope and something of an expectation that in the event we move to euros, we will find a deeper short end. And when it is all denominated in one currency, we may

find it much more comfortable to be invested in French government bills and to have a shorter duration to the portfolio.

CHAIRMAN GREENSPAN. Any further questions for Peter?

VICE CHAIRMAN MCDONOUGH. I was going to move approval.

CHAIRMAN GREENSPAN. Let's first have the Deputy Secretary read what we will be voting on.

MR. BERNARD. This would amend Paragraph 5 of the Authorization for Foreign Currency Operations. The new wording is found at the bottom of page 1 of Mr. Fisher's memo dated September 13, and it would replace the first two sentences of the existing wording in the Authorization. The new wording is as follows: "Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration)." What this new wording replaces may be found in the footnote on page 1 of Mr. Fisher's memo.

CHAIRMAN GREENSPAN. Would you like to move it?

VICE CHAIRMAN MCDONOUGH. I move approval, Mr. Chairman.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. All in favor say "aye."

SEVERAL. Aye.

CHAIRMAN GREENSPAN. No? The "ayes" have it. The next item, which is the final item on the agenda, is a request from Peter Fisher for the members' views on the liquidity management and maturity structure of the System's domestic portfolio. Does anyone have any questions to ask Peter before we move to the specific views of the members? Governor Meyer.

MR. MEYER. I think this is where the issues come up that I started to get into with respect to the investment of our foreign currency reserves. It seems to me that what you are talking about in terms of the portfolio is a compromise between two ideas that I call buy-side neutrality and sell-side liquidity. I am struggling to learn how you deal with that. Buy-side neutrality says that you mirror everything so that you do not have an impact on particular markets. The sell-side liquidity says that when you sell, you sell short-term securities. That is obviously how you deal with it. But it seems to me that the current practice is an attempt to deal with that compromise by segregating out a bills portion that you sell and then the rest is for mirroring. The question is whether or not we could be more systematic in how we decide on what those proportions should be. It seems to be very similar to the story we tell in our own regulation with respect to internal models, market-based risk, self assessment, stress testing, and all the rest. The Meulendyke memo on liquidity seems to be at least an attempt to get us to think in that way. But the question it seems to me is whether that procedure should be the

one that determines the correct proportion of bills in the total portfolio, whether it is 50/50 or 70/30. Is that the right spirit?

MR. FISHER. Yes, I think it is. Let me make one comment because it might help other members to comment on it: I wish I had made this point clear in my memo. In addition to the two different kinds of neutrality you are pointing to, there are two very different kinds of sell-side neutrality. One is a very short-run, sell-side neutrality that relates to the impact on the market today. The other is a very long-term, sell-side neutrality that has to do with how the public portfolio is affected by the selling. In some of the hypothetical cases that the Meulendyke memo points to, if we were to liquidate \$50 to \$100 billion and did it all through the short end, that would have a rather profound impact on the public portfolio and thus would not be sell-side neutral or market neutral in a long-run sense. So, there is another balancing going on there. I think much of the history of the portfolio has reflected a tension between these two different kinds of neutrality. Obviously, there are market situations where we would not want to sell across the yield curve, but there might be some where we would. Clearly, it is generally most convenient to liquidate principally through the short end. But with that caveat, I agree entirely with your formulation of the problem.

CHAIRMAN GREENSPAN. Any further questions? What Peter needs to have from the members is some reaction to his memorandum so that he can move forward.

MR. BOEHNE. I think the case for moving toward a somewhat more liquid portfolio makes a lot of sense. I don't know whether it ought to be 60 percent bills, or 2/3 bills, and the rest coupons, but I think Peter rather persuasively laid out the case that we need to move in that direction. Perhaps the way to do it would be to move to, say, a 60/40 split and see if we like that. If we feel that we need to move more than that once we get there, then we could move further. How long do you think it would take to move to a 60/40 split portfolio?

MR. FISHER. While Sandy Krieger thinks about how long the transition might take us, I would note that to move in that direction we probably would need to have the Treasury treat us explicitly as an "add-on" in the bill auctions. They do not do that now because, as deficits have come down, they have been contracting their bill offers and we along with the foreign central banks have become a rather large share of the competitive auctions. But I think that issue is solvable and that the Treasury would be amenable, if that is what we want to do, to working with us on that. Once we had their agreement that we would be an add-on--I am trying to think off the top of my head how quickly the portfolio behaves--I would guess that it might take five years to move our holdings of bills up in a smooth way from 50 percent to 60 percent of our portfolio.

MR. BOEHNE. I think we ought to move in that direction and then take another look at it. We might not wait five years but might look toward getting a progress report two or three years from now to judge if the 60 percent makes sense. I don't think there is an absolutely right number, but I think we know the direction in which we ought to be moving, and we ought to get started.

CHAIRMAN GREENSPAN. In the past, we have discussed the possibility of having an agreement with the Treasury to swap maturities with them in the event of a need on our part to liquefy a significant amount of our portfolio. I have forgotten what the answer was. Does anyone recall what it was?

MR. KOHN. I do not recall.

MR. FISHER. I do not have a sense of a definitive answer from the Treasury on that.

CHAIRMAN GREENSPAN. Let me start from scratch. If we have a maturity structure problem that would prevent us from selling a desired amount of securities at specific times, that would make us lean toward a much more liquid portfolio. But what is there to prevent us from making an agreement with the Treasury to have them swap two-day bills, or something like that, for our coupons?

MR. FISHER. I do not know of any constraint on that.

MR. KOHN. As we sold the bills, it would make the average maturity of the debt in the hands of the public much shorter.

CHAIRMAN GREENSPAN. Exactly. I am only raising the issue of the difficulty of selling coupon issues in the market and as a consequence either affecting the price or affecting our earnings. If on the other hand we made a straight swap with the Treasury, that presumably would not be an issue.

MR. KOHN. That approach would help in terms of averting the effect on prices in the market if there were a concern about selling coupons because there was a flight to liquidity as well as to quality. Presumably, the Treasury would do it at the market value of the securities.

MR. JORDAN. You can't conclude that there would be no effect on market prices because if we swapped out of coupons into short-dated bills that are going to mature, the Treasury would have to issue new debt. We don't know what their marketing strategy would be, so we don't know what the price effect would be.

CHAIRMAN GREENSPAN. What we would effectively have done is to require them to refinance fairly quickly. But depending on the maturity of the bills, even if we made it a 20-day maturity, that would not really affect our ability to sell the bills, but it could make it easier for the Treasury to choose an appropriate time frame to refinance. If 20 days is not good, 45 days is not going to make much difference for us either.

MR. JORDAN. But without knowing what their overall deficit financing strategy is, it would be hard for us to--

CHAIRMAN GREENSPAN. There is no doubt that the Treasury's reaction to this would be 110 percent negative before they heard the end of the sentence. That does not make it the right answer.

MR. JORDAN. I think this is an issue because regimes and ideas at the Treasury change periodically. Like Ed Boehne, I think

that increasing the liquidity of our portfolio is the right thing to do. Liquidity is not just a primary portfolio objective. It is so far out in front that I do not even know what the second objective is. And going forward we may not want to go to bills only, but going dramatically in that direction is the right thing to do.

CHAIRMAN GREENSPAN. We do not care about the earnings aspect and we should not because it is merely a bookkeeping transfer between ourselves and the Treasury. I do not know if there is a problem here. There would be a big problem if the net issues of Treasury debt to the public were disproportionately in the form of short-term bills because that would make budget policy very closely affected by interest rate policy. But it has nothing to do with us on the other side.

MR. LINDSEY. But why wouldn't it if we are adding to our short-term portfolio in an era of, say, low deficits? Why wouldn't that allow the Treasury to ease off on its issuance of long-term debt and move the whole maturity structure of the debt toward short term issues?

CHAIRMAN GREENSPAN. If you move the debt to short term, it is the outstanding debt, not the budget deficit, that determines the impact of--

MR. LINDSEY. I would imagine that to accommodate a growing money supply and a move toward liquidity on our part over time the Treasury is going to have to respond in an era of low deficits by lowering the average maturity of the debt structure. I think that is the incentive we are creating.

CHAIRMAN GREENSPAN. Versus doing what?

MR. LINDSEY. If the deficit comes down and we are increasing our take of the short-term debt, why wouldn't they have to respond by moving into supplying more short-term debt?

MR. JORDAN. Some 20 percent of the \$6 trillion debt rolls over every year and needs to be reset at the average 5-year maturity of the existing debt. The Treasury needs to refund over a trillion dollars of maturing debt every year

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Raising the issue of being able to do swaps with Treasury would add another item to the list of possible liquidity resources in Peter's paper. Rather than working out a deal that would involve 2-day paper, or perhaps 20-day paper, we probably should instruct our Manager, in dealing with Darcy Bradbury's successor, to see if an agreement could be worked out that would be in the best interest of our customer, the Treasury, and in our best interest. That would be one of the things that we could do as part of developing a panoply of liquidity resources.

CHAIRMAN GREENSPAN. Why don't you talk to them over there and see whether they slam the phone down before you can get a couple of words in. They are more than disinclined to listen to anything that complicates their task because they think they are over their

heads with work. If you impose any more work on them, you are not a friend. Any further comments? President Melzer.

MR. MELZER. Thanks, Alan. I have one question for Peter. After looking at this, I would agree with what has been said. I think liquidity is the most important objective, and as you said, what we earn on our portfolio does not really matter. It is not like the foreign portfolio where there is some tradeoff between liquidity and earnings.

CHAIRMAN GREENSPAN. Those are real earnings!

MR. MELZER. That's right. The question I have, Peter, relates to the loans of Treasury securities by the Desk to dealers in government obligations if there is a delivery squeeze involving particular issues. If we went all the way and at some point got to a "bills only" portfolio, would your inability then to lend securities create any significant problems for the functioning of the government securities market?

MR. FISHER. That is a good question. I am somewhat uncomfortable with our current securities lending program, to say the least. The program itself goes back to the period before government securities were in book entry form. It was designed to deal with the tardiness in the paper clearing process. With the development of book entry, I believe that the Desk became eager to discontinue the program and was on the verge of doing so at the time of the Salomon Brothers episode. But that just seemed to be the wrong time to make the change. To put it bluntly, I am desperate to find an occasion to discontinue the securities lending program, and if I can find the right cover I will urge the Committee to discontinue it. I do not think, however, that this issue raises itself to the issue of the overall structure of the portfolio.

MR. MELZER. Okay.

MR. FISHER. But perhaps on another occasion I may come back and talk to the Committee about some of those more mechanical issues.

MR. MELZER. Maybe you can get rid of it in the context of this portfolio issue.

MR. FISHER. We might be able to. I might add that even if our coupon portfolio went down to 20 percent or 30 percent or 40 percent of the total, we would still have plenty of securities to lend, given the kinds of limits that we impose. But that would not be an obstacle to me, and I do not think it would be viewed as a serious matter in the market.

CHAIRMAN GREENSPAN. If we went to bills only, the earnings of the System would be highly correlated with the federal funds rate. Would it be assumed that as earnings go up we are going to use those funds to go out on the town or something like that?

MS. MINEHAN. Probably.

MR. HOENIG. I am sure someone would assume that.

SPEAKER(?). We could use the profits to support our "airforce"!

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I agree with the recommendation of trying to increase the liquidity of the System portfolio. I am not sure that I know what the right percentage is, but I take your point. I also appreciate your efforts, Peter, to try to identify and analyze the previous portfolio objectives. I take it that what you plan to do following this discussion is to go back and try to come up with some kind of statement of procedures or policy. I thought the principles that you noted on page 5 of your memo were sound. They all seemed important to me, but they were not prioritized or weighted. So, when you go back to redo them, I think it would be helpful if you were to put them into some kind of operating context.

MR. FISHER. Absolutely. I am hearing some encouragement of the super preeminence of liquidity, which will be reflected in our effort.

MS. PHILLIPS. You do have it as the first item in your list, but then I can't quite tell where else it fits in.

CHAIRMAN GREENSPAN. Any other comments? President Minehan.

MS. MINEHAN. This may be a naive question, but is liquidity absolutely determined by the percentage of bills in the System portfolio? A priori, the more bills, the more liquidity? Are not the other securities that are commonly used in repo transactions every bit as liquid or is that not accurate?

MR. FISHER. There is certainly a good deal of depth to the long end of the yield curve, but given the history and current structure of the Treasury securities market, there is no doubt in anyone's mind that the bill sector is much more liquid. Now, I think that we have to stay in touch with a possible evolution at the Treasury on this. Over a long period of time the relative liquidity of bills could change. For example, in the German yield curve it is the short end that is illiquid and that I am trying to get out of.

MS. MINEHAN. That is less liquid, yes.

MR. FISHER. That is not an immutable fact, but it is a fact today and has been a fact for the last couple of decades.

MS. MINEHAN. I know the presumption is that the bill area is more liquid; there are more securities at that end, although I believe that the Treasury has been extending the overall maturity structure.

MR. KOHN. The Treasury has shortened the debt structure.

CHAIRMAN GREENSPAN. Liquidity through repos, or the ease with which one can arrange them, decreases in a crisis atmosphere. It is precisely then that we may really need a liquid portfolio. There is never a question about, say, 12-day bills, whereas finding counterparties may be difficult when we want to do repos during a crisis. Everyone is then running for cover.

MR. KOHN. The other point on the liquidity of bills, President Minehan, is that we could absorb reserves very readily by simply allowing them to run off at maturity.

MS. MINEHAN. Right.

MR. KOHN. That was one reason why the Committee decided in the mid-1980s to shift more of the portfolio toward bills because that meant that outright sales in the market would not be required to accomplish a large amount of reserve absorption.

MR. FISHER. I would just note that we are also using the traders' definition of liquidity, which is the ability to execute transactions in volume without moving price. Clearly, the long end is less liquid in that sense. The further out the maturity curve we go and the more we are selling, the bigger the price effect we will have.

MS. MINEHAN. Right. But I would think that if we went to an all bills strategy, we would have complications associated with how large a share we are of the auction and perhaps how large a share we own of any given issue. That might be a problem as well. So, I think some gradual move to a more liquid position without going all the way is probably the one to be preferred. You asked the question about income. I do not think we should have an income objective either, as nobody else seems to.

MR. KOHN. I think in the past the Committee has talked about conducting at least some transactions in the coupon end of the market just to be in the market from time to time, and the possibility of buying coupons in certain unusual circumstances probably should not be ruled out. It is something that the Desk has done in the past. Only four or five years ago, the Committee was concerned that the portfolio was getting too liquid, and the Desk was instructed to stop moving it in that direction.

CHAIRMAN GREENSPAN. Further comments or questions? Peter, do you think you have enough to move forward?

MR. FISHER. I will take a stab at the next step. Thank you.

CHAIRMAN GREENSPAN. Very good. The next meeting is scheduled for Wednesday, November 13. We have now concluded this meeting.

END OF MEETING