Meeting of the Federal Open Market Committee
December 17, 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, December 17, 1996, at 9:00 a.m.

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

Messrs. Broaddus, Guynn, 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, Rolnick, 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
Mr. Slifman, Associate Director, Division of Research and Statistics, Board of Governors
Mr. Reinhart, Assistant Director, Division of Monetary Affairs, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Beebe, Davis, Eisenbeis, and Goodfriend, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Kansas City, Atlanta, and Richmond respectively

Messrs. Gavin, Kos, and Rosengren, Vice Presidents, Federal Reserve Banks of St. Louis, New York, and Boston respectively

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

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CHAIRMAN GREENSPAN. Good morning, everyone. This is Tom Davis's last meeting. He has been coming to these meetings for 20 years, and I suspect that by now he knows what they are all about, and just as he finally gets it, he has to leave. I think he has made an extraordinary niche in the System, and if there is ever a plaque in Jackson Hole, his name will be on it. One thing that you can say about the Jackson Hole symposium, which of course Tom struggled mightily to help bring into existence, is that we all put the symposium on our calendar each year and then adjust everything else. Tom, we certainly are going to miss you. [Applause]

MS. RIVLIN. I hope this does not mean the end of the Jackson Hole conferences.

CHAIRMAN GREENSPAN. If it means the end of Jackson Hole, Tom is coming back no matter where he is! [Laughter]

Shall we start off? Would somebody like to move approval of the minutes for the meeting of November 13?

VICE CHAIRMAN MCDONOUGH. So moved.

MR. MOSKOW. Mr. Chairman, I have a minor suggestion on one of the changes from the preliminary draft of the minutes that we received just last night. It's in paragraph 13, and I talked to Mike Prell about this. I think that the suggested rewording gives the impression that inflation is projected to come down in a meaningful way, but when we allow for the methodological changes that the BLS is putting into effect, the changed wording may give a somewhat misleading impression. This is probably a technical matter that we could work out after the meeting if the Committee is willing to give us that privilege.

CHAIRMAN GREENSPAN. Why don't you do that. The problem here is that minutes are supposed to interpret what the FOMC members said, even when they are wrong. So, you can't argue that the minutes are wrong when they record what was said; you can only argue that they are wrong when the Secretariat inappropriately summarized what individual members said.

MR. PRELL. Mr. Chairman, in this case the reference is to the staff forecast, and the question is how to portray the movement of inflation in 1996, 1997, and 1998 and its relationship to--

CHAIRMAN GREENSPAN. Does the statement refer to what you said or to what one of your colleagues said?

MR. PRELL. In essence, it refers to the Greenbook forecast. We could go back to the original wording in the preliminary draft of the minutes or we could put in something that says the price forecast is adjusted for technical changes.

CHAIRMAN GREENSPAN. I presume, as President Moskow says, that this is a solvable problem and not something that we have to discuss here at length. Let us get it done. Without objection, we will give you all of our proxies.

MR. MOSKOW. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Peter Fisher.

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

CHAIRMAN GREENSPAN. You mentioned that the dollar is holding up remarkably well considering the degree of downward pressure on dollar-denominated asset markets. A while ago, we discussed whether in fact one could ferret out the apparent intermediate- to longer-term effect on the dollar from rising dollar interest rates, the presumption being that as U.S. interest rates rise, other things equal, the dollar will rise. The experience you are noting and the experience that we have discussed previously is that in periods of significant worldwide sales of dollar-denominated assets and rising U.S. interest rates, our exchange rate falls or tends to. We presumably were going to be looking at whether there is any systematic analysis we can do to differentiate those contradictory phenomena. Have you made any progress on that?

MR. FISHER. Members of Ted's staff and my staff have been working on this, and I am afraid there is nothing that we can come forward with that is conclusive or very satisfactory. Staff are arguing back and forth, and I do not think there is anything that we can put our fingers on that provides a systematic explanation. The work is going along. I think what is most on market participants' minds is the abrupt decline that the dollar suffered in July when our equity markets experienced a reversal. The dollar-mark lost 3 pfennigs very rapidly and the dollar-yen also came under pressure. I am very cognizant of the fact that markets are driven to a great extent by habit. They look at the most recent episode to see what other things might happen and to give them a clue as to how they should behave. In July, we had pressure in equity markets, and it translated immediately into a weakening dollar. Many people were expecting that to happen again as they looked for pressures in our asset markets. So, I am just reflecting on market participants' observations that that did not happen when they expected it to.

CHAIRMAN GREENSPAN. The presumption, of course, is that if a significant part of dollar asset sales occurs on foreign accounts and the proceeds are exchanged into other currencies that would explain the decline in the dollar. Obviously, sales of dollar-denominated assets in which there is no exchange into foreign currencies by definition do not have that effect. In this regard, I take it that you do not have any information on sales of dollar-denominated securities or purchases by foreign accounts that is usable on a sufficiently short-term basis. You only have it on a quarterly basis, not a monthly basis.

MR. FISHER. Yes, that is right. The lags are a bit long in that regard. I would also note that in addition to the mechanism that you are referring to, there is another mechanism. If risk appetites are large at the end of the cycle and these happen to be expressed in long dollar positions, people might collapse dollar positions in a period where risk aversion comes to the fore because of uncertainty and might do so independently of whether they actually are liquidating dollar assets. That is, there may not be a direct pass-through from the closing of a stock position to the sale of dollars. There may also be some management of foreign exchange market exposures that simply implies just a reduction in risks and a reduction in positions.

CHAIRMAN GREENSPAN. You talk like an economist! [Laughter]

MR. FISHER. I have been exposed to them for a while!

MR. BOEHNE. Peter, I have a couple of questions on your planned changes for Desk Operations. As I understand this, you have operations for customer accounts and you have operations for System account. Is my understanding correct that on System operations you are now going to announce the amount after the bids have been accepted? You already announce the size of customer transactions, but on that side do I understand correctly that you announce the amount of bids that you are looking for and not the amount accepted?

MR. FISHER. Yes. That is the historic practice we have continued. Now, I may have gone too far in explaining this, but I think that in all likelihood customer operations may die on the vine. I do not want to announce that we will never do another customer operation, but I am hard pressed to see circumstances when I would be tempted to do it.

MR. BOEHNE. My question does not focus primarily on the customer side. Are there any advantages or disadvantages when you are doing System operations to announcing the amount of bids that you are looking for?

MR. FISHER. Yes, I think there are some pros and cons to announcing the quantity in advance. The pro is that telling the market the amount of the contemplated operation is normally thought to be helpful. The con is that we like to look at dealer appetites as one indicator of funding needs, so I am rather uncomfortable in situations where we announce we are doing a $1 billion customer operation and we get so many bids that we do $2 billion, which is rather typical. I am not saying that the amount of the bids is always double, but that is rather common. The amount of dealer bids for financing is actually a very helpful piece of information in assessing the amount of reserves we think we may need to inject. As we have focused increasingly on day-to-day operations because of the much reduced operating balances and related uncertainty, the size of dealer bids has become a variable of growing importance. I accept in principle that it would be better to announce the size of intended System operations, but that makes me somewhat uncomfortable because I like to see the dealers' appetite as an indicator that may lead me to shade the size of the operation one way or another. In my view, announcing the size of the contemplated operation becomes problematic.

MR. BOEHNE. That seems like a reasonable tradeoff. If you are planning to go in earlier, and I presume this is just a way station to entering the market still earlier as more information becomes available, that opens up the possibility, or maybe the likelihood, that you can come into the market more than once during the day.

MR. FISHER. As I explained in the memo.

MR. BOEHNE. Yes. What are the kinds of things that you look for--you have talked about this some, but could you elaborate--in deciding whether to go into the market a second time? Do you look at reserves; do you look at the funds rate; do you look at both; or do you in a sense put your hands over the market to get its feel? What happens?

MR. FISHER. Well, it has been a while since the Desk had any kind of habit of going into the market multiple times a day--I guess twenty years or so. I certainly have no hands-on experience with such multiple daily operations. Among the things we would look for would be an unexpected shift in the Treasury balance that could be a big factor that we would become aware of later in the day. The drain of reserves from a rise in the Treasury balance is information that is available to us, as would be an unexpected shift of funds and drain stemming from our customer operations. These are the first order of flows about which we would become aware with some degree of certainty. Another reserve factor about which we are certain relates to those occasions, which I am hoping avoid, where we do not get to add as much in reserves as we wanted to. Then, it would be nice, if we did not shock the market in the process, to be able to come back and conduct further operations because we did not get enough bids the first time. That is another sort of fact, certainly.

The harder issues are those where the funds rate just stays firm and, in the current environment where we operate once a day, we are left to wonder in the early afternoon whether we made a mistake. We talk to brokers and funding desks to find out where something is going wrong; sometimes we can determine the reason, such as funds getting trapped in a bank that is having wire transfer problems. The bank may continue to have a wire transfer problem throughout the day, and adding a little reserves could be helpful in that situation. I think that is the sort of issue that we have to look at. Don Kohn and I have talked about this at some length over the last couple of years. What we are really rather hopeful for, but is still even further off, is some way to be able to operate truly late in the day, that is, at 3:00 p.m. or 4:00 p.m.--which would require a change in Fedwire rules and perhaps the window--or even later at 6:00 p.m. We certainly would have more information then about a number of factors and would know whether there is a reserve miss or not and could try to respond to it.

MR. KOHN. We would have a better sense of the demand for reserves late in the day. I think that one of the phenomena of this low reserve balance situation, at least a couple of years ago, was that things could shift rather dramatically in terms of demands for excess reserves very late in the day. I think many other central banks operate more than once a day, and particularly if there is an interest rate target, it would be nice to have that flexibility.

MR. FISHER. So, in terms of the new framework for conducting operations, I think multiple operations on one day would be used infrequently but would be available to us. So, whether we operated at 9:30 a.m. or at 10:30 a.m., we would have the option of coming back at 11:30 a.m. if we became aware of something very tangible about the Treasury balance or other developments unexpectedly affecting reserves. But I am also trying to set the dealers up for the time some months or years hence where we might try to create a window for the Desk late in the day if the combination of low operating balances and volatility late in the day really becomes an issue. We do not know that that will happen, but in case it does, I want to alert them to that possibility.

MR. BOEHNE. Thank you.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. In that vein and before multiple interventions on the same day become commonplace, I think it would be helpful to the Committee to see some analysis of that. I have not thought about it a lot, but one of the things that worries me a little is the presumption among market participants that we are going to be there, and that creates a disincentive for them to maintain proper operating balances.

MR. FISHER. I would like to echo that concern. I agree with you and I would want the Committee to have that discussion. I also am quite worried that if we jump too quickly into multiple daily operations, we will actually reduce the incentive for intermediation in the fed funds market. Clearly, these incentives have been declining. As reserve balances have come down and sweep accounts have taken hold, there has been less juice in the system for an individual bank desk or treasurer to intermediate in the market, so their incentives to do so have been coming down. We have to be careful not to reduce those incentives further by our behavior. That means intervening only when we think the market really is not working, when something looks as if it is broken.

MR. MELZER. Overall, I think what you are doing is responsive to developments in the marketplace, and I applaud the steps you are taking. So, I am supportive of that. One other suggestion I would make, Peter, is that when you talk to the dealers about moving to an earlier time for Desk operations, you might want to telegraph that when our statistical system will support it, you are going to want to go to a still earlier time. That will give them an idea of where you ultimately want to get in terms of the timing of the first intervention in the day. Thank you.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Peter, you talked about the expected performance gains. Can you say anything more about the magnitude of those gains by going in earlier?

MR. FISHER. In terms of bids?

MR. GUYNN. Do you have any quantitative sense about that?

MR. FISHER. Well, in the last couple of weeks, as you will have observed, we have operated a number of times at 10:30 a.m., in part responding to firm conditions in the funds market and the large need that I was worried that we might not have enough bids to cover. I should have this statistic on the tip of my tongue, but I don't--I think we almost routinely saw something like a doubling in the amount of propositions from the dealers when we have operated at 10:30 a.m.

rather than at the normal time of 11:30 a.m. Now, whether that is a function of the surprise value of our being in the market and their knowing that we were looking to fill big needs, I could not sort out. But, clearly, we have seen a substantial improvement in the amount of propositions by going in one hour earlier.

MR. CHAIRMAN. President Jordan.

MR. JORDAN. I also applaud these moves in the direction of greater transparency. I think these are the kinds of things we should be doing. But you also are taking away one piece of information, for better or worse, stemming from the use of customer RPs. The way that was used in the past by the Desk was to help estimate the reserve need. So that got me to wondering, why not go a step further? What are the pros and cons of actually telling the markets what your rolling projections of the reserve needs for the period are? Is there some reason why you think that would create adverse incentives on the part of the banks?

MR. FISHER. I have thought quite a bit about the pros and cons of providing some sense of our reserve forecast. Clearly in one sense, that would provide some modicum of certainty, but as soon as I have that thought I realize that it does not provide a modicum of certainty. Our forecasts are really quite movable feasts, and I will start at the end of my own analysis of it. One of the things that I have come to realize is that the forecasters who work for Don and me are actually most valuable in telling me what the probability distribution is of their forecast error. That is, on which side do they think their errors are most likely to be? That actually is the most useful bit of information for me in the whole exercise. That is because we can then think through which way we want to lean on the basis of our own utility function. Now, that would be impossible to communicate to the market unless we sort of did it by shading the forecast.

That leads me back to the start of my own analysis. When I look at the whole issue of transparency, whether it is the Committee's transparency on policy or our transparency in operating in the market, I think those are two things about which we need to be clear. In my case the objective is simple: You have told me that the target rate is 5.25 percent. It is in our operations where we have not been as transparent. The process that drives our decision-making is a little fuzzier and a little harder to communicate, particularly while we are going through a shift in market behavior associated with low operating balances and a heightened degree of uncertainty. If I had much greater confidence in the accuracy of our forecasts and in turn in the relevance of our two-week forecasts to the day-to-day volatility in the market than I have today, I would be leaning more on the side of reporting our forecasts. But given where I am now in my own uncertainty about the relationship between our two-week forecasts and day-to-day demand for reserves, I really am quite squeamish about it. So, I think there are definitely pluses and minuses, pros and cons, but it is--

MR. JORDAN. I understand that the errors in the daily forecasts stem principally from unexpected changes in the Treasury balance, but other factors such as float get in the way of accurate forecasts. Of course, that kind of uncertainty exists now in the way that what you announce to customers is interpreted, so I don't see where that changes anything. All of the analysts on the outside understand that. Most of them worked at the Desk! [Laughter] In fact, isn't it the case that the Bank of England, which may intervene a number of times in a day, puts out a number on the amount they have in mind?

MR. FISHER. Yes, they do, and I think that raises an interesting question. They have a one-day maintenance period. If the decline in reserves balances and operating balances in the System led us to conclude that a two-week maintenance period was becoming irrelevant--it does not look like that is going to happen but we are on that trend even though there is no certainty about it--then I think we would have to come back and think very hard about operating on a de facto one-day maintenance period basis. We would have to decide how much money the banking system needs each day. The Bank of England with its one-day maintenance period has 3 or 4 windows every day during which they may operate. They announce what their forecast shortage will be for the day, decide whether to provide some money or not, and whether to enter the market immediately or later in the day. With the one-day horizon, there is not much intermediation across time, which is something I think we would want to encourage our banks to do. If we get to that point, we will have to rethink quite a number of things. A one-day horizon gives rise to questions of what the target should be, the forecast itself, and whether, given the implications for incentives as President Melzer pointed out, we should be operating multiple times a day on an ongoing basis.

MR. JORDAN. I presume that that would take away the intra-period gaming that we see going on. I agree completely with Tom Melzer on the need for that kind of discussion, and I would suggest that when we have it that we include consideration of a more flexible use of the window. I am not against activity later in the day, but I also think that we may need to rethink the role of the window in an environment where we make adjustments to unexpected reserve needs late in the day. That applies not only to what we do on our side in managing the window, but also to how we should influence perceptions on the other side about the availability of the window for adjustments.

MR. FISHER. Absolutely. Don Kohn and I had the benefit of being on a conference call with all the discount officers from the Reserve Banks, and we gently urged them to encourage greater flexibility in thinking about the use of the discount window. I think that group is very helpfully working on a number of issues, including the consistency of collateral management across different Districts and the implicit messages that are sent to banks about the use of the discount window. Quite frankly, one of the issues that we have now--and I don't have a sense of which Districts are relevant--relates to the fact that, as discount officers have noted, major banks in some Districts just never want to come to the discount window. Now, that translates very rapidly back to us at the Desk with regard to developments in the fed funds market. That is because certain regional banks are not going to the discount window but they are coming into the funds market when they have a miss or an unexpected heightened demand for funds late in the day. That is one source of pressure in the funds market. So, I agree completely with the desirability of discussing the role of the discount window.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Peter, just to get a little better handle on the magnitude of the benefits, do you have any sense as to whether the variance per day around the average effective fed funds target rate is greater in recent years? Are you having more trouble hitting your target in some sense?

MR. FISHER. We have not had more trouble. At some point, I would like to bring an analysis forward to the Committee; it is not finished yet. We have begun using internally a standard deviation of the prior day's effective federal funds rate in volume-weighted terms. We have the raw data that are used to calculate the effective rate, and we currently look each day at a standard deviation of that. There has been considerable volatility this year, concentrated roughly speaking in the middle half of the year as I recall. But it does not appear to be anywhere near the kind of volatility that we experienced in 1991. Interestingly, even though it has been high for the year as a whole, there are some months this year in which it has been lower than in some months in 1994 or 1995. So, we are nowhere near a crisis in our ability to manage the fed funds rate, but volatility has been moving up. Some of the fed funds watchers have printed charts that show volatility, but they only cover the last two years. From a longer perspective, the volatility this year is still well below that experienced in both 1991 and the early 1980s. One would expect that for the early 1980s, of course, and it is more relevant to look at the broad sweep. So, we are observing developments, and I would like to bring that analysis forward to the Committee at some point. The people who work for me wonder whether we shouldn't publish the daily standard deviation along with the effective rate. That is an issue we will be thinking about, and we will bring it back to the Committee.

MR. KOHN. Peter, I now have a table in front of me that shows this. The standard deviation of the daily federal funds rate from the FOMC's targets this year is a little higher than in 1993, 1994, or 1995 and about the same as in 1992. So, it really has been in about the same range for several years. I think an interesting aspect, though, is that the intra-day variations have been a little higher this year. There has been a tendency, as Peter reported before, for spikes to occur late in the day. If one looks at the highs relative to the average and at some of those types of volatility measures, they are a bit higher.

MR. FISHER. Right. That applies to the rates at which funds have traded without taking volume into account. For example, it does not tell us how much trading there was at the higher rates during the day.

MR. KOHN. The high-low range, for example, is wider this year than it has been for a couple of years.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I want to add my approval; I welcome the changes. I think they will be helpful to you in getting a better range of bids.

I did want to comment a little on your thoughts for making our operations more transparent, granted that there is a range of uncertainty, particularly about the projected need for reserves over a period of time. We have been hearing from some of the fund managers in Boston about the interpretation of a lack of a coupon pass in December that coincided with concerns about market asset prices and so forth. The temporary nature of the System's operations at a time when normally more permanent, outright operations were expected was interpreted as a subtle way of keeping things tighter than they otherwise would have been. Of course, there was no way to reply to this, knowing that the information you share with us is not to be shared with other people. But perhaps some of that might have dissipated a little and maybe it would have had some effect on the stock market volatility. Of course, these fund managers were in the stock market more than in any other market. In any event, the effect on market expectations was very marginal.

MR. FISHER. I think the shift in expected interest rates that occurred in the first week of December can hardly be attributed to the presence or absence of the Federal Reserve in the coupon market. Trading volume in that market is $70 to $100 billion a day, and whether or not we bought $4 billion would hardly seem to matter. It is true that many people talked about the absence of a coupon pass, but how that could have affected the March futures contracts has challenged me a little. It is awkward--I will be blunt about this--that the last remaining business for the Fed watchers is predicting when we will do coupon passes. That is what the franchise has been reduced to since we adopted the current practice of announcing policy changes. So, that is about the last thing that the people who write the weekly reports and screens have to offer to their subscribers. To leave that thought with you, we have a certain feedback problem.

MS. MINEHAN. Yes, I realize that. The more transparent you get, the more everybody wants.

CHAIRMAN GREENSPAN. He is creating unemployment! [Laughter]

MR. FISHER. Some analysts who write these screens got it right. There was one who was absolutely on the money when he explained that the Desk probably was concerned about having to drain reserves in January. That is exactly what I told you, and I could have read his analysis here instead of my own.

CHAIRMAN GREENSPAN. If there are no other questions, would somebody like to move to ratify the Desk's domestic operations?

VICE CHAIRMAN MCDONOUGH. I move to ratify the operations of the Domestic Desk.

CHAIRMAN GREENSPAN. Without objection. Let us now go on to Messrs. Prell and Truman.

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

MR. TRUMAN. (Statement--see Appendix)

CHAIRMAN GREENSPAN. Mike, what is the change in the December industrial production index that is implicit in your fourth-quarter average?

MR. PRELL. As I recall, it is up about 3/10 of a percent.

CHAIRMAN GREENSPAN. The weekly data, for what they are worth, are suggesting that it is flat to down.

MR. PRELL. They account for a very small portion, as you know, of the overall index.

CHAIRMAN GREENSPAN. So, I gather they will affect the quarter by only .1 or .2 percent.

MR. PRELL. You mean the quarterly average?

CHAIRMAN GREENSPAN. The total percentage change from the third to the fourth quarters if you are only affecting the December index.

MR. PRELL. Exactly, it's a very small weight in the outcome for the quarter, but we have been looking at the other evidence such as trends in orders, and we are comfortable in anticipating a moderate increase.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mike, I have two questions. The first deals with the PCE in the fourth quarter. Based upon the data that we have, which of course include the PCE for October, retail sales for October and November, and what we are hearing about retail sales for the Christmas season, do you feel that this is consistent with a PCE growth rate in excess of 3 percent in the fourth quarter?

MR. PRELL. We feel comfortable with that at this point. We are anticipating that, in part because of the effects of the cold weather that showed up in the utilities component of IP in November, the energy component of PCE services would be quite robust in November. I don't know what to make of all the anecdotal reports on Christmas sales activities, but I will note for what it is worth--and it may not be very much, for even though it has gained some prominence, it is a very small sample--that the Mitsubishi chain store report that came out this morning showed a quite sharp further increase in the latest week. So, we have had a couple of weeks of distinct upward movement there. We have heard other good things about retail sales. So we are reasonably comfortable, especially given that--going back to the Chairman's arithmetic point--a deviation of a few tenths in the outcome for December will have only a modest effect on annualized growth rates.

MR. PARRY. The second question relates to what I heard you say about the distribution around GDP numbers for the fourth quarter. Based on the data you have seen, particularly the more recent data, would you, if you were to give us a new estimate, revise that estimate as well?

MR. PRELL. Not materially.

MR. PARRY. But probably up?

MR. PRELL. More likely up than down given, for example, the stronger industrial production data. Also, the single-family housing starts will feed through rather directly in the calculation of residential construction activity in the current quarter and add a smidge. So, the adjustment might be in an upward direction but nothing of great significance.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. Who would like to start the roundtable? President Hoenig.

MR. HOENIG. Mr. Chairman, I will keep my comments brief because economic conditions in the Kansas City District have not changed a great deal since the last time we met. Our regional economy has continued to grow consistently, although at a moderate pace. On the anecdotal side, our directors and other business contacts report solid economic growth throughout our District. Retail sales have been robust during the first two weeks of the holiday season. Manufacturing remains healthy. Homebuilding has been strong. Of the major sectors, I think the only moderately weak area has been nonresidential construction. Estimated employment, reinforcing these other reports, actually increased in October after remaining flat for most of the year. Our farm and energy sectors continue to improve. Our grain sector reported excellent crops and is doing quite well at current prices. We are again seeing some of that translate into purchases of equipment as farmers take some of their sales proceeds and reinvest them. Our cattle industry is profitable on the feed side, although ranchers are still losing money. In our energy sector, current prices have encouraged small but persistent increases in drilling activity. Wholesale and consumer prices appear to be rising slowly but consistently throughout the District. Our labor markets, as I have said before, continue to be tight, and we are hearing more reports of wage pressures.

On the national level, I do not have a lot to add to what I have heard from Mike Prell today. We are in general agreement with his forecast. I would note, and again raise some concerns about, the fact that both we and the Board staff are projecting rising core inflation, even allowing for the technical adjustments. The higher inflation would be even more apparent without these technical adjustments. That concludes my comments.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, relatively fast economic growth continued in the Twelfth District in recent months, making this a very good year in the West. Almost 1/3 of the jobs added across the 50 states over the last year have been in the Twelfth District states. As a matter of fact, the percentage growth in employment in our District states has been twice that of the other states. In terms of year-over-year employment growth, the District's inter-mountain states of Nevada, Utah, Arizona, and Idaho have been the four fastest growing states in the country. The 12-month pace of job gains in the inter-mountain West exceeded 4-1/2 percent. Although employment growth has slowed a bit in recent months, it has maintained a healthy pace. The

Pacific Northwest is the next fastest growing region in the country. After the four inter-mountain states, Washington and Oregon rank fifth and sixth in terms of the underlying pace of job growth, which has been about 4 percent. Employment growth recently picked up to this fast pace in Washington largely owing to the rebound at Boeing, although companies such as Microsoft are contributing as well.

The sizable California economy is growing faster than the national pace, with employment in the state recently growing at a rate of about 3 percent. Not all sectors have shared equally in the long-delayed California recovery, but we now see a pickup in some of the lagging sectors. The state government budget situation finally has improved enough to allow the hiring of many needed public school teachers, and much additional hiring is expected next year. In the residential real estate sector, sales, prices, and new construction were weak throughout the first half of the '90s but began to increase in 1996 in some areas of the state. As a matter of fact, the Silicon Valley area surrounding San Jose is actually booming.

Turning to the national economy, if the current stance of policy were maintained, I would envision the economy for 1997 as a whole growing at its trend rate as a result of several roughly offsetting positive and negative factors. On the positive side, it does seem that exports should be boosted by the healthy growth of our trading partners, and spending on computers and related products most likely will continue to grow rapidly. On the negative side, it appears that strong increases in consumer spending on real assets like housing and durables to satisfy pent-up demands has largely run its course. Of course, fiscal policy will continue to be on the restrictive side. With the economy slowing in the current quarter and then advancing at around its trend rate next year, we have scaled back our estimate of the level of resource utilization for 1997. Of course, judging resource utilization is particularly difficult right now, especially in labor markets. My best estimate is that there probably will still be a slight degree of excess demand in the economy next year, which suggests that there will be only a very gradual upward trend in underlying inflation. Our forecast shows core CPI rising from under 2-3/4 percent this year to close to 3 percent in 1998. In the longer-term context, our model simulations suggest that it actually would take a slight tightening of the stance of policy next year to make the inflation rate settle in at around 3 percent in future years. However, it appears unlikely that a downward tilt to inflation, which I think would be desirable, would be forthcoming unless policy were tightened more substantially next year. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, overall conditions in the Seventh District economy are little changed since our last meeting. Our regional economy continues to operate at a high level, with unemployment rates in each of our five states still below the national average and most of our key manufacturing industries producing at or near capacity. Although some increase in compensation rates has been reported for selected labor market areas, there does not appear to be any spillover into prices. The one major change in the District economy is that the recent evidence shows a definite slowing in housing activity similar to what was reported for the nation earlier. Purchasing Manager surveys from around the District still indicate healthy expansion in the manufacturing sector. The December Chicago Purchasing Managers' report, which will not be publicly available until the end of this month, indicates a slight slowing from the November pace, but it is still at 57.4 percent. The supplier deliveries component moved up by .6 percent to 49.9 percent in December and the prices paid component moved up to 53.9 percent from 50.7 percent in November.

Retailers generally report that holiday sales have been somewhat better than expected. One major national retailer expressed concern that their recent sales have been so strong that they could be borrowing sales from early 1997. Some weakness has been reported in sales of appliances, but that may reflect the housing slowdown more than the holidays.

Turning to the steel industry, concern was raised at our last meeting about possible weakness in the early part of 1997, and we have made some special efforts to check with our contacts in the Seventh District. They suggest that the demand for steel remains quite strong. Order books are full through the first quarter and into the second quarter of next year. Mills in the Midwest are reported to be operating at higher levels than elsewhere in the country, likely because of heavy orders from the automobile industry, but our contacts also report strong orders from a broad spectrum of customers. The outlook for steel prices is uncertain. One contact expects prices to rise early next year as a result of continued firmness in demand but not enough to reach the early 1996 price levels. Another indicated that steel prices would remain stable because of increasing imports as well as additional mini-mill capacity coming on stream in 1997 and into 1998.

In the automobile industry, light vehicle sales came in at 14.8 million units in both October and November, and early reports indicate that sales are continuing at about the same pace in December. We expect sales in 1997 to decline somewhat from the 15 million units of this year, given the slower economic growth expected next year, fewer price incentives, and a record number of cars coming off lease in 1997. On the production side, we all know that the production of a large number of new models introduced by General Motors has been constrained by strikes. Our latest information is that GM model changeovers now are proceeding somewhat better than GM officials had anticipated, but strike-related production losses will not be completely recouped until early next year. One problem in making up lost production is the availability of parts for light trucks. Several suppliers reported that they will be working over the holidays to catch up on orders, which is unusual for these suppliers.

Turning to the national economy, the outlook has not changed much since our last meeting. Growth in the economy has decelerated substantially since the first half of the year, and we see output growing at or slightly above potential in 1997, similar to the Greenbook forecast. Earlier this month, we hosted our annual economic outlook symposium for business contacts and economists from around the District. The consensus of around 30 forecasts submitted for this meeting was for real GDP growth of about 2 percent in 1997 and CPI inflation running a little under 3 percent next year. My own view of the risks to our forecast is that they are slightly tilted to the up side. The Greenbook forecast for core CPI inflation remains below 3 percent but only because of the BLS methodological improvements, as Tom Hoenig mentioned. At previous meetings, we have talked a lot about the value of low inflation, and although we may have disagreed slightly over the timing and the approach to achieving price stability, I believe that there was broad agreement that we should at least cap inflation at current levels. The question is, what are current levels? This is reminiscent of our problem in interpreting the change to a chain-weighted GDP methodology a year ago when we all had to recalibrate our assessment of potential output growth. Now, we need to stop thinking about targets like 3 percent for core inflation, if we are to maintain our progress in reducing the core inflation rate. I think this will be an issue of increasing importance next year.

CHAIRMAN GREENSPAN. Mike, our reports from somewhat softer than what you are reporting. They have solid orders through January, softening in February, and there is no indication of firming into the second quarter. Did you check with them as well?

MR. MOSKOW. We did, though they are not located in our District. We primarily contacted firms in our District, but we made a special effort to contact and we did not get any sense that there was any slowdown. But I think we only asked them about the first quarter, if I recall correctly. The firms that I talked to personally were talking about the whole year.

CHAIRMAN GREENSPAN. Their cold-rolled sheet demand coming from autos is pretty good, but their pipe demand is poor. As I recall, they had not yet filled their first-quarter order books. The mini-mills, I suspect, are doing a good deal better, so your sample may have been more in that direction.

MR. MOSKOW. Well, we specifically checked because this question had come up at the last meeting, and the word that I got from that orders for oil-related and tubular steel goods were very strong.

CHAIRMAN GREENSPAN. That is true. President Minehan.

MS. MINEHAN. The New England economy is humming along, though there is some bounciness in the data. Unemployment rates remain low; job growth is solid and on trend from an historical perspective. Net out-migration of the labor force is less than it was in the early '90s. Consumer confidence is better than it was a year ago. Real estate markets are in particularly good shape, especially in Massachusetts, and both manufacturers and retailers see prospects for a solid Christmas and a good beginning of 1997.

On the negative side, while anecdotal reports continue to stress the inability of individual firms to raise prices and the average rate of growth of wages in New England remains slower than for the country as a whole, the Boston CPI has experienced a couple of months of increases that are sharper than for the nation, largely because of medical, shelter, and fuel costs. Moreover, anecdotes about wage pressures in selected occupations and areas have begun to flourish once again. A mutual fund company, for example, just instituted an across-the-board salary increase of between 5 and 10 percent on top of a merit increase of 5 percent because of intense demand for system and service professionals and sales people. A high-tech manufacturer reported that the lid has blown on salaries of engineers and software specialists in the Boston area where such professionals command salaries over $100,000. Given our inability to hire such people at the Boston Fed, I think this is probably accurate. Another high-tech firm is offering stock options and starting pay 20% above a year ago to attract new technical talent. Thus, while this sort of competition has not found its way into average wage numbers, we do see some pressure on overall costs from other than wage components, and it may be only a matter of time before general wage levels rebound as well.

As we all do, I meet periodically with various groups. In Boston, we focus on investment professionals in the mutual fund industry and on a panel of academic advisers. A couple of similar trends were evident in our meetings this time, and I thought I would give you some perspective on that. Several of the market types and some of our directors as well reported extreme competition for yield among the mutual funds--which I suppose is not news to anyone--and declining liquidity ratios. They expressed concern about the liquidity of the mutual funds, particularly the equity mutual funds, and more generally about the higher and higher degree of leverage in financial markets. Our contacts are worried that this degree of leverage could make stock market adjustments more painful than otherwise and, in contrast to 1987, they perceive that the economy is growing more slowly now so that its resilience in the face of a market downturn might be less.

There was some discussion of what, if anything, the Fed could do aside from the occasional speech to let the air slowly out of an asset price bubble, assuming one exists. There seemed to be general agreement that raising margin requirements, while not particularly effective in substance, might send a message to the markets. But there really was no great enthusiasm for an increase. There was concern that more proactive actions, such as raising the funds rate, might not be a good idea unless one were sure that there would be an orderly regrouping after the market adjustment. One person on the academic panel commented that it was probably unlikely that we had any firm sense of, or control over, what would happen after a market adjustment, and that playing with avalanches was always risky. Finally, the academics saw wage inflation as the dominant risk on the horizon, but most of them thought preemptive policy was not appropriate at this point. One participant referred to the lack of evidence on the relationship between unemployment and prices at low levels of inflation and noted that uncertainty made it difficult for monetary policy to be extremely forward-looking. There were also some comments to the effect that there is not a sharp distinction between being reactive and being forward-looking. A central bank that is nervously reactive may be as close to forward-looking as it can get. [Laughter]

On the national scene, we have no serious questions about the Greenbook forecast. We think the staff may be overly optimistic about inflation and that the elements of strong growth that are present--job growth, rising real wages, good disposable income, buoyant financial markets, everybody knows all of these--may end up creating more pressure next year than expected. However, we think the staff may continue to be slightly overly optimistic about foreign growth as well, and who knows whether the Grinch will actually steal Christmas or even if that would be an adverse development, given the level of consumer debt. In sum, we are pretty much in agreement with the Greenbook forecast.

CHAIRMAN GREENSPAN. President Guynn.

PRESIDENT GUYNN. Thank you, Mr. Chairman. Reports that we get from around the Atlanta District indicate that growth has moderated somewhat since the summer, and the slowdown seems to be continuing into the fourth quarter. The signs of that slowdown are most apparent in residential construction and homes sales, but they also show up in consumer and commercial loan demand. Manufacturing activity remains subdued, but businesses are optimistic about the near-term outlook. We are seeing for the first time some speculative office building in Atlanta and in some cities in Florida, but such building is not at a level that is worrisome at the moment. A particularly robust tourist season is helping the economy throughout Florida and in Nashville, but the gaming industry, which has become a big business in the South, is going through some restructuring and some shakeout and is doing particularly poorly in the city of New Orleans.

Job creation in our District, which we have reported meeting after meeting as stronger than the national average, now lags behind the nation as a whole. Labor markets remain tight in many areas. As is the case nationwide, these labor shortages have yet to manifest themselves in significant wage pressures. Finally, retailers in the District report that they have gotten off to a strong holiday season in November. I am reluctant to make any predictions based on that limited information, but they are still cautiously optimistic about the month of December.

The financial crisis in the city of Miami is creating quite a stir, with considerable negative publicity. Our reading is that the situation, while serious, does not involve a large amount of dollars since the city of Miami is a relatively small and poor core of a much larger and healthier metropolitan Dade County area. Interestingly, one of our Atlanta Bank directors has been named by the Governor of the State of Florida as one of the five oversight committee members.

At the national level, the economy does appear to be showing some signs of slowing. For me, the major uncertainties continue to be whether labor shortages will eventually begin to be reflected in inflationary wage pressures, whether consumer demand will slow, and what will happen with government expenditures. So far, there is no indication that labor shortages have been severe enough to cause rising wage inflation. We have talked a great deal in the past about the influence of job uncertainty on workers, and the threat or actual influence of competition, both domestic and foreign, that still seem to be keeping wage pressures in check. Our forecast suggests that consumer spending will be maintained despite a decline in the growth of personal income. In line with the assessment in the Greenbook, we do not feel that current consumer spending has been buoyed significantly by the run-up in stock market prices. Finally, a point that Bob Parry made, it is likely that government demand will remain moderate in the near future. Federal spending has been on a downward track and the recent announcement by the President that obtaining a balanced budget would be a top priority would suggest that this trend will continue. Similarly, while states may feel the need to initiate many expensive infrastructure projects, major uncertainties concerning welfare and other federal programs that may get pushed down to the states for funding will probably act to damp state spending in the near term.

All things considered, I expect economic growth to slow somewhat in the period immediately ahead, perhaps to a rate of around 2 percent, and to pick up somewhat later in 1997 and into 1998. Inflation and unemployment are likely to hold at the levels that we have been seeing recently. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. The Eleventh District economy has continued its reduced, modest pace of expansion over the recent period. The typical situation in our District is for employment growth to be higher than the national average, but with the unemployment rate higher as well because of net in-migration. That pattern was reversed in the course of 1996, with employment growth slowing but the unemployment rate also falling. The latter fell to slightly below the national average, its lowest level in fifteen years. The unemployment rate in Texas is 5.2 percent, and if we took away the counties along the Mexican border it would be 4.7 percent. Of course, on the basis of the commentaries so far this morning, at least before Jack Guynn spoke, it appears that we all have unemployment rates below the national average, [laughter] suggesting a Lake Wobegon economy. The recovery in the Mexican and Californian economies has apparently slowed our labor force growth and the growth of anecdotal evidence of tight labor markets, but the upward pressure on wages has not abated. The slow expansion of employable labor apparently is constraining output growth.

Factors contributing to strength in our area are higher oil prices, which are stimulating our shrunken energy sector, capacity limits, which are limiting the rig count right now, and the rebound in the Mexican economy. In the first half of 1996, Texas exports to Mexico increased 17 percent--that is, at a 34 percent annual rate--and such exports have now surpassed their pre peso devaluation levels. Based on the period since 1986, Texas exports to Mexico normally would grow at a rate of about 14 percent compared to a 34 percent rate this year. Our construction sector, both residential and commercial, also has been a strong factor for us in 1996. Home prices are rising again after a long dry period, as are office rents, and announcements of new commercial projects are increasing. Contributing to weakness in Texas this year are the drought, the downturn in the semiconductor industry worldwide, and the slower labor force growth.

On the national economy we have no major quarrel with the Greenbook. Our estimate of real GDP growth in the fourth quarter is somewhat below the Greenbook estimate of 2.3 percent, although our estimate was made before the strong industrial production number came in for November. I am not sure what to make of it, but I am struck by the fact that in both 1995 and 1996 we have had only one strong quarter in each of those years, with growth in the other six quarters being very unimpressive. I am sorry to see the overall CPI in 1996 break the string of years below 3 percent, but the reason is primarily energy-related. The opposite occurred in 1986 when sharply declining energy prices brought the overall CPI well below the core CPI. It seems to me that the price of the dollar in foreign exchange markets, the price of gold, commodity prices, and the growth of the monetary aggregates are all fairly reassuring on the inflation front.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, economic conditions in our District have not not changed very much in the period since our last meeting. Growth overall remained relatively moderate compared to earlier in the year. Most of the anecdotal information that we get from our directors and others suggests a more moderate tone than earlier. We see sluggish conditions in some sectors. As Jack Guynn reported for the Atlanta District, housing in our region clearly has been more sluggish lately and that is fairly recent information. So, it is a little out of line with the published data for November that you mentioned earlier, Mike. At the same time, labor markets remain exceptionally tight in our region. We hear that from virtually everyone--directors, other business contacts, just about anybody we talk to. It appears that the tightness is perhaps greatest right here in the Washington metro area. We are told that the inflow of new workers into the labor force here has slowed significantly. Business at temp agencies for both skilled and unskilled labor in this area is booming, and again we are told that the supply of new workers has been constrained. We see evidence of tight labor markets just about everywhere. Yesterday, when Marvin Goodfriend and I were driving up Interstate 95 from Richmond, my eyes happened to fall on a mudflap of an 18-wheeler ahead of me, and they were advertising for truck drivers. I have the number if anybody would like it! [Laughter]

At the national level, we have no strong reason to disagree with the Greenbook's forecast that real GDP will grow at a rate somewhere near its longer-term trend and that CPI inflation will remain moderate at a little under 3 percent, at least with the help of the recent technical adjustments to that index. In the Greenbook scenario, the unemployment rate stays near 5-1/4 percent, with the continuation of only a gradual rise in hourly workers' compensation along the lines of what we have seen recently. Not very long ago, an unemployment rate this low would have been accompanied by expectations of greater upward pressures on both wages and prices, and I have to confess to a little nervousness on this score. But I think the staff is right in pointing in particular to the considerable capacity that exists in a number of manufacturing industries. We see that in textiles and furniture in our District. And while I am not ready to uncross my fingers yet, I think the near-term risks in the Greenbook projections are more balanced than they were 3 months or so ago, especially on the inflation side. Some of the points that Bob Parry made are very relevant here. In a sense, the picture might even be brighter in view of the emerging consensus that the CPI overstates actual inflation by something like a percentage point. With both the overall CPI and the core CPI projected by the Greenbook to remain below 3 percent in 1997 and 1998, this would imply that the underlying true inflation rate is in some sense closer to 2 percent, which would mean that we may be closing in on price stability at least after help from those technical adjustments.

Having said all of that and before anyone concludes that I have become complacent about inflation--[Laughter]

SPEAKER (?). You are ready to declare victory?

MR. BROADDUS. I am not ready to do that. In a very important sense, and this is really the main point I want to make, I think we still have some distance to go before we can be comfortable that we have achieved price stability in the way we have defined it. The old Neal Resolution language, which we endorsed, defines price stability as a condition where expectations of future inflation do not play a significant role in economic decision-making. I think one of the best indicators of inflation expectations is the long-term bond rate. That rate averaged around 3-1/2 percent in the late 1950s and about 4 percent in the early 1960s when the CPI inflation rate was in a range of 1/2 percent to 1-1/2 percent at an annual rate. Today the long-term bond rate is at 6-1/2 percent, about the midpoint of its recent range between a little below 6 percent and a little over 7 percent. There is not a lot of reason to think that the real long-term bond rate is much different now than it was in the earlier period when it appeared to average around 3 percent. That seems to be generally consistent with the surveys depicted in the Bluebook, which suggest that long-term inflation expectations are still on the order of 3-1/2 percent today. Alternatively, if we compare nominal rates in the earlier period with nominal rates today and attribute most of the difference to inflation expectations between the two periods, the implication would be that inflation expectations are anywhere from 2-1/2 to 3 percentage points higher today than they were in the late 1950s and early 1960s. Beyond that, the volatility of bond rates is a lot greater than it was in the earlier period and that volatility almost certainly reflects, at least to some extent, more volatile inflation expectations.

So, Mr. Chairman, I would conclude that we are still some distance from achieving price stability in the Neal Resolution sense, and I think we need to remain vigilant going forward.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I am reassured that President Broaddus is standing firm in his commitment to price stability. I was getting worried about that!

The Philadelphia region continues on a modest growth trend, with most sectors reflecting this trend. Attitudes are positive and the outlook is generally positive as well. Labor markets are generally snug, although places like the southern-most part of New Jersey and parts of Pennsylvania still have relatively high unemployment rates. Getting "qualified workers" is becoming an increasingly familiar refrain among business people. It is something that one hears almost regularly. Average wage increases, however, still remain in the 3 to 4 percent area, although I think they probably are concentrated more in the 3-1/2 to 4 percent range. Almost everyone trying to sell something, from large businesses to street vendors, still reports stiff competition, which tempers the tendency to raise prices in this kind of environment.

There is not much to be added on the national economy. I think the key points are that the economy appears to have successfully made the adjustment downward from unsustainable growth rates earlier; it appears to be on a more sustainable track, and I think that is the outlook. On inflation, we are still operating in a cautionary zone. Performance is better, actually remarkably better, than one might have expected on the basis of historical experience. So, we are doing reasonably well there and are generally looking at a positive, even enviable, position to be in. As has been pointed out, there are worries and potential problems, and we need to stay alert. But we can also continue to be patient.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. The Ninth District economy is still characterized by favorable business conditions almost throughout. Perhaps the most noteworthy thing to report relates to a recent meeting that we had with about 30 business leaders. The most striking thing they had to report is something I have commented on here but they certainly emphasized it, namely, how tight labor markets are and how difficult it is to find both skilled and unskilled workers. This is translating into higher wages. The wage pressures are by no means pervasive, but I think it is fair to say that larger wage increases are becoming more common. The business leaders talked about new hires being increasingly expensive, both because of the skills or lack of skills they bring and because they are finding that at least in some cases they have to offer more generous benefit packages, especially to attract part-timers. Those conditions have been in evidence for some time and I think they probably have intensified a bit.

As far as the national economy is concerned, I am generally comfortable with the path of the Greenbook forecast. I am hard pressed to think of something that would materially change that pattern going forward, at least through 1997. To be sure, there are risks that aggregate demand could either fall short or turn out to be somewhat stronger than envisioned in the forecast, but it is hard for me to assess those risks with any degree of confidence. Without being very rigorous about this, the risk that I, at least, can identify most clearly is on the supply side. With labor markets in the shape they are in and with what we are seeing in wages and are starting to hear about compensation more generally, there is clearly a risk that those pressures are going to build. We need to keep our eye on the implications for inflation going forward, at least in the short term.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. The Eighth District economy continues to grow at a steady pace. District retailers report that September and October sales were up about 4 percent from a year earlier, and most are expecting a strong holiday season. Sales the weekend after Thanksgiving were especially robust. Despite a somewhat lackluster autumn, most Eighth District contacts were optimistic about December auto sales. District auto and light truck manufacturers have increased their planned production slightly for the fourth quarter of 1996 and the first quarter of 1997, so District production is running above year-earlier levels in autos. Payroll employment in the Eighth District rose at an annualized rate of 1.9 percent from July to October. The average unemployment rate remains low at 4.7 percent. The local employment effects resulting from Monsanto's division into two companies are highly uncertain. Monsanto plans to eliminate 1,500 to 2,500 of its 28,000 jobs worldwide. About 4,600 of its employees work at company headquarters in St. Louis. The employment effects resulting from the Boeing merger with McDonnell Douglas, which is the largest employer in St. Louis, are also uncertain. Labor markets remain tight around the District. Hiring and keeping qualified workers, as a number of others have mentioned, is still a big concern for District companies. Materials prices are generally stable to slightly higher. Real estate markets are strong in the District, with year-to-date permits levels above 1995 levels. Loan demand, particularly for business loans, remains robust, and District banks continue to record high profits with only a slight increase in nonperforming loans. Farmers have had an excellent year, with yields generally above average and crop prices comparatively high.

At the national level, relatively low inflation in recent years has been good for investment and growth. Tight labor markets are reflected in unemployment rates that remain low by historical standards. Although real growth has slowed from the rapid second-quarter pace, it remains near our estimate of the sustainable trend--in the 2 to 2-1/2 percent range. This pattern is observed in the labor market as well. The average net increase in payroll employment, which was 240,000 per month over the first eight months of the year, slowed to 113,000 over the three months through November. That average increase is close to the sustainable growth in the labor force.

On a fourth-quarter-over-fourth-quarter basis, CPI inflation is forecast to be 3.2 percent in 1996 compared with 2.7 percent in the prior year. Although the 1997 staff forecast has a return to the 2.7 percent level, more than half of that improvement is due to technical changes in the way the BLS computes the CPI. Furthermore, rising average hourly earnings, weak productivity growth, and firm energy prices suggest that there are upside risks to this forecast. In any event, the fact of a 1/2-point rise in 1996 inflation may harm our credibility in ways that cannot be repaired by the staff's confidential forecast of a 1997 inflation decline.

Our policy report to Congress last February suggested that we would resist pressures that might push inflation above recent trends. Economic forecasters have often interpreted our policy as a 3 percent cap on CPI inflation. Events in 1996 put us at considerable risk of losing credibility for even that modest goal. In my view, we should reaffirm our commitment to resist inflation above 3 percent. At the same time, we should continue to emphasize that all we influence in the long run is inflation. I personally believe we should go further and announce targets for bringing inflation down over time, but an announcement in February of an intended cap at 3 percent for inflation would be a good start. Thank you.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, economic conditions in the Second District have been mixed, but on balance they have been positive since our last meeting. Private-sector job growth, which had been above trend earlier this year, has slowed, but unemployment rates are still rather good. The 5.9 percent rate in New York State is holding at a 6-year low, and the 6.2 percent rate in New Jersey is still relatively good for that state as well. Retail sales generally have been running on or above plan throughout November according to our sources, and the traditional holiday shopping season seems to be off to a good start. Rising consumer confidence and record bonuses, including virtually astronomical bonuses on Wall Street, also bode well for consumer spending. In New York, we are getting an incredible wave of tourism, in fact to a point where hotel rates are up about 15 percent and hotel occupancy is very high. New York State's residential real estate markets picked up in October, and Manhattan's commercial real estate markets remain strong. The regional surveys of purchasing managers indicate persistent strength in the manufacturing sector and some easing of price pressures in that sector as well. Consumer price inflation in the New York and northeastern New Jersey area held steady at 2.8 percent in November, so we are looking good compared to the rest of the country.

On the national level, we are basically in line with the Greenbook forecast. Our forecast for real growth is just a bit lower, so it is a little more comfortable in relation to growth within capacity. But we share the concern that others have expressed that the risks are slightly on the high side as regards price pressures. However, I believe that the risk the Committee has taken in the course of this year by assuming that the economy was in fact behaving somewhat differently has turned out to be a risk extremely well taken and that the present stance of monetary policy is correct.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. I do not know whether we have been smart or lucky, but we do seem to be blessed with a nearly ideal economy that is growing at a rate very close to potential. I have no reason to quarrel with the Greenbook forecast. Certainly, there is reason for concern about future inflation, given the tight labor markets and the beginnings of accelerating wage increases. But I think we ought to remember that if we can keep labor markets tight, in the long run we may be increasing the potential of the economy to grow without inflation. If tight labor markets encourage training, give more job experience to workers who would not otherwise have had it, encourage investment in efficient equipment and productivity-enhancing processes --and there is a good deal of evidence to think that this does happen --then we are improving our potential for economic growth without inflation in the future. The wage increases that we are beginning to see at the low end of the wage scale also augur well in the sense that they will encourage the transition from welfare to work, which hopefully will be made over the next several years, and will give us some new workers with job experience. Clearly, the most worrisome problem on the horizon is the stock market, but I am not sure how that will work out. It could contribute to an upward bounce in consumer spending, which was suggested by some of you, or to a significant correction that will reduce confidence and cut spending in the future.

I share the staff's optimism about the prospects for a budget agreement, and I want to underline that because I have been fussing at them for about six months for being too pessimistic. They have finally gotten a little more optimistic about the budget outlook, which I think is right. I believe the Congress and the President will get together over the next few months and work out a deal that will keep the deficit from rising in 1997 and bring it down more significantly in 1998.

The main element has to be a Medicare agreement on reduced reimbursement rates, possibly a means testing of the Part B premium, and some more aggressive action on Medicare fraud; such action already seems to be paying off quite well. The Congress and the Administration could get hung up on what to do about Medicaid, but I sense less intensity in the Congressional Republicans' demands for block grants as the states begin to realize that they have taken on a lot already. We may actually see some softening of the harsh treatment of legal immigrants under welfare reform, but I do not expect that that will mean a lot more spending, although some easing for disabled legal immigrants seems likely. We also may see more near-term cuts in discretionary spending, creating a more realistic track over time for spending. The previous spending agreements had unrealistic trajectories in that they had precipitous declines in discretionary spending in the period close to the year 2002.

I think that there is even a chance that the President and the Congress might tackle the longer-run Social Security problem by taking advantage of the Boskin Report and solving what is a relatively easy long-run Social Security problem with some downward shift in the CPI adjustment, probably not 1.1 percent but maybe half of that, and some future benefit cuts in the form of a higher retirement age. If that were to happen, and I admit that is pretty optimistic, it is not clear what the near-term effect would be. Spending would be reduced some as the benefits were pared back slightly, but it might have a positive effect on confidence. If it is true that consumers are spending less and saving more because they are worried about Social Security and their long-term retirement incomes, we might actually see a positive effect on consumption.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. I had a joint meeting of all three of our boards of directors last week and it included a go-around of the directors. The most commonly used word to describe their business activity was "flat"--flat at currently high levels of activity with expectations that activity in 1997 will be about the same overall as in 1996. In the motor vehicles area, there is an expectation--from the suppliers' side at least--that production next year will be down about 1 percent or so. Because motor vehicles--both autos and trucks --are extremely important to our region, developments in that industry not only affect the reality but also the perceptions of what is happening. There is also an expectation among the suppliers that the prices of materials are going to be down in 1997, so they expect their margins to improve even though they anticipate somewhat lower volumes.

With regard to the steel industry, we did get information that was a little different. Most of it was on the outlook for steel prices. In that industry, mini-mills that have been under construction for some time will be coming on stream next year and adding to capacity. Moreover, the growing efficiency of the integrated companies and expanding capacity abroad--we are seeing more sources of steel supplies from around the world--suggest that steel prices will be flat at best. In fact, one of our directors who is very much involved in steel feels that steel prices at the end of 1997 are likely to be below where they are today, and as Mike Prell noted they currently are below where they were at the beginning of this year.

There are growing concerns about the outlook for residential and nonresidential construction. The feeling is that the residential projects that are now being completed are not being replaced in the construction pipeline, so that as they are finished next year residential construction activity will be coming down. On the commercial side, there is a special concern about too many shopping centers--too much retail space. The bankers say that they are tightening up on credit for this type of lending. They feel that they have been extending too much credit for the construction of retail space on terms with which they are no longer comfortable.

Employment is generally characterized as flat at very low levels of unemployment. We simply do not have very much population or labor force growth in the region anymore. I think people are going back to California! That population trend is expected to continue.

One of the remarks that Governor Rivlin just made about the way the causality runs in labor markets is reinforced by views expressed by some of our directors. One of our directors, who is now leaving the board, said that when he arrived inflation psychology was an issue. He does not believe that anymore. He thinks it has been replaced by what he calls a productivity psychology. He notes that in management retreats and in meetings of boards of directors, people do not talk about inflation. They talk about efficiency and about productivity and they lay their plans for the next year and set their longer-run strategies with the objective of accomplishing greater productivity. The director believes that the productivity psychology is pervading business organizations and that employees understand very well that that is what is driving their companies.

On the stock market, one director made a comment that I thought was intriguing, so I tested it with a few other individuals--I had a sort of aggregation problem. The comment was that the shares of an individual's firm were fairly priced in the market or maybe a little undervalued, but the stock of other business firms was overvalued. [Laughter]

On the national economy, I do not pay very much attention to what the Commerce Department reports on real output and even less to what the Board staff projects for real output. [Laughter] What Mike Prell does with the real growth measure makes sense, but I believe it is increasingly flawed conceptually. We don't know how to define output and we have all the related problems and concerns about productivity that we have discussed a number of times. The numbers simply are not squaring up with what I, at least--and I think a lot of you, too--hear and see is going on in the economy. In any event, I do not think that the growth measure has much to do with the purchasing power of the dollar. I find the uncertainties about the linkage between measures of inflation and of real output and productivity to be something more than I can deal with when I am so unsure about how to estimate output and productivity.

I do spend a fair amount of time looking at the price statistics. Of course, there is a danger in that we can fall into the trap of thinking that inflation is caused by rising prices, but it is not. [Laughter] I do look at the numbers for prices and I look at the numbers for wages. Now, even in theory the only way we can have wage-push inflation is for firms to pay people more than the value of their marginal product. We do not find a lot of businesses that claim to be paying their workers more than they are worth. However, when I look at the Greenbook projections of the deflators--the chain-weighted deflator or the gross domestic purchases deflator--out to 1998 and see that uptick out there in 1998, that certainly gives me reason to pause. When we come back together in February, I am going to be very interested in seeing what the numbers look like going out for five years. I think a crucial issue for this Committee at this point is the inflation forecast beyond 1998. Nothing that we could conceive of doing today or in the early part of 1997 is going to have much effect on reported rates of inflation in 1997. The implications of current policy for the year 1998 are a matter of interest, but much more so is what the inflation trend will be beyond 1998. Implicit in the Greenbook's 1998 numbers is an inflation trend that is rising beyond 1998. And yet I am very puzzled because when I look at the Greenbook projections of nominal GDP for 1997, those in the current Greenbook are the lowest that we have seen since the Greenbook began to include projections for 1997. About one year ago, at the time of the January meeting, the country was in a funk, with the economy perceived as bad and getting worse. That sentiment changed by spring, and going into the summer the economy was seen as booming and getting stronger. Now, the psychology may be back almost to where it was one year ago. The numbers are softer in terms of nominal spending growth in 1997 and we have had three Greenbooks now with projections of 1998 nominal GDP, and each of those projections has been lower than the prior one. So, the trend for nominal income growth is going in one direction, yet I am expecting staff to say that after 1998 nominal GDP is going to grow at a faster rate and produce higher inflation. What I would like the staff to do, at least to humor me, is to show us what policy and the environment would look like if we set an objective of stable prices at the end of five years. We have a pretty good idea of what it would mean in terms of nominal income. We even have a pretty good idea of what it might mean in terms of nominal interest rates--they would be lower than they are today. What kind of heroic assumptions would one have to make in your analytical framework, as it relates to growth in output and productivity, that would be consistent with that objective without first widening the output gap or pushing up the unemployment rate? I think it is possible to put that scenario together in some alternative framework other than a gap analysis.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I have very little to add this morning, and I will be very brief. As we know, this was a very short intermeeting interval, and it seems to me that the incoming data have had very little significance for policy in the short run. So, I believe that on balance the economic situation very much calls for the status quo. The Greenbook always makes for fascinating reading, but I have to say that the current edition is as bland as any I have seen since I have been here, which I do not mean as a complaint or a criticism. That is the way things are. We continue to be in a period of watchful waiting; that is what seems to be appropriate in my view. This period is not going to go on forever, but it does seem to continue at least for now. I would like to add that I think that the risks continue to become a little more symmetric, but I am in no rush to change the direction of the intermeeting bias. Thank you.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. The economic expansion still seems to be holding in a sustainable zone. We have further confirmation of the slowdown in the third quarter that we were anticipating. The fourth-quarter results have been mixed but seem to point to a marginally stronger economy as we reach the year-end. The question for us now is how much momentum the economy will carry into 1997. I have been impressed by the mixture of the reports around the table today. There are some areas of strength in the economy: a strong labor market, low unemployment, shortages of certain types of workers, fewer layoffs this year than in recent years, increased wages and income, and reasonably strong consumer confidence that is perhaps related to the strength in the labor markets and to some wealth effects from the stock market gains, at least until a few weeks ago. Housing markets could be getting a boost from lower mortgage rates, and we have some evidence of that in the data for November that we received this morning. There could even be some increased consumer spending capacity if a mini mortgage refinancing wave gets going. On the business side, commercial construction has strengthened as the current business cycle has lengthened and put pressure on capacity. We are even getting reports that available commercial rental space is now becoming scarce in some areas. I never thought that I would be hearing such reports at this juncture. Industrial production bounced back strongly in November.

In support of this increased activity, the external financing cost of capital has been relatively low. Profit levels and cash flow also have permitted internal funding. In this financing environment, business fixed investment has consistently outpaced the Greenbook projections. Inventories seem to be reasonably balanced as we go forward, so we should not face a workout from an inventory overhang nor a slowdown because of shortages.

Even in this environment, I think there are some potential problems for the economy. One I would point to is consumer spending. While such spending is unlikely to fade given the strong labor market and high confidence levels, it is not likely to grow much faster than the rate of increase in incomes. Consumer debt levels continue to be a constraint. We have worked through all of the pent-up demand. There is also the whole question of labor market uncertainty. During my first two years on this Committee, I talked a lot about this subject. I got tired of talking about it so it dropped off my list of things to mention, but the issue does remain.

Another potential uncertainty is the stock market situation, which was highlighted by Mike Prell in the Greenbook. It may well be that the cold shower that was given to the markets by the Chairman may have done the trick. In any case, market participants are taking a second serious look at their valuations. In fact, somebody that I talk to fairly regularly tells me that traders continue to be obsessed by the Chairman's remarks.

I will turn to another problem that I place in the potential risk category. I hope that Governor Rivlin is right in her optimism regarding the federal budget outlook. But if some kind of budget deal is not worked out, I think the markets will likely extract a premium via higher interest rates, and that could have a retarding effect on the economy.

Another risk that has been mentioned today is inflation. It seems that "benign" and "tamed" are the more recent adjectives of choice. That certainly seems fair for the major core indexes, the deflators, and commodities including gold. But energy and food are still experiencing price increases. If, as expected, those increases tail off or decline as supply pressures ease, we could see some marginal progress on inflation. But if not, inflation remains a risk to the economy, particularly to the fairly fragile consumer spending situation. Wages are another potential pressure point for inflation and the economy. Maybe we are experiencing enough productivity improvement in enough industries to keep the pressure off prices, and there still is the safety valve of profits. But either prices or profits are going to have to change in the future if labor markets remain tight.

In sum, I think that the outlook for sustainable growth looks even better from the December vantage point than it did in September or November, perhaps with a bit more strength going into 1997 than we had earlier thought.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. The limited amount of data that we now have available since the last meeting does not alter the picture of the economy, and that picture is a remarkably good one. Economic growth has now slowed to trend. I read core measures of inflation as stable to still declining. The unemployment rate remains locked in a low but narrow band. Still, I think we all appreciate that good monetary policy is forward-looking. So, the relevant question is, what change can we look forward to with enough confidence to justify a change in policy today?

Given that we are beginning from full employment, one justification for a policy change would be a strong conviction that growth over the forecast horizon will be persistently above or below trend. But the risks related to growth have really become more balanced over the last several months. The Greenbook forecast indicates trend growth immediately ahead. The discussion around the table suggests that few of us have a conviction that would justify a very different forecast. I compared the Greenbook forecast to five of my favorite private-sector forecasts, and the range is remarkably tight. On a fourth-quarter-to-fourth-quarter basis, the range for next year is from a low of 2.0 percent to a high of 2.4 percent. This is a very narrow range. Unemployment rates tend to be slightly higher than in the staff forecast; they jump off from about 5.4 percent, which is the current rate, rather than the lower 5.2 percent rate in the Greenbook, but again these forecasts are in a very narrow range that pretty much encompasses the estimates of trend growth.

When we begin from trend growth, I think one thing that we might also recognize is that slight differences in the forecast for GDP growth, differences that are much smaller than the margin of forecast error, produce qualitatively different forecasts. A forecast of slightly slower GDP growth at the lower limit of that range, like 2 percent, produces rising unemployment rates, as in the consensus Blue Chip forecast, whereas a slightly higher forecast of GDP growth produces a degree of further tightness in the economy and further risks of rising inflation that none of us views as acceptable.

A second justification for policy change would be the conviction that we are already below NAIRU and not likely to move back to it quickly enough to prevent an uptick in inflation. This is basically the staff forecast, and my view has been and continues to be that this is the most serious risk factor in the outlook. Yet, we get stuck in place because we continue to be confronted by the reality of stable to declining core inflation in the face of this prevailing low unemployment rate. So, we wait for additional data to resolve our doubts. The risk of waiting, judging from the modest rise in inflation in the staff forecast, is not very great. Still, it is probably worthwhile noting that in all of the five private-sector forecasts that I looked at, there are increases in core inflation over the next year or two. That is a pervasive tendency that just about everybody is worried about. I think we need to keep that in mind.

Just a little historical perspective: I think the major threat to an expansion comes from an ultimate overshooting of demand relative to productive capacity and from the resulting acceleration of inflation. I do not believe that business cycles are dead. Rather, I think there has been a coincidence of events that so far have permitted us to avoid pervasive excess demand and rising price pressures. I want to suggest a few of them that we have not discussed very much. Demand is always chasing supply during the expansion, but I think supply has been more elusive than normal in this particular cycle. Effective labor supply has been increased by an apparent decline in NAIRU, so the unemployment rate has been chasing down a falling NAIRU. In addition, we have had very strong capital spending in this expansion, and as a result we have seen very rapid growth in industrial capacity. So, if we look at the price pressures in the product markets, they seem even better contained than the price pressures in the labor markets. I think that is an important distinction. One reason why this absence of pricing leverage makes sense is a lack of excess demand pressure in the product markets that makes firms more cautious about raising wages in response to labor market pressures and also more cautious about passing on wage increases that do occur. Other factors that have inhibited the normal buoyancy in demand at this stage in the cycle have been the continuing fiscal restraint and the persistent drag from net exports. So, supply has been increasing more rapidly perhaps than normal, demand has been less buoyant, and that is what has created the current environment.

But as I said, the business cycle is not dead; history suggests that the risks are tilted in favor of demand ultimately overshooting productive capacity and causing higher inflation. While this should not prevent us from enjoying the current balanced prosperity and good performance, it does suggest vigilance rather than complacency as we move into 1997.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. I think that in spite of your best efforts, 1997 is going to be a very good year for irrational exuberance. [Laughter] I take the Greenbook as Exhibit One. In mid-1993 I got into a little trouble because the wire services quoted a quip I made at the beginning of a speech to the effect that monetary policy had been reduced to the number 3 or 3 something: 3 percent inflation, 3 percent growth, 3 percent fed funds rate. Now, I have to change it to 2 something because what I see in the Greenbook forecast is quarterly GDP growth rates of 2.1, 2.3, 2.3, 2.2, 2.1, and 1.9 percent; and for the implicit deflator from the second quarter of 1997 it goes 2.1, 2.0, 2.0, 2.3, 2.2, 2.2 and 2.3 percent. I suppose the real fed funds rate is "2 something" percent, too. So there we are. That is known on Wall Street as the Goldilocks economy, and that perception is exactly what is causing the stock market boom. I remember Goldilocks from when I was a kid, but I have not read it to my kids. I can cite Green Eggs and Ham by heart, which I will spare you, [laughter] but I cannot remember too much about Goldilocks except that there were three bears. So, here are the three bears that I think are going to give us a little further irrational exuberance in 1997, and when we write the history of 1997, we will ask ourselves why we didn't realize it at the time.

The first relates to the budget deal cited by Governor Rivlin. I share her optimism that a deal will be reached, but I also have a substantial amount more cynicism than she was willing to express. I think the core of the budget deal will be, as it is with most political deals, to make things sound a lot better than they are. If we look at the Greenbook we note, for example, that the high employment budget deficit actually rises in the next year in spite of all the talk around town and during the campaign about record low deficits. Basically FY97 is locked in. So, we might think of 1997, at least from the point of view of perceptions, as the "all gain, no pain" year. I also agree that there probably will be a Medicare deal, which will make us all feel better. My suspicion is that the rhetoric will focus on a line that the President used, namely, that we will have extended the life of Medicare by 10 years. Now, I actually chased this quotation down with some CEA staff when I was in Paris. The President said it first in 1995 and the 10 years he had in mind were through 2005, which really is an extension of 4 years. But since everyone will be signing on, everyone will be saying that we extended Medicare by 10 years. The examples that you gave--a little squeeze on the reimbursement rates for doctors and a tad of means testing are not going to hurt anybody--will make it sound as if the Medicare problem has been put off for 10 years.

MS. RIVLIN. His 10 years did not include the means testing.

MR. LINDSEY. Did not include means testing--so maybe its inclusion will get us to 11 or 12 years, but it still will not be that far into the future. In addition, I think both OMB and CBO have become a little too optimistic with regard to tax receipts. They discovered that the increased tax receipts were not from capital gains, which should make us all pause a little because that means that those gains are not being realized and are not in the spending stream boosting consumption right now. Instead, the discovery was that the extra tax receipts were coming from higher small business receipts. That was certainly true for 1994 and 1995. People who were downsized formed their own businesses and started paying the very high tax rates that small business people pay basically because their fringe benefits are not deductible. But as our staff discovered, small business profit margins are now starting to be squeezed. I think that the declaration that this tax gain is a permanent gain--because it is from small business and not from capital gains--will in retrospect prove to be false. We will look back and find that, in fact, our deficits have been larger than either the Congress or the Administration now believe they will be. For the short term, the news will be great. We will have a fiscal deal, but in fact, we will not have solved our budget problems. The bond market will think that we have and will help fuel irrational exuberance.

I think the second bit of fuel for irrational exuberance during 1997 is going to be the credit situation. I noticed that today's Wall Street Journal was carrying a story that the next Congress was going to be considering bankruptcy reform. I can think of few worse ideas, frankly. First are the politics that are involved. Here we have a group of bankers saying that Congress has to tighten up on bankruptcies, and on the other side we have bankrupt people, some of whom have sick children, some of whom were unemployed for very good reason, and some of whom have gone through divorces, although they do not generate enough sympathy to serve on the panel. If we have to satisfy those two constituencies and we open up the bankruptcy laws, those laws will only get worse. Unfortunately, the reason I think the exuberance will be irrational is that the lenders have now switched from saying that they were not making a mistake lending to these people because their models were so sophisticated to now saying the problem is that the bankruptcy laws are too easy. If we actually ask lenders what they are doing, we find that they are turning around and making loans to people who just declared bankruptcy. The easiest solution to this problem in my mind is for banks and other lenders just to say they will not lend to anyone who has declared bankruptcy within the past three years. The lenders are not ready to do that. Instead, they are going to push for new bankruptcy laws. That will create the illusion that something is being done when that really is not the case. So, I think we have probably another year to go on the excessive credit expansion.

The third bear is going to be the dollar. I think Ted Truman has underestimated how much the dollar is going to appreciate this year. In both Japan and Europe, there is now one clear recipe for getting out of their mess. That is export growth, and there is only one place to export to and that is the United States. The way to increase exports quickly is to devalue. The Japanese, I am told, decided that they were willing to let the yen go to 120. The Europeans are now deciding whether it is better to devalue before or after convergence. I think in the end, they will go for it before. That is going to be good news, and it is going to feed irrational exuberance in this country as well because it is going to keep inflation artificially low for a little while longer. We are going to be able to continue to sustain demand in the context of downward price pressures on domestic producers because of relatively cheaper imports.

All in all, I think there will be good news in 1997 on the fiscal front, the credit front, and the international front. But in each case it is going to be creating bigger problems for us to solve down the road. So, 1998 looks like the year in which irrational exuberance will meet its match.

CHAIRMAN GREENSPAN. I will make another speech. [Laughter]

MR. LINDSEY. Don't wait a whole year.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Thank you, Mr. Chairman. I will try to be brief this morning because my view is little changed from last time. The limited new data that are available since our last meeting support the staff's prediction that the lull in consumer spending over the summer was likely a temporary aberration and not the onset of any period of significant retrenchment due to tightening consumer credit or escalating debt burdens. Indeed, I have been fighting the crowds and searching in frustration for parking spots at local malls in recent days only, I assure you, to provide some firsthand independent research concerning the strength of Christmas spending. [Laughter] Frankly, my concern with the possibility that consumer spending may be too robust rather than too weak has increased. At a minimum, the risks with respect to consumption now seem to me to be quite balanced. However, moderation in government spending and residential investment combined with the significant drag from net exports--and that drag has been revised upward in the latest Greenbook due to the stronger dollar as Ted Truman mentioned--those sources of drag, I think, should offset above-trend growth in consumption and investment spending over the forecast period. If we add to that the fact that inventories are seemingly at reasonable levels in relation to sales, the Greenbook forecast of overall growth in demand seems perfectly plausible with the risks looking quite balanced, as Governor Meyer stated a minute ago. Meanwhile, the news on the inflation front does suggest continued moderation in core inflation, with relief on the horizon most likely with respect to energy prices.

To my mind, labor markets are undeniably tight. You remarked last time, Mr. Chairman, that we should be careful not to lull ourselves into a false sense of security about incipient wage pressures by reading too much into that suspiciously low third-quarter ECI, and I agree with that. So, I still feel that we need to avoid complacency about the potential for inflationary pressures to emerge from the labor market down the road. But while I think we cannot rule out the possibility that this long expansion is about to end with a period of stagflation and that that is a significant risk over the term of this forecast, that outcome is by no means a certainty. Capacity utilization, as a number of you have mentioned, is not strained at this point. Incoming data do suggest that earnings and profitability remain strong, so I do not see any squeeze on corporate profits at this stage. In fact, this stunning combination of strong corporate profits, a healthy but sustainable pace of real growth, low and maybe even declining inflation, and lower real interest rates due to enhanced prospects of a balanced budget is a mix that may indeed continue to support a level of stock prices that the Greenbook--I liked the staff's term for this--called aggressive. I thought, if anything, that that was an accurate statement and, given the careful analysis done here at the Board, that it was perhaps an understatement. Like Governor Lindsey and some of the rest of you, I consider the stock market a significant continuing risk to the outlook. So, I do worry that this confluence of favorable events has fostered what you describe, Mr. Chairman--I think appropriately--as irrational exuberance in asset markets. I think your recent remarks alluding to the potential for large asset price movements that are likely to have adverse impacts on economic activity was extraordinarily useful in prompting at least some introspection and some second thoughts by market participants about the rationality underlying the current evaluation of equity prices. Maybe your speech also served to heighten just a little the appreciation by the market that there do remain real risks around what is admittedly a very rosy forecast.

CHAIRMAN GREENSPAN. Thank you all. We can go to coffee now.

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

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

CHAIRMAN GREENSPAN. Questions for Don? I guess you overwhelmed everybody.

VICE CHAIRMAN MCDONOUGH. I was wondering if applause is in order.

CHAIRMAN GREENSPAN. The Vice Chairman is suggesting applause but don't. [Laughter]

If there are no questions, let me get started on policy and the directive. As many of you have mentioned, no really significant changes have occurred since the last meeting. The numbers go up and down, all sorts of adjustments take place, and one can easily get mesmerized by small changes, but the evidence suggests that there just has not been much change in the economy since our last meeting. I believe it is correct to say that the expansion is moving along at a reasonably good pace; its underpinnings are fairly solid. There is no credible evidence of cumulative deterioration. Goldilocks may not be the type of story that Governor Lindsey feels appropriate for his children, but the principle of Goldilocks probably will live on for at least a short period of time, though my fear is that her locks are going to get clipped at some point reasonably soon.

Personal consumption expenditures appear to be running at a moderate pace. The Christmas data are always very difficult to read. I would suggest to Governor Yellen that her survey has a problem in that there are five fewer shopping days than usual before Christmas--

MS. YELLEN. I forgot that.

CHAIRMAN GREENSPAN. --so there are more cars per square minute [laughter] than we normally would expect. Nonetheless, as Mike Prell points out, the weekly seasonally adjusted data on chain store sales do show some significant strength. I presume that our X-11 seasonal adjustment program is not mesmerized by the shorter selling season phenomenon.

I thought that, to date, the slightly disappointing December motor vehicle sales number was perhaps just as important as the somewhat firmer Christmas season sales in the usual GAF goods categories. Given shortfalls in the last month or two in motor vehicle sales owing to the strike, one would have expected these data to start coming back this month. But, to date, the surveys that Mike Moskow has made and that we are making ourselves do not show any significant improvement in motor vehicle sales. It is conceivable, since we are only halfway through the month, that we could get a lot of action over the rest of the month in both regular Christmas buying and motor vehicle sales. I would say that for the moment it is not self-evident that we will have very strong growth in personal consumption expenditures in the fourth quarter, but clearly growth will be markedly above the pace in the third quarter. I think consumer spending in that quarter was artificially reduced, in part by Department of Commerce adjustments for the hurricane and that sort of thing.

One interesting aspect of consumer markets can be seen from a disaggregation we have made of consumer credit into gross extensions, repayments, and net change, the latter being our published number. This statistical construction has much the same form as was used a number of years ago in publishing installment credit extensions and repayments. What it shows is a very significant increase in the last year or two in the ratio of nonautomotive gross extensions to nonautomotive retail sales. That was the case until the last couple of observations, for October and November, when all of a sudden it looked as though consumer credit had hit a ceiling. After rising like this, it went flat. This is consistent with the general notion that consumers as a group may be running up against some credit limit.

To test this hypothesis, I asked the staff to try to use our Survey of Consumer Finances, which we conduct every three years, in conjunction with the data on income quintiles and the flow-of-funds aggregates to estimate the different types of household assets by income groups. Those statistics were employed to make judgments as to how the household balance sheet would look on a disaggregated basis as we moved well into 1996. Granted that there is a lot of weakness in all of these data, there is a certain robustness to the result because we do have, in addition to income, controlling aggregates of consumer credit and stock market wealth including equity mutual funds. Even though a lot of statistical manipulations are involved, the robustness of the results is really quite remarkable when we have very strong trends. The numbers that we endeavor to adjust in a matrix with controlled rows and columns and nonnegative components are constrained by algebra. The matrix algebra severely limits how much leeway we have in the various cells, provided they are all nonnegative or zero, which they are.

The end result of all of this confirms the fact that consumers at the lower end of the income distribution indeed have more significant consumer debts than equity assets, which are the two big surging items that have been moving household balance sheets of late. This is consistent with the notion of some constraint on consumer spending, although the detail that we have and the limited breakdown of only five quintiles are not in and of themselves all that conclusive. All one can say is that there are not enough assets, specifically equity assets, on the balance sheets of those with constraining consumer debt to overwhelm the debt argument. That is, the data suggest that there is a fairly large number of individual households that have a lot of consumer debt and very little equity assets or indeed much of anything else. This, in a sense, confirms the fact that there is some debt limit against which we are running, although one can argue it is not all that much of a constraint. It is a constraint against an acceleration in spending but clearly not one that suggests a pulling back. It may well be part of the explanation as to why the wealth effect on consumer spending seems to be falling somewhat short of econometric estimates that we obtain from the aggregate data when we try to filter out the impact of changes in the value of equity market holdings on personal consumption expenditures. I hope to be able to get something more out of this data system, but it is hard to know because a lot of guesswork is going into our equations, and we are not quite sure whether what we are getting out is the guesswork we put in! [Laughter]

On the residential building issue, a quick appraisal of the sharp rise in starts reported this morning suggests that it is going to be partly retraced in December. The reason is that the best short-term forecasting system that I have seen on housing starts is one that tries to track the pace of net permits through to the starts figures. November data show, as indeed I think we have seen in the past, that the level of net permits, meaning permits adjusted to the level of starts less cancellations, is significantly below the current level of starts whereas they were above in October. One of the ways of looking at the November figure is in terms of the pipeline effect, which is in fact the question that Jerry Jordan was raising. There is some evidence that what is in the pipeline at this stage is well under the level of single-family starts. My guess is that we will get some retrenchment. Indeed, whenever the permits backlog declines, the probability of a retrenchment in starts the next month is a good deal better than 50/50. Having said that, all the other evidence, including that sharp rise in mortgage loan applications for the week ended December 6 shown in the mortgage bankers' weekly release, has been rather startling. I do not know whether I should believe the seasonal, but if one looks at the data, it goes like this and then there is a spike. Usually that means that something is happening even though it may be exaggerated in the data. So, I think there is good evidence that while December starts may be down, the residential real estate market is probably in the process of stabilizing.

The inventory data, as a number of you have mentioned, are really quite benign, and it is hard to find any significant changes in inventory investment in either direction. The October figures in constant dollars were running at the pace of the third quarter. There is no reason to believe that anything of great significance is going to occur. The only point that may be worth making is that there were somewhat more imported inventories implicit in the third-quarter data than is normal, so it may be that the size of the adjustment if we go to a slower inventory investment level will be somewhat less. The one caveat there is that theoretically one should see those imported inventories reflected on the import side of the GDP accounts. As hard as Ted Truman's people have worked on finding it, it is not there, which I would guess is a statistical discrepancy rather than reality. But no matter how one cuts it, there does not seem to be anything of importance in the inventory data.

Wages do appear to be accelerating very modestly, but let me caution you on the .8 percent increase in the November figure for average hourly earnings. The fixed-weight numbers are lower; the fixed-weight plus adjustment for the overtime number that we calculate brings the increase down to about .4 percent from .8 percent. Nonetheless, even with all of these adjustments, we are still getting a mild degree of acceleration, which has not ceased. As a consequence of that, I have also asked the staff to work a little more on getting a better sense numerically of this tradeoff question between job security and wage gains. At my suggestion, they put together a very interesting model that provides clear evidence that the trend of job leavers has been very flat in the context of a falling unemployment rate. At least historically, that is not the way labor markets are supposed to function. The staff has very cleverly been able to extract the average duration of unemployment for job leavers consistent with that overall statistic. One would presume, and indeed the data do show, that the number of job leavers is a function of the average period of unemployment--that is, a proxy for the cost of becoming unemployed. The longer the duration is, the greater the possibility that becoming unemployed is going to be very costly to a worker, and hence the worker will be increasingly disinclined to leave. These data do in fact, with one caveat, suggest that a goodly part of the shortfall in the ability of our regular wage equation to project what actually has been happening is correlated with this statistic. The caveat is that, as you all know, we had a discontinuity in the household series as of January 1994, and the job leaver series has gone a little off kilter. I am not sure it means all that much, but until we ascertain that the discontinuity is not creating a lot of this correlation with the residuals from our Phillips wage equations, it would not be that convincing to use this type of model as a numerical measure of the job insecurity/wage gain tradeoff.

I might add that the type of residuals that we are talking about, if translated into a system in which everything is exactly on track but where the NAIRU is the residual unknown variable, would imply a NAIRU well under 5 percent to bring all this together. So, we are getting a gradual increase in labor costs in a data system that is explaining a phenomenon known in principle to be transitional. The only issue is when the transition period will end and we will get a normal reacceleration of wages at lower unemployment levels than they have been historically but where the rate of change in wages and its effect on prices revert to historical patterns.

Remember that this wage shortfall also mirrors the opening up of operating profits. What one must assume about all of this is that we are getting such a benign price pattern in this environment because these very large operating margins are creating a rate of return on equity that is higher than normal. This is another way of saying that, if any competitor tries to move prices up in that environment, the profit margins of other competitors are such as to enable them to compete at a lower price and still be above their hurdle rate of return on equity. We do not have to bring into the equation all sorts of noneconomic forces to explain these price phenomena. It is the old basic rate of return on capital that is keeping the cap on the price level. What is keeping the return on capital up is the subnormal rate of wage increases. When one element goes, the whole thing starts to unravel. There is no evidence at this stage that that is occurring, but it is going to happen at some point. When it happens, we are going to find that we are back on the old track.

I guess the key question is the same issue that we raised last time. Will the economy soften sufficiently quickly to take the pressure off the wage structure before the transition occurs? I would say at this stage that there is as yet no evidence to suggest any such softening: Order patterns still look reasonably solid; the levels of consumer confidence are beyond belief at this stage; there are very few imbalances of the kind that usually have led to problems historically; profit margins apparently have flattened out, but they surely have not turned down. As a consequence, we are still faced with pressures in the labor market such that, if the latter ever reverts to a normal pattern, a whole new set of inflationary forces will be created. Therefore, while I think we can stay at "B" for a while as we assess whether diminished demand pressures in the economy will reduce pressures in the labor markets before this transitional process is over, I believe we confront a far greater likelihood that the next move will be up rather than down. So, I would hope that we can stay asymmetric today and still remain at "B." Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, for all the reasons you suggested, I believe that maintaining official interest rates at their present levels is appropriate and therefore "B" is appropriate. I agree that it is very likely that our next move will be up and that asymmetry should be used to indicate that there is a strong consensus among Committee members that the risks to the forecast are on the up side. That is how I would interpret asymmetry rather than as reflecting a high likelihood that we would move to change rates between now and into the new year. So, I believe "B" asymmetric is clearly the right conclusion for today.

CHAIRMAN GREENSPAN. I accept your definition of asymmetry. Governor Rivlin.

MS. RIVLIN. I agree and especially with the Vice Chair's formulation of it. I do not see any reason for a move at the moment. We are doing fine, but the risks are clearly on the up side, though they may be less so than we thought when we launched into the asymmetric pattern. They are not enough less to convince me that we should revert to symmetry, although I must say that I find the meaning of these asymmetries a little mysterious.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, our forecast suggests that it may be necessary sometime next year to tighten the stance of policy to impart some downward momentum to the underlying rate of inflation. However, there would seem to be little or no reason to take action now. At our Bank, we consult two monetary policy rules as a starting point for thinking about the appropriate stance of policy: an estimated version of Taylor's rule and a nominal income growth rate rule. Even if we assume a 2 percent target for core CPI inflation, both rules suggest that the funds rate should be left at about 5-1/4 percent at the present time, although when applied to our forecast they do suggest higher rates will be needed in the future. In addition, it appears to us at least that there is considerable uncertainty at this time about the prospective strength of economic activity. Therefore, I support the Bluebook alternative B, with a 5-1/4 percent funds rate and asymmetric language on the side of tightening.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I support the recommendation for "B" asymmetric. I think the risks are clearly on the up side.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, as I said earlier I think the risks are more balanced now. Because of that I do not believe the need to tighten our short-term policy stance is as urgent as it was earlier and I would accept your recommendation, although if you had recommended a slight snugging, my opposition would have been less than heated. [Laughter]

I would like to make one other quick comment that is very much in the spirit of what Tom Melzer and Jerry Jordan said during the economic go-around. Our next meeting is a Humphrey-Hawkins meeting where we once again have an opportunity to look at our longer-term strategy. I hope we will take that oppportunity to sharpen our strategy perhaps a little and communicate it even more concretely than we have. This, it seems to me, is an appropriate time to do that since, with the Boskin Committee report, there now is an emerging consensus on the magnitude of the bias in the CPI. It has always struck me as a little ironic or at least curious that at these Humphrey-Hawkins meetings we all submit a forecast for inflation for one year out and then just stop there. Obviously, the Fed can control the inflation rate over a reasonable time period, so we cannot help but ask ourselves why we do not just set out a multiyear path to full price stability that we expect to follow over some sensible time period, state it publicly, and then pursue it. Or at a minimum along the lines of Tom Melzer's comment earlier, we could state explicitly that we will not tolerate a backup in the inflation rate to a level over 3 percent. If I am not mistaken, we briefly discussed the possibility of doing something like that at our last Humphrey-Hawkins meeting, and I would hope that we would consider it again at the next meeting in February. I think this is the time to do it while the current inflation rate is relatively low. If we lock in the currently low level of the inflation rate, I think that will position us to make some further progress on the expectations side, which seems to me to be the big thing now.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, I am in full agreement with your recommendation for "B" asymmetric. I also believe that Vice Chairman McDonough's definition of the various aspects of symmetry is quite in line with mine. I think that our indicating symmetry or asymmetry in our directive really does communicate the direction to our thinking and does not have any impact on what the process will be in terms of how that will be implemented. I would like to see that understood by everybody because the notion of symmetry in our directive is confusing. I think we can make it less so.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, given that I also agree that the risks are on the up side, I support your recommendation.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. I, too, support your recommendation, Mr. Chairman, and like Cathy Minehan I would associate myself with the understanding of asymmetry that Vice Chairman McDonough enunciated.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I support your recommendation.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. This is for Ed Boehne and others. I do not want them to get too nervous about Al Broaddus and me both "selling out" on an earlier view. CPI inflation is up 1/2 percentage point this year over last year, and I think the risks are that it could rise further. Personally, as I view the incoming information and listen to the comments today, I see the risks of rising inflation as somewhat greater now than they were at the time of the last meeting, not less. So, I would favor a modest increase in the degree of reserve restraint.

Now, such an increase clearly would catch markets off guard and if we acted, which of course is not going to happen today, we would have to put that action in the context of a long-run inflation objective. At this stage I would put it in the context of trying to cap inflation at 3 percent. In some sense we should not have to explain that. I think markets should have a better idea of what our objectives are. The fact that we have not been more explicit about our objectives, I think, is probably the most significant risk to our independence in comparison to other things we worry about. I think we are perceived to have much more influence than we really do, and we could deflect that perception if we explained that what we are really focused on is the inflation rate in the long run and that is all we influence.

So, I would support what Al has said here with respect to a discussion in February. We really need to zero in on this issue and be more explicit about our long-term intentions with respect to inflation. Personally, as I think you all know, I would be in favor of laying out a path like Al described, but whatever we can get in terms of being more explicit would be better than the situation that we are in now. I do not think we can wait for legislative results that might clarify that. I think we have a job to do to educate the public about what our intentions are, and a good starting point is by being more explicit about our objectives. Setting our inflation objectives is something we would have to ease into, but I think that it is very important. I would like to encourage a discussion in February and maybe some staff work that would lay out some possibilities with respect to things we might do that would take us in that direction.

CHAIRMAN GREENSPAN. Governor Kelley.

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

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I also support "B" asymmetric in view of the renewed strength of the economy in the current quarter. It seems to me that the balance of risks has shifted to the up side, implying the necessity of vigilance on inflation developments.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I support your recommendation.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I support your recommendation.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. I support your recommendation. I see policy as appropriately positioned now and agree with President Parry that that becomes apparent from the observation of rules or from the Greenbook forecast. But to my mind the risks are asymmetric. I appreciate the clarification of the meaning of that term, and with that clarification I certainly am happy to support continued asymmetry today.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I agree with the recommendation to leave the funds rate unchanged at this meeting, but I am troubled by this issue of the meaning of asymmetry, not only among ourselves but also what we communicate to others. In one sense, a central bank should always be asymmetric toward firming with regard to the issue of inflation. In another sense, I cannot imagine the circumstances under which there would be any new information that would cause an action in the near term--between now and the next meeting. So what asymmetry means is that if the consensus of this group is that the next action is more likely up than down, it is because of rising inflation well out there in the future, given the long and variable lags that exist. In my view, we have done a much better job recently of avoiding communicating that we are concerned as such about too much growth or too many people working or not enough unemployed people and other idle resources. We do not want to fall back into those kinds of communications. So, how are we going to communicate the need to move the funds rate up when we face it, because of our concern about inflation in 1998 and beyond, if we do not set out explicit multiyear objectives and couch any action we have to take in that context?

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I support your recommendation. I was just thinking about what Jerry Jordan said. I like the line--I am sorry I forgot who said it--that nervous reactiveness may be the best we can hope for. When we look at the loss function and the amount of uncertainty out there, I think prompt action when we first get a signal in this environment is a reasonable conclusion. I would say that that is very much along the lines of an asymmetric directive. I could imagine asymmetry going the other way as well; in fact, we were asymmetric going the other way through much of 1991 and 1992. So, I think it is the right recommendation and that it is consistent with the way President McDonough defined it.

CHAIRMAN GREENSPAN. Finally, Governor Meyer.

MR. MEYER. Mr. Chairman, I support your recommendation. As the risks have become more balanced over the last few months, it has clearly become a closer call as to whether the directive should be symmetric or asymmetric. Nevertheless, the major risk seems to be a rise in the inflation rate and I therefore concur with that asymmetric directive.

Let me just preview our next discussion since we seem to be focusing in advance on the February meeting and the potential discussion of longer-term targets and strategies. I would certainly respond well to some notion of a cap like 3 percent on inflation, but I am going to be very troubled from my opportunistic perspective about laying out a specific year-to-year path. I would not want to feel committed to a specific path. Thank you.

CHAIRMAN GREENSPAN. Thank you. The consensus appears to be "B" asymmetric. Would you read the directive that would accomplish that?

MR. BERNARD. It 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 relatively strong expansion in 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	Yes
Governor Yellen	Yes

CHAIRMAN GREENSPAN. The next meeting is February 4 and 5, which is a Humphrey-Hawkins meeting.

END OF MEETING