

Meeting of the Federal Open Market Committee  
October 5, 1999

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, October 5, 1999, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Mr. Boehne  
Mr. Ferguson  
Mr. Gramlich  
Mr. Kelley  
Mr. McTeer  
Mr. Meyer  
Mr. Moskow  
Mr. Stern

Messrs. Broaddus, Guynn, Jordan, and Parry, Alternate Members of the  
Federal Open Market Committee

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

Mr. Kohn, Secretary and Economist  
Ms. Fox, Assistant Secretary  
Mr. Gillum, Assistant Secretary  
Mr. Mattingly, General Counsel  
Mr. Prell, Economist  
Ms. Johnson, Economist

Ms. Cumming, Messrs. Howard, Lang, Lindsey, Rolnick, Rosenblum,  
Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Messrs. Ettin and Reinhart, Deputy Directors, Divisions of Research and  
Statistics and International Finance respectively, Board of Governors

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

Mr. Whitesell, Assistant Director, Division of Monetary Affairs,  
Board of Governors

Mr. Kumasaka, Assistant Economist, Division of Monetary Affairs,  
Board of Governors

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

Ms. Browne, Messrs. Eisenbeis, Goodfriend, Kos, Rasche, and Sniderman,  
Senior Vice Presidents, Federal Reserve Banks of Boston, Atlanta,  
Richmond, New York, St. Louis, and Cleveland respectively

Messrs. Judd and Sullivan, Vice Presidents, Federal Reserve Banks of  
San Francisco and Chicago respectively

Mr. Filardo, Assistant Vice President, Federal Reserve Bank of  
Kansas City

Transcript of the Federal Open Market Committee Meeting of  
October 5, 1999

CHAIRMAN GREENSPAN. Would someone like to move approval of the minutes for the meeting of August 24<sup>th</sup>?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection, they are approved. Mr. Fisher.

MR. FISHER. Thank you, Mr. Chairman. I will be referring to the package of colored charts that should be in front of you. 1/

I offer the array of forward rates shown in the first chart as a precaution against any thought that there is a simple, single description of interest rate expectations, given the pronounced Y2K effects we're seeing in conjunction with some shifts in expectations about the outlook around the world. In broad brush strokes, you can see in the top panel of this chart that U.S. rates drifted sideways after your last meeting and then moved a bit lower before ticking up late last week on some data releases that suggested continued strength in demand in the U.S. economy. Euro rates have moved up more or less consistently since your last meeting. And they increased quite a bit at the end of last week, as forecasts for Euro area growth were revised up and as the market became filled with the thought that the European Central Bank might actually raise rates before the end of this year. Japanese forward rates generally declined throughout the period and were down substantially until the speculation around the time of the Bank of Japan's September 21<sup>st</sup> policy meeting created some noise. But clearly, the show was stolen by the current 3-month Libor rates, which are usually the sleepy flat line at the bottom. As we moved into the fourth quarter and the end dates of that contract included the turn of the year--both the December 31<sup>st</sup> and January 3<sup>rd</sup> dates--those rates shot up. Now, this may be just a brief effect and may calm down a bit, as we have seen with other Y2K spikes over the past year. I hope so, but I don't think we know in any way for certain.

There is also, as you can see particularly in the Euro rate chart, a sort of fanning out of these rates as one reflection of the uncertainty. Anecdotally our traders report, as we have moved into the fourth quarter, increasingly diverse pricing by our counterparties for a number of instruments--sort of idiosyncratic firm approaches to pricing for the year-end. Some firms think one thing is going to happen and other firms think something completely different is going to happen. So a lot of the data sources we look at--the data points we take off of Bloomberg, for example--are going to be the blended averages of some very disparate rates as firms take increasingly idiosyncratic approaches to the uncertainties about the year-end. And I think we should be even more cautious than usual in interpreting these interest rate charts.

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<sup>1/</sup> A copy of the material used by Mr. Fisher is appended to the transcript.

Turning to the second page, the top panel shows exchange rates since the start of the year: yen per Euro in green; yen per dollar in red on the left-hand scale; and dollars per Euro in blue on the right-hand scale. Interestingly, the two scales happen to match in percentage terms with a slightly different location of the decimal. When I look at this chart, what I see is the herding behavior of Japanese institutional investors rushing back into the yen in the third quarter. You can see the shift beginning at the time of our meeting on June 30th. Now, it may be that economic fundamentals change abruptly with calendar quarters, but to my way of thinking it is much more likely that it is investor behavior that changes abruptly with calendar quarters. I don't know what to expect with this change of calendar quarters, but when I look at the third-quarter picture I see a rush of Japanese investors back into the yen.

The bottom panel depicts 1-month option implied volatilities on each of these exchange rate pairs. If there are anxieties being expressed in foreign exchange markets, those anxieties to me seem focused on the yen and not the dollar, at least so far this year. As you can see, the green and red yen-based volatilities tracked one another and spiked as we came to the end of the third quarter. The euro/dollar implied volatilities traded at a rather calm pace.

Turning to page 3 and domestic open market operations, during the three maintenance periods since your last meeting, with the exception of last Thursday and Friday, the fed funds market behaved in a fairly typical and calm manner. The deviation of the effective rate from the target and the intra-day volatility, expressed in the standard deviation, were both moderate and similar to the experience of other recent months. Last Thursday, September 30th, was actually a fairly typical month-end day. Friday, October 1st, also a day of big flows in the market, was a little less typical. We ended up providing sufficient reserves on the day to have the effective rate trade on the target, as you can see with the red horizontal tick right on the dotted line. But in doing so we clearly provided a sufficiency of reserves that was more than the market looked for in terms of the standard deviation, and we had a very wide trading range and a whopping 60 basis points standard deviation of the trading range. But that's in effect what it takes to try to get the fed funds rate to trade on average at the target on a day of volatile payment flows.

I'd just note that currency in circulation has continued to grow at a rather rapid clip of about 10 percent per year. That is consistent with the rates we have seen this year, but well ahead of past years. I don't know about the Board's staff, but we have not found any evidence suggesting that consumer demand for currency is Y2K-related. We do see what appears to be some stockpiling of currency by small banks in anticipation of consumer demand, but we don't yet see anything we could pinpoint as indicative of consumer demand for notes.

Turning to the next page, the fourth chart depicts spreads on selected longer-term instruments to comparable U.S. Treasuries. I included this chart to emphasize the noticeable impact on September 8th when we announced our special year-end

operations and again on September 14th when we had a meeting with the primary dealers to discuss the details of our operation and get some feedback. You can see that both of those events seemed to have had a pronounced effect, particularly on mortgage-backed spreads, the 10-year swap spread, and the Fannie Mae benchmark, but they obviously had hardly any effect on the corporate index. I want to be careful not to overstate the impact. Our announcement came just a few days after Labor Day when traders were coming back and were likely to bring more volume into the market. The backup in spreads that occurred in the thin markets of late August was going to unwind at some point in September absent some exogenous shock. We may have just provided a bit of the impetus to pull the spreads down a bit--and a little more quickly than they might have come down otherwise. But all in all we were pleased with the market reaction to our announcement and we received quite a lot of feedback on it.

In the next few pages I have outlined some notes to try to take you through a number of issues associated with our year-end operations. Forgive me for this format, but I thought it would be the most efficient way. With respect to the expanded collateral, tri-party, and longer-term operations, we've now completed the legal documents. The basic operational procedures are in place and we expect in the next few days to be able to start the tri-party operations with a broader array of collateral. I want to be quite blunt that I think we are going to scuff our knees a few times as we try to figure out the best way to do this. We have different classes of collateral, and a number of dealers have urged that we provide separate pricing for each of the major types of collateral. At the same time, there is a difference between tri-party settlement and fed-wire settlement, and some other dealers want us to price that. We cannot do all of those things at once. It would just be an operational rat's nest if we tried to do all that. So we are going to learn something from doing and we will just try to get a feel for how we can slice the operations to try to let the dealers price as efficiently as possible.

Another point is that I'd like to announce the pricing details of the Desk's temporary operations. By tradition, the Desk has not announced the lowest repo rate at which we operate nor any details of dealer propositions. The philosophy has been that we're managing quantities of reserves and that there is no operational--and certainly no policy--significance to this stop-out rate, or lowest rate at which we operate. However, given the intense interest in turn-of-the-year financing rates and to avoid rumors about rates paid on our operations, I'd like to begin announcing the details of rates submitted in our operations, both for repos and matched sales. It would be possible to limit these announcements just to those operations that span the year-end. But I think trying to maintain that distinction would be awkward and probably unsustainable given dealer interest in pricing other time horizons, not just the turn-of-the-year period. Moreover, a number of central banks now routinely provide this information and, taking a step back and thinking about it, I concluded that we also should provide this information. I would plan to include a review of this announcement practice in March of next year when we present the Committee with a complete review of our year-end operations.

At the top of page 6 I have listed in detail what we propose to announce after each operation: the range of repo rates submitted by dealers; the total volume of propositions submitted; the stop-out rate, i.e. the lowest repo rate accepted; the volume-weighted average of repo rates accepted; and the volume of propositions that we accepted, and thus the reserves we injected. The latter we have been announcing for some time now. We would make similar announcements on the breakdown of information on matched sales used in reserve draining operations. And, obviously, if we have different classes of pricing, we would make the announcements for each class of collateral that we price.

Turning to the standby financing facility in the options proposal, we received a number of comments from the dealers and we sent the dealers another revision to that program last Wednesday, which I circulated to you in memo form last Wednesday. I would plan to announce the details of those auctions also. Along with the results of the auctions, we would provide pricing information to the dealers, the range of bids submitted, the volume of bids submitted, the lowest bid accepted--which in the Dutch auction would be where all awards are priced--and the volume-weighted average of all accepted bids. Consistent with our practice of announcing the amount of reserves injected, we would also plan to announce the dollar volume of options exercised each day during the period of time when options can be exercised.

We've received from the dealer community and from other market participants a fairly wide range of indications of the potential demand for these options. If one listened to the money market mutual fund managers and some of the big corporate players in financing markets, one would think we would be writing \$100 billion or \$150 billion of these options. Making a guesstimate on the basis of listening to the CFOs of dealer firms, the number of options we would write would measure roughly in the tens of billions, probably in the several tens of billions. If one listened just to the repo dealers, who are very picky and think these things are deeply out of the money and rather a nuisance, they suggest that we might need to provide an amount in the \$5 billion to \$20 billion range. So we have a full range of reactions from the market. Just in the last few days, in response to our revised proposal, we've gotten the sense of the demand going up a little even in the CFO community--the ones who really do want to take out the flood insurance. And I think we've structured this whole package on the premise that we're going to meet demand. We're going to sell enough for that constituency to be comfortable. So, we may need to revise up the amounts for our initial auction that I put in the revision last week and make those a little higher. Inevitably, we're going to need to adjust to the demand as it becomes evident in the first auction and over the series of auctions. But I'd like to be clear, since meeting demand is one of our objectives, that an unfilled auction is not going to be an embarrassment but one sign of success. We're not looking for a high bid-to-cover ratio here but rather the opposite. We're trying to meet the communities' demand.

After we have launched the expanded collateral and tri-party operations and the stand-by financing facility auctions on repos, we will then turn our attention and

the dealers' attention to the practicalities of late-day operations and possibly provide options on matched sale transactions. As I noted on the last page of my package, some dealers and some money market fund managers have continued to press us to write options on matched sales and reverse repos. The longer one scratches the surface of that, though, it is clear that the impulse behind that request is the desire of the money market funds to save a few basis points. It really isn't an issue of the functioning of markets; they'd just rather get a slightly higher rate of return. We will continue to listen to their views once we get the other pieces in place and will talk about this some more. But my interest has shifted to just trying to ensure that we have the flexibility to add or drain reserves on any day. Even some of the money market fund managers admit that if we are leaving the market roughly in balance each day, that really addresses their concern, even if we are not addressing their individual set of leaky pipes, if you will.

But if demand for Treasury securities becomes sufficiently high to push the general collateral rate on overnight repos toward zero for a prolonged period of time, that could create a negative spillover on confidence and the functioning of financing markets. If that were the case, we might then want to consider undertaking matched sale or reverse repo transactions in order to add to the supply of Treasury collateral available in the market. But we'd look at the systemic issue of the functioning of the markets, not whether some money market funds feel they are missing out on a few basis points in their return.

Mr. Chairman, we had no foreign exchange operations during the period. I will need the Committee's ratification of our domestic operations. I would be happy to answer questions on any aspect of my report, including our year-end operations.

CHAIRMAN GREENSPAN. Thank you. Questions for Peter? President Broaddus.

MR. BROADDUS. Peter, with respect to the last point, I remember that about a year ago-- or maybe not that long ago--we talked about your securities lending program. Are you going to use that at all in the year-end program? Would you use that if you had a shortage of collateral?

MR. FISHER. Earlier this summer we raised the amounts we're auctioning off through that program and it is in a sense on autopilot. Without getting too far into the arcana, that program actually is one of the things I'm worried about. We price that at a negative spread, 150 basis points off of the general collateral rate. If the general collateral rate were to trade down toward zero because of the scarcity of Treasury collateral, we could be running with a negative rate there, which we would have to think through. That's not somewhere we'd want to go. While that's on autopilot and will be available to the dealers, it really will not address a systemic issue--if, say, all Treasury securities were trading at such a premium that they were being financed at rates approaching zero. It helps at the margin, but it is not going to be an answer. That's one of the issues of concern. We are consistently providing supply through that program at predictable amounts, which we spent a

long time designing it to do. The dealers are happy with that. If we divert our supply of Treasury bills into some intervention in the market, we'll then be crimping what we can put out through that structured program. So that's exactly one example of the issues that create complexities for us in the matched sale area.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Don Kohn in the Bluebook discussion and you in your discussion of the weekly data referred to the rather positive impact, in terms of spreads and so forth, of your announcement of these year-end facilities to deal with Y2K uncertainties. But there has been a bounceback subsequent to that. What do we know about that? Is that Y2K-related or is it reflective of credit market conditions?

MR. FISHER. I think two factors are involved that are hard to put one's finger on. Traders at many different firms have talked to us about the fact that our options program provided them some relief but in their minds provided the Committee with more flexibility to raise rates in November and December. As I say, they talk about that, but it is hard to find evidence of it in the fed funds futures pricing. The other factor is that as we approached September 30<sup>th</sup>, a whole host of contracts--like the 3-month Libor I showed on my first chart--then captured the year-end date. And all sorts of rates traded up in sympathy with that year-end pressure--some rationally and some maybe not so rationally. I think that had a general and pervasive effect on a lot of interest rate pricing. Those are the two stories that I can cite.

MS. MINEHAN. But do you really have a sense that some of the--I don't know how to characterize it--feeding frenzy or hysteria has abated a bit?

MR. FISHER. The dealer firms certainly now feel a little more comfortable that they have a flexible tool or "flood insurance" to manage their balance sheets at the end of the year. I think that has put them in the position that they can't turn around and tell their customers, "Gee, we just can't do anything for you." It has forced that discussion, rather awkwardly, clearly onto price. That may be having a spillover effect in some of the interest rate markets. It is all about price now; it's not about availability. That's how I would put it.

CHAIRMAN GREENSPAN. Concerning the issue of liquidity, is "flood insurance" the appropriate language? [Laughter]

MR. FISHER. I'm sorry. I got that term in my mind in late August and I should take it out again. I have some neighbors who had some serious flood damage who didn't have flood insurance.



MR. HOENIG. Call it drought insurance.

MR. KOHN. I would just add that I think one important reason the swap spread came down and stayed down was the announcement effects on the mortgage-backed securities market in particular, which is closely related to the swap market. But another reason was that the flood of issuance that had been anticipated for September really did not happen. And one of the things we're hearing is that issuers are a little more relaxed about the possibility of coming to market in October and November. So, we are hearing less of those stories about people believing they had to get all their financing done before September was over or at least before October was over. At the very least one could say that the frenzy hasn't gotten any worse. Things may have calmed down a little. But the spreads that you cited suggest that people are still being very, very cautious about extending credit--particularly unsecured short-term credit over the turn of the year. That is where the risks are.

CHAIRMAN GREENSPAN. Further questions for Peter? If not, who would like to move approval?

VICE CHAIRMAN MCDONOUGH. Move approval of the domestic operations.

CHAIRMAN GREENSPAN. Without objection they are approved. Shall we move to the staff reports of Mr. Prell and Ms. Johnson?

MR. PRELL. Thank you, Mr. Chairman.

As we noted in the Greenbook, the information received since the last meeting has strongly confirmed the notion that the low GDP growth reported for the second quarter grossly overstated any moderating tendencies in the economic expansion. Indeed, the data available as of last Wednesday persuaded us to raise our sights regarding the pace of output growth over the second half--bringing us back up to the 3.7 percent Q4/Q4 total that we discussed in the midyear Chart Show.

The incoming statistical data and the anecdotal evidence found in the Beigebook paint a fairly consistent picture of robust private domestic demand in recent months. Consumer spending has continued to rise at a fairly brisk pace, with the advance of light vehicle sales to around the 17 million unit mark underscoring that households remain confident enough to tap into their accumulated assets or borrow to finance their purchases.

The same positive fundamentals seem to have buoyed the residential real estate market well into the summer in the face of higher mortgage rates. The initial estimate of August new home sales that was released late last week and showed them rising monotonically since the spring, likely was biased upward by some technical problems. But, that said, it's our assessment that demand for homes will

be subsiding only gently over the remainder of the year and that a backlog of projects will help to sustain building activity.

The biggest surprise of the third quarter was the apparent acceleration of business fixed investment. I say "apparent" because there are considerable gaps in the source data in hand, and these numbers can be quite erratic. But the strength of the computer and communications equipment industries seems pretty clear, and shipments from that sector likely paced a large increase in overall equipment spending.

Finally, on the private spending side, the fragmentary evidence suggests that inventory investment picked up this summer from the very low pace of the second quarter. Still, by all reports, stocks remain comfortable, if not lean, overall, leaving room for further appreciable accumulation in the coming months.

All told, then, there's no reason to doubt that domestic demand has retained substantial positive momentum into the fall. Moreover, as Karen will be discussing, improving foreign economies are giving an increasing lift to our export sales. Though some of the demand in the economy is leaking abroad in a very steep rise in imports, there's enough left over to this point to provide ample impetus to domestic production.

Indeed, under the circumstances, one might reasonably ask whether our projection of a slackening in the pace of expansion in the coming year, with only a little further policy tightening, is realistic.

In responding to that question, I want to begin by noting that, as impressive as the economy's strength has been of late, it does appear that the expansion actually may already have moderated somewhat this year. On our estimate, real GDP growth thus far this year has been about 3½ percent, at an annual rate, versus the 4¼ percent increase registered in 1998 as a whole. Granted, this is a thin reed statistically--perhaps especially on the eve of a major revision of the national income accounts--but it's certainly not at odds with our longstanding expectation of deceleration.

Furthermore, a little of the strength in demand we've observed lately could be a Y2K phenomenon, and thus inherently transitory. We highlighted in the Greenbook our hunch that the recent surge in computer sales was in part simply a more exaggerated version of the story of information system remediation and then lock-down than we previously had allowed for. Likewise, it's also possible that the economy is already beginning to feel the effects of Y2K-inspired precautionary stocking by households and businesses.

That said, I wouldn't push either of those points very far. And I'd give at least as much consideration to what may be one of the major upside risks to our forecast of moderating aggregate demand in the intermediate term. As we've emphasized, that forecast hinges importantly on the flat path for equity prices that

we have anticipated. To be sure, past, and what we have assumed to be prospective, increases in interest rates imply some restraint on activity going forward. However, that restraint--occurring against a backdrop of a depreciating dollar, a rebounding world economy, and a somewhat more expansive fiscal policy--doesn't seem great enough to outweigh the impetus to demand that would be supplied by a resumption of a stock market rise even remotely resembling the average performance of the past few years.

As we indicated in the Greenbook, we can see a rational basis for anticipating an even weaker market than we've built into our forecast, but we've said the same in the past, only to be trampled by the bulls of Wall Street. From a policy standpoint, it would seem a central issue whether you want to bet on this recent correction being a major break-point in the market trend, or whether you will want to take the initiative yourselves to impose some added restraint on demand.

Obviously, there would be no reason to worry about restraining demand if it weren't for the danger of an unsatisfactory inflation outcome. In our forecast, that danger is manifest. However, a forecast is a forecast; it's not a fact. And the facts are ambiguous at this point. The broadest measures of goods and services inflation have picked up this year, but if one parses the indexes, the story is the sharp reversal of oil prices. Indeed, some measures of "core inflation" have even slowed--for example, the CPI excluding food and energy.

One must of course exercise some caution in engaging in such slicing and dicing in the effort to assess the underlying trends. It usually makes sense to try to filter out the noise in short-term movements in indexes like the overall CPI that stems from erratic elements like energy prices; but this becomes an increasingly risky approach when you do it over ever-lengthening time spans. At some point, you have to take the overall price measures as the better indication of the macro phenomenon of inflation.

Put differently, over time the movements in energy prices influence those of other prices--either through their effect on production and distribution costs or as a factor influencing wages. In this regard, last year's sharp drop in oil prices probably contributed significantly to this year's favorable wage and price performance, and this year's even sharper run-up in oil prices is likely to leave its mark on wages and core prices in coming quarters.

We can already see some of that effect in the behavior of intermediate materials prices. The PPI for core intermediate materials has risen considerably in recent months and the September jump in the NAPM index of prices paid probably bodes ill for the PPI measure in the near term.

Items for which petroleum is an important input have played a significant part in this surge. But oil isn't the only factor. Another is the strengthening of foreign economies and the peaking of the dollar on exchange markets. These have brought a cessation of the declines in core non-oil import prices that we enjoyed in 1998 and

early 1999. This undoubtedly has contributed to the pickup in “pipeline” inflation. If our expectations about foreign growth and the dollar prove correct, one can anticipate a further lessening of the disinflationary force from the external sector.

That still leaves the crucial questions of productivity and compensation. Recent productivity developments have been pretty much in line with what we would expect, given the strength of output and our basic assumptions about the “trend” of output per hour. On the other hand, they cannot be said to rule out a still more optimistic view that structural improvements in efficiency are in an ongoing escalation, which might translate into a temporarily more favorable trade-off between unemployment and inflation. This is one of the issues that we shall have to review carefully when we get the revised NIPA data at the end of the month.

As regards pay rates, the most recent average hourly earnings figures have shown no intensification of wage inflation--quite the contrary. But there have been some disturbing signs as well. On the benefits side, it's becoming increasingly clear that health insurance premiums are in a substantial acceleration. And the recent auto agreements, coming on the heels of the Boeing settlement, suggest that labor has gained some bargaining power in a tight economy. With Congress seemingly headed for an agreement to raise the minimum wage next year and this year's higher consumer price inflation likely to be showing through in pay decisions, there is in our view a likelihood that nominal compensation will accelerate.

Thus, though there clearly are many interesting things going on in terms of technological innovations and other changes in the business environment, under the present circumstances we think the odds favor an upward drift in inflation over our projection period.

MS. JOHNSON. The basic message from the external sector this round is that economic activity in the rest of the world seems to be strengthening even more than we--and most other forecasters--had expected. There were several positive surprises concerning activity in the second quarter, such as small, positive real GDP growth in Japan and double-digit growth in some emerging market economies in Asia. Some signs to the contrary--for example in Brazil the recent weakening of production and court decisions just announced on Monday that appear to be at least a partial set-back in the fiscal reform process--have tempered our optimism. Nonetheless, on balance we have raised our projection for foreign output growth through next year and we expect additional firming in 2001.

As described by Peter Fisher earlier, the yen/dollar rate fluctuated quite widely during the intermeeting period. In part, these fluctuations reflect swings in views on the current cyclical position of the Japanese economy and its outlook for growth over the rest of this year and next. The positive change in second-quarter real GDP reinforced the impact of the very large first-quarter number and contributed to a general reassessment in asset markets and among forecasters, including the staff. Moreover, some indicators that have been released since the Greenbook was completed suggest that we may still have been overly cautious in

our thinking about the very near term for the Japanese economy. During August, industrial production surged and housing starts posted an unexpectedly strong rebound from July's steep decline. Unemployment edged down in August.

However, the Tankan survey of business confidence, just released yesterday, seems to have partly disappointed the markets. Whereas there was a sizable, positive swing in sentiment for large manufacturing firms, outside this sector and for the total index the shift was much less. Importantly, firms in the survey continue to plan large cuts in fixed investment expenditures, consistent with their outlook for negligible sales growth.

On balance, we judge our upward revision to the forecast for real output growth in Japan to be appropriate and we might even shade up the numbers for the rest of this year and both 2000 and 2001 in response to the additional data. Nevertheless, we retain the view that expansion will slow from its rapid first-half pace to around 1 to 1½ percent over the forecast period. That assessment reflects our continued serious concerns about the underlying strength of Japanese domestic demand, particularly private investment, given headwinds from corporate restructuring, persistent difficulties in the financial sector, and possible loss of confidence as a result of yen appreciation over the past year.

There have also been some additional positive indicators for near-term activity in Europe and Canada in the past few days. Canadian production in the third quarter appears to be above expectations. The latest survey data for the United Kingdom and the euro area reinforce the upward revisions that we made to their forecasts and suggest possible upside risk for real output growth in Europe.

This recent evidence confirms a stronger picture for prospects in the industrial countries and complements the substantial upward revision we made to the Greenbook forecast for the Asian developing economies. With foreign output--aside from small fluctuations owing to Y2K--set to grow somewhat below the extremely rapid rate of the first half of this year but at a robust pace over the forecast period, we see U.S. export volumes expanding at rates much above the pace of last year and the first half of this year.

The change in the relative cyclical positions of the United States and our trading partners is one of the factors behind our thinking in incorporating a depreciation of the dollar into the forecast. With other global problems attracting reduced attention, we expect that the large and expanding U.S. external deficits will contribute to market sentiment for declines in the dollar as well. With no basis on which to predict the timing of an abrupt dollar change, we have projected a moderate move down in real terms of the exchange value of the dollar spread over the forecast period. This dollar depreciation should add to the projected improvement in our export performance. As a consequence, we see the external sector as continuing to subtract from GDP growth, but at a much reduced pace, over the forecast period.

We'd be happy to answer any questions.

CHAIRMAN GREENSPAN. Questions? President McTeer.

MR. MCTEER. We keep hearing that the yen's appreciation is a result of expectations of a stronger Japanese economy. You just indicated sort of the opposite as far as the United States is concerned--that the change in relative cyclical positions is expected to cause the dollar to depreciate. Why the difference? Why is Japanese strength supposed to strengthen the yen and relative U.S. weakness weaken the dollar?

MS. JOHNSON. Well, I think the directions are consistent. Generally speaking I would attribute it to expectations about the interest rate consequences of stronger activity in the one economy, not necessarily weaker activity in the United States. The relative change is all that is needed. If the rest of the world begins to operate closer to capacity, those countries will experience a rise in interest rates owing to demand effects and to possible monetary policy responses that will come. We've already seen rumors in the markets about action by the European Central Bank, with some people even speculating that it will come as early as Thursday. That seems to be very early in the process of some strengthening in Europe. But it's that expectation of relative monetary policy moves and relative interest rate changes that would feed through into the exchange rates.

MR. MCTEER. Capital accounts are becoming more important than current accounts?

MS. JOHNSON. Well, more important, less important. The current account goes the same way in that such a move in exchange rates would tend to lessen surpluses that are apparent in Europe and Japan and remedy to some extent deficits in the United States. So in that sense these factors are not in conflict but are just reinforcing one another.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Karen, the recent Greenbook forecast of real GDP for China indicates growth of 3.4 percent in 1999 and 5.4 percent in the year 2000. Of course, those growth rates are much below what China had experienced in the previous five years or longer. Is that consistent with a gradual, as opposed to a sharp, decline in the value of the renminbi, continued reform of state owned enterprises, and further financial modernization?

MS. JOHNSON. In our view, the Chinese authorities will make a discretionary decision about the renminbi. Because of their very strong reserve position and the fact that they are still running surpluses, we don't see market forces triggering an event there. So the decision that they will make at some point in time to introduce some flexibility in their exchange rate is something

over which they have more control than some other monetary authorities might have. Even so, they may decide to make a one-step adjustment. We are not presuming to rule that out. It is just impossible for us to know whether that could be their choice and when they might actually act. So, for forecast purposes we tend to put in a smooth adjustment, but in no sense does that mean that we are betting that that is the way it will necessarily happen and that it will not happen in one or two steps. It is the political process within China that might lead to a quicker reaction, as slower growth creates pressures on employment and standards of living and political support for different factions in China. As the effort to continue reforms for the state-owned enterprises is in conflict with that--and to create a source of demand to offset perhaps the spillovers from the dilemmas with the state-owned enterprises--I think they would choose at some point to introduce some exchange rate flexibility. But exactly when and how is more than we are prepared to take a position on.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. I'd like to pursue a bit more the question that Bob McTeer raised about the role of the current account. We certainly do hear discussion about the exchange value of the dollar moving in the direction of becoming weaker, given that the U.S. current account is in such a substantial deficit. Let me focus on Japan and give you a back of the envelope calculation, which I am sure you can correct, to convey the nature of my thinking on this. Japan, of course, has a large current account surplus. But my instinct is that to a large extent that reflects the fact that the economy has been so weak and, therefore, import demand is weaker than it otherwise would be.

Let's suppose--and this is the back of the envelope calculation that you can fix--that Japan is operating at 10 percent below potential in terms of output, and suppose its propensity to import is 0.15. If Japan were operating at full capacity, imports would be 1½ percent of GDP higher and its current account surplus would be a whole lot lower. And the case for the yen to appreciate would be weaker because the current account surplus would suddenly look quite different if Japan were importing a whole lot more. Obviously, this analysis applies to the United States as well. In part, the deficit in our current account reflects the fact that exports have been weaker than anticipated because so many economies around the world have not been doing very well. So, although it is true that revival abroad will raise interest rates abroad and its effect on the capital account will tend to weaken the dollar, it is also true that the demand for U.S. goods will rise quite substantially. Can you give any sense, just in the context of the Japanese example because that is where the focus of

attention is right now, how much of the Japanese surplus is a consequence of the fact that their economy has been going nowhere for a decade?

MS. JOHNSON. I hesitate to attempt to do the arithmetic on the spot. My guess is that we would probably say that 10 percent is too large an estimate of the output gap in Japan, in part because a whole decade of largely reduced capital accumulation has had a bearing on the size of that gap. And with labor force growth essentially zero at this point, we see Japanese potential as radically different from what it had been in previous decades-- perhaps as low as 1½ to 2 percent or something like that. But let's say for the sake of argument that Japan could grow at 5 percent, the gap is 5 to 6 percent, and its rate of growth could rise steeply. It could be 2 or 3 years before they close the gap. Japan's propensity to import is not as strong as that of some other countries, and I think it is probably unit elastic on income. That would be my guess, so an increase in imports could well occur. The dilemma is that to the extent Japan can close the output gap, that feeds through and no doubt has a positive effect on the U.S. economy. Indeed, our stronger export picture in this Greenbook does lead to our net export contribution becoming almost zero by the end of the forecast horizon. But for Japan, the greater vigor that such a scenario--growing at 2 to 3 percent for three years, closing the gap, and then growing at potential--would impart to the domestic economy, would make Japan a much more attractive place for Japanese investors to invest than the United States. Thus, their investment in the United States would slow. So even though there is a reduced current account surplus, each and every month Japan will have to make net investments in the rest of the world. And that will fight the tide, as it were, of a Japan that seems to be the place that is gaining cyclical vigor but where interest rate and exchange rate adjustments nonetheless make it look like a good idea for them to invest abroad. So while it is true that these adjustments through the income channel in some sense add to the capital account problem, there is a need for interest rate and exchange rate adjustments that attract money out of Japan despite its cyclical strengthening. How all that balances out will depend a great deal on risk premiums, expectations, and investor preferences. And we do not claim that the number we've written down is in any sense the result of a truly analytical calculation. We have tried to indicate what we think is the general direction and we put a magnitude in there that will show through. But the econometric art of balancing these things and their effect on the exchange rate is in the Dark Ages somewhere.

MR. POOLE. Not for want of trying.

MS. JOHNSON. Right.



MR. POOLE. I understand that.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Speaking of prospects for Japan, what is the current and prospective state of play of policy in Japan these days, including their attitude toward intervention, either unilateral or joint?

MS. JOHNSON. Of course, that attracted much attention over the weekend of the G-7 meeting and the preceding week and was a factor in some of the buffeting of the yen/dollar rate that occurred. At the moment they apparently have no plans for intervention. Just today, for example, a Japanese official--I've forgotten exactly which one--was quoted as saying that if the yen were to stabilize in the 105 to 106 yen/dollar range, intervention would not be necessary. So that was the latest statement from them. And that's perhaps indicative of the fact that their propensity to talk is higher than might seem constructive.

We see fiscal policy coming through with a supplemental budget large enough to yield the forecast that we have put in the Greenbook. We have a view of when it will happen and how much it will be, but that is designed to give us the forecast that we have here. We believe Japanese authorities have committed certainly to an additional supplement this fall. And we believe that they will have another next year, given the huge negative shock that would occur were that not to happen. We think that such a policy will have smooth sailing.

The Bank of Japan seems to be considering some alternative monetary policy measures in order to get reserves out into the economy more effectively than with their present procedures; the latter leave a lot of excess reserves in the banks and in these broker firms called Danchi who just tend to sit on them. In their mind that practice is futile. There is no point in adding to those reserves; they are not doing anything. And the Bank of Japan has stated on several recent occasions that it does not want to do that. So they have suggested that they are considering some alternatives that might be available to them should they decide they need to find a way to ease even further. They have discussed perhaps doing foreign exchange swaps, which would be to some degree focused on the yen/dollar exchange rate. But those actions would be at the discretion of the Bank of Japan and its policy board as opposed to a decision of the Ministry of Finance.

In the last couple of days, they have been leaving 1½ trillion yen in excess reserves in the system instead of 1 trillion yen, which is something they said they would not do or did not see the

point of doing. And they have been explaining those on the grounds of seasonal factors relating to the end of the half fiscal year. So in principle they could leave in 1½ trillion instead of 1 trillion yen or maybe decide to implement some of these additional tools. I think they are at least trying to give the market the impression that there are other possibilities. They are stepping back a bit from the statement they made on September 21<sup>st</sup> that suggested there were no options and they were not thinking about any options. There will be another meeting of the policy board on October 13<sup>th</sup>. I don't know that we will get a statement from them that soon, but we might get one indicating that they are prepared to take certain actions if needed. That's what I would look for. At the moment the market seems to think that such a statement or such a modification in their policy course is a possibility.

CHAIRMAN GREENSPAN. Are there any further questions for either of our colleagues? If not, would somebody like to start the general discussion? President Broaddus.

MR. BROADDUS. Of course, the principal development in our region since the last meeting was hurricane Floyd. It did some damage in eastern South Carolina but, as I am sure you know from the news reports, the brunt of the storm was borne by eastern North Carolina and the coast of Virginia. Apart from the resort areas on the Outer Banks, I would describe eastern North Carolina as a moderately depressed, thinly populated, agricultural region. It contrasts very sharply with the central part of the state where so much is going on. So, while the farmers and others who were hit directly by the storm are really devastated in many cases, at the end of the day I don't think the overall impact on the District's economy is going to be that great. And any impact at the national level is likely to be relatively small. I gather the staff does have a slight increase in its housing starts forecast to cover the rebuilding, and I think that is about right.

Apart from that situation, as far as the District economy as a whole is concerned, the story is basically the same old story I have been telling you all year. We don't see any signs of a significant slackening in demand in our region. We do a monthly survey of retail activity, and when we conducted that survey in August we detected a little deceleration in spending. But sales came back very strongly in September, so the August report was probably noise. Demand is strong essentially across the board, especially for automobiles but also for furniture and other durables, for soft goods--you name it. All of our directors and other contacts who sell to consumers, or know people who do, have stressed the extraordinary strength of household spending at this stage of the expansion. A lot of them refer to it as a household spending "binge," and nearly all doubt that it can be sustained.

Elsewhere, labor markets remain very tight in our region. We continue to hear a lot of individual reports of sizable wage increases in certain markets, though I wouldn't say that is the general pattern. The bottom line on the District is that if you are not under water, you are probably doing pretty well, at least for now--and maybe too well.

In a broad way, as I read the Greenbook and listened to the staff's comments this morning, I think that description applies to the national economy as well. It seems clear at this point that economic activity in the third quarter was a lot stronger than we thought it was going to be when we discussed it at our August meeting. All indications are that household and business spending were truly robust across the board in the quarter. As we all know, a lot of that spending spilled over into imports, and that propensity seems to have intensified recently. The current Greenbook projects that real net exports will reduce GDP in 1999 by 1¼ percentage points as opposed to 1 percentage point at the time of our August meeting. Also, the exceptionally strong demand for cars and for computing and communications equipment has revived the manufacturing sector very nicely. The level of industrial production in August, I think it is worth pointing out, was 1¼ percentage points above the second-quarter average. That's about 4 or 5 percent at an annual rate, and that is a lot! So the growth of aggregate demand is continuing to outstrip the growth of potential GDP, it seems to me, further straining labor resources. According to the Greenbook, aggregate hours worked currently exceed the second-quarter average by close to a percentage point--that is not annualized--and that also is a lot. So for me at least, it is very hard to see how these trends can continue.

As I see it, a couple of things principally have allowed the economy to sustain this boom situation to this point without any run-up in inflation. I doubt that this is news to any of you, but I think it is useful to point them out. Clearly, it's basically two things. First, higher productivity growth has enabled firms to pay the higher wages needed to attract additional workers in these very tight labor markets. If nominal wage increases at some point begin to exceed the growth in productivity, I think we would have a problem. We would have a profit squeeze that would likely produce some combination of higher inflation and declining stock prices. Second, imports, supported by capital inflows, have been a safety valve as I see it, relieving some of the pressure we otherwise would have experienced in labor markets. That valve would tighten if net exports were to improve, and we do have a projection of higher U.S. exports in the current Greenbook, given the signs of revival in Asia and Europe and the weaker dollar. I believe we need to keep a very close watch on both of these factors, which have been supporting our noninflationary expansion. If

either gives way, it seems to me that the expansion will be threatened. And the perception in some quarters is that they are weakening; I think that has been a factor in the recent decline of the stock market. What I worry about is that things could unravel pretty quickly if these pessimistic perceptions were to build rapidly. And I don't think we necessarily have a lot of time to react once a process like that gets under way. So, bottom line, I think we need to be especially vigilant at this stage and in my view we at least ought to consider seriously a further preemptive action later in the meeting.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. In line with Al's comments, I'd say the most significant thing that has happened in New England recently had nothing to do with floods, thankfully, but with a golf game, the Ryder Cup tournament. We've seen the impact on the economy of that, but certainly there was an impact from national and international press coverage--not necessarily all favorable, I should add, for the New England District.

The District economy overall continues to expand at a moderate pace. In fact, there are a few straws in the wind that suggest that growth is picking up and that wage and price pressures are as well. In particular, while manufacturing jobs continue to decline on a year-over-year basis, the August data showed an increase, which likely reflects an upturn in regional merchandise exports. Second-quarter figures show a rebound in exports, particularly to Singapore and the crisis areas of Asia and to Mexico. So this one rather weak part of the New England economy is starting to look brighter again. Indeed, anecdotes from our Beigebook contacts suggest that many manufacturers believe that the worst is over in terms of their trade with Asia and that the future bodes quite well.

Labor markets in the region remain extremely tight and even manufacturing firms report difficulty in hiring and retaining production workers, a trend that is likely only to get worse as regional exports grow. The regional unemployment rate hit 3 percent in August, which equals its low for the expansion and is the lowest rate since 1988. Beigebook contacts in every industry reported shortages of workers at all skill levels, from technical to production to office and secretarial workers. Temporary employment firms contacted in September reported a continuation and deepening of earlier trends: solid growth in their business revenues, with a potential for much greater returns if an additional supply of labor could possibly be found. Temporary help firms are actually recruiting. Some are using signing bonuses but most are trying to tap new sources of workers such as retirees, the otherwise unemployed--including former welfare recipients--and even

refugee populations. We also hear from temporary firms that they are doing some retraining of workers themselves.

The tourism industry has been particularly hard hit by labor shortages. Members of the Bank's small business New England Advisory Council reported that restaurants and other tourist-related businesses in southern Maine were forced to close a couple of days during the week over this past summer because there just was not sufficient staff to keep them open. This situation became increasingly difficult in late August when college students left for school. Looking at the other seasonal industry, the ski resorts, one ski area owner reported that he paid the summer medical insurance premiums for key seasonal workers and their families in order to ensure that the workers will return this winter.

Given the tightness in labor markets, the continued commentary in the Beigebook of moderate wage increases in the range of 3 to 5 percent remains a bit of a puzzle. Indeed, we are seeing some increase in manufacturing wages in the aggregate regional data and an increase in the rate of growth in the Boston CPI. In addition, manufacturing contacts report that input price increases are now more prevalent than decreases, which is a shift from earlier reports. There is also a concern about accelerating costs for health insurance. Businesses in the region appear to be fighting to retain control of costs and are linking compensation to revenues as much as possible. While it is hard to see it yet in the aggregate data or to reconcile it with the reports of moderate wage increases, one gets the sense that they may be slowly in the process of losing that battle on both the wage and the raw material sides. One area of the region where the battle clearly has been lost is real estate, both residential and commercial. The Boston office market is red hot, with very low vacancy rates and rising rent prices. It is not likely to get much better even with new construction since the vast majority of new space under construction is already leased. Beyond Boston, the suburban office markets are vibrant as well. Even the long depressed city of Hartford is staging a comeback, with lower vacancy rates and rising prices. Finally, the prices of residential real estate continue to climb at a faster rate than for the nation as a whole.

Turning to the nation, we have no major disagreements with the Greenbook forecast. It is quite similar in shape to our own. Incoming data on the real domestic economy are considerably stronger than we and others had expected earlier in the year, and we see considerable momentum through the last part of this year and into 2000. Foreign growth is surpassing expectations, and rising exports are bringing manufacturing back to life after the Asian problem. Indeed, it would seem that all the temporary factors that acted to restrain price increases in the face of extremely

tight labor markets and above-trend growth--declining commodity prices, excess world capacity, the strong dollar, declining health benefit costs--are now slipping away. Will increased productivity growth save the day? Can we really count on stabilization or decline in the stock market and widening credit spreads to rein in consumer and business spending? Even if we can count on productivity growth and stock market restraint, that really only puts us in line for what looks like a considerable upturn in prices next year, if one believes the Greenbook forecast. Should one believe the Greenbook forecast? Is this forecast of increasing price pressures more believable now than it was earlier this year, or a year ago, or even two years ago? My own view is that it is more believable because of the waning effects of the beneficial temporary factors and the beginnings of pipeline inflation that Mike Prell referred to in his comments. Moreover, we are clearly running the risk that the very strong rates of near-term growth could exacerbate rather than damp the imbalances reflected in unrealistic asset prices and in high and growing levels of consumer and business debt.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the Twelfth District's expansion has gained momentum since early in the year. Following moderate growth in the first quarter, job growth picked up to a 2.8 percent rate during the second quarter and that pace was maintained in July and August. Economic activity has been expanding more quickly in California than in the rest of the District. This has helped California attract jobs and residents from other states and has spurred substantial gains in construction activity. Nonetheless, conditions outside of California have remained robust. For example, Nevada's economy has picked up steam recently with gaming revenues growing at their fastest pace since 1994.

Rapid job growth has tightened District labor markets. After remaining roughly constant in 1998, the District unemployment rate has fallen by ½ percentage point so far this year. This is due to improved conditions in California where the August unemployment rate of 5.1 percent was the lowest recorded since 1969. Although the unemployment rate remains higher in the Twelfth District than in the rest of the nation, labor compensation costs have risen more rapidly in the West, with a strong upward trend evident over the past several years. Moreover, tight labor markets have prompted employers to find alternative methods for attracting and retaining workers. These methods include the provision of on-site benefits that conserve workers' time and enable them to spend more hours on the job.

Despite strength in the economy as a whole, the District's high-tech and aerospace manufacturers face significant challenges. California's makers of semiconductors have begun expanding again, but employment in that industry remains below its peak of early last year. Manufacturers of computer equipment throughout the District have continued to shed jobs in recent months, with makers of disk drives being especially hard hit. Moreover, the recent earthquake in Taiwan interrupted that country's extensive semiconductor and computer equipment production and that has clouded the outlook for prices and the availability of computer components in the fall and winter. In the aerospace sector, Boeing is well on its way to its target of 53,000 job cuts by the end of 2000, having eliminated about 35,000 since early last year. Most of these cuts have been in Washington State, but the rate of reduction picked up recently in Southern California where Boeing is phasing out several models of aircraft that it inherited from McDonnell Douglas.

In contrast to the computer hardware and aerospace sectors, computer software and service providers have been expanding employment and output at a torrid pace. That has caused total employment growth in the Seattle area actually to pick up in spite of the cuts at Boeing. It also has kept Silicon Valley's economy healthy despite job losses in the hardware sector. As a result, housing prices in Silicon Valley rose about 15 percent during the 12 months ending in July.

Turning to the national economy, the data made available since we met in August certainly suggest that the supply shock of recent years has not yet run its course. Based on recent monthly data, we have revised up our estimate of third-quarter real GDP growth from 3½ to 4½ percent, similar to the projection in the Greenbook. This has combined with favorable news on the core CPI in August, which brought the most recent 12-month increase to just under 2 percent. This apparent supply shock makes forecasting especially treacherous, but our best estimate continues to show a modest slowdown in the rate of real GDP growth next year. Under the assumption of no further change in the federal funds rate, we now project a 3 percent increase in real GDP in 2000 as domestic demand slows in response to the recent tightening of monetary policy, combined with an assumed flattening of the stock market's trajectory. Growth at this pace would leave labor markets tight next year and continue to indicate upward price pressures. We are showing a 2½ percent increase in the core CPI next year despite a slowing of GDP growth to just below trend. And with labor markets projected to be tight through the end of 2000, more upward price pressures would be forthcoming in 2001.

Obviously, there are a number of important risks to this outlook. First, the modest drop in the dollar and a pickup in foreign growth could add significantly to inflationary pressures if they

were to gain momentum. Second, the recent modest drop in equity prices reminds us that the economy remains vulnerable to a much larger stock market correction from today's very high levels. And finally, there is simply no way to determine the size or persistence of the current supply shock. A review of forecast errors in recent years indicates that this shock has consistently surprised us on the positive side. Although we don't know how long the supply shock will last, I don't think there is reason to believe it has ended yet. Its continuation, supported by recent data, reduces the chance of an inflation problem in the foreseeable future. Thank you.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. Although the overall pace of growth in the Southeastern region appears to have moderated, our economy still seems to be on a path that is slightly above that of the nation as a whole. Our important and thriving Florida tourism industry dodged the Hurricane Floyd bullet with only a modest temporary impact, including the closing of Disney World for the first time in its 28-year history. Perhaps I should publicly apologize to my friends in North Carolina for wishing the storm would go somewhere else and having it end up there.

MR. BROADDUS. I'll pass your apology along!

MR. GUYNN. Our energy sector finally seems to be responding to the higher oil prices with some pickup in oil and natural gas drilling, but the increased rig count has not yet had much trickle-down effect on the boat-building and other support businesses. Our contacts in that industry still say, however, that the major players in the business are giving higher priority to drilling in other parts of the world and are somewhat distracted by their mergers.

The moderation in our region is coming from a couple of places. Single-family residential home building and sales have slowed measurably in all of our areas except Florida. Manufacturing activity is a mixed bag. A regional survey of manufacturers in August showed some slowdown in both current activity and in the outlook. This is reflected in our port activity, which is still very unbalanced, with imports continuing to flood in while exports have been slow to respond.

One more time: Labor markets remain very tight. Some say they are even a bit tighter than earlier in the year. Unusually large wage increases still seem primarily confined to services at this point. As has already been commented on by a couple of others, reports of large health insurance cost increases have become more prevalent, and people in that industry say, "Get used to it." One of my Rotary Club colleagues told me yesterday at lunch that if we are waiting to find the flow-through effect from higher oil prices, he clearly sees it in the added cost of his asphalt business.



Our staff members who talk to contacts just before each FOMC meeting were struck by, and remarked on, the noticeable lack of comments this time around about competition holding down price increases. That had become a very predictable message. And it gives me some pause to think that these competitive pressures, perhaps attributable now to rising prices for some competitive imports, may be abating and fueling the hope for some long postponed price increases.

On the national level, as others have already observed, most of the current data surprises have once again been on the upside, and the overall strength of the economy has been much greater than I expected at the time of our last meeting. The Greenbook does a good job of highlighting where that strength is coming from.

I found myself during most of the intermeeting period getting more comfortable with the notion that large productivity gains are very likely still ahead of us. In the absence of compelling data to make that case, we have pressed our 44 District directors for two months now for their sense of where those productivity gains are coming from and what is ahead. Almost without exception we are told that we may have seen only the tip of the iceberg in terms of the long-term potential of inexpensive computers and communications technology. We have been given examples of the opportunities that are still ahead for all kinds of businesses, large and small. Having said publicly that I was skeptical that we could fully count on the continuation of recent large productivity gains, I am getting more comfortable that higher productivity and, therefore, a higher rate of economic growth may be more sustainable than we thought.

I also began to take some comfort in the unfolding inventory story. Here again, we have turned to our District directors for some business insights into what is really going on. Interestingly, the overwhelming consensus is that the recent inventory rundown is likely permanent. The reasons given are heavily dependent on the spread of technological advances in communications and the broad use of more sophisticated analytical approaches to inventory management. Equally interesting was the fact that most of the people we have been talking to about this feel that the process is not nearly complete. These insights suggest to me that we may not get large additional stimulus in the period ahead from inventory building and that we may be less burdened with an inventory overhang following any correction in the future.

These comforting insights into productivity and inventory management, taken along with the direct and signal effects of our two recent tightening moves, were giving me the sense that we might have some breathing room with policy for the moment. However, the FOMC meeting preparation period this time has rekindled my uneasiness about what may lie ahead. I do not like

the run-up in inflation forecast in the Greenbook. I do not like the same run-up in inflation forecast in my own staff's analytical work, including the signals of higher inflation given by our VAR model--even adjusted for the extraordinary energy price increases. And these forecasts based on the analytical work are not inconsistent with the unfolding story of continued strength in so many sectors of the economy. We see continued strong job and income growth, continued strong consumer and investment spending, persistent strength in housing, an improving outlook for exports, prospects for higher-than-expected government spending, and indications of price pressures in some recent data and anecdotal reports. Monetary policy may still be too accommodative, so we have a more difficult, more interesting, and more important policy discussion ahead this morning than I thought likely just a couple of weeks ago. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Thank you, Mr. Chairman. The regional economy for the Philadelphia District continues to operate at high levels, with tight labor markets and benign inflation. Consumers are spending freely. The market for homes is robust. Recent increases in mortgage rates have caused more homebuyers simply to shift to variable rate mortgages. Commercial real estate is also very active, with low vacancy rates for office buildings. Some uptick in rents is occurring, although given the amount of new building there is a consensus that the increases may be short-lived. Manufacturers report moderate growth, capacity appears adequate to handle the increase in demand, and output prices are stable. The labor market is especially tight for middle and lower level workers and mixed for professional people. For example, bank tellers are in short supply but senior level banking people are available. Accountants are in short supply but lawyers are in ample supply. [Laughter]

CHAIRMAN GREENSPAN. Does that mean the price is coming down?

MR. BOEHNE. The stress in the health care industry is becoming widespread. Hospitals and medical schools are increasingly squeezed financially. Physicians are more amenable to unionization or dropping out of government insurance programs. Patients are turning to politicians more and more to seek relief from the "deny and delay" tactics of insurers. The frustrations associated with non-price rationing techniques are becoming more acute. The Philadelphia area is disproportionately dependent on the health care industry, and the fallout from health care stresses is clearly negative for the regional economy.

Turning to the national economy, incoming information points to a strong second half with labor markets becoming even more stretched. Yet inflation remains tame. The longer this favorable combination lasts, the more I consider faster productivity growth to be a more important factor holding inflationary pressures down than the assortment of temporary factors. Nonetheless, there still is a large element of uncertainty about the outlook for productivity. This kind of uncertainty can be resolved only with time, tempered by policy actions motivated by an ongoing assessment of where the balance of risks lies. Against a background of continuing benign inflation, two recent increases in the federal funds rate, and more edginess in financial markets, my assessment is that the risks are sufficiently balanced to warrant a wait-and-see approach to policy for now.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. The Seventh District economy, with the notable exception of the agricultural sector, remains on a moderate growth path with activity in most sectors at very high levels. A key driving force continues to be the strength in demand for automobiles and light trucks. Sales of light vehicles again were quite robust in September, as Mike Prell mentioned, and automakers have raised their sales forecasts for next year. Similarly, many small and medium sized manufacturing firms surveyed by our directors are forecasting good economic performance in their sectors for as far as two to three years ahead. Producers of consumer durables, such as appliances and lawn and garden equipment, are benefiting from a relatively strong regional housing market. The District's share of domestic steel production has increased significantly in recent months and solid performance continues to be reported by contacts in the printing and publishing industry. Some producers of heavy-duty trucks, paper and packaging, food equipment, and some housing construction materials reported a recent moderation in activity, but none voiced concern because activity has remained at very high levels. For example, orders for heavy-duty trucks are still considered to be good, although they have come down recently in part because order books are being cleared out, which is the normal practice at this time of the year.

The agricultural sector remains weak, though there has been some slight improvement from what I reported at our last meeting. Over the past few weeks I have met with members from the Illinois Farm Bureau as well as our own Agriculture Advisory Council. Council members noted that dairy farmers are benefiting from low feed costs resulting from unbelievably good hay production and a good corn crop. Members also reported that they were pleased with corn yields

except in Indiana where dry summer weather limited yields. Of course, with the low grain prices, grain farmers are still under a great deal of pressure. Moreover, egg, poultry, and hog prices are below the cost of production, which will lead to adjustments over the next 12 to 18 months that will result in reduced supplies and higher prices. In addition, farm equipment manufacturers have announced further production cuts that will result in layoffs.

Labor markets remain tight, with scattered reports of shortages for entry-level workers, truck drivers, farm laborers, construction workers, and some management positions. However, contacts generally indicate that wage gains remain in the same range seen over the past two years or so; that is in contrast to the national data on average hourly earnings and employment costs, which show some moderation. The labor contract negotiations in the automobile industry have proceeded rather smoothly so far. My contacts at the major automakers describe the terms of the Daimler-Chrysler and the GM contracts as definitely more expensive than last time. Wage gains are 3 percent per year plus a cost of living allowance, and signing bonuses and pensions were improved. The new contracts place some restrictions on outsourcing, but they are not as severe as reported in the press. Automakers are required to send a letter to suppliers requesting them to be neutral on unionizing efforts, but the letter is not expected to have any significant effect. The new contracts are for four years rather than three years. Nonetheless, neither the automakers nor the United Automobile Workers expect the contracts to set a pattern for suppliers or for labor negotiations in other industries.

In terms of price developments, there are some concerns about the future but so far a pickup in the underlying inflation rate is not evident. Several manufacturers noted that higher energy prices were likely to raise their input costs in the future. Sharp increases in health insurance costs, especially for prescriptions, were also noted. I had an interesting conversation with a national specialty retailer who has stores all over the country. He noted that higher construction costs are significantly increasing his occupancy costs and resulting in 1 to 2 percent increases in his overall operating costs for new stores as compared with existing stores. For the most part, however, firms continue to have little pricing power and seek to lower costs through various means or increased labor productivity, or both. As one of the members of our Small Businesses Advisory Council put it, "We continue to look for more efficiencies since no one is interested in paying us more money just because our health insurance premium rose 21 percent recently."

Turning to the national economy, our outlook is quite similar to that in the Greenbook. The strength of domestic demand has been very impressive since our last meeting. The third quarter

appears to have been remarkably strong and some of the momentum should carry forward. The slowing in domestic demand that we continue to expect seems no closer now than at our last meeting. Moreover, while there clearly are downside risks, foreign demand continues to pick up and we are losing that safety valve. Given those trends, the labor market could tighten even a bit more, raising the risk of accelerating inflation. Of course, we've been forecasting an acceleration of inflation for a while and core inflation has continued to edge down. But, clearly, some of the factors that have contributed to that decline have turned around--the value of the dollar, the price of oil and other commodities, and health insurance premiums. One can now even point to at least some evidence of pipeline inflationary pressures in the PPI data. So, even with the policy actions we have taken to date, in my judgment the risks still seem to be tilted to the upside.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. The Tenth District's economy continues to operate at a relatively high level of activity. Our year-over-year employment growth was 1.3 percent, and that is from already high levels of labor participation and employment. Retailers have reported that sales are flat but at high levels, and they expect to continue to experience good levels of activity. Despite the slowing in employment growth in some areas, construction remains our fastest growing sector in the District. Energy activity in the District has turned around significantly--60 percent above the level in March--although it is still slightly below year-ago levels in terms of employment.

In manufacturing, few jobs have been added but that is due in part to cutbacks by Boeing in Missouri and Kansas. Taking that into account, exports of manufactured goods out of the District are estimated to be at pre-crisis levels. So there has been a very strong recovery in that area.

The District's unemployment rate edged down to about 3.4 percent in August and we continue to have tight labor markets. We hear an increasing number of anecdotal reports of wage pressures, especially in our metropolitan areas such as Denver and Kansas City. Consumer prices have shown very modest increases, although on the input side prices of some manufacturing and construction materials have edged up or have increased significantly, depending on the particular type of input one is speaking about.

The farm economy, of course, is the area that remains weak. But government payments are keeping farm incomes and finances at good levels and recent legislation may put farm support payments at or near the record levels that we saw in the 1980s. Overall, though, the District is doing very well.

At the national level, I have no major disagreements with the Greenbook. I understand and recognize that forecasting is a risky business in and of itself. I think it is important, then, to look at the circumstances we face at this time. Demand is very strong--some would suggest excessive--with GDP growth well above 3 percent when, in thinking about labor growth and productivity, potential may be in the 3 percent range. In many ways we are comfortable with that because inflation remains modest and productivity gains continue. But it is important to look at some of the other factors that are in play. The strong demand is being accommodated importantly by a trade deficit and a current account deficit that are at record levels. Personal saving rates are estimated to be in the negative range, labor costs are rising, and labor demand remains very strong. When we talk to business people about wage pressures, they give some indication that they're paying "above normal" to retain workers. But the definition of "normal" is moving higher. So we're continually seeing an increase in the so-called normal rate that gives me some pause.

When I look at the demand in the economy in terms of both the consumer and corporate sectors, consumer debt is rising to record levels and corporate debt is increasing. I think we have to take that into account. Margin credit is rising to record levels as well. The question for us, of course, is whether monetary policy is accommodating this debt increase. We've had two recent funds rate increases and that is worth noting. But at the same time, the growth rates in the monetary aggregates remain at or above our projected targets. I think that has to be taken into account as well as we look at all these other factors. So, I believe our policy involves some continued upside risk for inflation and we should be mindful of that as we enter the policy discussion phase of the meeting.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. To convey the story of our District it is often tempting to say, "It's motor vehicles." If motor vehicles are booming, the economy is booming. And as you all know, motor vehicles are booming. Like Mike Moskow, I was hearing reports from directors, especially those from steel companies, on how they characterized the auto contracts. They were talking about them as being generous or even extravagant. But unlike the views Mike encountered, they were claiming that the auto contracts were pattern-setting, and they are concerned about the effects. The AFL-CIO is putting out some talking points for the press about how generous this package was. That has been disturbing to small business owners because their employees see that. Besides, they live next door to some of the autoworkers benefiting from those contracts.

One very large company headquartered in the District that supplies the motor vehicle industry and housing markets worldwide had what I considered a very strong report about increasing export demand combined with reduced import competition. It means that they have the best opportunity for raising prices they have seen in years. The instruction has gone out throughout the organization that they are to work to raise prices at any and every opportunity. They do see their own raw materials prices rising, but they also feel that they're going to be able to pass those increases along.

Labor cost pressures continue to intensify. We hear the same kinds of stories about benefit costs increasing at double-digit rates that everybody has been talking about. The general sense is that, as far as health care costs are concerned, it has been bad in 1999 and it will be worse next year. People mention severe shortages of nurses, aides, and other health care workers. Those in the health care industry talk about the packages they have to pay to attract people or to retain workers. One executive at a small manufacturing company said it got hit hard by the increase in its health care costs--he used the same 21 percent figure that you did, Mike--and expects the increase in the next year to be higher if anything.

As an indication of what's going on in construction, a comment was made that the demand has been so strong that union contractors are now subcontracting to nonunion firms just to try to get the work done. One small businessman in the mid-Ohio area, a supplier of luxury consumer goods --swimming pools, hot tubs, patio furniture, and the like--said they had a very strong June. They saw a leveling off at what they considered to be a very high level in July and August, but then in September sales took off like gangbusters. It was surprising to them, given the nature of the products they sell, to see September come in so strong. Another company that supplies the trucking industry said that it is expecting to finish out this year with about an 8 percent increase in sales and is budgeting for an increase next year in the 10 to 15 percent range.

As we've done before at this time of year, we took a look at what has been going on in the race horse auction business. At Keeneland this year gross sales for September were up 37 percent and at \$253 million reached an all-time record for any thoroughbred sale anywhere in the world. The average price was up 30 percent and the number of horses sold was up 5 percent. The prior record for the number of horses sold at \$1million or more was 17. This year they sold 23, with one horse going at \$3.9 million--the highest ever recorded. I wanted to probe a little deeper, beyond the issue of prices, to find out where the buyers were coming from. Were they all people from Microsoft or Wall Street? I was told that after a slump last year, there was a rebound in Japanese

purchases. Also evident was a return of demand out of the Middle East. In total, where the source could be identified, foreigners spent \$52 million in the September sales this year versus \$32 million last year, for a large gain.

Some of the issues that came up in our Advisory Council meetings caused us to look into Y2K planning in a different way than we had before. Companies, both banks and others, were saying that they didn't expect to have cash around for their own operations or to meet employees' needs for cash. They plan to send their employees to check cashing facilities. So we decided to contact the check cashing facilities and found none that is planning to add to its currency holdings. They don't view that as being the business they are in and they don't expect to do so. One simply said, "If we run out of cash, we'll just close the door for a few days." Another Y2K-related item that came from an Advisory Council member who is in the warehousing business caught our attention. He said that Proctor and Gamble has been moving through the area taking up additional warehouse space because it wants to accumulate several months of extra inventory by the time we get to December.

Let me report one more example, in a somewhat different area, where the idea that there's no pricing power is becoming an increasingly quaint notion. We looked at tuition increases at public and private universities, and they are quite sharp. All of the public universities in Ohio that we contacted said that their tuition charges were up by 4 percent or more. The big three-- University of Akron, Ohio State, and Ohio University--were all up 6 percent. They said they would have done more but several years ago the state legislature imposed a maximum tuition increase of 6 percent in one year, so they'll just have to raise tuition prices again next year. Carnegie Mellon in Pittsburgh raised the tuition for entering freshmen by 11.3 percent and that for returning sophomores, juniors, and seniors by 3.5 percent.

On the national economy, it's nice to have a Greenbook forecast that final demand, or nominal spending, will decelerate somewhat next year and the year beyond. But we've had that forecast before and there is just nothing in the numbers to suggest that that is going to happen. Growth in nominal spending this year is not just a lot above the rate forecast a year ago, it has doubled. That may have been because of the pessimism coming from Asia. But even if we go back six months, it's much stronger than what was expected then. Again we have a forecast that the expansion is going to slow down. But that is just a forecast and I can't see anything in the recent data that supports it. There certainly is nothing in any of the monetary statistics or the credit



statistics we're seeing. So I'm very skeptical that we've already calibrated policy to insure that nominal demand slows to a rate consistent with nonaccelerating inflation.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Economic growth in the Eleventh District continues to expand at a brisk pace. Employment growth in recent months has been running over 3 percent, well above the national average. The improved condition of our trading partners, especially Mexico, has been an important factor. The purchasing power of the Mexican peso is up by more than 10 percent since the beginning of the year. And other leading indicators of future Mexican economic activity, especially real oil prices and inventories, suggest that the expansion will continue.

Rising oil prices are beginning to provide a slight boost to the District economy. However, I need to emphasize that the Texas economy was growing strongly in late 1998 and early 1999, when oil prices were hovering around \$12 a barrel and were anticipated to fall still further. Texas is only about one-fourth as sensitive to changing energy prices as it was a little more than a decade ago. Rising oil prices have triggered a modest increase in drilling activity, although most industry insiders continue to believe, along with the futures market, that today's high prices are not sustainable. The Texas rig count has increased 43 percent since June but would need to increase another 45 percent to reach the level that prevailed the last time prices were above \$20 a barrel.

Most other sectors of the regional economy are doing well. Construction activity remains steady and retailers report good sales growth. The growth in demand for both computers and semiconductors has been stronger than anticipated a few months ago.

The wage data in our region continue to appear benign, while the anecdotal information signals some upward pressure on labor costs. Some firms are hiring workers with fewer skills than usual. One contact reported that "the unemployable are now being employed." The rising tide appears to be raising more boats. We see this dramatically along the Texas-Mexico border where unemployment rates have fallen to single-digit levels in three of the four major metro areas that typically experience unemployment rates above 12 percent. The pull of a strong labor market in other parts of Texas and elsewhere in the United States has been working wonders on boosting economic opportunity for those at the bottom. We must not forget that this has taken place in recent years against the backdrop of declining inflation.

Turning to the national economy, I'm looking for growth over the forecast horizon to remain in the 3½ percent range that we've experienced so far this year. This may be on the optimistic side given the condition of financial markets. Most major stock market indexes have

fallen by about 10 percent since our last meeting and there has been a noticeable pickup in yield spreads, both of which should restrain spending behavior by households and businesses. Perhaps our growing current account deficit is already acting to restrain future capital inflows, thereby reinforcing the tightened stance of monetary policy. I'm not foreseeing any significant pickup in inflation in the next year or so. Most broad measures of inflation, including the core CPI, the PCE deflator, and the GDP deflator, are running below 2 percent. The core PPI for finished goods has declined at a 0.4 percent annual rate over the last eight months, suggesting mild deflationary pressure. Commodity prices other than oil have stabilized or risen only slightly from their lows. Indeed, it is surprising how little the uptick in commodity prices has been, given the pickup in demand from Asia and Europe combined with the need to build inventories to deal with Y2K concerns. To me this suggests a continued relative absence of inflation in the pipeline.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. The major trends in the District economy remain intact, which is to say that outside of the agricultural sector the District economy is very healthy. Consumer spending is strong; auto sales are particularly strong. My casual observation, for what it's worth, is that one of the things going on in the automobile area is that an increasing number of households now have more cars than drivers. There seems to be specialization; people are buying cars for particular purposes. Some of that might be weather-related in our District; nevertheless, that's clearly occurring.

Housing activity is also strong. Home prices in the Twin Cities metropolitan area have been rising significantly and home improvement activity is robust. I suspect it's limited only by the availability of contractors because in any neighborhood I drive through I see evidence that people are improving their homes by remodeling or adding to them.

Employment growth in the District has slowed. I think that's basically because we're running out of workers. Apropos that, the unemployment rate in the Twin Cities metro area has dropped below 2 percent again, and there is a mid-sized city or two where the unemployment rates are even lower than that. The only other thing I would pass on about the District is that I expect to see some deterioration in credit quality at the banks, which is partly related to agriculture, of course. But beyond that, in talking to bankers it seems to me that they are still chasing the marginal customer. And sooner or later I think that will come home to roost.

My view of the national economy is similar to my view of the District in the sense that I think the trends that have been in place for some time will continue. It seemed likely that the

second-quarter slowdown in growth was an aberration and that turns out to be right. Inflation has remained modest. As we all know, if we take a step back and think about the last several years, the national economy has performed remarkably well. We've had rapid growth and modest inflation, which is quite consistent with what our VAR model was forecasting over that period of time. If this keeps up, I'm going to have to develop some confidence in that model! I would note that the model continues to forecast essentially more of the same. But I think the Greenbook raises the right question: Is inflation going to accelerate from here? Several people have commented, and I agree, that it depends a lot on how productivity performs in the future. I'm relatively optimistic about that, but I'll reserve the rest of my comments until later.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, as I travel around the Eighth District I try to press people on what's new or what's different. There's usually a silence and then somebody will talk about the pressures in the labor market. Of course, that's not really new. So what I'm hearing is just a broken record. When I press people about the labor market, they say it's awfully hard to find workers, but they are finding them. At the end of the day they're hiring people, though they have to struggle to do so. They get people who apply for receptionist jobs who have body piercing in any number of places. [Laughter] They wonder how these people have the nerve to walk in, but they do. Apparently the employers end up coaching them or whatever and put them in those positions. So, those are the kinds of stories we hear. Essentially there is nothing new except a few amusing anecdotes along the way.

My contacts at UPS and FedEx confirm the strong recovery in U.S. exports, particularly to Asia. They emphasize especially that the resurgence in activity in Korea and Japan is very clear though Malaysia and the Philippines still have problems. They say that they just can't get enough capacity out of Hong Kong--that the market is very strong there. Exports to Latin America are fairly flat; I get the impression from my contacts that nothing much is going on there. In terms of export volume, UPS at the beginning of this year was anticipating an increase of

At this point UPS is projecting volume in the year 2000 to be over this year. So, UPS is anticipating in U.S. exports to those markets.

I continue to hear stories about the difficulties of keeping staff levels up but, again, UPS and FedEx are finding ways to do it. On the Y2K issue, UPS is expecting some surge in both U.S. exports and imports--some shift of shipments that would have occurred in January into December

for precautionary purposes. I think all of the things we're hearing along those lines make sense. The FedEx picture is very much the same, so I won't say anything specific about that.

On the national picture, I think we can reasonably forecast that we will have an upward creep in pressures on inflation and an upward creep in the possibilities for productivity growth. It is somewhat of a race as to where those two will come out. I must say that I would be a lot happier if money growth were coming down during this period of rising interest rates. Obviously, with rising interest rates, we'd generally say that, other things equal, there would be less money demanded. Yet money supply growth is continuing above the growth of nominal spending, or at least what is a reasonable track for nominal spending. So I am certainly concerned about that.

On the inflation outlook, besides the "creeping" part, whether it does creep up really depends critically on expectations. And as long as expectations remain very, very solid, as they are, I think we're not going to be faced with any sudden outbreak. On the other hand, we play the critical role in keeping those expectations where they are. Thank you.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The Second District's economy appears to be expanding at a rather steady pace despite intensifying price pressures in the manufacturing and construction sectors. Consumer price inflation apparently remains in check. Private sector employment grew at a 1.7 percent annual rate in August, down from July's robust 3.2 percent pace but matching the second-quarter pace. Retailers report that sales picked up in early September following a sluggish performance in August. They also note that there was a good deal less discounting in the third quarter than a year earlier. Tropical storm Floyd caused some flooding and utility disruptions in New Jersey and may have affected retail sales in mid-September. However, its overall effect on the regional economy appears to have been modest.

The housing market remains strong, though new construction is being hampered by widespread supply shortages and bottlenecks. Single-family housing permits have picked up in the most recent quarter and double-digit increases in home prices are reported in New Jersey and Manhattan. Office vacancy rates in Manhattan fell to cyclical lows in August but rents, though still increasing, have risen at a less frenzied pace than last year. Purchasing managers indicate that manufacturing activity was mixed but generally strong in September following brisk growth in August. Price pressures intensified a bit in September. Banks report steady loan demand, increasingly tight credit standards, and few delinquencies.

As for the national economy, while listening to my colleagues around the table, a sign outside The Mayflower Doughnut Shop in my native city of Chicago kept passing through my mind. That sign was entitled the optimist's creed and said, "As you wander on through life, brother, whatever be your goal, keep your eye upon the doughnut and not upon the hole." It seems to me that some people look at the current situation and say: We are experiencing the soon-to-be longest economic expansion ever, we have a 4.2 percent unemployment rate, we have the unemployable being employed, and isn't that terrible! I don't think it's terrible at all. I think it's great and wonderful, especially if we remember that our goal in monetary policy is to promote sustainable economic growth and that the tool we are supposed to use is price stability. With a year-over-year rate of 1.9 percent in the core CPI at the end of August, I think we surely have price stability.

The forecasting models of all the Reserve Banks and of the Board's staff have been consistently wrong in that they have forecast inflation increases. The same models predict that there will be inflation increases in the future. I wonder if at some point we shouldn't put in a humility discount based on past performance. Perhaps we should realize that these forecasts, since they have been consistently wrong, are likely to stay wrong and that, therefore, the inflation we are concerned about is rather like Don Quixote's windmills--a fiction of our own minds.

We've also been very worried about tight labor markets and yet the tight labor markets have not in fact been resulting in inflation, even though we continue to worry about them. What concerns me a great deal is that all of us speak in shorthand and the American people don't understand our shorthand. If we continue to talk about tight labor markets as if that is a truly evil phenomenon, we are going to convince the American people that what we believe in is not price stability, which is for the good of everybody, but a differentiation in income distribution that goes against the working people. That is not a good signal to be giving. I'm sure it's not a deliberate signal but I think it's one we are increasingly giving. The most recent data on the distribution of income show the top quintile getting 49 percent of the income distribution and the bottom quintile getting just above 3 percent. I don't think that's a time when the central bank should be giving a signal that it is opposed to possible increases in remuneration, especially if those increases in remuneration are financed by productivity.

As I've said at previous meetings, we don't have to have a firm belief that productivity improvements are here to stay and that we are experiencing one of those once-in-a-century phenomena, although I'm increasingly inclined to think that we probably are. All we really have to

decide is whether that increase in productivity that has been financing the improvement in the lifestyles of the less fortunate--with the low unemployment rate--is likely to continue for the period to which our current monetary policy applies, which is one to two years. I am very convinced that that will be the case. As we consider our responsibilities, we have to be very careful that the goal we're looking toward is price stability and not anything else. That price stability is supposed to bring about sustainable economic growth, and it is. In my view we should declare victory on what has been a very good piece of work and stop worrying ourselves into believing that we have to stand in the way of something that I think is very positive. Thank you.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. As I said at our last meeting, and a number of people have said again at this meeting, we are clearly faced with the issue of whether or not inflation has reached an inflection point. Or to put it another way, we have to decide whether or not aggregate supply and demand are out of balance or becoming out of balance. Many people around the table have cited arguments that suggest inflation is reaching an inflection point. Those tend to focus on two things. One is that we have tight labor markets, which is normally a precursor to some inflationary pressures. The other is that some of the short-term factors that have held inflation at bay appear to be weakening. Among those are that foreign economies, which have given us the benefit of some of their excess capacity, are generally strengthening and that the dollar, whose strength has kept import prices low, appears to be weakening. All of this is occurring against a backdrop of what is clearly a very strong domestic economy and one in which many interest-sensitive sectors clearly are showing some strength.

However, there are some strong counter-arguments to this view. One is that there has been capital deepening, which is continuing. We aren't sure when the run of productivity growth that we've benefited from thus far is going to come to an end. The second counter-argument--and there are weaknesses in it--is that we've had an unemployment rate below 4.5 percent for most of this year and some of last year and wage demands have not been excessive. We have some new evidence that wage demands may have changed in some of the union bargaining situations. On the other hand, we're not yet sure if that is going to flow over into pricing or is simply going to be a case in which dividends will not be as attractive as they have been. With respect to the rest of the world, it's certainly true that many economies seem to be healing. But Japan, I think, still has a way to go, and its recovery depends very much on the ability of its government to borrow and spend. And in some Southeast Asian economies the fundamentals certainly aren't very strong.

Finally, as a few people have noted, long-term interest rates have indeed trended up. Now, one might argue that they've trended up but have had no impact, or very little impact, thus far.

Putting all of this together, the risks do seem slightly out of balance. On the other hand, we should be mindful of the fact that there are many things we don't know and that our models have been inaccurate for quite a while. So I do think we are faced with a very tough choice later today. But at this stage it seems to me that the risks are slightly skewed to the upside.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. At the last meeting, I argued that we should do what we're going to do with interest rates and, absent jarring new information, leave them alone until the turn of the year. Markets pretty much expect us to do that and I'm reluctant to dissent from this happy consensus. Nevertheless, while the information that has come in since the last meeting may not qualify as jarring, it is at least disconcerting, and I fear that we may be close to the time when we have to think about changing policy. Most of this disconcerting information is on the demand side and some of it is based on theories of how the economy is supposed to work. Let me run down the list.

First, because of gridlock problems on Capitol Hill, government spending is likely to be stronger than we had thought. Second, consumption seems to be rising at relatively rapid rates and consumer sentiment is very high, even with a fairly significant stock market correction. Third, investment soared in the third quarter. The staff has responded to that development largely by shifting investment out of the fourth quarter, making the overall forecast only a bit stronger. But it may be that investment demand is just simply stronger than we had thought. Fourth, there's an increasing upward drift in core inflation. That's partly tied to an unreliable estimate of NAIRU, I know, but it is augmented by increases in commodity prices, the minimum wage, autoworker wages, health care costs, and other such factors. Fifth, the unemployment rate is forecast to get to a pretty low level. I recognize what Bill McDonough said and I agree that the downward trend in unemployment is great, but reduced unemployment has to be sustainable. And sixth, after the Y2K quarter, the flat funds rate version of the forecast now has demand growth averaging about 3½ percent, which is rather strong for an economy that begins with already extremely tight labor markets, even with a change in productivity trends.

But in some ways the biggest concern of all is the dollar. Let me spend a minute discussing that. Previously, when the United States was growing at healthy rates and most of our trading partners were dealing with recession, the U.S. trade deficit rose sharply. Then we didn't worry

about imbalances. After all, our trading partners were getting extra aggregate demand and the United States was trimming aggregate demand. Or from the capital account standpoint, our trading partners were investing their savings at higher rates of return and we were getting a foreign-financed investment boom.

But now all that is changing and our trading partners are beginning to recover. The goods and services deficit, which is analogous to the primary deficit, is \$272 billion this year, 3 percent of GDP. In the Greenbook forecast it rises to \$345 billion in 2001, 3½ percent of GDP. If we make the reasonable assumption that foreigners will want to limit the ratio of their assets here to GDP, this goods and services deficit must at some point drop to zero. Actually, it may be even less than zero if our real interest rate exceeds our GDP growth rate and/or there is modest dollar depreciation. But 3½ percent of GDP is a long way from zero. What can bring the U.S. trade deficit into balance? The happiest scenario is for foreign GDP to grow more rapidly, but unfortunately that scenario cannot help much. The staff already has trade-weighted foreign real GDP growth at a 3.4 percent rate over the forecast horizon and realistically it cannot grow much faster than that. I asked the staff to simulate an extra ½ percent of foreign GDP growth and that only cut the goods and services deficit by \$10 billion in 2001--essentially peanuts. That's not enough even to eliminate the rise in the ratio of the goods and services deficit to GDP.

Another happy scenario would be to get there by low U.S. inflation. In the forecast our inflation rate averages ½ percent below the trade-weighted inflation rate of our trading partners. That does limit the growth in the trade deficit, but it doesn't restore the balance. And it will not help at all if our inflation rate increases. Unfortunately for this calculation, our trading partners either have had serious recessions or have been very good at fighting inflation, with the consequence that their inflation rates are already low enough to largely close off this channel.

Then we get to less happy scenarios. We could reverse the Asian crisis by having a domestic recession, which I doubt anybody wants. The only reasonable and effective way to right the balance, I'm afraid, is for the dollar to decline by quite a lot--far more than the staff has already incorporated into the forecast. We may consider this a ticking time bomb or merely the inevitable after-effect of the healthy, stabilizing move in our trade deficit during the Asian crisis.

But there are two implications for monetary policy. The first is that it's even more important than in normal times to stabilize prices. The best way to get the desired change in our prices relative to foreign prices is price stability here, and we should promote that especially in adjusting to the international imbalance. The second point is that we should remember that the



Asian crisis kept a headwind on the U.S. economy. That headwind was a force that tended to push down rates of growth of both aggregate demand and inflation--a nice safety belt should the economy overheat. Now that is over, or at least changing. The world economy is rebalancing and for the next few years that headwind is likely to be replaced by a tailwind that will tend to push up real growth and U.S. inflation. Just when we need low inflation more, it will become harder to achieve.

All of these factors are on the demand side and in principle there could be a productivity boom sufficient to handle all that demand without rising inflation. But for that to happen, the rate of productivity increase must increase. That is, the second derivative of productivity must be positive, which is a difficult requirement. And if it is not met, the economy is in danger of moving to higher, perhaps accelerating, rates of inflation.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. As we've all been saying, the economy is resurging after its second-quarter slump and the inflation news continues to be highly favorable. It's amazing to me that policy formulation can become more difficult when all the news is good, but it has. Recent news has made our choices still more difficult. As I look at the available policy alternatives, it seems to me that a perfectly plausible case can be made for at least three different policies. And there is a perfectly plausible rebuttal argument against each. Yet choose we must, and I'll leave that discussion for the next phase of our meeting.

Let me make two brief observations. Many supply side factors that have contributed importantly to this favorable inflation performance are shifting adversely. Cheap oil has gone away; bargain commodity prices are firming; the dollar has ceased to strengthen and has begun to reverse; world demand for U.S. exports is beginning to increase, further straining our labor force; and interest rates have been rising. Our strong productivity surge has obviously been of vital importance and appears to remain vibrantly in place. But going forward, we must judge if it's safe to depend on that almost entirely to keep rising cost pressures at bay.

Secondly, the demand side looks increasingly frothy to me. Consumption is surging, even as consumers continue to run with a negative saving rate. And that, I think, introduces the danger of fragility. Consumer sentiment is rising again from a consistently elevated reading. We will shortly get a new reading, but to date new job formation continues strong, with many reports of an inability to fill job openings. We seem to be entering an inventory cycle of unknown dimensions. Capital spending remains very strong and purchasing managers report slower deliveries and higher

prices. Housing activity appears to be slowing, but auto sales continue to fly higher and higher, defying gravity.

This Committee has been correct for several years in allowing the economy free rein to grow, and I feel comfortable that we have responsibly timed a course reversal in recent meetings. Is it now time to rest on our oars a bit? Perhaps, and a strong case can be--and has been--made for that. But I think it's worth noting that the fed funds rate today is  $\frac{1}{4}$  point below where it was on September 29<sup>th</sup> of last year, the date of our first downward move. At that time the unemployment rate was at 4.5 percent and the level of real GDP was 4 percent lower than today. The rate of GDP growth in the third quarter of 1998 was 3.7 percent, slightly slower than the rate now anticipated in the third quarter of this year. We must take great care not to risk losing the degree of stability in prices that we have worked so long and hard to achieve and that has served our economy so well. Thank you.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. I agree with Governor Kelley that today's decision is especially challenging. The recent data for compensation and core CPI have been remarkably benign. On that basis it would appear to be a reach to argue that there is an urgency to tighten. But the Greenbook tells a different story, one in which the interactions of tight labor markets, above-trend growth in the near term, and the dissipation or reversal of favorable supply shocks result in a steady rise in inflation over the forecast period. The challenge in our policy decision today is to reflect our assessment of the balance of risks appropriately. In my view, those risks are tilted toward rising inflation.

The inflation news has been so remarkably good in terms of both compensation and core prices that it's easy to lose sight of a key reality. Overall CPI inflation is projected to increase by almost  $1\frac{1}{4}$  percentage points this year relative to last year. This contrasts with a decline of about  $\frac{1}{2}$  percentage point in overall CPI inflation last year compared to the previous year. This year nominal compensation gains have been restrained by last year's decline in overall inflation. Next year, in contrast, compensation will be boosted by the rebound in overall inflation this year. This development highlights what may be a fundamental change in the inflation environment. Instead of lower inflation blunting the force of low unemployment rates on nominal wage changes, rising inflation going forward is likely to reinforce the effects of tight labor markets on nominal compensation gains. The Greenbook inflation story has many chapters. I'm in broad agreement with both the qualitative themes and the quantitative implications.

By my count there are nine factors that contribute to higher inflation in this forecast: (1) tight labor markets today; (2) tighter labor markets around the corner; (3) rising capacity utilization rates; (4) a rebound in nonoil import prices; (5) the secondary effects of the sharp rise in energy prices this year; (6) a rebound in benefit costs; (7) an increase in the minimum wage; (8) an upward trend in nonoil commodity prices; and (9) the stabilization in trend productivity growth. There is an important partial offset from an assumed decline in energy prices over next year and the following year. But the cards seem stacked. To be sure, this is just a forecast. You might say, "Been there, done that!" [Laughter] Maybe productivity will accelerate further; I cannot rule that out. Maybe NAIRU is even lower than the staff estimate; it could be.

But I find the Greenbook story line compelling. If it is wrong, it is likely to be a matter of degree rather than direction. Perhaps it will not take four or more  $\frac{1}{4}$  percentage point increases in the funds rate to limit the rise in core CPI to  $2\frac{1}{2}$  percent over the forecast period. But how likely is it that we would come to regret another move this year? The case for tighter policy always seems more compelling when near-term above-trend growth is projected to aggravate already tight labor markets. That is a one-two punch that should be resisted. And once again the data point to faster growth than previously expected. The outlook for growth was revised upward from the last Greenbook. Growth appears to have moved again into the above-trend zone and remains quite strong, though slightly below trend, in 2000 and 2001. This is the case despite the assumed tighter monetary policy and flat equity prices in the Greenbook forecast. Persistence of strong growth reflects a combination of still favorable financial conditions even with a tightening, flat equity prices, stronger global growth, a declining exchange rate, and increased fiscal stimulus.

The generally favorite forecast paradigm since at least mid-1996, when I arrived at the Board, has been slower growth and rising inflation. One can say the same paradigm is reflected in the current forecast. But the slowdown in growth is now much more modest and the rise in inflation more aggressive. Instead of looking like a transition from exceptional performance to a modestly uncomfortable period of stagflation, the forecast is beginning to look a little more like a boom/bust scenario, with the boom part admittedly more evident than the bust in this part of the forecast. Thank you.

CHAIRMAN GREENSPAN. I believe coffee is ready. Let's break for coffee.

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

MR. KOHN. Thank you, Mr. Chairman.

Committee decisions at this meeting would seem to be complicated not only by continuing uncertainty about the sources of the unusually good economic performance of the United States and how best to sustain it, but also by the possible effects on policy strategy over the near term of the coming century date change. Mike and Karen have described the forces in the staff forecast that give a distinct upward tilt to projected inflation over the next few years, even with a moderate amount of policy tightening next year. Of course, the Committee may not share the staff's concerns, in which case many of these complications recede. Broad measures of prices and wages behaved remarkably favorably over the intermeeting period--more so than before the August meeting. These data, along with the sideways movement of the unemployment rate this year, suggest that to date aggregate supply has been sufficient to satisfy aggregate demand, even with the economy operating at a high level and demand expanding rapidly. If the Committee believes that this balance has a good chance of continuing--or wanted to wait a while to see whether it did--it may see preemptive tightening as inappropriate at this time, especially after two preemptive actions at the last two meetings, and hold policy unchanged. Moreover, in this environment, the Committee may be sufficiently uncertain that inflation is headed higher to have no priors about the predominant weight of information that will be coming in for a time, making an unbiased directive a good description of its policy inclinations over the next few months.

While market participants generally do not expect a change in the stance of policy at this meeting, a growing number have come to anticipate that the Committee will adopt and announce a biased directive. Moreover, markets have priced in significant odds on a tightening in November. If a symmetric directive is taken as a sign that the chances are good that the Committee will be on hold until next year, prices in financial markets could rise some. To the extent the Committee's choices were seen as driven more by Y2K concerns than a downplaying of inflation risks, firming actions for next year should continue to be built into the yield curve, limiting the extent of the rally. Still, a more substantial upward turn in bond and stock prices cannot be ruled out.

Even a limited rally might be counterproductive to the Committee's goals, especially so if the inflation risks were viewed as substantial enough to raise the possibility of policy adjustments over the next few months. The misimpression that policy was on hold might make it more difficult for the Committee to act later in the year or make market adjustments more wrenching when it did so. And a rally would lessen any check on spending currently being imparted in financial markets. This would be especially serious if the Committee felt that domestic demand might not slow sufficiently to offset the pickup in worldwide growth that is already raising commodity prices and exerting pressure on the foreign exchange value of the dollar. As Mike noted, incoming data over the intermeeting period also showed surprisingly persistent strength in various elements of domestic spending.

The Committee's strategy for dealing with such developments might depend on its assessment both of the degree of inflation risks and of whether Y2K

considerations might constrain its actions at its next meeting in November. Considerable information will become available between now and then that could be of particular help in shedding some light on the various uncertainties the Committee faces. On the demand side, signs should be more evident about how domestic spending is responding to the tightening of policy and the more general increases in interest rates and leveling out of stock prices of recent months. On the supply side, substantial new data on labor costs--including an ECI and two readings on average hourly earnings--should aid in getting a better fix on whether pressures on costs and prices are likely to be mounting. And the two employment reports also will provide considerable new information on the balance of supply and demand.

But at the same time, those incoming data will commingle the effects of precautionary Y2K purchases and the more fundamental strength in demand. The picture in financial markets will likely be even more obscure: Markets are likely to be thinner than usual in mid-November, as many borrowers will already have satisfied their borrowing needs and extended the maturity of their obligations to avoid the year-end. Yield spreads, particularly for short-term credits, should be wide as lenders draw back from taking risks, and are unlikely to provide reliable readings on assessments of borrower risk and credit conditions beyond the century rollover period. Moreover, the reactions to policy changes will be harder to predict, especially if the change is unexpected.

If the Committee thought Y2K-related distortions to data and effects on the fragility of market conditions would be a substantial barrier to raising rates before next February or to publishing an asymmetric directive at this or coming meetings, and also saw the inflation risks as quite substantial and likely to intensify over the coming few quarters, it might be more inclined to tighten at this meeting. A delay of several months under these circumstances would tend to accentuate the overshooting of the economy and require considerably more disruptive adjustments down the road, especially if perceptions that the Committee was on hold sparked a substantial rally in financial markets. Indeed, if the Committee thought there was a considerable likelihood that tightening would be called for in the near term, taking that action at this meeting and indicating that another move was unlikely for a while might remove one element of uncertainty from markets--clearing the decks, so to speak, for participants to deal with Y2K. To be effective, however, such a statement would need to be credible. Reference to completing the retrenchment from the 75 basis points of easing last fall might be helpful. But, tightening at this meeting would follow a "truly symmetrical" announcement in August, possibly making market participants difficult to convince that this time you truly were on hold.

Nonetheless, the greater likelihood is that Y2K effects will not rule out action in November. While markets may be thin, spreads may not be much different than they are now if many people succeed in getting their financing done early. And the backup mechanisms put in place for the discount window and open market operations should provide the Committee with some assurance of protection against some of the adverse consequences of even more intense flights to liquidity and safety. As noted, those who should be most sensitive to these considerations,

market participants themselves, in their commentary and their asset pricing have not ruled out a November tightening. And, not all incoming information will be equally muddied by any precautionary stockpiling for the century date change. For example, such activity is likely to have a greater distorting effect on spending data than on broad measures of prices and costs, given the normal inertia of the latter, except in commodity markets. Adverse information on labor costs or inflation could cause markets to build in expectations of Federal Reserve action. Failing to meet those expectations, without a good economic rationale, might itself raise questions about the Federal Reserve's lack of confidence in the functioning of markets through the century date rollover period.

If the Committee believes it should be able to tighten in November if necessary, it might want to keep policy unchanged but consider whether to adopt and publish an asymmetrical directive. The market's response to an asymmetric directive would be conditioned in part by recent history. Given the Committee's evident reluctance to announce an asymmetrical directive in June, markets might interpret such a directive at this time as indicating that the Federal Reserve was seriously considering near-term policy action. The Committee might be able to temper this response with the wording of the announcement. Still, market participants could price in a little higher odds on a firming in November than they now have, with an associated backing up of interest rates. Such a reaction would not be a problem if, in fact, the Committee was concerned about inflation risks, because any firming of financial conditions would impart some restraint sooner. Notice that the Federal Reserve was poised to act would tend to increase the response of financial asset prices to incoming information and to policymaker statements over the intermeeting period. The risk, of course, is that the markets might build in a considerably greater likelihood of tightening than is consistent with the Committee's assessment of the economic situation, complicating your choices in November.

If the Committee were uncomfortable with this risk, but also uncomfortable with the potential interpretation and market response to the announcement of an unbiased directive, it could try to find a middle way. The experience in June suggests that this will be difficult to pull off effectively. In that instance, markets were surprised to find out well after the announcement that some bias toward tightening was embedded in a symmetric directive. One approach to this apparent inconsistency would be to suspend voting on the sentence containing the bias by removing it from the operating paragraph until the Committee has a chance to consider the working group's recommendations next spring, but to convey in an announcement the Committee's assessment of the balance of risks to economic performance. By focusing on what many members of the Committee already saw as the important information it had to impart to markets, this alternative might have some attractive features both as a near-term stop-gap measure and as a longer-term solution to excessive weight being placed on the Committee's choice of very few standardized words about future policy. And, it could well have the desired effect relative to asymmetry of damping market responses to any announcement today and to subsequent information. Its possible drawbacks include the potential for adding

to market uncertainties about your attitude toward policy biases and their meaning, and the risk that the precedent it set would narrow the Committee's options when the subcommittee reports back next spring. Finally, the Committee could vote for an asymmetric directive.

CHAIRMAN GREENSPAN. Questions for Don? President Jordan.

MR. JORDAN. Don, you began your remarks and then referred again later to the point that aggregate demand and aggregate supply, if anything, look better balanced now than before. You cited, if I heard you right, evidence of balance in the data that have been released on labor markets and price markets. If I were doing assessments of risks to the domestic economy, let alone other risks in other places in the world as I once did, I would not have looked at these data as indicative of a finely balanced situation. In looking at the numbers for the past and at the projections for the next two years, I would note how much of nominal spending is consumption, the negative saving rate, the growth in credit, and the growth in money. I would examine all the variables one might want to look at and I would say that there are some serious questions about the stance of policy in this country, and I would say the economy is not well balanced.

MR. KOHN. I think one can differentiate between where we've been and where we're projected to go in that regard. I absolutely agree with your characterization of the forecast. It is not a balanced forecast. Aggregate demand exceeds aggregate supply. There are upward pressures on inflation. And implicitly in the forecast the unemployment rate needs to rise by a significant amount before demand is brought down. Growth needs to slow and the unemployment rate needs to rise before demand and supply are brought into balance.

MR. JORDAN. I'm not at all convinced that the unemployment rate has to rise, but I am convinced that the trade balance cannot stay where it is, let alone continue to rise. Other people said it better than I did: We need to see this trend reversed. At some point the United States needs to stop being a net absorber of world savings and become a net supplier of savings to the rest of the world.

MR. KOHN. Looking back, one could say that aggregate supply and demand have been in balance, at least in total, as evidenced by what has been happening to prices. But there are elements of imbalance within that total. We've talked about this before, certainly, and one such element is the current account deficit and the trade balance. Another that people often cite is the level of asset prices--particularly the level of stock market prices, which seem out of balance with reasonable expectations of earnings and reasonable discount factors for risky assets. I think how

that international imbalance is corrected is very key. Governor Gramlich brought up a couple of possibilities. One possibility that we modeled in a previous Bluebook--that would have been in July, I think--was that of a rise in U.S. saving rates. That was a relatively benign possibility. The stock market levels out and starts heading down in part because other places appear to be better places to invest than the United States. U.S. saving rates begin to rise as wealth-to-income ratios fall. We cut back consumption, and exports begin to replace that consumption. In that example we actually had a fairly easy restoration of balance within the aggregate demand sector and kept the balance between aggregate supply and demand as well.

It's very hard to tell what will happen. Certainly the risks, as Karen Johnson and others have pointed out, would be that before saving increases in the United States, the willingness of others to ship their savings to us to accumulate more dollar assets declines. And we'd have what looks like an exogenous shift in the demand for dollars, putting downward pressure on the dollar. So there is a risk involved that would add to inflation pressures as well as to demand on the United States. But I think it is very crucial how that correction occurs and what is happening to domestic demand at the time it occurs. Rather than focusing on just that piece by itself, the context in which these developments occur has to be taken into account as well.

CHAIRMAN GREENSPAN. Any further questions for Don? If not, let me get started.

We have a very difficult set of issues to evaluate. The reason relates largely to what I see as growing evidence that the models with which we have been trying to explain how the American economy functions are becoming increasingly obsolete. It is not that the econometric structure of the models is inappropriate, but certain simple assumptions are made in their structure that are driving the results we observe and are creating at least the presumption that we are missing something important.

Let me just say very simply--this is really a repetition of what I've been saying in the past--that we have all been brought up to a greater or lesser extent on the presumption that the supply side is a very stable force. The assumption has been that the working-age population is increasing at a fairly predictable rate and that trend productivity is growing at a fairly stable one percent annual rate. So, the presumption has been that we could look at the supply side as an independent variable in the complex interaction of our equations. That presumption generally has been not challenged largely because it has worked. But what people around the table have been saying is that third-quarter growth has rebounded quite substantially. And indeed it has. So has productivity growth.



In my judgment our models fail to account appropriately for the interaction between the supply side and the demand side largely because historically it has not been necessary for them to do so. A crucial variable in our models is trend productivity growth, and the conventional procedure in our quarterly forecasts is to specify a constant trend rate of productivity growth. Yet, our official figures indicate that the growth in productivity has been moving up at an annual rate of around  $\frac{1}{2}$  percent each year since early 1997. On top of that, the review of 1995 to 1997 in retrospect is adding another 0.3 percentage point to the annual rate of growth in the most recent years. So what we have, in effect, is a set of trend productivity values whose second derivative has been positive.

We have two choices. We can either project a continuation of the positive second derivative for productivity, or we can assume that the second derivative goes to zero and we will have a flat productivity growth rate.

You may say that there are arguments for both. And indeed, as I will make a case in a moment, there are. But we have chosen the second automatically. As a result, we--as well as everyone who has the same structural model--have created a necessary outcome because of the algebra of our models. It is algebraically necessary for such models to project a rise in inflation if they incorporate a constant rate of growth in productivity and we have a very low unemployment rate, which presumably creates some pressure for wages to increase more rapidly than the trend productivity rate. I will stipulate that that is exactly the situation we are looking at and one that has always been associated with rising inflation.

What is the case for automatically assuming that the second derivative of productivity goes to zero? Certainly the most recent productivity data--whether we are looking at growth rates calculated on a four-quarter moving average basis, a two-quarter basis, or any other basis we want to use--do not confirm that assumption because all those data indicate that the rate of growth in productivity has been rising. Then the question is why this happens. When we engage in growth accounting analysis in an effort to get to the bottom of this, we find, as Governor Ferguson said, that there has been a very significant increase in capital deepening. That means, in effect, that we are getting very substantial acceleration in the growth of the stock of capital--or, to be more precise, capital services. In addition, we clearly are getting evidence of acceleration in multifactor productivity, the residual in growth accounting, which is another way of saying that the synergies of productivity-enhancing investments are coming together and in the process are creating an acceleration in productivity. What this implies, if it is true, is that we should be seeing a fairly

marked upswing in profit margins or, another way of looking at it, in the ratio of profits to compensation or to a variety of other measures that productivity may spill into such as real wages.

I have raised the issue before as a hypothesis, and I think the anecdotal evidence as well as the data are increasingly supportive. That is, there appears to be as a consequence of productivity gains a very marked and at the moment persistent rise in expected rates of return on new plant and equipment. We can get that from a number of different calculations. We can get it from one of the calculations I like to use, which is a rough endeavor to weight changes in productivity and in capacity--the two major elements toward which capital expenditures are directed. We try to infer using some simplifying assumptions what part of the increase in productivity that we observe plus the increase in capacity is attributable to a specific year's capital investment. When we do that we find, not unexpectedly, a very significant acceleration in the rate of return for each recent year's capital investment. I don't want to get into the embodied technology problems, which are tricky here, but the most revealing indication that the rates of return are very high and rising is to observe the behavior of capital investment. It simply is not credible that we could be getting the type of boom in capital investment that we are observing, and one that is accelerating, if the plant managers who are in fact initiating these investments have not been getting the returns that they expected.

We also see, as I have mentioned previously, a fairly continuous upward revision on the part of security analysts of their long-term forecasts for earnings. The last observation we have is for the month of September, and this number is at a record high. It is continuing to rise. I'm not saying that these forecasts are any good as far as earnings projections are concerned. Indeed, they're awful. They are biased on the upside, as they are made by people who are getting paid largely to project rising earnings in order to sell stocks, which is the business of the people who employ them. But the question really is how much the bias has changed over the relatively short period of time in which there has been this dramatic acceleration of the rate of return in all the measures, starting in 1995. After talking to a lot of these analysts, the answer as far as I'm concerned is that corporate executives, from whom they get the information they use for projecting the earnings of the individual companies, are telling them that they are consistently lowering their costs. And the way they lower their costs is essentially through labor-displacing capital investment. They don't use the term "labor-displacing," they use "cost." But as we know, on a consolidated basis, 70 percent of cost is labor. And if we are getting an increasing amount of labor-displacing investment, by definition we are getting an increase in output per hour. If we are getting

an increase in output per hour, we also are getting an increase in real income. And if we are getting an increase in real income, we are going to get an increase in personal consumption expenditures.

Indeed, if we look at the whole pattern that is involved, there's a very interesting question of when structural productivity growth is going to be adequate to offset the growth that is occurring on the demand side. I would argue that we may be asking the wrong question, because it may well be that it's the productivity acceleration that is engendering the growth on the demand side, directly and indirectly--directly obviously through income and indirectly through the increase in capital asset values. That is, leaving aside the question of price-earnings ratios and whether there is a bubble, there is no question that a significant part of the increase in the market value of equities and other assets reflects the fact that productivity has accelerated.

If we look at a breakdown of the supply side of the economy, what we end up with is that the total change in GDP is algebraically equal to structural productivity growth plus the growth in the labor force or the working age population or some similar measure. And leaving aside a number of minor issues such as average hours and statistical discrepancies--which are not unimportant--we find that the measure of the difference between the change in GDP and the sum of labor force growth plus structural productivity growth is effectively some measure of changing unemployment. And declining unemployment is very likely the consequence of the wealth effect, which is boosting consumption over and above what is normally expected of PCE out of income.

Whether in current circumstances it will be possible to offset the increase in demand on the cost side, I think, is the wrong question to ask. That's because it is by no means evident that the current expansion is going to slow at all. The reason is that if productivity is continuing to accelerate and we put that into our econometric model, we are not going to get a slowdown in economic activity. We are going to get motor vehicle sales possibly of 20 million at an annual rate instead of, say, 17 million. We are going to get housing starts of, say, 2 million and not 1.5 million because gross domestic income and gross domestic product--leaving out the discrepancy, as I have indicated previously--have to balance.

The reason I raise this question is that we are seeing a remarkable acceleration in economic activity now, which under our old regime where the supply side is relatively stable would lead us to say that this expansion is getting dramatically out of hand. But let us turn the thing around by supposing that instead of putting a flat productivity growth path into our models we put in a positive second derivative. That would mean that productivity growth would continue to increase. I submit to you that if we do that and it happens, we are not going to get a slowdown in economic

activity. We will come to the next meeting and say that the markets are going berserk and that there is a consumer binge in progress. Indeed, that is what has to happen. The key question we have to ask ourselves is whether this is an overheated economy. Is it unsustainable and do we need to apply the brakes? I think the answer at this stage is that we don't really know for sure.

If I were doing a forecast, I could make the case as to why I might put in a non-zero second derivative for structural productivity--just leave it there, run our projection, and then discuss it. Or I might do precisely the opposite, which is what Mike Prell and his colleagues have done, and keep the structural productivity growth rate flat and discuss that. I will submit to you that neither case is easy to make and that there is evidence to support both cases, as I think Mike Kelley has indicated. The presumption that, logically and necessarily, the only choice we can make at this stage is to use the flat productivity growth rate is unverifiable in my view. As a consequence, I think it is important for us to recognize that this is a very unusual period.

It is extraordinary to have, as the forecast in the Greenbook, a trend productivity growth rate that rises from an annual rate of about 1 percent to 2.3 percent when in effect we already have nonfarm productivity rising in the last four quarters to a rate of 3.2 percent. If we look at the growth of GDP from the income side and use the household hours-worked data, which are then consistent with the unemployment rate, we get a still faster acceleration in productivity. The reason why the unemployment rate has been stable at 4.2 percent or thereabouts at a time when our productivity growth numbers have not looked all that significant relative to the rapid growth of output is that we are measuring productivity with hours from the payroll survey. But the payroll survey numbers have been rising at an average of 50,000 to 70,000 people per month in excess of the rise in the adjusted household data. Average weekly hours look the same, meaning that the growth in total hours from the payroll survey has been far more in the last two or three years after being closely parallel to that of the household survey data. As a consequence, if we did nothing but look at the household data--the unemployment rate, the changes in employment, and the hours data--we would end up with a far more rapid rise in productivity growth.

So, I would say that the issue is not whether productivity can grow fast enough to keep pace with demand growth. We are dealing with a simultaneously structured economy in which the very forces that are driving productivity--primarily technology--are boosting the income side and the capital assets side, both of which are having an impact on the demand side. I think it is essential for us to recognize that we have this kind of interaction. If we don't, we very well could be looking

at a benign expansion on the demand side that is being fostered wholly by increased productivity and wrongly view it as overheating.

I am not saying that the evidence is completely consistent with the argument I have just made. Even with that argument, we still have a significant wealth effect, so that actual demand growth is in excess of potential supply; but both are rising very rapidly. All I can say is that at this particular stage the number of workers who are seeking jobs is decreasing. As that number shrinks, real compensation per hour obviously will move well ahead of productivity at some point, in which case inflation will take place. So, even under my assumption that the second derivative is positive, all that does is to prevent unit labor costs from rising for a while. But at some point, that process engenders greater growth in real compensation per hour than in productivity, which itself is accelerating, and at the end of the day we end up with acceleration in prices. The difference between the two scenarios is that the time frames are dramatically different. In one case we are looking at acceleration in inflation almost immediately as we get into the year 2000, while the other scenario delays the whole process--perhaps quite significantly. Moreover, it may very well be, as I think a number of us are expecting, that the wealth effect will finally simmer down because of the existence of a bubble that can't persist and that the two effects will converge and there will be no inflationary imbalances.

I didn't mean to get into this long lecture, but after listening to what we've been talking about I have the uncomfortable feeling that we are misreading the economic signals. That said, let me go on quickly to a couple of other issues.

Two or three of you mentioned money supply growth. As you know, if velocity is constant the desired money supply growth for zero inflation should basically be the sum of the growth in the civilian labor force, the growth in productivity, and the extent to which the CPI is biased upward. That comes out very approximately to an annual rate of about 5 percent. That rate is not all that far from where we are, especially after adjusting for Y2K. So, looking at policy from the money supply side, I'm not terribly certain that we are very far off. You will recall that the annual ranges selected are based on a 1 percent productivity growth trend. We decided not to put in an allowance for higher productivity and I think advisedly so. But let's not fool ourselves as to the fact that normal money supply growth is affected by the rate of growth in productivity.

Finally, let me just say that there are a number of things that we can spot to know that the economic process is running into trouble. For example, if we see domestic operating profit margins begin to flatten out or decline--after adjustment for IVA, I might add--we would know that

productivity growth is no longer accelerating and that would be a signal that something is going wrong. That would mean the second derivative is no longer positive, or we are getting down to the bottom of the employment barrel where real compensation per hour begins to move well ahead of even accelerating productivity growth. We see nothing of that sort at the moment. Growth in total unit costs is still declining. Growth in unit labor costs is still declining. We have productivity growth data through the second quarter for the total and through August for manufacturing. The latter is not a forecast; the industrial production and hours data that we already have now show that productivity is up quite sharply.

I submit that we have a very complex set of problems to deal with, and we have to exercise a bit of humility in looking at the models we are employing to reflect reality, as a number of you have said. Because we have used a zero second derivative for productivity in every forecast, we have underestimated real economic growth and overestimated inflation. A lot of you have mentioned that. I submit that we are doing it again. That does not mean it's the wrong thing to do, but I do wish to suggest that there is an alternative assumption. The difference is whether you consider the first derivative to be positive and constant or you wish to add a second derivative that is also positive. I am saying that the most recent trend would argue in favor of the second alternative, which is just an extrapolation of what has been occurring. The question is whether that assumption is valid.

I come to the basic conclusion that we really don't know at this stage. We do know, as Jack Guynn mentioned, that a lot of people in the technology area are saying that we are only at the beginning of a big productivity growth process. That's probably true, but it doesn't tell us much about the outlook for actual productivity growth over the projection period. If, for example, as Lew Gerstner of IBM has suggested, we are a third of the way through the investment in unexploited technology, we still have two-thirds to go. It is quite possible that the one-third has been moving at a very fast pace and that the two-thirds will move at a much slower pace. Under those conditions productivity growth will fall, even though the level of productivity itself continues to rise. We can't simply argue that innovation has a long way to go and conclude that productivity growth will either stay up where it is or go higher in this period. That's a non sequitur. It depends entirely on the time horizon over which that remaining two-thirds of innovation is exploited.

Having gone on far longer than I had anticipated, let me just get to what I hope is the bottom line. My own judgment is that having done 50 basis points and having seen a very significant rise in corporate bond yields--as you know they are up significantly more than

Treasuries--I think we ought to wait at this point to see what happens as a consequence of that rise. Nonetheless, if we do vote for "B," I would prefer not to give a message that we are necessarily through for the year. I think it would be a mistake in the current context to leave the presumption in the marketplace that the Federal Reserve is quiescent and is not concerned about what may emerge over the balance of the year. Consequently, I would favor asymmetry, and I would have no difficulty with that if we were still on our old regime where we just voted for asymmetry and published our decision about six weeks later.

In my view we have a secondary set of disclosure problems, which Don Kohn raised, that are unrelated to the policy decision itself. As I see it, we created a very difficult problem when we started to announce our symmetry/asymmetry decision. I wish we had not done it but, frankly, I don't know how to get out of it. But if we are going to be fully forthcoming in our accountability to Congress and to the electorate, we are going to do things that in hindsight we probably will wish we had not done. The answer is not to stop doing them. We have to live with certain mistakes that we make because they are irreversible. I am not arguing that we should not have tried; I just regret that we did not succeed.

All this leaves us with a very tricky question. If we agree to adopt asymmetry, we could announce our decision in the usual manner. That is, we would just announce it. My preference, which is not a big one I must say, would be to try to convey the same message in a press statement as distinct from indicating very specifically that we are asymmetric. In a sense that would amount to publishing our consensus of where we think we are likely to be after the usual six- or seven-week intermeeting period. I don't like the implication that we are committed in one direction. In fact, we never did say we were going to publish our asymmetry or symmetry decision after every meeting. All we said was that we would convey information about important changes in our thinking. We can convey that sort of information, probably in a more sensitive manner, in the language of a press statement. Therefore, I would prefer, if we adopt "B" asymmetric, that we convey the asymmetry in a statement rather than in a direct announcement of its adoption, which has all sorts of bells and whistles associated with it.

There is an alternative, which would involve announcing that we have decided to put the issue of symmetry and asymmetry aside pending the outcome of the Ferguson subcommittee's evaluation and recommendations. That essentially would say that we are not going to incorporate any reference to symmetry in our directives for a while. That's a possibility and members of the Committee may find that useful. Frankly, I find none of the three alternatives ideal. The ideal

would be for us to have stayed where we were, but we are beyond that now and I don't think we have the choice of going back.

So, I have two recommendations to put on the table. One is my hope that we can at this stage put our policy on hold for a while. With Y2K apparently coming under some control, even though I am wondering about the inventory data, I don't see a problem should we decide to move in November. I do think we would have a problem in December, but I believe the November window is still open. If we conclude then, after looking at the substantial amount of data we will be getting in the interim, that a further advance would be appropriate in November, I see no reason why we can't move at that time. I don't think our policy stance is far from where we want it to be. I don't think we are behind the curve. My impression is that the markets have interpreted our policy moves as preemptive and regard us as credible. I don't think we are on the edge of a major breakout of inflation. I see that as the most non-credible prospect at this point. A price erosion on the upside is definitely possible, but not one that occurs rapidly. The more likely thing that may happen, if something happens abruptly, is in the other direction. The stock market could crash and, as the wealth effect implodes, we actually could end up eventually moving in the other direction.

At any rate, I would like to put "B" asymmetric on the table and request some views on how we should proceed with regard to making our decision public. If we choose an asymmetric directive, our alternatives would seem to be: (1) issuing a statement with no reference to symmetry; (2) explicitly announcing that we went asymmetric; or (3) temporarily removing the symmetry question from our directive and announcing that we are doing that pending what we will decide after the Ferguson subcommittee completes its work. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I very much support the "B" part of your recommendation. As for how we handle the verbiage, you and others may remember that I've tried to make the distinction in previous meetings of asymmetry being either strategic or tactical. If we publish some verbiage that describes our assessment of the balance of risks but do not say that we are asymmetric, I think we would in fact be making that distinction between strategic asymmetry and tactical asymmetry. I believe that is a good thing. I share your view that at the November meeting we will be fully free to do what we think is appropriate. At the December meeting, since it's so close to the Y2K date, we might not have much freedom. But as you are all probably aware, I think our December meeting is always too late. The markets are essentially closed for the year and, therefore, it's a very awkward meeting for us to take any action. As we



plan meetings for the future, I'd be very much happier if we could move the December meeting date forward so we'd still have some functioning markets when we might actually need them.

As for the third possibility of announcing that we're putting symmetry and asymmetry aside until Roger Ferguson's group reports, I rather like that. But I think it would be very, very difficult to explain in a way that would not come across as a bit ludicrous. So I share your view that the best thing to do is to have "B" with strategic asymmetry, which means that we would use verbiage rather than the word "asymmetric."

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Mr. Chairman, once again your presentation was a most interesting one. I felt as if I was riding a roller coaster for a while. [Laughter] Sometimes when you start out and begin to talk about accelerating productivity, I feel a bit of discomfort. But I've heard it often enough to know that if I'm patient and just sit back, we're going to end up pretty much in agreement. Nevertheless, I was holding on to my chair! [Laughter] But soon enough you came back and we agreed that there are tight labor markets and potential inflation risks.

The story is that we have two scenarios out there. We have the Greenbook scenario with constant trend productivity growth. That's the one I'm comfortable with and that's why I am concerned about inflation risks. We have your alternative--one that's certainly shared by others around the table--that we could continue to see accelerating productivity growth. Clearly, the task here is to make monetary policy fully respecting that uncertainty. That might be a little too simple, though, because we might really want to ask the question of just how much of an acceleration of productivity would be required to overturn the increase of inflation that's in the forecast. At any rate, at times like this I like a maximin type of strategy that looks at each of these scenarios and pairs it with the wrong policy action to see how bad the outcome is. It seems to me that if we have the wrong policy with the constant productivity growth scenario, we have a rather unpleasant outcome ahead of us.

However, if we begin to tighten and you're right that productivity growth is accelerating, it's just hard to see, given the fact that rates of return are rising so aggressively in the economy, that very much damage is going to be done. The bottom line here is that I'd be very uncomfortable if you had said that in light of your optimism about productivity the place to be was at no change with a symmetric directive. I do appreciate the leadership you provided in bringing us toward a consensus. We have a variety of options and I think I could live with a number of them.

I have more than a slight preference for going "B" asymmetric and publishing it because the artifice of saying that we're not going to say we're asymmetric but use language that reflects our bias in that direction will seem strange to everybody. People will note that we used asymmetric language in our policy release but didn't want to use the word in the directive and will then worry about that. In this circumstance we have the benefit that the markets expect, more than any other outcome, the decision today to be no change asymmetric. There was a survey in Stone and McCarthy in which 46 percent of the respondents expected that outcome. That was the largest single expectation. I think that gives us some opportunity to get the job done with an appropriate announcement. But if the preference were for doing it and saying that we weren't going to vote on symmetry or asymmetry but reflect it in the announcement, I think that would be fine too. I would prefer not to adopt "B" asymmetric and say we will let people find out in six or eight weeks. That I don't like. But I think an announcement to the markets that doesn't mislead them about what our assessment of the balance of risks is today would be appropriate.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you. First, let me say that with respect to your overall recommendation, I think you're right on "B" and on some indication of asymmetry. I would join with Governor Meyer in saying--and this goes back to a staff paper that came out earlier--that if in fact productivity isn't picking up, then we clearly want to tighten to bring supply and demand closer into balance. If it turns out that productivity in the second derivative sense is continuing to grow, as Governor Meyer said and as I think the staff paper also indicated earlier, that is consistent with a higher equilibrium rate of interest. So in a sense, as hard as the decision is, in some ways it's an easy decision.

On the communications issue, let me first tell the Committee what the working group talked about yesterday because we asked ourselves what we should do in the interim before we complete our task. We started with the thought that perhaps we should simply no longer vote on symmetry or asymmetry. But then we were concerned that we would be doing two things: (1) prejudging an outcome and (2) putting us in a position where we hadn't really thought through the implications. We would be rushing through something and we wouldn't be sure how to communicate it and so forth. Other members of the working group can speak to this, but I think we were most uncomfortable with your third option--announcing that we're thinking about this and therefore aren't voting on symmetry or asymmetry.

As to my personal preference, I would be inclined to go in the direction that Governor Meyer indicated, which is to be quite clear that we've voted for a bias toward asymmetry. If the consensus is that we don't want to announce the asymmetry but let words about the balance of risks cover it, then I would be supportive of that. My reason is that, as I think about what happened when we first went down this path, the market reaction to our announcing the asymmetry was not particularly jarring. On the other hand, the market reaction to a number of statements that occurred afterwards started to get more jarring. So I think we should learn the lesson accurately. It was not being transparent that was the issue. It was much more, for lack of better words, a case of needing a bit of discipline. So I think we could manage an asymmetry announcement if we are a disciplined Committee. I have a slight preference for doing that because I know--or maybe I should say I assume--we will continue to be disciplined. Thank you.

CHAIRMAN GREENSPAN. Third derivative! [Laughter] President Jordan.

MR. JORDAN. Thank you. Let me start first with this question of symmetry or asymmetry. I think everybody knows my views on that, but I'd just like to remind everyone that there was an action in August following our adoption of a symmetric directive on June 30<sup>th</sup>. So having a symmetric directive now doesn't preclude an action. My basic assumption is that there will be enough speeches and press commentary and quotes for us to signal markets if that's necessary. It seems to happen all the time.

On the question of policy objectives, though, it's one thing when we have a high inflation environment--whether it's a high, single-digit inflation rate let alone a double-digit rate--to bring it down using rhetoric like price stability, zero inflation, and other terms like that. I think it's quite different when we have achieved an environment that by most statistical measures is somewhere in the zone at least of what those words are taken to mean. That makes it more difficult to try to find a way of communicating why we do things when we do. That's because I think we mostly would agree that taking anyone's statistical measure as an objective of policy and saying raise this, plus or minus, would be the wrong thing to do.

I agree that we're having a productivity surprise that is very positive and significant. I hope it continues. And I'm very willing to base policy on the assumption that it's true. But I also know that it's not evenly distributed throughout the economy. Certain sectors or industries have very pronounced favorable productivity surprises--computers, telecommunications, and the like. Others have none at all, like the marina where I keep my boat, which raised my fee 10 percent. And some

even have a negative--declining productivity--because of a decline in the quality of the labor pool they have to work with and so forth. All that is no doubt true.

I also know that when there is a favorable productivity surprise, it's like a bumper crop. We're going to have a relative price effect. Relative price effects can come about either from a decline in the price of the products with favorable productivity surprises or an increase in the price of things with no productivity rise or, more likely, some combination of the two. The question is: Do we have overall monetary stability when some prices--on items where there is no favorable productivity--rise? Clearly not. Under a gold standard, all of the wealth gains are manifested and distributed in higher purchasing power of money; when you don't have price rises at the marina, you have price declines at the establishment where you have coffee.

Now, overall, I wouldn't worry about all this too much except for the intermediation process. The way the credit markets work through the banking system, I worry about asset price increases in a relative price sense--relative to goods prices--when those assets are financed in ways that make those price rises unsustainable. And though I know that a second derivative can be positive for a while, I also know that the second derivative for nothing in the universe is positive forever. It must always go to zero if not negative. So I worry about the second derivatives of asset prices being positive--financed by the banking industry or pension funds or life insurance companies--and the prices getting to unsustainable levels. When that inevitable point comes where the second derivative must go to zero or negative for asset prices, people will find out that they've made a mistake and then we will have a credit crunch. We will have a debt/deficit cycle that becomes a problem. So overall monetary stability in the zone we're in still leaves us with a challenge. Even if the projection for the CPI over the forecast horizon were 1 percent and not rising, I would still say that we have a challenge of achieving overall monetary stability that is sustainable.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, I support "B" asymmetric. I want to talk about the disclosure issue in a minute, but let me first say that I think "B" is the right place to be. Even though we have all these uncertainties about both productivity growth and labor force participation, there is always the possibility that with very favorable surprises we would end up with lower inflation than the point forecast. And I don't think that's a bad outcome, given that I still believe we have a positive, though very small, rate of inflation in the economy in a trend sense.

The way I want to look at this situation is to recognize that a lot of the stabilization work is being done by the market and eventually, I'll say, "ratified" by the Fed--but granting that the Fed has established the basis for such a stable environment. So we want our communication with the market to be such that as data arrive the market moves interest rates in the right direction. It seems to me that if we do not publish some notion of asymmetry at this point, we may well be indicating to the market that we think our policy adjustments are completed. I think that's the way the market would read it. Therefore, upward surprises or very strong data, which are what we expect to see coming down the pike, might not move interest rates in the way that would be constructive over the longer run. So I believe we do want to indicate that we are asymmetric, whatever language we use, so that we will get the right market responses as the data come in. If the data come in on the low side or are very benign, then we would get the response that we need out of that, too.

In terms of what to publish, part of the issue--maybe a good part of it--stems from our statement that we would publish symmetry or the lack thereof from time to time when we felt it was particularly important. So I think some of the market overreaction, as we read it, has come about because the market believes we're really trying to tell it something. In my view, the best way out of this is to indicate to the market that we expect to have a statement after every meeting, although in practice many of those statements might be very routine boilerplate that doesn't really say anything. But we could try to take some of the special ring out of a statement by saying that we now intend to issue statements routinely after every meeting. That to me is what I would call the least unsatisfactory way of getting out of the situation we find ourselves in at this point. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I agree with the "B" option here. Given the two moves we've taken and balancing the supply side and the demand side uncertainties, I think "B" is right. However, I believe we could undo a lot of the good we're going to do with a "B" decision by fooling around with this asymmetry and symmetry issue at this meeting. Our experience with announcing asymmetrical directives has not worked very well. It may work better in the future. I'm hopeful that Roger and his colleagues will come up with something that will make it work. But a formal asymmetric directive, when it is at best a confusing tool and at a time when we want to keep open our options because of uncertainties about what's going on in the economy, really is foolhardy. I feel very strongly that we ought not have a formal asymmetric directive because it will end up doing more harm than good.

I view the use of words as more promising, however, because words can help us lay out a framework for our thinking about incoming information and policy. We may very well want to tighten in November, but we may not want to tighten. So I don't think we want to box ourselves in by the language that we use, and an asymmetric directive runs a big risk of boxing us in. Words, if carefully chosen, can give the slant that we want without loading the dice. And this is a time above all when we want the markets to know that, yes, we may tighten, but we may not. It is not a foregone conclusion.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, before I came to this meeting I concluded from reading the staff documentation that the Bluebook didn't make a very strong case for tightening but that the Greenbook really did. The Greenbook projection may be wrong but I'm just not prepared to discount it to the extent that I think you have. I believe the comments that you made--I had to hold on to my seat as Larry Meyer did--were a very useful reminder. I really do. But at the end of the day, I think we're still just very, very uncertain about what's happening to the second derivative of productivity growth. So that's where I'm coming from. And against that background, what we have is very strong growth in domestic demand and continued tightening in domestic labor markets. I agree with Bill McDonough that we don't want to fight either growth or lower unemployment. But to be concerned about the possibility that demand growth is not sustainable is a legitimate worry for this group. Moreover, the Greenbook at least is projecting a rather steady increase in core inflation from about 2 percent this year to 3 percent in 2001. That strikes me as a plausible projection, given what is happening to some intermediate prices and given the kind of anecdotal information Jack Guynn offered about attitudes toward pricing power. We hear a little of the same thing in our District.

And finally, I was interested in one of the alternative simulations in the Greenbook, which suggested that in order to hold the line on inflation the funds rate needs to rise another point. We probably still have some time before we absolutely have to act, mainly because our credibility currently is so high, but I just don't see any particular reason to delay. I doubt that it is going to get any easier to tighten policy and it might get a lot harder.

There is one other point that I consider quite important, which I think Larry Meyer mentioned. Even if you are right about productivity growth continuing to accelerate, in that situation an increase in interest rates is not necessarily inappropriate. We need to keep that in mind. If, as appears likely, we don't raise rates today but stay with "B" and have an asymmetric

directive, I have a very strong preference for announcing that. I would be very concerned about trying to do that with language. I have the same feelings a lot of other people have expressed, but perhaps I have those leanings even more strongly. To me it's a matter of credibility. If we don't announce asymmetry, I'd probably prefer the third alternative--just saying we've changed the rules of the game. But when we first adopted the procedure we're now using we indicated that if we had a material change that would interest the markets, then we would announce it. To go back on that at this stage of the game would be a mistake.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. First, my students back at Michigan would be delighted to know that the term "second derivative" has crept into policy discussions.

[Laughter] I compliment you on that!

On your criticism of models, I'll plead guilty to thinking for a long time in terms of matching aggregate demand with fixed or predictable levels of aggregate supply. There is nothing engraved on a stone tablet that says that's the way to do it. I believe you're right that we ought to get out of the box, if you will, and think about new ways to view the economy. I will try to do that. It's possible that we are on the verge of some kind of shift not only in economic outcomes, but also in the way of thinking about economics. That's a reasonable point to put on the table.

In terms of more immediate policy considerations, I'm not totally against waiting to see what happens. I would make two points. One is that it is harder to raise the funds rate than to lower it. Secondly, in my heart--even with what I just said about new ways of thinking about economics--I would be more comfortable with a higher funds rate than the one we have now, in case we're wrong about the second derivative issue. I make no bones about that. I'm delighted to see that there seems to be a growing consensus that if we have to act, we could act in November. It's important to get that on the table because I believe we might have to act in November.

In terms of what we do today, I have a preference for what I'll call straightforward asymmetry. I'll give three reasons for that. The first is that these are the rules that we agreed to live by and it's not a good idea to change the procedures until we've gone through the process of considering various alternatives, which is a process we are going through. I don't think that boxes us in. It has been pointed out statistically that asymmetry has been followed by rate increases less than half the time in the recent past. So I really don't accept the argument that asymmetry boxes us in. As a general matter, I think we have a tendency to try to do too much with language and I would prefer the more straightforward approach of "B" asymmetric.

CHAIRMAN GREENSPAN. And announcing or publishing it?

MR. GRAMLICH. And announcing it.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. I agree with your recommendation of "B" asymmetric. And I certainly agree with your statement that we should be humble about our ability to forecast the future. We've talked about this, and it's a concern that nags us all.

I do want to note two points about the forecast that I thought were worth mentioning to this group even though we have some questions about the forecast. But if we accept the Greenbook forecast as it is, I thought it was striking that, in the alternative scenarios the staff presented, core CPI in 2000 varied by only 0.1 of a point, from 2.7 to 2.8 percent. There was virtually no difference in any of the scenarios. It's almost as if that is baked in the cake already in this forecast. Of course, the output varies significantly.

The second point is that if we adjust core CPI on a consistent methodological basis going backward, that 2.7 percent forecast for the year 2000 will be the highest rate of increase in core CPI since 1992 when it was 2.9 percent on that adjusted basis. So, those are two points that really concern me as I look at this forecast. Of course, the forecast may be wrong, as we all know, but these are the points of concern.

On the question of how to disclose this to the public, I participated in the discussion yesterday with Roger Ferguson's group and I described our effort as looking for the "least worst" option among the three that you presented. None of them is really satisfactory at this point. I do not think we should freeze the use of this tool between now and the time the working group's report comes out and we make a decision on what we're going to do. I have a slight preference for the recommendation you made for using language instead of the tool itself at this point. We made a mistake when we adopted this procedure. I just remember the problems we had when we used it last time. So I would have a slight preference for using language instead of the actual tool of asymmetry.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, before this meeting I favored "B" but concluded that the time for raising rates is probably not that far off. As a result of the discussion today, I think it's even nearer but I still would favor alternative B.

With regard to the symmetry issue, I must admit that I found the experience we encountered--in terms of market reaction to the May press release about asymmetry--so distasteful



that it makes me want to try to use words to describe our views about the risks to the outlook. Clearly, we are not talking about a symmetrical situation. So I'd like to indicate a preference to use words to deal with this issue of risks to the outlook. But if we can't do that in an efficient way, I certainly could buy an announcement of asymmetry.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Mr. Chairman, I truly enjoyed your lecture a moment ago and when you publish it I recommend the title "The Rediscovery of Say's Law." I think it is important for us to give Say's Law at least equal billing with Keynes's Law in these discussions.

During the go-around there was a lot of talk about favorable but temporary factors that have helped us out on inflation and how a lot of those are petering out. That is true, but I still believe the fundamental factor that has been helping us is the high-tech boom, which is not petering out and is not likely to peter out any time soon. That's the general phenomenon. And the specific phenomenon is the Internet, which is changing the whole world as we speak. When I refer to the high-tech boom, I'm talking about high-tech electronics, which is helping the GDP numbers. But high-biotech is also raising our standard of living in ways that probably don't improve those numbers. It may even have a perverse effect on the numbers. Cures of diseases, the prevention of diseases, and shorter hospital stays all may generate less GDP than diseases would.

Another huge development that is not over yet, even though it has been going on for almost a decade, is the collapse of communism and hard core socialism around the world. The fact is that many more countries and many more workers are now part of the world market economy than before. And even where it hasn't involved a lowering of the iron curtain, there has been a lowering of the protectionist curtain--in Latin America, for example. So we have a big, new, world out there with lots of new people. There's a lot of catching up to do, a lot of consolidations are going on, and a lot of privatization. And there is still excess capacity in many places around the world, including the United States. We've been adding to capacity faster than we've been using it. So I feel good about the prospects for further progress on inflation.

I know that the current account deficit is large and that we don't want to rely forever on capital inflows to augment domestic savings. But if it is true that a strong country leads to a strong currency, we are the premier country in this revolution. I think it's not unreasonable to expect the dollar generally to remain strong and to continue to give us the benefits of a strong currency in our inflation battle.

On the policy decision today, I suspect it's no surprise that I like the "B" alternative of no change. In my view we've had three tightenings already. The first was the announcement of the asymmetric directive, which probably did more harm to the markets than the two other tightening moves we've had. I do think we created a monster with our new disclosure policy and the way we worded that policy. But it is still very new, and everybody--especially market participants--knows it's not working well. So it would seem very reasonable to me for us to announce that because it's not working as we had expected, we are going to reassess it--we have formed a subcommittee to reassess it--and that until that subcommittee reports, we're not going to be releasing any information about the symmetry in the directive. I would go even further and suggest that the Committee decide to bury it later on. As Ed Boehne said and I believe Bob Parry said, we can still use words to communicate anything we want. But if we could use the opportunity to get out of the box we're in on announcing the directive, it would be a very good thing.

CHAIRMAN GREENSPAN. Between words or announcing the decision on asymmetry, which would you choose? I'm trying to get a sense of where everyone is to formulate a proposal for the vote. You seemed to imply that of the three variations, the least desirable is to publish the asymmetry. A second option would be to have asymmetry and not publish it, just use words to describe it. The first is what you're opposed to?

MR. MCTEER. I'm for the third--to suspend our use and thus announcements of symmetry or asymmetry. I think it's a tie between the first and the second options. I'll go along with whatever you decide to do on that question. But I think we will miss a great opportunity to get rid of that bogeyman if we don't do it now. It would be a great time to say this is not working the way we intended and we're going to study it. And all we have to announce today is no change in the target fed funds rate.

CHAIRMAN GREENSPAN. I'm not sure there's a majority for that position at this stage.

MR. MCTEER. Well, that was before they heard my eloquent argument! [Laughter]

CHAIRMAN GREENSPAN. Touché! President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. I listened to your arguments with great interest, and they are very persuasive. At the same time, my own view is still that we should move the funds rate up  $\frac{1}{4}$  point now. While I believe productivity is truly increasing, as I said earlier, I think there are other important imbalances in the economy that, if addressed now, will result in a better economic performance in the long term. We should take advantage of that opportunity now. Also, to the extent that the productivity increases are positive in terms of the second derivative and are

continuing, we can act now to address some of these other imbalances and not affect those strong gains. We should keep that in mind as we consider monetary policy today.

On the issue of symmetry, I personally would like to leave the directive symmetric. My reason is that I don't think there has been a major change in our attitude. The last two times we met, we increased rates. We're obviously alert to the possible need for more firming. We're aware of it today. Because we don't take an action today doesn't mean we're not as concerned as we have been, especially as the data come out. However, if asymmetric is the way the Committee wishes to go, I think we're in the stew here in terms of announcing. The law of unintended consequences has manifest itself on this and we are somewhat bound to announce how we are leaning, although I will tell you that our original announcement does not say that we're necessarily going to disclose our decision on symmetry. But that's not what many people read. So I think we're compelled in a way and I would have to suggest that we disclose our decision if we go asymmetric. But I think we'd be wise not to go asymmetric.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I, too, favor alternative B. Let me take just a few seconds to say why. First of all, as I said earlier this morning, I am relatively optimistic about productivity, and that gives me some confidence going forward. Secondly, that optimism assuages some of my concerns about inflationary pressures. I simply don't think the case for a significant acceleration of inflation is all that convincing at this point. And thirdly, I do believe we have a little time. We have moved the funds rate up. The markets, especially long-term markets, have moved rates up even more. I think we can wait to see what all that brings. So, I favor "B."

On the symmetry versus asymmetry issue, normally I favor symmetry, and that's true today. But it's not a big deal to me. If we go asymmetric, given the procedures we have set up, we have to say something about it. I would come out about as Ned Gramlich did. Probably the least bad alternative under these circumstances is just to publish it. Also, I think the markets--or some participants in the market--are probably expecting asymmetry. Several people have commented along those lines. And it's probably not a bad idea to remind people that the door is not closed as far as the November meeting of the Committee is concerned.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. As I listened to the go-around, I found myself identifying with those who would have preferred to go ahead and tighten today. But I am comfortable supporting "B" asymmetric, basically for three reasons. First of all, both in the context

of what we've talked about here today and also for a number of other reasons, I'm delighted that the window still appears to be open for action in November. Secondly, there is an abnormally strong flow of data that will be coming in over the relatively brief period of time between now and our November meeting, and that should be of great benefit to us. Thirdly, how we do it is part of the reason for supporting "B," in my opinion. We talked about this yesterday in Roger Ferguson's working group, and I am beginning to feel--I don't think I was alone in this view--that it could be very counterproductive if we did something in a new way today. It would be ad hoc. We haven't really thought it through in terms of where we're going or where we want to wind up. But more importantly, the market will not be prepared for it at all. It would introduce an additional complication at a time when we don't need any additional complications. It could induce considerable confusion, possibly volatility, and unfortunate speculation. So I'd be very careful about doing something new and different that was a departure from our past practices. I think that would be highly undesirable. The market is only now beginning to become a little more comfortable with the procedures we have recently adopted, and to change them on the fly scares me.

What then does that call for? This is a change in the directive and it represents a change in the Committee's central thinking if, as I believe, we have a consensus for "B" asymmetric. And I think the most straightforward way to handle this would be to adopt an asymmetric directive, announce it to the public, and append a brief explanation to our statement.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. I, too, could have been enthusiastic about increasing the fed funds rate by 25 basis points at this meeting and going with a symmetric directive. That would have conveyed to the markets our concern about the potential for a pickup in inflation--recognizing all the problems associated with forecasting--given the strength of the data and the unwinding of some of the temporary factors. And it would have cleared the decks, in my view anyway, for year-end.

That said, I can support "B" for some of the same reasons that Mike Kelley just noted. We may have some time. Certainly, inflation is not going to jump up tomorrow. There is the ongoing question about productivity. I've spent a long time in the Federal Reserve System associated with the operations side; and when management gets involved, it's usually around the issue of productivity changes from improvements in operations. In my view, anyway, those occur in step functions. We make a big change and consolidate for a while, reorganize, and get the benefits out

of the change and then go forward from there. Not very routinely does productivity keep going up in a constant arc nor do we routinely get year-after-year continued positive second derivative changes. You mentioned yourself that it will come to an end sometime. We don't know when. But we probably do have some time, because productivity improvements seem to have a momentum that is deeply engrained in the way the economy is running right now. It's also good that action in November continues to be a possibility. So I can support "B."

I also feel that if we start now to change the process by which we communicate asymmetry --and I do think we should communicate how we feel about the balance of risks--the outcome won't be beneficial. It will introduce another level of surprise and uncertainty into the market. It may be that the markets reacted badly to the announcement of asymmetry last May, as we have discussed. But I'd rather stick with that language until we have a firm view on the way to go forward and can communicate that with some confidence. So, I'd go along with Governors Gramlich and Kelley and others around the table on "B" asymmetric, using the customary language.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I identify most closely with the comments Cathy Minehan just made and those of Ed Kelley and Ned Gramlich earlier. In my earlier comments, I indicated that I came into this meeting with the notion that I would be comfortable with another modest tightening move today. Even after discounting our forecast and our genetic tendency to worry--and even factoring in your reminder about productivity--I think one could still make the case that another modest tightening would perhaps be the cleanest, most honest, most expeditious way to get policy to the appropriate place. But I can be comfortable with no policy action today. As my colleague across the table reminded us last week, and as others have commented, the world is not going to come to an end between meetings--especially if we're open to considering a policy action again in November.

I also came to the meeting thinking that the worst of all worlds was some kind of asymmetric directive. As Don Kohn first ticked off the alternatives and then you ticked off the alternatives, I was thinking that if there were a box labeled "none of the above" I would have checked it because none of them feels right.

Having said that, and having listened to the discussion, I have changed my mind a bit during the course of this session. My sense is that we see some inflation risk, and I think we ought to go ahead and communicate that concern. I, too, am uncomfortable with the notion of

introducing still another way of trying to convey that to the markets. As badly as we handled it the first time, I would rather try again very straightforwardly to see if we can get the words right this time to explain an asymmetric directive and be done with it. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. This has been an interesting discussion. I must admit, as I said earlier, that I would have preferred to go asymmetric and put out a press release but not announce our decision with regard to the asymmetry. But I find the arguments in the other direction actually quite convincing.

MR. MCDONOUGH. So do I.

CHAIRMAN GREENSPAN. I am now inclined to announce the asymmetry. The current members preferred that option by a 5 to 4 margin, but if we include those who are not currently members of the Committee, there is a very clear majority in favor of announcing the asymmetry. On an issue such as this, which commits the Committee in a broader sense, I believe we should take into consideration the views of the nonvoting members even if that is not legally required. So what we will vote on at this point is "B" asymmetric with the understanding that we will publish our decision. Would you read the directive language?

MR. GILLUM. Yes, Mr. Chairman. I will be reading from page 13 of the Bluebook: "To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5¼ percent. In view of the evidence currently available, the Committee believes that prospective developments are more likely to warrant an increase than a decrease in the federal funds rate operating objective during the intermeeting period."

CHAIRMAN GREENSPAN. Call the roll.

MR. GILLUM.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Boehne	Yes
Governor Ferguson	Yes
Governor Gramlich	Yes
Governor Kelley	Yes
President McTeer	Yes
Governor Meyer	Yes
President Moskow	Yes
President Stern	Yes

CHAIRMAN GREENSPAN. We have a draft statement, which I'd like to circulate so everyone can take a look at it instead of my reading it. I can read it but I think it would be helpful for you to have the text in front of you. I'll wait until it's distributed. [Pause] Does anybody have any comments?

MR. JORDAN. I have a question about something that wasn't raised in the discussion because I didn't think about it until after I listened to everybody. It may be too late to raise it for today but it may be useful for next time. Without in any way prejudging whether the Committee would want to take an action in November, what would be the implications of removing the asymmetry from the directive in November? Or does that matter? We could be in the situation we were in on June 30<sup>th</sup> where the action and the words seemed to convey different messages and we got varying market responses.

CHAIRMAN GREENSPAN. One of the things that I'd like to ask of the Ferguson working group is whether it can perhaps expedite its report if possible. You had a long discussion--

MR. FERGUSON. We can do it.

CHAIRMAN GREENSPAN. If you can report to the Committee at the beginning of the November meeting, we could fold that into our deliberations. I think it would be quite useful if we could address that particular issue soon because we've got to resolve it. While looking forward to March seemed to be desirable because it would give us a lot of time and flexibility, it's turning out that we're struggling with this at each and every meeting. So the sooner we can come to a resolution, I suspect the better.

MR. FERGUSON. I think we can probably report by the next meeting.

MR. HOENIG. Mr. Chairman, given President McDonough's earlier comments and my own sense of this, is it necessary to spend so much time on the labor markets in this press release?

CHAIRMAN GREENSPAN. Strangely enough, as a consequence of President McDonough's remarks, I put in additional words here to emphasize that the key question is inflation and its potential for undermining the impressive performance of the economy.

MR. HOENIG. Right. But could we take out the labor market reference?

MR. MEYER. We ought to be careful. There is a sense of causality here; this is what we're worried about. I don't see any reason to hide that.

MR. HOENIG. Well, if we're going to do that, there are a lot of other things I'd like to list.

MR. GUYNN. I had the same reaction. It seems awfully limiting to hang all of our hats on one item.

MR. MEYER. The point here, it seems to me, is that the more serious problem is in the realization of above-trend growth in the form of high utilization rates. Do you want to mention what brought about the high utilization rates? This captures it pretty well.

MR. HOENIG. I'm not convinced.

MR. GUYNN. One more comment. People continue to pound me with the question: What is it that you're looking at? The way this is worded, it essentially tells people to watch that one statistic and that one part of the economy, and whether that behaves or misbehaves will guide our actions. I think it's more complicated than that. I wouldn't want to limit ourselves by having that appear to be the only thing that will trigger a tightening move later on.

CHAIRMAN GREENSPAN. Well, what we can do is to say that we need to be especially alert in the months ahead to potential cost increases that could lead to inflation pressures.

SEVERAL. I like that.

MR. MEYER. I disagree with that. Take a situation where we have cost increases and a 0.2 or 0.3 percentage point decline in the unemployment rate next time. I know where I'm going to be. If everybody else isn't there, that's fine. Are preemptive responses by us to changes in the balance of supply and demand appropriate even before those cost pressures show up? That's the question. If you're not prepared to respond to that--

MS. MINEHAN. But if we say "potential" for cost increases, that gets to your point, I think.

MR. MEYER. That's fine.

MR. MCTEER. I don't want to vote next time for a tightening of monetary policy because the unemployment rate went down.

MR. BOEHNE. Neither do I.

SPEAKER(?). You don't have to! [Laughter]

MR. MCTEER. My colleagues won't want to either.

MR. BOEHNE. It's hard to re-edit a statement 55 minutes before press time, but I think a good way out of this is to drop the word "labor" in front of costs. Labor costs are the biggest part of costs, but I don't think we need to single it out.

CHAIRMAN GREENSPAN. Why don't we do this: "In these circumstances, the Federal Open Market Committee will need to be especially alert in the months ahead to the potential for cost increases significantly in excess of productivity in a manner that could contribute to inflation pressures and undermine the impressive performance of the economy."



MR. BOEHNE. That's fine.

VICE CHAIRMAN MCDONOUGH. For Larry Meyer's peace of mind, we do discuss above the decrease in the pool of available workers.

MR. MEYER. I'm happy!

MR. POOLE. Mr. Chairman, it seems to me that the most low-key way of doing this would simply be to take the first paragraph plus the last paragraph of the draft press release without the first three words. That would be a simple statement about what was done--period.

MR. MEYER. That says what we did but not why we did it. It goes against the notion that an announcement is supposed to give the rationale for what we're doing.

MR. KELLEY. And it would be a departure from what we've done for the last few meetings.

SEVERAL. That's right.

MR. HOENIG. I'm okay with the latest changes.

VICE CHAIRMAN MCDONOUGH. Adjust it as the Chairman said and declare victory!

MR. BOEHNE. Let's quickly adjourn! [Laughter]

CHAIRMAN GREENSPAN. For everybody's benefit, I am not of the opinion that writing a press release by committee is the most productive way of doing it, but this is a crucial one. Let me just reread it to be sure that everyone feels comfortable. "The Federal Open Market Committee decided today to leave its target for the federal funds rate unchanged." That's very straightforward.

"Strengthening productivity growth has been fostering favorable trends in unit costs and prices, and much recent information suggests that these trends have been sustained. Nonetheless, the growth in demand has continued to outpace that of supply, as evidenced by a decrease in the pool of available workers willing to take jobs." We're not saying that's the cause of it; that's merely a measure of it. "In these circumstances, the Federal Open Market Committee will need to be especially alert in the months ahead to the potential for cost increases significantly in excess of productivity in a manner that could contribute to inflation pressures and undermine the impressive performance of the economy." Okay?

SPEAKER(?). That's fine!

MR. KELLEY. Yes, sir.

MR. BOEHNE. Why don't we just toss these copies in the middle of the table and get fresh ones?

MR. KOHN. You read "cost increases significantly" rather than "costs to increase"?

VICE CHAIRMAN MCDONOUGH. Yes, he took out “costs to increase.”

CHAIRMAN GREENSPAN. “The potential for cost increases.” Plural.

MR. KOHN. Then “in a manner” doesn’t work.

CHAIRMAN GREENSPAN. You want to take out the reference to productivity?

SEVERAL(?). No, no.

MR. BOEHNE. Fix it up, Don!

CHAIRMAN GREENSPAN. Okay, fine. Sold! Our next meeting is November 16<sup>th</sup>.

MR. KOHN. One reminder, Mr. Chairman. The Committee in its mail-in ballot, voted-- including the nonvoting Presidents the vote was 10 to 3, I think--to change the order of the lead-in paragraph in the directive so that the inflation sentence is first.

CHAIRMAN GREENSPAN. Yes, I forgot to mention that. The very substantial majority agreed with President Poole on moving the sentence. Are you all familiar with what I’m referring to? The only question on the table is not whether we want to do it but if we should do it now or as part of the Ferguson report. I would prefer to wait.

MS. MINEHAN. I would prefer to wait, too.

MR. BOEHNE. I do, too.

MS. MINEHAN. I think we should adjust all those things at once.

SEVERAL. Let’s do it all at one time.

CHAIRMAN GREENSPAN. Let’s wait and do it then.

MR. KOHN. So we’ll go with the old one?

MS. MINEHAN. Yes.

CHAIRMAN GREENSPAN. Okay, we’re done! Let’s go to lunch.

END OF MEETING