

Meeting of the Federal Open Market Committee
May 20, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 20, 1997, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Gynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

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

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

Messrs. Beebe, Eisenbeis, Goodfriend, Hunter, Lindsey, Mishkin, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

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

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

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

Mr. Conrad, First Vice President, Federal Reserve Bank of
Chicago

Messrs. Dewald, Hakkio, Ms. Krieger, Messrs. Lang,
Rosenblum, and Sniderman, Senior Vice Presidents, Federal
Reserve Banks of St. Louis, Kansas City, New York,
Philadelphia, Dallas, and Cleveland respectively

Messrs. Cox, Rosengren, and Weber, Vice Presidents, Federal
Reserve Banks of Dallas, Boston, and Minneapolis
respectively

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CHAIRMAN GREENSPAN. Would somebody like to move approval of the minutes?

VICE CHAIRMAN MCDONOUGH. Move approval.

CHAIRMAN GREENSPAN. Without objection. Mr. Fisher.

MR. FISHER. Thank you, Mr. Chairman. I will be referring to a package of six colored charts with a peach FOMC Class II cover. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. The dollar/yen decline from May 5 through this morning is as sharp as I recall a major exchange rate ever moving. Is my memory faulty or is this a quite extraordinary shift?

MR. FISHER. Yes, it is extraordinary. I'm sorry that I don't know precisely how it compares with large movements in the past, but I think the shift over this period of several days now exceeds the dollar/yen move during February 1994 after the Clinton/Hosokawa disagreement on trade. I can't recall any larger move over the last 5 years.

CHAIRMAN GREENSPAN. Do we have any evidence that the Bank of Japan was selling U.S. Treasuries in this period?

MR. FISHER. No.

CHAIRMAN GREENSPAN. In other words, you are not picking up evidence of official intervention in the data or other sources of information, and as far as you can see, the currency price change is strictly the result of private market forces.

MR. FISHER. That goes one step further than I would be comfortable with. Let me try to explain what I only hinted at in my statement, namely, the impact on the dollar of

intervention by the Bank of Thailand and other Asian central banks. I will try to be pithy about this. I think the simplest example is to take the Hong Kong dollar but only as a hypothetical case; that currency did not come under much pressure in this period. As you know, Hong Kong runs a peg to the U.S. dollar. If \$20 billion, for example, moves from Hong Kong to Japan and the peg is maintained, the one thing that we know will happen is that the dollar will go down against the yen. Now, if we extrapolate that to Thailand just for purposes of an example, that country runs a peg against a currency index in which the dollar has a roughly 80 percent weight. When the Thai authorities defend their currency, funds flow out of Thailand to repay leveraged financing in Tokyo. Thailand defends the baht by selling dollars either spot or forward, and the net effect shows up in dollar/yen movements to the extent that the Thai authorities are successful in maintaining their peg to their index, which they have so far. So, I think the dollar/yen was affected to a significant extent by some of the intervention in defense of Asian currencies and other currencies in this period. It was not a direct effect.

CHAIRMAN GREENSPAN. Since we know the particular days when the dollar was under real tension, and I presume that we at least had the benefit of some judgment from market sources, if not officially, as to when a lot of the intervention and related movements of funds was occurring, can we trace such intervention to the actual days in which the dollar was particularly weak against the yen?

MR. FISHER. Yes, the dollar's weakness occurred on the days when the Bank of Thailand initially intervened in size, May 6 and 7, but not so much in the days that followed. May 6 and 7 were days when the Bank of Thailand's defense of its currency was building up, although there were indications that they had been defending their currency for a while

on a modest scale. It was at the start of that week of May 5 to 9 that Thailand announced some disappointing forecasts for its budget and economic growth for the coming year. Pressures began to build on their currency, and the exchange market activities were thought to be related to that.

CHAIRMAN GREENSPAN. It doesn't necessarily have to happen immediately.

MR. FISHER. No, no.

CHAIRMAN GREENSPAN. What happens is that portfolio adjustments start to cascade--

MR. FISHER. Yes, precisely.

CHAIRMAN GREENSPAN. And it takes a few days at least for that to work its way through. A lot of it is essentially automatic because individuals have no particular desire to sell dollar holdings, but they end up with a maldistribution to which they have to adjust, and that is what has been happening. Governor Rivlin.

MS. RIVLIN. Peter, what do you think you learned from the April surprises affecting the federal funds rate, or what do you think you need to learn before next April?

MR. FISHER. That we all need to go back to the drawing board on forecasting taxes, and I will not pretend to be the expert on that subject. I think our projection problems were universal--New York, the Board, and the Treasury. None of us had it right. Mike Prell may be able to offer more insights into this than I. Such a study clearly will require a major effort. We had some rather big surprises last year, and to be candid we thought we had learned from them. So, that is a major area for study.

CHAIRMAN GREENSPAN. Do we have sufficient regional data to help us locate as we go along where an excess Treasury balance is coming from?

MR. FISHER. No, we do not. There is a rather disappointing inability to take the Treasury tax information and quickly derive statistics that we would find useful.

CHAIRMAN GREENSPAN. We have daily information on some regional characteristics of the tax receipts, and we know from the statistics of income where there are big capital-gains taxpayers and what may change. Has anyone been able to infer anything from the regional pattern?

MR. PRELL. I am not aware that anyone has tried that; it is an interesting idea. It sounds like a lot of work.

CHAIRMAN GREENSPAN. Big Blue could do it. [Laughter]

MR. PRELL. I am not sure that we have that much free computer space right now! We can check into it.

MR. FISHER. The other part of your question, Governor Rivlin--or the other part of my answer--is that I was very pleased that our announcing the quantity of RPs helped the market get a quicker handle on how far off we all were on our forecasts, and that I think was a help. We did operate twice in one day on two occasions. That was not to fine-tune the rates but because of the paucity of propositions we had from the dealers and how far off we were going to be unless we tried to add some reserves by going back into the market. I think the dealer community responded rather well to that in terms of not thinking we were flying off the handle. The added flexibility to the Desk was helpful. I think the tools worked fairly well. The first time we had a big miss in propositions, it did occur to me that it might be nice to be able to do foreign exchange swaps to inject reserves when there was a paucity of collateral. I don't think it was really necessary, but that thought at least crossed my mind.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Throughout this period, wasn't there evidence of a reduced appetite for U.S. securities by Japanese investors and some speculation that the Ministry of Finance actually had played a role in this reduced appetite?

MR. FISHER. Anecdotally, we at the Desk have heard the same stories. I have not been able to see that in any data anyone has shown me, but there are some lags in this process.

MR. PARRY. There will be data on that?

MR. FISHER. There will be some data on that. I have heard it said by a number of people whose views on the markets I respect that they think the very sharp movement in the dollar/yen means that U.S. Treasuries are now at attractive levels for Japanese investors to purchase on the principle that they have taken losses and it is done. I think that the net impact of these movements has been to produce a fairly good two-way market. Clearly, there was some aggressive verbal intervention, both public and private, on the part of the Ministry of Finance. I think that is regrettable, given the nature of the volatility it has engendered.

CHAIRMAN GREENSPAN. Mr. Hoenig.

MR. HOENIG. Peter, in your statement, you said that you thought there were more adjustments to come in the dollar/yen. I don't know if that had to do with portfolio adjustments. Can you elaborate on that just a little?

MR. FISHER. I just mean that this is only an initial round of market expectations that the Bank of Japan may start tightening sometime later this year. Differentials remain rather wide against yen fixed-income assets. I do not mean to draw a perfect analogy from this, but in 1994 the Committee started raising rates in February and we all remember the

Orange County bloodbath in December. That was a full thirteen months after long bond yields started to back up in October and November of 1993. There are different mark-to-market conventions in Japan. Some institutions do not have to; they can just hold their fixed-income assets at historic cost. Others have to mark to market. We have a more mark-to-market financial system than the Japanese. That does not mean the losses in Japan are not buried there somewhere. They are, but they do not come to the fore as quickly. Foreigners who borrow at low interest rates in Japan are subject to a mark-to-market discipline.

CHAIRMAN GREENSPAN. Any further questions for Peter? Would somebody like to move approval of the Desk's operations?

VICE CHAIRMAN MCDONOUGH. Move approval of the domestic operations.

CHAIRMAN GREENSPAN. Thank you, is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Let us move on to the economic report, Mr. Prell.

MR. PRELL. Thank you very much, Mr. Chairman. Carol Low is distributing a table to which I will be referring in a couple of minutes. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Mike?

MR. JORDAN. Mike, the story you tell about the past and your concerns about the future are consistent with a supply side surprise--a productivity shock. In a passive sense, what happens is that we accommodate the existing demand because we peg a nominal interest rate while the natural rate--the real rate--is shifting up during the period. We see not only an acceleration in nominal spending growth but in money and credit growth to go along

with it and make it all possible. What are the dynamics, then, that cause this process to reverse and growth in nominal spending to slow? I am referring to your baseline forecast and not to your concern about the upside. Is it not true that, in effect, the natural rate shifts back down and we then get the slowing that the staff is projecting in money and bank credit growth? We get what you refer to as a fairly attractive scenario.

MR. PRELL. You are talking about the natural rate of interest, I presume.

MR. JORDAN. Right.

MR. PRELL. I guess one could interpret what I have said about the stocks of capital goods and so on as implying a lower natural rate going forward. One could look at this from various vantage points. Whether, indeed, one should view the development of surprisingly strong growth over the past year as a favorable supply shock, I am not sure. There certainly are some elements in the picture that support that view. The labor force growth that we have had over the past year might fall in that category. If one felt that we were seeing something more than the normal kind of cyclical kick to productivity over the past couple of quarters as output growth surged, say from strengthened aggregate demand, then that might be characterized as a supply shock. I am not sure that conclusion is clearcut. Indeed, by our normal rules of thumb and model results, I do not think we have had any more productivity acceleration in the past couple of quarters than one would have expected with a surge in aggregate demand, a rise in output, and firms being able to get more mileage out of their existing resources.

MR. KOHN. President Jordan, in thinking about the real rate relative to its equilibrium or natural level, I don't believe that a real rate a bit below its equilibrium level, as apparently it has been, would be inconsistent with the staff forecast. In fact, it is perfectly

consistent with the economy producing at a level beyond its potential on a sustained basis and inflation just creeping up under those circumstances. It would not necessarily be the case that if the real rate were a bit below its equilibrium rate, the gap between where the economy was and its potential would widen. So, I do not think the staff forecast requires the equilibrium rate to drop back down again. In fact, the staff forecast is consistent with the equilibrium rate being a bit above where real rates are right now.

MR. JORDAN. I am not clear on that. I understand that your framework is different, but if growth in nominal demand accelerates to a rate of 8 percent, as it did in the first quarter, what are the dynamics that will cut such growth in half unless you say the surge is all statistical error and it will unwind itself? But if the dynamics of your adjustment process include an accommodation in behavior to the increase in nominal demand, what causes the second difference to turn negative?

CHAIRMAN GREENSPAN. Can I answer that? I think there are two factors that, taken together, are consistent with your framework. One involves inventories. If we have a buildup in inventories that is incapable of being sustained at the same rate, we do not have to have a change in the actual interest rate versus the natural rate for the growth process to turn down. What we have here is an adjustment process that is not affected by the differential between the actual and the natural rate. Secondly, there is a serious question here about seasonal adjustments. If growth in nominal demand was significantly higher, seasonally adjusted, in the first quarter because the weather was warmer than usual, and such growth was unusually low in the second quarter, you would not be looking for an explanation in the real world. I suspect that the combination of both of those factors is enough to explain

the full shift in the nominal GDP. I do not know that for a fact, but it is certainly going in the right direction.

MR. JORDAN. For confirming evidence of that, we would expect to see slower money and bank credit growth emerge in this period. At least the staff projection, I take it, is that we are going to get that. Some of the surge never was real because it reflected bad seasonals and an inventory buildup that will go away. To be sure that interpretation is right, we would need in a sense to accommodate a much slower growth of money and credit; otherwise we missed it.

MR. PRELL. Barring some shift in the demand for money--this is almost tautological--we would expect to see slower money growth with the moderation in nominal GDP expansion that we are anticipating. But our forecast in a sense says that, on an intermediate-term basis rather than looking quarter-to-quarter and defining movements in natural rates of interest in that sense, we have the actual rate too low relative to the natural rate to bring us back to equilibrium between actual and potential output. In other terms, we have an ongoing gap between the natural unemployment rate and the actual unemployment rate and some tendency for inflation to pick up.

MR. KOHN. In our judgment, President Jordan, we are seeing some slowing in money growth in recent months when we abstract from the accumulation of balances for the payment of taxes. In looking through that kind of thing and taking account of the fact that we have essentially a no-growth forecast for M2 in May, we think that the rate of growth in that aggregate has in fact decelerated a couple of percentage points from the first to the second quarter.

MR. JORDAN. As you know, we use MZM to monitor how these things happen because it does not have the sweep problem. It grew at a rate of 8 percent in the first quarter, right in there with nominal GDP. For the second half of this year, we would expect MZM to get down to a 3 to 4 percent growth rate if this forecast is right.

MR. PRELL. As we have pointed out previously, the money demand relationship, the relationship of velocity and opportunity cost, has been quite stable over the past couple of years. And we have not had a big movement in interest rates, so you would expect close to equal growth of M2 and nominal GDP.

CHAIRMAN GREENSPAN. Okay, any further questions for Mike? If not, would somebody like to start the Committee discussion? Mr. President.

MR. MCTEER. Me?

MR. PARRY. From the Republic of Texas. [Laughter]

MS. MINEHAN. President of the Republic of Texas.

CHAIRMAN GREENSPAN. Just remember that we cannot take a position on political issues. [Laughter]

MR. MCTEER. Mr. Chairman, the Republic of Texas and the Eleventh District are much the same for all practical purposes, and they both continue to do as well as the national economy. Our job growth has been converging on the national mean for about a year, after several years of stronger growth. Positive factors contributing to the performance of the Eleventh District include the continued recovery of the Mexican economy, the more recent recovery in semiconductors, and technology-driven gains in oil and gas exploration.

Based on my careful monitoring of cocktail party conversations--which I consider an important part of my job description--I can report that Texas is experiencing a mild but

discernible mood shift having to do with the incipient recovery in commercial real estate. There have been several recent sightings of the construction crane, which had been the national bird of Texas [laughter] but which has hardly been seen in the past 10 years and was thought by many people to be extinct. The emerging mood is one of exuberance, although tempered and made more rational by the long memories of the people with whom I hang around. But even rational exuberance makes many Texans nervous given the bust that followed the previous boom. That sort of caution, of course, is to be expected and welcomed.

However, I hope the crowd around this table does not become overly nervous about the recent show of strength of the national economy. If the first quarter's 5.6 percent real growth rate is too much for comfort, I suggest that we focus on the real final sales number of only 3.8 percent. That is still a high number, but we are already down the road from the first quarter and have some "reassuringly" weak recent monthly numbers. Let the record show quotations marks around the word "reassuringly."

Industrial production was flat in April. Payroll employment growth slowed in March and April. Retail sales declined slightly in April after being flat in March. Producer prices have declined for 4 consecutive months, down .6 percent in April. CPI increases also have moderated as energy prices have reversed last year's buildup. The Greenbook has real GDP rising only at a 1.8 percent rate in the second quarter and for the next 6 quarters it projects growth rates of 2.5, 2.3, 2.1, 2.0, 1.9 and 1.9 percent. As I understand it, these projections assume no fed funds target rate increase until mid-1998. Even if strong real growth were something to fear, those numbers would hardly seem frightening. Actual measured inflation also has declined in recent months. The Greenbook has the first-quarter

CPI rate at 2.3 percent; its CPI forecast for the second quarter is 1.2-percent; then it rises to 3 percent in the second half of 1998. So, the Greenbook is forecasting rather slow real growth as well as rather low CPI inflation. While I do not remember past Greenbooks as well as Jerry Jordan, I do recall that in recent times the Greenbook has underestimated real growth and overestimated inflation more often than the other way around. If that pattern is repeated, it would make the outlook even better than the Greenbook anticipates.

In terms of guides to monetary policy as it is currently practiced, I do not know what is the precisely correct federal funds target rate. Apparently a lot of people, including Gail Cincotta, thought the correct rate was precisely 5.25 percent and that 5.5 percent is a travesty. I do not know, but I will note that when the recently lower inflation rate is taken into account, the funds rate probably has increased by more than 25 basis points in real terms. Also, the recently reduced need for federal deficit financing seems to make the current target rate tighter in some sense than it otherwise would be.

If we look to market-based indicators as guidelines, they are fairly reassuring. Despite the recent backup in the yen, the dollar remains on the strong side and is probably putting direct downward pressure on import prices and indirect downward pressure on the prices of exportable goods. Commodity and metals prices, including gold, also reveal little buildup of inflationary pressures in the pipeline. Unfortunately, money growth has picked up recently to levels that used to be inflationary. I hope the Greenbook is right in attributing that money growth to the April surge in tax receipts, which should indicate a near-term reversal. In any case, money growth is about the only evidence that suggests to me the need for some urgency to counter a potential rise in inflation. Otherwise, warning signs are conspicuous by their absence.

CHAIRMAN GREENSPAN. President Parry from the Republic of California.

[Laughter]

MR. PARRY. Mr. Chairman, strong economic growth has continued in the Twelfth Federal Reserve District in recent months, although the pace has slowed slightly in some of the fastest growing states. During the first quarter of 1997, District jobs expanded by 3-1/2 percent at an annual rate. In the fastest growing states--Nevada, Arizona, Utah, and Oregon--growth is averaging between 3-1/2 and 7 percent. With the exception of Alaska and Hawaii, employment growth in the other District states is running at or above 3 percent. Construction and services continue to be the fastest growing sectors in the District economy, but manufacturing is becoming a key contributor to the growth in District employment. Manufacturing employment grew by 3 percent at an annual rate during the first quarter, as rapid expansion in high-tech and aircraft production was boosted by growth in food processing and textile industries.

Accompanying strong employment growth has been a recent surge in the District's labor force. In most states, labor force growth has been broad-based. In California, however, our estimates are that perhaps one-half of the new labor market entrants have transitioned from welfare to work and are competing for a narrow range of low-skilled jobs. Of the total number of U.S. welfare recipients who must leave the rolls before July of this year, over 38 percent are in California. If all of these individuals move into the labor force, labor force participation in California will increase by 1/2 percentage point.

Despite rapid labor force growth, strong employment demand is creating tight labor market conditions in several parts of the District. The District-wide unemployment rate has fallen by 1/2 percentage point over the past quarter, and in several areas in the District

competition for employees is so fierce that employers are holding job fairs and offering finder's fees and signing bonuses to recruit new hires.

Turning to the national economy, the risk that inflationary pressures are building seems to me to have increased since our March meeting. The economy's rapid growth in recent quarters means that it is now operating at a noticeably higher level according to both the unemployment rate and the estimated GDP gap. The unemployment rate is now clearly in the inflation danger zone even when we take into account the rather large standard errors that characterize estimates of NAIRU, and the excess of real GDP over its potential level rose to about 1-3/4 percent in the first quarter according to our estimate. In addition, the industrial capacity utilization rate is somewhat above the level at which inflation typically has accelerated in the past.

With these indicators presenting a fairly uniform picture of excessive pressure on resources, I believe there is good reason to be worried about the trend of inflation in the future. Given this situation, the key question is whether real GDP is likely to slow enough and for a long enough period of time to eliminate inflationary pressures. Like the Greenbook, our forecast for the current quarter shows a rather sharp slowing of growth; our estimate is 2 percent for the current quarter. It certainly would not be surprising to see such a pause in activity following the torrid pace of the first quarter. Looking to the second half of the year, we expect growth to come in at around the trend rate of 2 percent. This would still leave the unemployment rate at just under 5 percent at the end of 1997.

The bottom line is that it is unlikely that the basic problem of pressure on resources would be solved anytime soon with an unchanged funds rate. My best judgment at this point is that underlying inflation would show a modest upward trend this year and next if

monetary policy remained unchanged. Of course, when we look at the CPI, a good deal of the upward trend would be obscured by the higher dollar and lower price of oil, not to mention the methodological changes being introduced by the BLS. As always, of course, we should acknowledge that this forecast of rising underlying inflation could turn out to be wrong for a number of reasons. For example, it is difficult to judge the magnitude of possible roles for enhanced productivity or changes in the labor market in holding down inflation. However, I believe that even with a slowdown in growth in the current quarter, the risk of rising inflation in the future has increased to a serious level.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. First, I want to comment about your speech at NYU a couple of weeks ago. I thought it not only was very effective but also very welcome even though the wire service types still do not know the difference between nominal and real GDP. It is worthwhile to continue to press on those issues. I have grown increasingly concerned that, with people on both the political left and the political right criticizing us, they could together foster a general environment of open season on the central bank. Criticism on either side does not constitute a great risk to us, but here we have a sort of unholy alliance of reasons to criticize us. So, I thought that your making the speech at that time was very desirable, and I hope that when you get the chance to testify on the Hill in July, you will be able to press the same arguments and maybe get some people to start listening.

Probably like others around the table, I spent this long interval between meetings traveling around the District to a lot of meetings, sometimes in small communities. One word that summarizes attitudes is "sobering." I noted a dramatic shift in mood and concerns

everywhere that I was traveling. I want to run through some of the highlights of what we have been hearing.

Executives in the steel industry are very concerned about the surge in imports stemming from very strong demand. Some interpretations of developments in the last couple of quarters suggest that we were fortunate in being able to draw in a lot of imports because the latter helped to hold down prices and minimize inflation. But both the steel companies and the auto companies know that once these foreign manufacturers get a foothold in our marketplace, they are very hard to dislodge.

Domestic steel companies are saying that their inventories are too high and that they are going to be working to get them back down. Specialty metals producers report that raw materials prices are up very sharply and their plants are running flat out. They say that their sales to aerospace firms are booming and that they have no more capacity to satisfy that market. They are now engaging in what they call precautionary ordering. They say that there are widely perceived shortages and longer delivery times and that sales in their medical equipment market are strong and getting stronger worldwide. A number of these companies, including some glass and rubber companies, indicate that they are revising up their sales projections for the second half of the year and that they are going to have a better year than they thought at the outset of the year. Oil and gas companies are saying that their operations are running flat out and that they do not have additional capacity to meet expanding market demand. Retail sales, though, have softened very considerably in the last few weeks after what retailers characterized as a surprisingly strong first quarter. They said that we should expect to see very aggressive efforts to move merchandise in the weeks ahead.

Labor market developments are unsettling. Union contract settlements in the first four months of this year were above those in the first four months of last year. The increase is not dramatic, but it is clear that the trend of successive contracts resulting in successively lower settlements is over, and it is just a question of how fast the increases will occur from this point. Entry-level wages are jumping throughout the District. We talked to bankers who said that they are losing employees. When we ask where those people go when they leave, the bankers say mainly to local school districts and to city and county governments. The dynamics are that tax revenues are very strong in these communities, and they are replacing retirees and others and adding staff at wages that are substantially above the earlier prevailing wages. In two different areas that we visited, bankers said that last year their starting wage for a teller was \$5.50 per hour, whereas it is now \$8.00 at one bank and \$9.00 at another, if they can find someone who is qualified. This kind of increase, of course, is raising their whole pay structure.

Farmland prices are a problem. As recently as last November, we were not hearing any reports of transactions that we would have characterized as speculation in farmland. No more. People are saying that farm prices are now 20 to 25 percent above where they were a year ago. One banker terms the increases that he sees as "scary." He says that on the basis of current crop values the price would pencil out to about \$1,500 per acre. A year ago the prices were in the range of \$1,800 to \$2,000 per acre. He says it is typical now to see them at \$2,300 to \$2,500, and everyone wants to borrow on the basis of this newly perceived higher level. I have two reports, one from south central Ohio and one from western Ohio, of foreign investors coming in and paying twice the highest price recorded previously in the county for large chunks of farmlands. I have two other reports, one in

Kentucky and one in western Ohio, that the Federal Farm Credit Banks are very aggressive in lending and are now willing to engage, once again, in types of financing that they did in the late 1970s and early 1980s. They stopped such financings in the mid-1980s, but they are starting to do them again.

Contacts in residential construction say that they are experiencing the same level of activity as in the spring of last year. One difference is that last spring the construction was all under contract; this year more than half of it is speculative. With regard to bank lending, one banker on our board said that there are no standards. Bankers are just pirating each other's loans. We asked one large banker what we would look for as large banks moved toward caution in their C&I lending, especially after our March move. He said that every deal was skinnier than the previous one, and that deals are now being done that would not even have been considered last summer. Small and medium banks say that they have become more cautious on consumer lending, and as a result, in order to achieve their profit plans, they have become more aggressive on business lending.

In the large manufacturing sector, we talked to representatives of quite a few companies both at our board meetings and as we traveled around the District. They say that they are convinced that 1997 will be a better year than they had anticipated, and, therefore, they are stepping up their capital spending for the year from what they had planned earlier, and they are placing larger orders for the second half than they had anticipated coming into the year.

On the national economy, the first time we got a look at a Greenbook forecast for 1997 was in September 1995--that's the way the timing usually runs. At that time, we had a 5-3/4 percent federal funds rate, and the projection showed nominal spending growth of less

than 4 percent for 1997. That definitely was a favorable outlook, and it looked as if we were on a track to move nominal spending down toward a rate of growth that we would think of as approximately consistent with price stability. But now we have nominal spending growth closer to 5 percent for 1997 even with the deceleration that the staff is currently projecting, and out through 1998 such growth is projected to remain above 4 percent. So, while we had what I thought was a very favorable trend a year and a half ago when we first starting looking as far out as 1997, the attainment of such growth has now been pushed well beyond the current forecast horizon.

What are the risks? If the Greenbook is right and we do get the projected decelerating growth in activity in the second quarter--and it is widely perceived on the basis of monthly reports and other evidence that this will be a soft quarter--whether growth for the quarter comes in at the projected 1.8 percent is not the important thing so long as the outcome is in that direction. And if we also are getting a lower increase in the CPI--and it may not get down to the projected 1.2 percent but again assuming it is in that direction--then what are the chances we would want to do something in July? We would not have any hard evidence that would justify tightening in the minds of many people who watch us. By August, second-quarter information is essentially all we are going to have and only very tentative indications of how the third quarter is shaping up. Even in September, we would not have much more in terms of hard numbers except for some additional monthly readings. So, it will probably be November before we will have the kind of hard evidence at hand to justify in everybody's mind the need to do something. That would be very late. For me, the policy issue is not a question of a little now or a little later. It may turn out to be a question of a little now or a whole lot later.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, I will start this comment off the same way I started my comments at the last several meetings: Economic activity in the Fifth District is still very strong. The survey readings for our manufacturing and services sectors did slip a little in April, but they remained very close to the high levels to which they had jumped in March. This indicated a rate of expansion in our region that we had not seen since the first half of 1994. Moreover, our directors and other contacts suggest little, if any, softening in demand. Labor markets remain very tight. The demand for lower skilled labor continues to increase at a substantial rate. Despite some reports of rising wages recently in some parts of the District, we have had fewer reports of price pass-throughs in the last several weeks than we were getting a little earlier this year and that I reported on earlier.

The most striking new development in the District is something that fits in with what Mike Prell said about commercial real estate. In our real estate markets, especially in northern Virginia, we are told that rental rates for industrial and office space have now gotten back to the peaks that they reached in 1989. Also for the first time in this expansion, we are getting increasing reports of speculative building, especially of office buildings in northern Virginia.

Turning to the national picture, the Greenbook projects that real GDP growth will slow of its own accord in coming months. Certainly given the extraordinary growth we have seen in the last couple of quarters, some slowing seems likely. But as I see it, nothing in the fundamentals really assures us that the rate of expansion is going to slow to trend. That obviously is what needs to happen if we are going to avoid a boom. I think that is the point Jerry Jordan was making in his question earlier. On the contrary, the staff candidly

recognizes in its write-up that household fundamentals and general economic fundamentals remain exceptionally strong. I continue to see some significant upside risk in the outlook. The projected deceleration reflects in considerable part reduced inventory building after the big run-up in the last quarter, as Mike Prell emphasized. In this regard, the Greenbook authors do not seem to be concerned that a constrained availability of supplies will generate a precautionary demand for inventories at this time as it did in 1994. That conclusion may be right, but if it is, the interesting question is why. Maybe firms wanted extra stocks in 1994 because they were not sure that monetary policy would do what was needed to contain the expansion. Maybe they have more confidence in us this year, and if that is the case, I think that would underscore the important role our own credibility needs to play in generating and reinforcing the sustained moderation in economic activity the staff is projecting. In any case, I think stock building needs to be counted as an upside risk in the near-term outlook.

Another considerable upside risk in the Greenbook forecast is that the projected increase in the labor force participation rate will not happen. The Greenbook is projecting a real GDP growth rate of 3.1 percent for 1997, and that is expected to take the unemployment rate down to 4.8 percent by the end of the year, leaving it around that level through 1998. If such a rate is sustained for that long, it could in itself create capacity problems. If the expected further increase in labor force participation does not occur and we still get the predicted growth, obviously the unemployment rate could be driven even lower. Given the relatively moderate increase in productivity the staff has forecast, I think Mike Prell made the point that payroll employment has to rise 2 percent to generate the 3 percent growth projected for this year. That is twice the longer-term trend growth in the labor force. Increased participation may bail us out. It bailed us out last year; maybe it will do it this

year, but then again maybe it won't. Of course, an alternative possibility is that productivity will rise more rapidly this year than the 1.2 percent increase the staff is projecting because the trend rate may have moved up to 2 percent or so, as a number of economists and others are arguing.

Let me conclude with just a couple of brief remarks about what this alternative scenario might imply for aggregate demand and interest rates. This is a little counter-intuitive, but I think even this possibility involves an upside risk. Let us suppose that markets are confident that the Fed will conduct policy so as to hold the CPI increase to a rate of 3 percent this year and that inflation expectations are anchored at 2 percent--that that is not an issue. Let us assume in that environment that the productivity trend increases. What does that do to financial markets and specifically to real interest rates? Broadly speaking, the improved productivity trend is going to cause firms to expect higher future earnings and workers to expect higher future wages. The point that needs to be emphasized in this situation is that, at the existing level of real interest rates, businesses and households are going to want to bring some of that expected future income into the present. Workers may want to fix up their houses; business firms may want to invest in new plant and equipment; and they will try to do this by borrowing against expected future increases in income. But, of course, the economy does not have the future income and output yet so real interest rates have to rise in order to restrain this new demand for credit. In effect, the higher real rates raise the price of current consumption in terms of future consumption foregone so that firms and households will be content to wait until the economy actually has the output in hand before they try to consume it. The point of the story is--and this is the bottom line--that even if the productivity trend turns out to be higher than the staff is assuming, which would

remove some of the inflationary risk stemming from the labor markets, real interest rates would still need to rise to prevent a further credit-driven increase in aggregate demand.

In sum, Mr. Chairman, I see considerable upside risk in the staff forecast, and I think we need to be in the market for a little more insurance.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Thank you, Mr. Chairman. The Philadelphia District economy generally continues to operate at high levels, although the rate of growth has moderated some in recent weeks. The more moderate growth is most notable in manufacturing and auto sales. Manufacturers generally expect a high level of activity for the balance of the year but relatively small additional increases. Auto dealers, too, report less than buoyant sales. Retailing more broadly is doing well, although there is so much competition that anecdotal reports from individual retailers sometimes understate the broader picture. Restaurant sales in particular are doing well, which is a fairly good indicator of consumer attitudes. Construction activity is mixed. The outlook for commercial building in suburban locations is strong. Buildings are now selling for more than reproduction costs, and there are the beginnings of some speculative building. On the other hand, some shakeout is likely in the construction of retail outlets, such as supermarkets, which are overbuilt.

There is more than ample liquidity available, and competition to make commercial loans is fierce. One executive in a highly leveraged company told me that some lenders are willing to lend up to 30 percent more than a new acquisition is worth. Some REIT activity also looks shortsighted. By contrast, however, there does appear to be more caution in the consumer lending area, particularly in credit cards.

Labor markets are tight in many areas of the District. One sign of this is that parents, although greatly relieved, are pleasantly surprised that someone is willing to hire their offspring. There is some upcreep in wages as labor markets tighten around the District. Many businesses, however, still say that they cannot raise prices and therefore must offset higher wage costs somewhere else, usually through improved efficiencies.

Turning to the nation, the uncertainties on the demand side of the economy are greater now than when we last met. There also are continuing uncertainties on the supply side. On the demand side, growth clearly is moderating more than was forecast at the last meeting. What we do not know is how long the slower pace will continue. My hunch is that there is still a fair amount of self-feeding momentum underlying the expansion. When people earn more and feel more secure in their jobs, they spend more and businesses invest more.

I think the risks for demand are still on the upside, but there is more uncertainty than when we last met. On the supply side, the uncertainties remain about as they have been, although with a higher level of anxiety as the economy moves further into territory not charted for nearly three decades. Both labor force growth and, apparently, productivity gains have increased capacity limits surprisingly far without generating broad-based price increases. The risk is that overheating will occur at some point, and we want to avoid that to prolong growth. At the same time, we do not want to act prematurely or unnecessarily. On balance, this strikes me as more of a time for heightened surveillance than for overt action.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. The economy in the Kansas City District remains strong, but as others around this table have mentioned with regard to their

regional economies, growth in our District has slowed a bit from the rapid pace of late 1996 and early 1997. Manufacturing and services remain the primary engines of growth in our seven states. Manufacturers are operating at high levels of capacity, and growth in service-related jobs is quite brisk. Manufacturing activity has been slowed somewhat because of strikes. The six-week strike at the GM plant in Oklahoma City has idled about 3,500 workers. The strike issue centers on GM's earlier decision to cut about 900 temporary workers from its workforce and, as reported to me, that has resulted in a union complaint that the cut is too large. The union wants GM to hire some permanent workers, several hundred in fact. There also is a steel strike in Kansas City that is affecting about 1,000 employees. The issues there are outsourcing and pension benefits; they do not currently involve wages. Data for the District states suggest that our employment has been about flat since March, indicating some easing in the region's pace of growth.

Our farm economy and energy sectors are in good shape. The District's winter wheat crop is in good condition despite freeze damage in some local areas. Soybean prices have risen, and this is going to be beneficial to producers in our area. Solid cattle prices are giving the cattle industry its best profits in a couple of years. In the energy sector, the recent drop in oil and gas prices has not yet affected production. Drilling activity is much higher than it was a year ago. In fact, there are some reports of capacity constraints in areas like Wyoming where reported shortages of trained crews are hampering activity.

Retail prices continue to hold steady in our District. The labor markets are tight and we continue to hear reports of wage pressures. An informal survey of firms in our region conducted by our Branch directors indicates tight labor markets in nearly all cities in the District. Labor shortages are pronounced for entry-level workers, as you have heard from

others here, and also for computer and other high-tech professionals: Several firms are reporting bigger wage hikes than normal, although the number of such firms is about the same as a month ago or so. So, we are not seeing an acceleration.

On the national economy, we anticipate as does the staff forecast that the expansion in economic activity will moderate in the second quarter after unusually rapid growth in the first. However, our estimates do not have the expansion slowing as dramatically in the immediate future as does the Greenbook. Consumer and business confidence remains high and income and employment growth appears solid and able to support substantial growth going forward. Despite this and the fact that resource utilization has continued high, inflation has been surprisingly well-behaved. Thus, while I remain concerned and alert regarding the inflation outlook, it is difficult to assess its near-term course with any great certainty.

Returning for a moment to District developments, like Jerry Jordan I have done quite a bit of traveling, and what I found particularly interesting in my meetings with labor, consumer, and business groups is a uniform view that the Fed should ease off in terms of contemplating any preemptive move. I found that an amazing change because when I went out before, I heard many people saying that we were doing a good job, that we needed to be vigilant, and that we needed to be ready to act. I no longer hear that. One group, a rural group, said that "you guys need to chill out," to use their phrase. What I am saying is that while we can build a case for a move, the fact that we have not seen the anticipated rise in inflation come through is leaving a very large number of people less patient with any kind of action. It is a noticeable change from 6 or 8 months ago, and I wanted to report that today. Thank you.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. Like everybody else, I continue to be amazed and pleasantly surprised by the strong performance of the economy and the lack of evidence of imbalances and dislocations, both regionally and nationally. Our southeastern region now looks very much like the nation as a whole after slowing a little over the last couple of quarters from the greater-than-national pace that we were seeing earlier. We also have one of the best balanced economies I can remember, and that balance extends across both the geographic areas and the various industries that make up the diverse economy of our Atlanta region.

Like Jerry Jordan and Tom Hoenig, I traveled a good bit during the last eight weeks. One of the most interesting regional stories that continue to emerge relates to what is going on in the oil and gas industry. Both Bob McTeer and I have reported before on the excitement in that industry over the new 3-D seismic technology that has fundamentally altered the economics of exploration. Bob mentioned it again this morning. At a breakfast meeting with a small group of business people in New Orleans three weeks ago, an independent driller told me that the break-even point has now dropped from about \$16 a barrel to about \$4 a barrel. Not only will this keep the Louisiana oil patch engaged in a more steady pace of exploration as the price of oil goes up and down, but it also is having a major spillover effect on the supporting businesses like rig construction and crew boat manufacturing. The Gulf of Mexico, which the local people referred to as the Dead Sea when the price of oil was in the \$20-\$25 range, is now a beehive of activity with the rig count up to 218 compared to 166 just a year ago. This is putting some pressure on the support industries in the short term; daily rates for crew boats are almost double what they

were a year ago. Judging by the backlog of barges and crew boats, it currently takes a much longer time to complete the planned construction of an oil rig, but my guess is that this technological breakthrough should help hold down the long-run cost of oil and petroleum products.

The other very positive story in our region is tourism. Both current and future bookings are strong, and that is driving the construction of large hotel projects in several cities and very strong demand for workers in the hospitality industry. Manufacturing, an industry where we thought we were seeing some slowing at the time of the last FOMC meeting, recently has shown signs of some pickup back to a moderate pace. Construction activity, despite some indicators of future slowing, is still at a generally high level. As others have noted was happening elsewhere, there are more reports of speculative projects, at least in the Atlanta market.

Labor markets remain tight across our region and across a growing number of skills. We are still hearing sporadic reports of increased wage pressures and some stories of nonconventional forms of compensation, as also described in the Greenbook. For example, a fast food operator came up to me after a recent speech and told me that he had issued over one hundred W-2s for tax year 1996 for a staff of 13; that reflects a 600 percent turnover rate. On some days he had to choose whether to operate the drive-in window or the sit-down part of his restaurant. Also, he was now paying employees for 40 hours of work, but having them work only 30 hours as a way of keeping them on his payroll instead of someone else's.

On the national level, the broad outline of my own outlook over the rest of 1997 into 1998 is very similar to that of the Greenbook and that of most private forecasters. I see considerably stronger-than-expected growth for 1997 on a year-over-year basis, a slowing

expansion as we move into 1998, and a modest upward drift in inflation. While many of us have been making a very reasonable forecast of slowing growth in final demand, and we are beginning to see some signs that may be happening, there also are some not insignificant risks on the upside. Consumer spending continues to be the greatest risk on my worry list as the underlying fundamentals to support continued strong spending still seem to be there: good job and income growth, record high levels of confidence, and the wild card kicker that we have talked about before--the rise in the value of assets that have not been appreciably drawn down. Although less likely, a pickup in export demand and even further inventory building, which Mike Prell alluded to as a possibility, could contribute to greater than expected growth. For me, the risks are still on the upside.

Recent inflation remains low by all conventional measures, lower I think than almost all of us expected. As all of us have noted before, there is growing evidence that underreported productivity gains and broad resistance to price increases are the biggest factors that have restrained general price advances in this cycle compared to those that we have seen in the past. At the same time, my own forecast, as well as those of most private sector forecasters and the Greenbook, shows a gradual upward drift in inflation at the end of 1997 and into 1998.

Obviously, the central policy question continues to be whether the stance of policy is too accommodative and, given the persistence of robust demand, how strongly we feel about not risking a loss of the ground we have gained in keeping inflation low. With the economy having gotten to a point where it must be near full employment, if not beyond it, we have a unique opportunity with little downside risk to lean a bit more against the expected upward creep in inflation that most of us are forecasting and, in doing so, to underscore our

resolve and credibility in the minds of financial market participants, business decisionmakers, and the general public. I also find myself wishing we had been more successful collectively in making the case for low, perhaps even lower, levels of inflation so that our various publics would be supportive of such a tightening move. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, the Seventh District economy continues to expand at a modest rate, and abstracting from the effects of the strike in the automobile industry, our manufacturing sector still seems to be outperforming the nation. Our labor markets are still very tight. The unemployment rate for District states has moved down again; it was 4.1 percent in both February and March. Payroll employment growth in our states continues to lag the nation, but many contacts regard this as a labor supply problem. Despite the tight labor markets, we still have not seen much upward pressure on wages, and District manufacturers and retailers continue to report that competitive pressures inhibit their ability to raise prices. There was an article in this morning's Washington Post about Milwaukee, Wisconsin that described this phenomenon in great detail. It is a phenomenon that I hear mentioned almost every time I speak to someone in the manufacturing industry. Another indication is that steel price increases of 3 to 5 percent announced for April and May are not sticking and in some cases are now being publicly rescinded.

It is clear from the published data and from our anecdotal information that the economy in the United States and the Seventh District has slowed from its rapid first-quarter pace. As Bob Parry mentioned before, the key question is the extent of the slowdown and

whether it is sufficient to return the economy to a path of sustainable growth without an acceleration in inflation.

Since we all have seen the published statistics in the Greenbook, let me focus on some of the anecdotes. First, with regard to signs of slower growth in business activity, retailers generally report that sales were sluggish last month. One large national retailer attributed the noticeable slowing in part to poor weather, and preliminary results from our survey of Michigan retailers show a moderating sales performance last month and some inventory buildup. As we all know, light vehicle sales in April were well below the first-quarter level. Our contacts report that sales so far this month have been somewhat stronger than in April but still below the sales pace expected for all of 1997. In the paper industry, we had reports of slowing in corrugated paper shipments as well as in heavy paper production. A very large telephone company in our area reported a slowdown in the number of lines installed in small businesses and homes during March and April. This is a markedly different pattern from that of the last two years, and our contacts believe it reflects an industry-wide slowdown rather than a loss of market share.

On the other hand, we also have had reports of strength from a number of our industry contacts. Heavy trucks continue on a strong recovery path from last year's depressed levels. The uptrend in sales and production of farm machinery equipment also is continuing. One national specialty realtor told us that land prices and rental costs for retail stores, both freestanding and in malls, are moving up rapidly. This is similar to some of the other comments made here today about real estate. Contacts at one large airline in our District reported very strong business, with forward bookings through the summer setting records for both business and vacation travel, and they believe that the forward bookings at

other airlines are also very strong. Next Tuesday, May 27, Manpower Inc. will publicly release the results from its Quarterly Employment Outlook survey; this information is confidential until May 27. They will report third-quarter hiring intentions in all regions of the nation, particularly in the Midwest, as the strongest since the boom years of 1988 and 1989. The chairman of Manpower believes that part of the demand is for seasonal workers, but some of the hiring plans are for jobs that firms have not been able to fill because of widespread labor shortages. So, the anecdotes and the published data paint a mixed picture of the expected extent of the slowdown in the expansion and the inflation outlook.

It is clear that the first-quarter growth rate is unsustainable, but we do not know whether inflation will continue to be restrained by the temporary damping factors that we have discussed for some time. If growth fails to moderate sufficiently just as these restraining factors lose their punch, we run the risk of opening up a sizable output gap with its attendant inflationary consequences. As additional data for the second quarter roll in, I think we must be on the lookout for the moderation needed to avoid accelerating inflation in the months ahead. I am concerned that imbalances may emerge later this year, so I still see the risk as being on the upside.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. The economy in the Ninth District remains healthy. The expansion is continuing; it remains well balanced and broadly based both geographically and by industry. There are three or four developments of relatively recent vintage that are worth commenting on. First, there was a very severe flood in the Red River Valley that runs between Minnesota and North Dakota and on into Canada. This flood has been very disruptive in that part of the world, but it probably will not have any broad

ramifications for the national economy or even for the District economy as a whole. Of course, part of its effect will be reversed because, while wealth has been destroyed, economic activity tends to pick up as replacement activity occurs. There also were significant losses in some of the cattle herds around the District due to the severe winter this year, and that is a double-edged phenomenon as well because, for those people who did not lose cattle, prices have improved recently.

At our recent directors' meeting and also at a meeting of our advisory council, a couple of things of interest came up. One is that we have further confirmation of the tautness of the labor markets in the District. If we look at the District data, as best we can get a handle on them, employment gains over the past 12 months outpaced the increase in the labor force by a significant amount. Our directors and advisory council people are very explicit about labor shortages and about very, very tight labor markets. That is not new; it is just a confirmation. They also indicated, and I think it is fair to say, that there have been some signs that wage and now price pressures are becoming a bit more generalized than formerly was the case. Business people are still very wary and talk a good deal about how competitive the business environment is, how difficult it is to raise prices, and how cautious they are about doing that. At the same time, I think they will admit that price increases are perhaps becoming more commonplace than was formerly the case in the District.

With regard to the national economy, I will strike a couple of familiar themes. I am sympathetic with the general pattern of the Greenbook forecast and with Mike Prell's description of where the risks lie. That is, I think they lie in the direction of our possibly getting a more rapid increase in aggregate demand than the Greenbook envisions, and that will lead to greater price pressures. In part, I feel that way because I am not entirely

persuaded that aggregate demand will slow as appreciably as is indicated in the Greenbook. There are a couple of reasons for that. First, the increase in wealth over the past 2-1/2 years or so has been enormous, and it seems to me that the implications for consumer spending are quite straightforward. It is just a question of degree. Secondly, I have a sense that the outlook for BFI is quite positive. So, it seems to me that the risks, in terms of how demand is likely to perform, are more on the high side. We may continue to get some very favorable developments on the supply side. We all have spent a lot of time trying to analyze exactly what is going on there and the extent to which that will continue. I do not have a conviction, but I would not place a large bet on favorable supply side developments continuing much longer; at least, I would not make such a wager without very favorable odds.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. There is not a lot to report that is new about the First District. The regional economy, despite the slow-to-arrive spring weather, continues to hum along at a rather rapid pace, buoyed by solid job growth at about the national pace, which is good for our region. There are low unemployment rates--in fact, I believe New Hampshire at 2.1 percent has the lowest unemployment rate of any state in the country--and moderate increases overall in prices and wages. Competition continues for specific skills so that we do continue to see a heating up in total compensation. Contacts in retail and manufacturing report solid growth over a year ago, and there are expectations that this favorable trend will continue. The District's high-tech industries--software, biotech, hardware producers, and telecommunications--remain extremely vibrant and continue to face a shortage of technical employees that I have mentioned in the past. On the financial services side, we have a sense that the downsizing in the commercial banking industry

locally may be moderating as firms realize that they cannot prosper any longer simply by cutting costs alone. They need to generate revenue and improve customer service. Insurance companies, on the other hand, may have just started on a trend of downsizing and consolidation. This is in direct contrast, of course, to the firms in the money management and mutual funds industries that are growing by leaps and bounds. This growth plays out in quite low office vacancy rates, particularly in the Boston metropolitan area; the low vacancy rates have spread from downtown Boston all the way out to Route 495. Contiguous office space of any size is just not available. Rents are rising and new construction cannot be far behind though, unlike reports from some other areas of the country, we are told that developers in our region continue to be wary of building "on spec" after the lessons of the 1980s.

Turning to the national scene, I am impressed a bit by the tone of somewhat quiet desperation in the Greenbook forecast. Things are really quite good, but we seem to be frustrated by our inability to gauge either the strength of the economy, even into the current quarter, or the quiescence of inflation. There are a lot of questions. One of them is when the current combination of very favorable trends will come to an end. It's not that we necessarily want them to end, but we would like to know when the economy will slow, perhaps on its own as a result of the projected moderation in the growth of consumer spending, a worsening of net exports, and a decline in residential investment. Alternatively, at what point will overall resource utilization become so tight that the wage-price spiral will take off? Just as important as these two questions is which of these reversals to trend, if they occur, will happen sooner. In my view anyway, the likelihood is that resource utilization will begin to bite before the strength of the economy wanes. It is true that the current economic

data show signs of some slowing but, frankly, some slowing from a first-quarter pace of 6 percent is inevitable and necessary. However, if one looks to the first half of the year, then assumes that the Greenbook is right about the degree of slowing in the second quarter, which may or may not be accurate but let us assume it is right, we still have GDP growing in the first half of 1997 at a rate that is nearly double our current estimates of economic potential. Will growth in economic activity moderate for the rest of the year as the Greenbook expects? Maybe, but we still see healthy job creation, good income growth, high consumer confidence, good business confidence, and booming financial markets. The same factors persist that have caused our projections of economic growth to be off the mark fairly consistently through 1996 and 1997. I must say that I remain agnostic about whether growth will slow in line with the Greenbook forecast, at least without some shock to the economy that no one is forecasting at present.

We, along with others, have been wrong about inflation. We have underestimated the potential of the economy to grow at a solid pace without the usual bottlenecks associated with tight resources. It would be comforting to think that this can continue, but here I am also agnostic. If we think about our estimates of labor market tightness not as a point but as a range of uncertainty that is fairly wide around a central tendency and we consider both the experience of the late 1980s and the current data, I am drawn at least to the proposition that we have not had sufficient constraint on resources long enough to produce the smoking gun of a real inflationary increase. But I do not think we are very far away from this, particularly given the continued labor market tightness projected in the Greenbook and elsewhere.

So, despite the recent indications of a slowing expansion, I think the risks are still strongly asymmetric. If anything, the Greenbook likely understates both growth and inflation.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. The Eighth District economy continues to grow moderately, with firms reporting sales increases and net new hiring. Labor markets are generally tight. In March, the unemployment rate in Missouri was 4.2 percent, the lowest since 1979. District automotive production by Ford and Chrysler was up 1.1 percent in the first quarter from the fourth quarter of 1996. Second-quarter production is expected to increase another 2 percent. Resolution in early May of the Mound Road engine strike in Detroit put about 2,500 auto workers, who had been out about a month, back on the job making pickup trucks at Chrysler's St. Louis plant. March flooding along the Ohio and Mississippi Rivers and tornadoes in Arkansas, Tennessee, and Kentucky led to about 6,000 claims for unemployment insurance. Estimates of total storm damage are sketchy but may total around \$80 million for infrastructure alone.

Nationally, real GDP growth in the last four quarters is just over 4 percent, matching the best performance since 1984. If adjusted for a change in survey methodology, the April unemployment rate would have been 4-1/2 percent, a level not seen since 1970. What about the future? Recent forecasting records have not been good. In October 1996, many forecasters projected that the economy would grow at an annual rate of less than 2-1/2 percent in the fourth quarter; that, of course, turned out to be well short of the observed rate of 3.8 percent. In January of this year, many forecasters projected that the economy would grow at a rate of less than 2-1/2 percent in the first quarter, and that forecast turned out to be

even further short of the observed rate of 5.6 percent reported so far. In the current quarter, forecasters are again projecting growth at a rate of 2-1/2 percent or less. They may be right this time, but with such a record, it is hard to argue that monetary policy actions should be based on forecasts of short-run real economic growth.

It is essential for us to maintain a longer-term orientation focused on the general level of prices, which is all that monetary policy ultimately can influence. Inflation has been running at a rate close to 3 percent for the past five years, and it has continued at about that rate so far in 1997. Thus, I see little reason to believe that the longer-run inflation trend will decline. Looking forward, the risks remain on the upside. Broad money and credit have been growing rapidly, which could easily translate into upward pressure on demand growth and inflation. Because the economy remains so strong, we have an ideal opportunity to take a longer-term view about appropriate action to temper inflation risks.

While sending a message that our intention to cap inflation at 3 percent is desirable, it is a mistake to give markets the impression that inflation near 3 percent is consistent with our long-run price stability goal. The most recent IMF report on the world economic outlook posed the question: Is inflation outside a range that the country's authorities consider to be consistent with price stability? According to the IMF report, the answer for the United States was "no." I think the question is a good one and the FOMC might benefit from discussing it. My judgment is that there is less than a percentage point of bias in the CPI and, accordingly, 2-1/2 to 3 percent inflation is not price stability in spite of the views that the IMF reports. Furthermore, I certainly am uncomfortable with an IMF forecast of U.S. consumer price inflation in 1997 and 1998 that is higher than that of any other G-7 country.

To clarify our goal, we need to get our inflation measurement straight. How can we answer the question about whether current inflation is consistent with price stability without being clear about what we are talking about: CPI, core CPI, median CPI, experimental CPI, GDP or PCE price indexes, or something else? We certainly need to be specific among ourselves if not before the public. How should we interpret the current 1997 and 1998 forecasts in the Greenbook of an acceleration in the GDP chain-weighted price index and the core CPI and a deceleration in the overall consumer price index? Is inflation accelerating or decelerating?

At our February meeting, there was general agreement on the need to be more explicit among ourselves about what we mean by price stability: what measure to emphasize, where we want to be with respect to that measure, and ideally a time frame to get there. I hope we can continue that dialogue at our July meeting and sharpen our internal understanding of our long-term objective.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. Economic growth in the Second District has slowed somewhat on balance from the brisk pace reported for the first quarter. Payroll job growth remains fairly strong, with employment levels running more than 1 percent ahead of a year ago. New York State's unemployment rate held steady at 6.3 percent in March, and New Jersey's went down to a cyclical low of 5.2 percent in April--the data for New Jersey come in earlier. Retail sales were generally below plan in March and especially in April, though much of the weakness was concentrated in seasonal merchandise and was attributed to unseasonably cold weather. Consumer confidence retreated in March and April and remains the lowest in the nation. This may seem rather

surprising given the fine economic performance of New York City, but that performance is attributable mainly to Wall Street and tourism. The northern tier of New York State from Buffalo to Albany and most of the way down the Hudson Valley is an area of psychological depression, where some breakdown in the leadership of the private sector is looking more and more apparent. We go to various places, even large cities like Syracuse, and are beckoned to take over the private-sector leadership of the community, which is a somewhat depressing experience. Commercial and residential real estate markets, especially around New York City, are continuing to gain momentum. In the early part of this year, permits to build new homes were up about 20 percent, led by the multifamily sector. Office vacancy rates have continued to fall in Manhattan, and we hear more and more discussion of new office construction, even of "spec" buildings.

On the national level, we too were surprised by the very strong first quarter, but we see the economy slowing to a growth rate of about 1-3/4 percent this quarter followed by growth at a rate of about 2 percent for the rest of this year and the two following years. We believe that the unemployment rate will stay near its present level of close to 5 percent during that period. As others also have noted, the strong dollar has helped price performance this year, both because of its drag on the economy and its direct immediate effect on prices. In addition, some recent research we have done at the New York Bank has convinced us that the microeconomic effect of the dollar's recovery since 1995 on the relatively open U.S. manufacturing economy has restrained both wage increases and investment growth in 1996 and thus far in 1997. This, we believe, has been a more important contributor to the excellent price performance in the manufactured goods area than generally has been realized. The

other side of that coin, of course, is the additional inflationary effect of a weaker dollar through that channel in the future.

We use the gap between actual and potential GDP as the best tool of inflation forecasting. That tool helps us understand why the good performance of inflation is less mysterious than it has seemed. The recent large discrepancy between the income and the product sides of the national income accounts and the unexpectedly large tax receipts suggest that GDP has been underestimated, meaning that productivity was underestimated. We think that is very important because it is a sustainable phenomenon that does not require a train of happy events that seem to have come together mysteriously to give us good results. So, we think that what appeared to be a sizable gap between actual and potential GDP really was not very substantial at all before the burst in growth in the last two quarters. If we take account of that burst of growth and then assume a trend rate of economic expansion, we conclude that real GDP is now somewhat above potential and likely to stay that way. Consequently, we, like the Greenbook, are forecasting accelerating core inflation. However, we keep on being surprised by an excellent inflation performance. What, therefore, should we conclude?

In more than two decades of trying to make a living in the private sector, it always seemed to me that if we have less confidence in a forecast, we should be less activist and more cautious in our decisionmaking. I asked Rick Mishkin to see if there was some economic research about policymaking in times of uncertainty. The principal author of such research is Bill Brainard, who is Chairman of the Board of the Boston Fed at the moment. The conclusion of that research is that the greater the uncertainty about the economic model and its forecast, the more cautious we should be in changing policy instruments. I was very happy to hear that economic research and two decades of private-sector experience seemed to

be in "sync." That suggests to me that, although our point forecast for inflation is for a fairly substantial acceleration, there is a great deal of uncertainty around that point forecast and therefore less information in output gaps about the path of future inflation. Accordingly, we need to look elsewhere for hints of inflationary pressures. The recent core CPI inflation number does have some troubling elements, particularly the rise in core services inflation which we think is the sector most susceptible to wage pressures being passed through to prices. But we have just one month's data, and we probably should not leap to a conclusion based on such limited data. Apart from that evidence, we see no hints of increasing inflation. We conclude that caution is the appropriate lesson to be learned. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. It seems to me that we are witnessing a very impressive performance by the U.S. economy. Everything that has been said around this table today and for quite some time is testimony to the basic strength and resilience of the economy and its ability to restructure itself. But we really do not know very much about how it is doing that. This is going to be a plea for trying to find out more.

Over the last few months, the economy has seemed to be handling the tightness of labor markets remarkably well. We need more information about exactly what is happening to different kinds of wages in different labor markets. We do not know a lot about that. The anecdotes convey the impression that labor markets are tight everywhere, employers are very short of technically skilled and especially computer skilled people, and they are going after them any way they can. But basically, given what has happened over the last few months, we have to conclude that we have very flexible labor markets and a very flexible economy.

Companies are doing a lot of training; they are doing a lot of upgrading; they are doing a lot of job reorganization; they are substituting capital for labor. They are doing something right or this tight labor market would have gotten out of hand long before now. But we do not know very much about all of that.

I met with Bill McDonough's boards, including the Buffalo board, and I was struck by the comments of one director--I think it was the chairman of the Buffalo branch--who was complaining that Columbus, Ohio had held a job fair in Buffalo. [Laughter] That is too bad for Buffalo, I guess, but it is exactly the kind of thing that ought to be happening. Columbus is doing the right thing. People are moving around; employers are looking for employees either by recruiting them to come to their workplace or by moving their operations to other places. Something is working quite well here, but we clearly do not know enough about it. We also don't know enough about what is happening to productivity, which is the other side of the same coin. The anecdotes are much more positive than the staff forecast of a return to trend would indicate. The staff is quite rightly worrying that as employers dip down into the unemployment pool, they will have less skilled workers, and that may take us back to a slower productivity growth trend. I'm not sure there are enough of those people; I suspect that their number is too marginal in relation to the overall number of workers to outweigh what may be happening to productivity generally as this flexible economy adjusts to the shortages in skills. But the fact is that we do not know. If my assumption is right that we are going to be struggling with these questions for some time to come, then clearly we should think about how we could get data that could fill the gap between aggregate statistics like the employment cost index, which don't tell us a great deal, and the anecdotes that we trade around the table.

It seems to me, as it seems to almost everybody, that the risks clearly are on the upside with respect to inflation and that the question to be discussed later in this meeting is whether we move now or move later. It seems to me that we sent a very valuable signal in March, namely that the Fed is awake and watching. The question is whether it would be better to send the signal now that we are still watching or leave it out there to be used later.

One final word about the other piece of good news, the budget deal. I am more positive than some in the press have been on the importance of this deal. The cynics seem so eager to be cynical that they point out that the deal does not involve a big cut in spending, but that is partly because we have done so well already. The deficit was down to 1 percent of GDP, so there was no need to cut spending much further. It is also because the big core pieces of the reductions are cuts in future rates of growth in Medicare, but it was extremely important to do that. It does not make it less effective that those are reductions in future rates of growth. The third point is that the spending cuts are to some extent offset by increases in spending for education, but this is an opportune time to do that. Such spending will involve more than just the national government, obviously, but if we as a nation can improve education and training over the next several years, we will be in better shape to take advantage of this huge opportunity that is presented to us by the very tight labor markets.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. It has been almost two months since our last meeting, but in many ways the economic situation seems like more of the same: strong growth in both demand and production, continued expectations of a slowdown, and inflationary pressures that generally seem to be contained. I don't see any need to review all the underlying factors, but I would like to comment on a few that seem particularly important

with respect to their contribution to the potential strength and length of the current expansion.

The first factor I would point to is one that was mentioned by Gary Stern, business fixed investment. This is an area the strength of which generally has been underestimated in this expansion, although the current Greenbook forecast does have a higher increase in such spending. Both construction and equipment expenditures have been adding to capacity. Not only is this investment allowing business firms to meet rising demand without having to increase prices, but it may also be generating some productivity increases. This productivity hypothesis is supported by continued strength in profits. I agree with Governor Rivlin that we do not really know how this is happening, but we can see the bottom line, which indicates that despite increases in unit labor costs--and those costs are rising at a faster rate than general price increases--businesses have been able to maintain their profits without raising prices.

All of this business fixed investment has been supported by a very favorable financial environment. Not only has the financial environment supported growth, but it also has allowed firms in the nonfinancial sector to strengthen their balance sheets. Internal financing has been available. The bond market has been deep and liquid and has provided significant debt financing opportunities. I would note that the spreads on speculative-grade debt are particularly low, so that even higher risk companies have had access to the debt market at favorable rates. Bank credit has remained available. Commercial delinquencies have been relatively low, so the outlook is good there. Securitizations of commercial credits have made this source of credit even more reliable. On the equity side, we have seen IPO issuance decline a bit from last year, but equity via IPOs is still available at a reasonable

price, particularly for firms with strong earnings outlooks. In short, the availability of financing will not be the culprit if business investment falls off.

In the U.S. economy, a forecast of the macroeconomy cannot ignore consumer spending, but I'm not sure that the prospects for such spending have changed much. I continue to believe that the most likely outlook is for sustained growth in consumer expenditures at a rate that about matches income growth, the so-called Goldilocks outlook. It is not too hot in that consumers are too leveraged to finance purchases with much more debt, and pent-up demand is an unlikely factor at this late stage in the business cycle. On the other hand, it is not too cold in the sense that unemployment is low, sentiment is good, and the wealth effects from the stock market should continue to provide some strength. So, I do not think that there is any reason to anticipate a slump in consumer spending.

The federal deficit situation is one of the factors that could throw the economy off this path to yet another soft landing, but as Governor Rivlin mentioned, the outlook for the deficit is actually a little better. The budget deal is good news, although we do have to recognize that there are some structural budget problems that still have to be addressed. We certainly are a lot farther down that trail than we were several years ago.

There can always be an external shock, and Mike Prell mentioned the possibility of Mideast oil disruptions. On the international side, net exports have been a drag on the economy, but at least for now the domestic economy is strong enough to offset weakness from the external sector. In addition, the strong dollar has been providing some salutary effects in the inflation area.

It does seem to me that with this fairly strong outlook, the risk does remain on the upside with respect to inflation. It is hard to judge how long employers can continue to

absorb wage increases without raising prices. I will say that I was comforted by the recent inflation reports, and like President McTeer, I was particularly comforted by the decline in the total PPI thus far this year and the rise of only .1 percent in the core PPI. I would point out, however, that after declining earlier the core CPI has now been flat for two years, so the progress that we had been making in terms of this key inflation measure seems to have stopped.

To wind up, I do think that there are tentative signs of a slowdown in the expansion and, as support, I would point to IP and to auto and retail sales in April. I think the risks to the economy are concentrated on inflation, but the news in that area indicates that the near-term threat appears to have abated a bit recently.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. Earlier when President McTeer was about to begin the "tour de table," reference was made to the recent episode of the so-called "Republic of Texas." If I understood President McTeer correctly, his reply was that the Republic of Texas and the Eleventh District are about the same thing. As Chairman of the Bank Affairs Committee, I can verify that that is correct. [Laughter]

The outlook for the balance of this year and next appears to be heavily weighted in the direction of offering a very attractive period of continued growth, a high level of utilization of the economy's resources, and an inflation rate that may begin to grow but almost certainly not to roar. Given that likelihood, I think it is appropriate to focus, as the Greenbook does at the end of its first section, on the forces that might be influencing the trend of events going into 1999 and out from there. Addressing the latter point, how should we think about policy for 1999 and forward?

Let me outline briefly two strands of thought in the context of our national economic goal of maximum sustainable growth, which we at the Fed believe requires price level stability as a prerequisite for success. First of all, we reversed policy at the last meeting. After holding our fire for many quarters in the face of rising labor market pressures, seeing a very strong surge of activity in the first quarter, which was counter to expectations, the FOMC raised the federal funds rate by 25 basis points. In absolute terms, this is a modest move, but such impact as it will have has not yet fully been felt. I believe it carried two meaningful psychological messages. First, there is a new policy paradigm in the sense that the basic thrust of monetary policy is now toward tightening. And second, the Fed continues to have no intention of permitting inflation to get a grip on the economy. I am entirely comfortable with that decision. In my opinion, it clearly was the right thing to do.

With that decision behind us, where do we stand today? The pace of economic activity, while still moving forward, appears to be slowing. The employment cost index moved up modestly in the first quarter. Most commodity prices are flat to down. Unit labor costs do not appear to be accelerating. Profit margins continue to be strong and deterioration there should provide us with an early warning of inflationary change. There appears to be no fear of inflation embedded in the yield curve. As I peruse the Beigebook, I have to go back to check the date because it continues to read precisely the same as it has for well over a year. My best judgment from all of this is that growth will continue, and we are seeing likely but not definitive signs of incipient inflationary creep. But in terms of our stated national economic goal, that does not seem to pose a clear and present danger.

Moving to line-of-thought number two: In the absence of a settled notion of the definition of price level stability, I think a responsible judgment can be made that we are now

either in that zone or very close to it. If the CPI measurement is about a percentage point too high, the real CPI is now increasing at a rate between 1 and 2 percent. Almost all the other price indexes indicate a steady rate of inflation in the 1 to 2 percent range, although some measures, including the core CPI, suggest that inflation may be beginning to edge up. The Chairman's qualitative definition of price stability, namely that we are there when inflation concerns are removed from economic decisionmaking, appears largely to be in place. If we are in or very close to the price stability zone, again in terms of national economic goals, the relevant question becomes how we hold the economy there and keep it robust.

First of all, if higher-than-trend growth continues or resumes soon--and it well may; I think the growth risks are on the upside--that clearly would seem to require additional tightening, perhaps a good deal of it. But if the economy returns to a trend rate of growth or slower than trend, there may be a significant probability, given the economy's performance characteristics over the past two years as a guide, that we will not need to adjust policy for some time and indeed there is no absolute certainty as to which direction we may ultimately move. Further, we do not satisfactorily understand why the economy is working so well right now. If we were to cut its momentum back too much too soon, we might forego a precious opportunity to learn more about what could be some critically important new realities. In my view, the risk/return ratio of alternative policies evaluated against national economic goals provides ample reason for waiting to see what happens as events unfold.

Thank you.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. My reading of first-quarter performance and incoming monthly data suggests the economy will slow sharply in the second quarter in line with the Greenbook

forecast. Special factors boosted growth in the first quarter while payback and special factors are at work in the current quarter. Inventory investment clearly is playing an important role in the near-term dynamics. On the other hand, the fundamentals supporting the expansion remain very positive and suggest a rebound in the second half to at least slightly above-trend growth. As a result, the economy is likely over the forecast horizon and in the absence of further policy action to remain at the high level of labor resource utilization rates reached in April.

Monetary policy decisions are appropriately conditioned by the inflow of data between meetings. I want to focus on an interpretation of that data, and there certainly was something for everyone in that data. First, we had the first-quarter GDP report with its surprisingly robust growth immediately followed by a decline in the unemployment rate in April to a 23-year low and to a level outside the narrow range that had prevailed over the last year and half. Second, we had reasonably strong evidence of a sharp slowdown in growth in the second quarter. Third, we had better-than-expected performance in labor costs, focusing on the first-quarter ECI report and the April reading on average hourly earnings, combined with mixed evidence on inflation. On balance, the evidence did not suggest a trend toward higher inflation, but it seemed to indicate a reduced prospect that core CPI inflation is still declining.

The data on the unemployment rate signal higher inflation risk. The information on current quarter growth, particularly when combined with the Greenbook forecast of near-trend growth beyond the second quarter, suggests less risk of further increases in utilization rates. But these two developments do not offset. The threat of continued above-trend growth we faced at the last meeting has already delivered its consequence in the

form of higher utilization rates. In the framework of utilization and growth risks that I have been using to assess the risk of higher inflation, the data since the last meeting simply have transformed growth risk into utilization risk. This was a bad trade from the perspective of inflation risk. We traded a speculative increase in utilization rates, because that is what growth risk is, for a realized increase in labor utilization rates.

There are at least two sources of increased uncertainty suggested by the flow of data between meetings. Such uncertainty sometimes encourages caution in policy action, and I expect it to weigh on our decision today. First, there may be greater uncertainty about the second-half outlook, given the sharpness of the slowdown that now appears under way in the second quarter and given questions about the degree and persistence of the expected slowing in inventory investment. That is, even though the combination of stronger-than-expected first-quarter growth and the sharp slowing projected in the Greenbook for the second quarter leaves the first half stronger than was projected at the last meeting, the distribution of that strength over the two quarters might add some downside risk to the second-half forecast. Second, the better-than-expected performance of labor costs in the first-quarter ECI report and the April reading for average hourly earnings might increase further the uncertainty about the estimate of NAIRU and hence increase the uncertainty about the degree of deterioration to be expected in the inflation outlook if the economy returns to trend growth and the unemployment rate stabilizes at its current level.

I believe that the fundamentals supporting the expansion remain very positive. I am going to focus on two examples of the positive underlying fundamentals: financial conditions broadly defined and consumer confidence. We might ask what factors have contributed to the strong above-trend growth over the last year and a half. A supportive set

of financial conditions certainly seems to have been a factor. Financial conditions either have been sufficiently stimulative to promote this strength or not sufficiently restrictive to prevent the resurgence. Borrowing terms generally are viewed as attractive for home buying, for consumer durable purchases, and for business fixed investment. If there is a problem, it is the excessive amount of borrowing that some households would like to undertake under prevailing financial conditions.

How have financial conditions changed since the March 25 policy action? That action was widely anticipated, so it largely was reflected in financial market conditions at the time of the move. Since the March move, however, long-term interest rates have edged slightly lower, the stock market has rallied, the dollar first rose and then declined to below its initial level. A monetary conditions index for the United States, which took account of short-term and long-term interest rates, the stock market, and exchange rates would, I believe, show more favorable financial market conditions today than was the case immediately following the March move.

I do not ordinarily place great weight on measures of consumer confidence in my own forecast, so I don't want to oversell the significance of the latest reading when it supports the case I want to make. But the preliminary report of the Michigan Consumer Sentiment Index for early May was extremely interesting. It shows a decline in the index as it relates to current economic conditions that are consistent with the projected near-term slowing. But it also indicates a sharp improvement in expectations about future conditions supportive of the prospect of a solid second-half rebound. Let me read you a few sentences from Richard Curtin's interpretation of the early May data on consumer sentiment:

“Extraordinary strength was recorded in consumer sentiment during the first half of May,

with the Sentiment Index reaching a new record level. The early May gain reflected consumer reactions to the very favorable economic news that has dominated the headlines: record low unemployment, strong GDP growth, and a resurgent stock market. Moreover, in sharp contrast with the initial reaction to the interest rate hike, consumers have now concluded that the recent increase will have little, if any, impact on future economic conditions. To be sure, consumers have not changed their views that further interest rate hikes would be forthcoming in the year ahead. Consumers, however, no longer expect those rate increases to damp income gains nor to represent a barrier to planned purchases.”

My conclusion is that the projected slowing in the current quarter is part payback, part special factors, part breather, but not likely to be the beginning of an extended period of below-trend growth. The underlying fundamentals remain very positive. As a result, from the perspective of monetary policy, we should give appropriate attention to the level of utilization rates. For better or worse, this is what will determine the course of inflation over the coming quarters.

CHAIRMAN GREENSPAN. Thank you all. I think we can go for coffee.

[Coffee break]

CHAIRMAN GREENSPAN. Shall we resume? Mr. Kohn.

MR. KOHN. Thank you, Mr. Chairman. (Statement--see Appendix)

CHAIRMAN GREENSPAN. Questions for Don? If not, let me start off. I think the probability that we are in a very unusual era is rising. A number of developments point in that direction, and they raise some very fundamental questions about how to view this economy and how to implement policy. At the risk of being a little more definitive than

indeed I think is appropriate, let me sketch out what I believe may well be happening, put that scenario on the table as a hypothesis, and then try to see what its shortcomings may be.

First, we have some very significant and unexpected evidence that profit margins are still rising at this late stage of the business cycle expansion. The preliminary earnings reports suggest that the domestic operating profits of nonfinancial corporations showed a fairly significant rise in margins for the first quarter. When we add in the dramatic rise in foreign affiliate earnings, which have increased despite the rise in the dollar, we find a quite impressive increase in total profits. That is, if we start with the firms in the S&P 500, whose domestic earnings are rising faster than those of smaller firms, add in the smaller companies, and allow for the nonpublic corporations that also appear in the national income accounts data, we see that total domestic operating margins are moving higher.

This has a very interesting implication for what is going on because if we disaggregate the data for nonfinancial corporations, it turns out that the estimated rate of increase in total unit costs from the first quarter of 1996 to the first quarter of 1997 is close to zero. This total, which combines unit labor and unit nonlabor costs, has been moving lower in recent years; that is, the rate of increase in underlying total unit costs has been slowing. The number for the first quarter of 1997, which is a rough estimate at this point but one that is based on accounting relationships, is the best that we have seen in a while. If we believe that the price data are reasonably accurate, meaning that the bias is not changing very much, and if we believe the profits estimates are about right--the latter are based on independent earnings reports--then, by arithmetic, total unit costs could not have changed much. If we subtract nonlabor unit costs, which are comprised essentially of capital consumption allowances and net interest per unit and which combined have been falling for quite a while--

you may recall that we discussed this a couple of meetings ago--the residual, unit labor costs, can be seen to have increased at a rate of about 1 percent in the past year, and that rate of increase, too, has been falling.

Any reasonable set of numbers for average hourly compensation, which has been rising in this period, permits us to derive productivity numbers that are accelerating significantly--up roughly 3 percent from the first quarter of 1996 to the first quarter of 1997. Now, one should remember that this productivity estimate does not cover the full economy. When we try to reconcile this estimate with the published nonfarm business sector productivity data that we usually deal with in our models, we run into that large anomaly of a long-term decline in productivity for the noncorporate business sector. This decline makes no sense. It seems to me that all the anecdotal evidence that comes to our attention is consistent with the data we are getting in the nonfinancial corporate area. Those are the data that everyone sees. The rest is an unfortunate fabrication that I think is distorting what we are looking at and that distorts our policy view, with potentially significant consequences.

It may well be that the rise we have seen in nonfarm business output per hour, which is the official series, may to a large extent be explainable through econometric analysis by the increase in the rate of growth in the economy. But I have more difficulty with the sharp acceleration in nonfinancial corporate productivity. There is an inflection point in those data that shows up very clearly in the last couple of years. The question is, why? What does it mean? Is it a statistical aberration or just a shot out of the blue? Here we have another unexplained set of data that I must say have been bedeviling me for quite a while.

This may suggest the explanation: If we look at the high-tech investment area or more generally the high-tech portion of gross domestic product, whether in nominal or real

terms, we get a gradual increase through the 1980s and early 1990s. But starting in 1993, such investment tilts up sharply and progressively, and its rate of growth has not turned down since then. The question is, why? One must assume that people make investments because they perceive prospects for increasing profitability. Indeed, the presumption is that each company has looked at its opportunities for profitable capital expansion and decided that such investment was a good idea. We have seen a fairly dramatic increase of capital investment in the high-tech area, less growth in the non-high-tech area, and in-between increases in the intermediate types of investment.

This raises the very interesting question reminiscent of the 1989 hypothesis of Paul David of Stanford, which I discussed at some length in previous meetings. He argued that the reason why the huge amount of computer investment prior to 1989 did not show up in productivity was not that it was inefficient investment but that, as in the development of the electric motor at the turn of the century, certain synergisms need to build their way into the system before productivity gains can emerge from a major new technological insight. You may recall that, in what I found to be a very persuasive paper, Professor David looked at the 1920s and the pattern preceding it and developed a view with respect to the gradual buildup of synergies after the introduction of the electric motor. The latter initially displaced the steam engine that had largely driven transmission belts utilizing the advantage of gravity in tall buildings. The electric motor could not do much to increase productivity in that environment. But as soon as the tall buildings were replaced by flatter ones the synergies began to take hold and productivity picked up very substantially in the 1920s. Professor David's view was that today's high-tech change represents a comparable situation.

Indeed, if in retrospect this hypothesis is correct, what has happened is that the synergies finally came together in recent years mainly as the software industry in this country expanded extensively and, as you all have observed, computer technology cumulatively enhanced our production capabilities. We presumably are seeing a rise in the potential rates of return on marginal investments in a system in which the synergies are coming together. If that is not happening, it is very difficult to explain the protracted, very extensive expansion in high-tech capital investment. The question is whether those making the high-tech investments were right. Did rising rates of return actually materialize? The productivity data that we are looking at here suggest "maybe." One would expect the rate of return on capital investment to rise in real terms as productivity increases.

If the inflection in the rate of growth at this late stage in the business cycle is in fact real--and it certainly appears less and less to be statistical noise as it continues quarter by quarter--then the issue essentially is why it is happening at a time when the unemployment rate is so low, when employers are of necessity drawing in marginal workers, even if we want to argue that they are not doing so extensively. The answer has to be that we are getting some long-term improvement in productivity performance cyclically adjusted and after any other adjustment one may wish to make. This would imply in the context of very tight labor markets that we are also getting a significant shift from labor to capital resources. Indeed, that would have to be the case. It does not have to be measured physical capital because it can be intellectual capital such as managerial changes, structural changes, and a variety of other changes that we do not include in our tangible capital stock. But the question really is whether we are indeed getting this long-term productivity increase. I will come to the issue

that I think Al Broaddus correctly raised in this connection, namely, the implication that has for the real long-term rate of interest.

In any event, the pickup in productivity helps to explain why inflation remains so well contained at this stage in the expansion despite the increasingly tight labor markets and other developments that, on the basis of our historical models, would have produced significant inflation. It also may partially explain why nominal and real GDP are as strong as they are. We need to remember that output does not stem only from the demand side; it also comes from the supply side. The containment of inflation also is consistent with the general notion, which we have discussed before, that it is very difficult for business firms to raise prices in this environment. The reason is that there is enough product slack in the economy to restrain firms that endeavor to raise their prices because they fear the loss of market share to competitors who may decide not to adjust their prices higher.

We have what increasingly strikes me not so much as noise in the data but as growing evidence that something quite fundamental is happening. The important question is where it goes from here. It is too soon to be sure of any magnitudes. I suspect that the 3 percent growth in productivity that I mentioned may well have occurred in the nonfinancial corporate area over the last year; incidentally, that improvement has been supported by a much stronger rate of growth in manufacturing, a significant component of that industry grouping. If those productivity estimates are correct and the productivity gain is coming from high rates of return on the capital investment side, then the latter is not about to slow down much, particularly at the moment.

This analysis basically argues that prices are in check for a while. It does not say, however, that we have cured inflation or that capacity is unlimited in some way or another.

It does suggest, I think, that we ought to be careful about how we evaluate what we are doing. While it is certainly the case, as Al Broaddus pointed out and others have implied, that we do get a higher real rate of interest or, as Don Kohn correctly said, a higher marginal product, there is a tradeoff. In other words, we get both lower inflation and higher real rates. Rephrasing what Al said, at constant nominal federal funds rates, we get a higher real long-term rate and a lower inflation trajectory.

The question arises as to what is the appropriate policy in this situation. It strikes me that there are risks on all sides because this hypothesis, which I would stress is only a hypothesis and by no means a certainty, involves some probability of being wrong. My own guess at this stage is that, even given this hypothesis, the rate of economic growth in the Greenbook may be too low. I think that the second-quarter number is phony for the same reasons that people are suggesting the first-quarter number is phony. I believe that there is a deeper underlying strength in the expansion, as Gary Stern suggested, and I agree with him that it is very hard to avoid the conclusion that the wealth effect has not spilled over in certain respects. It does not take very much in the way of a change in core productivity growth to alter radically the inflation outlook as presented in the Greenbook. If we consider that employment costs account for $2/3$ of total price, then a $1/2$ percentage point change in productivity growth, presuming it affects the total system irrespective of how we may look at the noncorporate sector, means a difference of $3/10$ point in long-term inflation rates. The improvement in productivity could very well be more than $1/2$ percentage point; I do not have a clue.

All I am telling you is that the numbers do not strike me as evidence that the old-fashioned model is working. I am not aware of any evidence suggesting that domestic

operating margins are declining in the second quarter. I think the gains in foreign affiliate earnings are probably coming to a halt, in part because of the lagged effects of the dollar's strength. But I hear nothing that suggests reduced growth in domestic operating earnings. If virtually all of the inflation is coming from rising profit margins and the increase in total unit costs has been near zero for the last year, it just is not credible to assert that policy is behind the curve. Indeed, I would suspect that the real funds rate, as appropriately measured depending on how one looks at it, is probably not terribly far from where we want it to be. I believe the fact that we are getting stronger growth at the current federal funds rate than we would have expected is a supply side as well as a demand side phenomenon, perhaps more supply than demand. I am not convinced that the inventory effect may not cause us some difficulty. It is hard to believe that the inventory growth rate will simmer down and stay down. The inventory risks are clearly on the upside.

Let me summarize quickly; I have been going on longer than I intended. The bottom line as I see it is that as I balance the demand side pressures and the supply side offsets, I suspect that we are going to have to tighten policy somewhere along the line. My guess is that we will need another 25 basis points, more likely more, by the end of the year. I would be concerned, however, about moving today. A move would give us too steep a trajectory for the endpoint of the interest rate pattern. Two things might happen, neither of which would be terribly helpful. One would be a market presumption that a big increase in rates is needed, something that I do not think we are in the process of implementing. Alternatively, and worse in a certain sense, would be the conclusion that the rate increases are all over, thereby removing the uncertainty that occurs when the Federal Reserve's

Damocles Sword overhangs the economy. That is not something that I would look upon with great tranquility.

I recommend that we not move today. If we do not, I think the probability that we will have to move and should move in July is better than 50/50 and, alternatively, the probability of a move by August is very high. I would add that the odds of a further move in the fall are better than 50/50. I think it is appropriate in this situation to weigh what seems to be a very important and fundamental shift that appears to be occurring coupled against the unquestioned notion that the amount of slack in the economy is not substantial. In that context, I think we ought to be looking at a potential trajectory for interest rates that is modest but definitely up. We need to continue to create an element of uncertainty about what we are going to do in order to damp what undoubtedly are some elements of speculation, especially in the commercial real estate area.

To conclude, I would recommend at this stage that we not move today but that we adopt an asymmetric directive. I think that with all of the things I have been saying about structural change, the risks unquestionably remain on the upside and are likely to be in that direction for quite a period of time. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, during the go-around I gave a shortened version, not intentionally, of the very interesting analysis you made of productivity developments. As I said then, an advantage of attributing the unusually favorable performance of unit costs to higher productivity growth was that it removed some of the mystery surrounding that performance. Our previous analysis that attributed much of the relatively subdued inflation to the dollar and to uncertainty among white collar workers might be compared in terms of its plausibility to a relay race in which people who never saw

each other before run on the same team and pass the baton perfectly. It was always very hard for me to believe. So, I think this analysis actually makes a good deal more sense.

I would add as you indicated, Mr. Chairman, that we are dealing with a working hypothesis, not a proved theory. Therefore, it does leave us with a rather high degree of uncertainty about what is going on in the economy even though we may be less uncertain. In the circumstances, caution is the appropriate response.

I agree with the idea that keeping participants in financial markets and the real economy somewhat uncertain about the exact timing of our moves has considerable merit since we still have rather frothy asset markets. As I mentioned, we are now heading toward speculative real estate development in New York. I can support very comfortably your recommendation of "B" asymmetric.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. I agree. I think your analysis is very appealing. I hope it is right; it will take us a little while to find out. I believe we all agree that the risks are still on the upside, that the economy is very strong, and that we probably will have to move again. In my view, the psychological argument is very much in favor of not moving now because the markets and other Fed watchers would interpret another move at this time as the end of the story, especially with the expansion softening. We will have a much bigger psychological effect if we do not move at this point, and I would support your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Let me begin with some further thoughts on the Taylor Rule perspective on monetary policy options and the changes in initial conditions and forecasts

between this meeting and the March meeting. This will lead me into my own version of the policy options for today's decision, with special attention to the interpretations attached to the options. I will conclude with some considerations relating to initial conditions and to other policy priorities that might justify a willingness to assume greater inflation risks.

The Taylor Rule perspective underlies my strongly held view that prudent monetary policy should lean against the cyclical winds by enforcing a procyclical pattern in real short-term interest rates. Specifically, I believe that real short-term interest rates should rise in proportion to increases in utilization rates over the course of a cycle and that such a disciplined response is especially critical as the economy approaches capacity. I interpreted our action at the last FOMC meeting as being justified by a forward-looking version of the Taylor rule; that is, by a forecast at the last meeting of rising utilization and inflation rates in the absence of policy action. The wisdom of that move was quickly apparent, to me at least, in the quicker-than-expected realization of higher labor utilization rates. We might in retrospect call it a "just-in-time" monetary policy action!

In my view, we tightened in March because we believed that continued above-trend growth would lower the unemployment rate to or below 5 percent by midyear, in line with the staff forecast. The unemployment rate is already where we feared it might go. Why should a forecast of more moderate growth ahead make us more relaxed? All the forecast of a return-to-trend growth guarantees is that the economy will linger indefinitely in this precarious position until inflation does turn up.

In short, we have more reason in my view to be concerned about inflation on May 20th than we did on March 25th, not less. If one accepts the view that there is indeed justification for some tightening, the next question is how much of a cumulative move is

justified by today's initial conditions and how gradually should such a tightening be implemented over time. We can get some guidance on this subject from alternative specifications of the Taylor Rule as well as from model simulations of alternative funds rate paths around the base forecast. I conclude on the basis of guidance from those sources that the real federal funds rate should move at least percentage point for percentage point with the unemployment rate, with some of the evidence suggesting that the best stabilizing results come from a gradual policy response that cumulates to twice this magnitude.

The bottom line of the analysis is that some further tightening appears justified by current initial conditions and forecasts. On the other hand, it would be hard to argue that recent data on labor costs and inflation suggest a high degree of urgency about taking the next step today. I also can accept the wisdom of a view that present uncertainties might suggest a more gradual implementation of any cumulative tightening than otherwise.

In my outlook statement, I noted two uncertainties that could influence our judgment today, particularly about the timing of any action. The first is that the data on labor cost inflation in the period between meetings raised further questions about the estimate of NAIRU and suggested that the staff forecast of rising inflation at prevailing utilization rates may be too pessimistic. The second is the sharpness of the projected decline in second-quarter growth, which encourages the Committee to wait until we confirm the expected rebound. The Chairman has focused on a third uncertainty--heightened by first-quarter profits data--the trend in productivity growth.

With the above considerations as background, let me offer my own version of the Bluebook policy options for your consideration. First, we have alternative B, no change. This alternative could be supported on the basis of two quite different arguments. I want to

place at least as much emphasis on the principles that underlie the action as on the action itself. Let me call the first rationale for no action the "B/reactive policy" alternative. It carries the following interpretation: growth is slowing sharply in the current quarter, and it is projected to be near trend over the remainder of the forecast horizon. Therefore, we can comfortably return to a reactive posture of watchful waiting. A move to a tighter policy in the absence of evidence of a sharper rise in labor costs or direct evidence of higher core inflation would require at least a forecast of above-trend growth if not evidence of persistent above-trend growth. This justification for no action seems to make growth the issue rather than utilization rates. It seems to be a surrender to a reactive posture. This approach could be taken a step further to hold that, given the uncertainty about productivity growth, we should not even worry about the strength of growth. Do not worry about utilization rates. Do not worry about growth. Do not worry about wages because their increase could simply be a response to higher productivity growth. Worry only about inflation, the ultimate reactive posture. This might be the best we can do if we believe that we know so little about the structure of the economy that past regularities provide no guidance for current policy. For my own part, the puzzles of the current episode have not yet pushed me into this camp. Some might worry that this view suggests that irrational exuberance has affected more than the stock market.

I will take the liberty of redefining alternative C in my menu of options as 1/4 percentage point of additional tightening today. This would be the second step in a cautious but still preemptive policy posture. It is justified by the increase in utilization rates since the last meeting combined with the expectation, consistent with the Greenbook forecast, that utilization rates are likely to remain at or below this level going forward. In light of the

uncertainties I have previously discussed, we could accompany this move with an announcement that indicates an intent to pause after the March and May moves. The pause would allow us to await confirmation of a rebound in demand in the third quarter, to assess the degree and persistence of the projected slowing in inventory investment, and to evaluate the implications of additional information on labor costs and inflation and whether utilization rates were already so high as to yield a rising trend of inflation. The pause also would provide an opportunity to assess the July NIPA revisions for insights about trend productivity growth. Given the prevailing large statistical discrepancy and the recent unexpected surge in tax receipts, there is reason to be particularly interested in this revision.

Let me offer a third alternative as a compromise, which I call "B/go slow," that I hope is in keeping with the spirit of the Chairman's proposal. Like the "B/reactive" policy, it calls for no change in policy today, presumably combined with an asymmetric directive that clearly is justified by the inflation risks in today's initial conditions. But it also carries the expectation that current utilization rates may justify additional tightening. We postpone any tightening today in light of present uncertainties in order to confirm expectations that demand and growth do firm, that unemployment remains at 5 percent or below, and to have time to assess the implications of additional data on trends in labor costs, inflation, and productivity.

"B/go slow" could be thought of as a slower moving version of "C." It still allows us to cling to a preemptive posture, but it suggests additional caution in light of the present uncertainties.

It might well be argued that there is only a hair of difference when all is said and done between any of these alternatives. But a "B/reactive" policy is of great concern to me. It suggests a willingness to abandon any sense of preemptive policy in favor of resuming a

reactive posture that history suggests will ultimately produce overheating and higher inflation and that will end up threatening the expansion.

I prefer "C." I think it is the more disciplined policy, the more balanced approach, but I could live with "B/go slow" if it contributes to a stronger FOMC consensus about current and prospective policy.

Let me turn now to two quite different sets of considerations that would be consistent with the choice of a reactive strategy. I am not promoting either of these justifications--I have already committed to preemptive "C"--but I believe they deserve to be put on the table. The first is the economic and political difficulty, what I will call a "reverse" soft landing. I view the monetary policy implementation through 1996 as an attempt to achieve a conventional soft landing. It involved slowing the expansion to trend before it overshot capacity, thereby stabilizing inflation and extending the expansion. We already have seen that it can be difficult to muster public support even for such a sensible policy effort. Given the recent decline in the unemployment rate, we might now need a monetary policy that is attempting a reverse soft landing in which we approach capacity from above and thus require a period of below-trend growth to allow actual output to drift back down to capacity. Perhaps more to the point, it would be a period of below-trend growth to raise the unemployment rate back to NAIRU. Such a policy is very difficult to sell and very difficult to achieve. It might be argued in this case that the best we can do is to attempt to slow the economy to trend, hope for the best, and react if necessary to clear and persistent signs of higher inflation. I wonder if this is a factor encouraging some to accept a reactive posture.

A second consideration, and one increasingly talked about, is that a policy priority for sustaining a high-pressure economy, one close to capacity, may have increased.

Achieving maximum sustainable employment would ensure an environment that would reduce the tensions and challenges associated with welfare reform and the associated movement from welfare to work. Given the continued uncertainty about NAIRU, it has been argued that this is an opportune time to experiment by allowing the unemployment rate to decline further, even below the best guess of the current NAIRU, to ensure that we avoid sacrificing any employment that could possibly be sustained without accelerating inflation.

I think these are provocative arguments for a reactive posture. They do not, however, sway me from my preference for a cautiously preemptive stance. I am still aiming to avoid overheating and sustain the expansion. I like my version of "C," but I can accept the Chairman's version of "B," which I take to be a "go slow" strategy and not a retreat to a reactive policy.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. I agree that there are a lot of similarities to the 1920s. I just do not want it to end the same way. [Laughter] I don't even know what to call the next decade when the years after 2000 are counted in single digits. Once we get to the teens, I'll be fine. But I expect to end my career in the next decade, and I do not want it to be labeled "the great contraction." I see a growing chance that the 1990s will be viewed at least as one of, if not the, most prosperous decade of the century. It will get some label like the "soaring 1990s" or something like that. There are some scholars who say that errors made starting in 1927 sowed the seeds for what happened in 1929 and afterward. I find some of the analysis of what occurred and how it looked and felt in that period rather compelling. I started my career in the Fed in 1967, a year in which some policy mistakes were made. I was out of the System in 1977, another year in which policy mistakes started to

be made. I was not in the System in 1987; a lot of you were, but I remember very well what kind of year that was. It is now 1997, and I think we need to be cautious about being too shortsighted regarding how much momentum is built into the expansion. If the productivity-supply side arguments are right about how much strength there is in the economy, then it must be true, as it was in the 1920s, that real interest rates are quite a bit higher than those we have gotten used to. I think that Al Broaddus's argument earlier and the Chairman's remarks say that we have to accept the idea, and maybe try to sell the story to some of our critics, that high real interest rates are a sign of a strong, healthy economy and are not a bad thing.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, like some others around the table, I would like to move steadily and persistently toward price stability as measured somehow. This will require some further tightening and I think the economy could absorb that tightening rather well. However, it is also very apparent to me--I commented on this earlier--that this will require a further debate, perhaps within this Committee but certainly with the public. We will have to make a greater effort to educate the public before they will accept the need for some further tightening of policy. For that reason, I would accept and support your recommendation and encourage us to make a very conscientious effort to improve our public educational activities.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. This has been a tough meeting, Mr. Chairman, but I think a very good one with a lot of constructive comments. Early in the meeting, Jerry Jordan

summed it up best for me when he said that the choice may well be between moving a little now and moving a lot more later on. Let me make a couple of observations.

We all recognize that there are significant upside risks. To repeat what everybody else has said, for me the key upside risk is that the expansion may not slow to trend as projected. The problem is, of course, that we are not going to know this for sure. If we find out that growth is well above trend at some point down the road, we could find ourselves in a box with some very, very difficult choices. There has been a lot of focus on uncertainty in the commentary around the table, and there certainly is a great deal of uncertainty. I agree with Bill McDonough that greater uncertainty should induce greater caution, but I think we need to be very careful not to let uncertainty paralyze us. I have been attending these meetings off and on since 1973 and there is always a lot of uncertainty. There may be a little more of it than the average at this meeting but in my experience not that much more.

With respect to productivity, I am glad that you have highlighted it today, Mr. Chairman. I think you are providing a very useful service not only to the Committee but to the country in emphasizing that we may well be in the midst of a significant increase in trend productivity growth. Again, as far as the short run is concerned, that does not necessarily mean that nominal rates need to go up, but it certainly does imply that real rates need to increase. That is another factor in my thinking.

As always, policy is a matter of balancing the risks. Let me tell you that I recognize the risk in moving today. But I think there is also a substantial risk, in my view a greater risk, if we do not move now. I would reiterate the point Tom Melzer made about our longer-term goal of price stability. We certainly need to keep it in mind as we go forward.

Someone mentioned today that the core CPI is flat; actually the growth rate is flat but the index itself is still moving up. We should not lose track of our longer-term goal. If we are going to try to make progress toward that goal, this is a very good time to try to achieve it.

I think we need to move today. This is not the beginning of 1994. The funds rate is already at 5-1/2 percent, so I am not saying we need to make a terribly robust move, but I believe that a 1/4 percentage move would be appropriate today.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, for me the policy choice comes down to assessing alternative risks. It appears to me that the risk associated with raising the funds rate is smaller than the risk of not raising it. If we tighten policy and that action turns out to have been unnecessary, we would slow the expansion a bit, but there would be relatively little risk of a prolonged period of weakness. If we do not raise the funds rate and the inflation rate begins to show a clear upward trend, the long lags in policy mean that we could end up with a problem on our hands.

On the basis of these considerations, I would prefer to raise the funds rate by 25 basis points at this meeting. However, since I do not see a possible pickup in inflation as imminent, I am willing, somewhat reluctantly, to support a policy of no change in the funds rate for the time being and asymmetric language even though I believe we are running the risk of a larger rate increase later.

Finally, I very much look forward to our next meeting and the opportunity for us to reconsider our decision not to change the rate.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I think my analysis is quite similar to Bob Parry's. We need to assess both the risks that we face and the costs of being wrong in any action we take. I, too, view staying put as a policy action.

As I noted earlier, the risks that growth will be more rapid and inflation more difficult seem to me to continue to be strongly asymmetric. In fact, if I thought the Greenbook forecast had a reasonable probability of being realized, I probably could live with it. It is a forecast of a pretty good economic outcome. But I do not think it has a good probability of coming about. In my view, some additional amount of tightening is necessary to provide an extra source of constraint on the economy and keep it on a healthy track. Your discussion of productivity was extremely interesting, Mr. Chairman, but in the end it seemed to me that you had some sense of the potential need for tightening at some point this year.

What if we were to tighten now by 25 basis points and we were wrong and everything started to come in at least as well as the Greenbook sees it, and maybe even a little slower? Are the costs of being wrong in that way unacceptably high? I do not think so, and one of the reasons has to do with the argument of the psychological impact on the markets. I meet with a group of investment managers on a fairly regular basis. Their discussions in recent weeks have continually focused on the availability of credit, the liquidity of the markets, and the excesses that they see everywhere, particularly when it comes to commercial real estate financing. Rather than feeding a sense of caution through uncertainty about our actions, I think that not moving at this meeting or certainly not moving soon will lead to a greater level of certainty among market participants that they can persist in their excessive activities and that will feed into more speculation in the asset markets than is healthy.

What if we stand pat and we are wrong? Of course, timing is everything and perhaps it really doesn't matter whether we tighten now or in July or August or whenever we meet during the rest of the year. I do think that in delaying we stand to lose a bit in the markets, as I mentioned, and we also stand to lose the high ground of advocating a proactive monetary policy. We need to reduce the risk of overshooting, and if we do not do it at a time of fast growth and tight labor markets, when will we do it?

For what it's worth, the same group of investment managers spent a lot of their time at our meeting discussing what they saw as the potential outside sources of resistance to Fed moves, along the line of what Tom Hoenig was reflecting on in his comments earlier. Their advice, again for what it's worth, is to do the right thing. For them, doing the right thing is to tighten up a bit on the markets and rein in the potential for inflation to get out of hand. I believe the right policy now is a further 25 basis point move. But again, timing is everything. I think our current policy stance is not too far away from where it should be, Mr. Chairman, and I could support your recommendation.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I have to admit that I feel a little like Dr. Watson to your Sherlock Holmes. You wove together all these strands and reconciled the various puzzles that I have been worried about. Whatever else may be going on, we know that as the period of economic growth has lengthened, gains in employment have outpaced what would seem to be consistent with what demographic trends normally would generate in terms of labor force growth and any reasonable long-term trend in participation rates and hours worked. So, I am still a little cautious about where we are and how the economy is performing.

I would add that I continue to agree with the basic concern that the risks here are that demand will outpace supply and that we will experience a buildup of inflationary pressures. I do not feel that it is absolutely urgent that we act on that concern at this meeting. But having said that, I ran through the same chronology that Jerry Jordan referred to earlier in the meeting and arrived at close to the same conclusion. That is, I think that if we delay action now, we may not find ourselves confronting circumstances where we are convinced and confident of the need for a policy tightening move and have a persuasive explanation until perhaps November. Now, I do not know if waiting until November would turn out to be a fatal error, but why find out? It does seem to me that circumstances today ought to persuade us not to wait that long or run the risk of waiting that long. So, I would certainly prefer a modest tightening now.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. This decision comes down to balancing the need for more insurance versus wait-and-see. I am more persuaded by the wait-and-see argument. There is, as I look at it, more upside risk on the demand side in the future, but there is also upside potential on the supply side, which we have consistently underestimated. If there is one unifying theme that we pick up when we travel around our District, it is that there are developments out there that really are enhancing productivity and working their way through on the supply side. I think a proactive monetary policy has to take both the demand side and the supply side into account. We want to see problems in a proactive sense, but we also need to see benefits in a proactive sense. I think it is a reasonable bet to have that wait-and-see attitude, particularly since current monetary policy is not loose. It is probably somewhat

restrictive, and I don't think we are that far behind the curve even if we are making a mistake and should be tightening today. I am quite comfortable with the "B" asymmetric proposal.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I had intended to say something much like what President Boehne just said. Let me simply associate myself with his remarks and concur with your recommendation.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. I think the inflation risks are on the upside, as I said before, and I believe it would be prudent to take out some additional insurance now in the form of a 25 basis point increase in the federal funds rate. To reemphasize a point that was made earlier--I know Al Broaddus made it and others probably did as well--we cannot lose sight of how important our credibility is in assuring the kind of economic climate we have enjoyed in recent years. The confidence that people have that we are going to keep inflation low and stable is very important, and I see a move in the direction that I am suggesting as consistent with maintaining that kind of credibility. As others have said, if we are wrong and there are unique circumstances here that would not lead to an imminent increase in the inflation rate, what would be so bad about moving the inflation rate lower? We are not at price stability. We have some distance to go, and frankly I think exercising monetary restraint at a time when the economy is strong is more likely to succeed in an opportunistic sense than doing so in a recession or a recovery. This is what is implied by the so-called opportunistic strategy. Even though people would associate me with the deliberate approach, I think one could characterize a tightening move today as opportunistic.

Finally, I do not think that inaction on our part will do anything to stem speculative behavior. If anything, inaction will foster such behavior.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I could support "B" symmetric or asymmetric. I do not have strong feelings on the symmetry question because if we were to move in the intermeeting period, I think there would be some kind of consultation. I do think that tightening is eventually going to be needed, but since inflation has been rather benign recently, it seems to me that there is room to wait a bit longer. As I said last time, I am not sure that a federal funds rate of 5-1/2 percent is that far out of alignment, particularly if we get a slowdown in the expansion or if productivity has moved us to a higher growth potential. It does seem to me that we have some time to let things play out a bit more, and I think it would be best to conserve our monetary tools for now.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. I have a preference for an additional 1/4 point tightening, but I can support your recommendation for today. In any event, I certainly would support an asymmetrical directive. In view of the hour, I will not repeat all the arguments. The possible payback of staying ahead of inflationary pressures that many of us think are probably building weighed against the very small downside risk of a modest tightening in a fully employed, solid economy leads me to conclude that a somewhat less accommodative policy would be both reasonable and explainable.

I would like to add, as we talk about policy options, that we always seem to be constrained by insufficient focus on the longer run. Without a better defined and better articulated goal, whatever we decide that goal needs to be, each meeting becomes an exercise

in judging the latest data in the context of a short-term forecast. While I would not want to give up our individual and collective judgments, especially in a period of fundamental changes in the way the economy may be working, our current approach to policy without a clearly understood anchor makes it very difficult to build the kind of understanding and support for policies that promise long-term gains but entail short-term costs. I hope we can get back to that debate in July or sometime soon. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, our outlook for the economy in 1997 is very similar to the Greenbook forecast, but we are a little more optimistic on inflation. However, we are assuming a slightly higher federal funds rate through the end of the year than does the Greenbook in its baseline forecast. I am very pleased that you raised the productivity point today because it is something that we have been talking about at our Bank, and I think it deserves a great deal more attention. If we look at the productivity improvement in the first quarter, which we did not talk very much about today, and if that is not the result of a structural change as you are suggesting in your hypothesis, it follows that the current high output levels are being achieved at very high resource utilization rates. Obviously, in this situation we will have an output gap that will open up further, and inflation almost certainly will accelerate. I very much hope that a structural change is occurring as you are hypothesizing. Any additional data or information that we can gather to get a better understanding of this will be of great help to us in our formulation of monetary policy. But regardless of whether this is a structural change or not, I think the risks clearly are on the upside, as we have all mentioned. We have to keep in mind the uncertainty that is caused by the methodological changes that are now being made in the consumer price index. We have

to keep adjusting our thinking to these slight methodological improvements of .1 percent a year that we are getting in measured inflation.

Although I, too, see a need for further tightening this year, I can accept your recommendation today for the "B" asymmetric directive. I do want to add one point, though. You will recall that at the March meeting we adopted a symmetric directive that will become public information on Thursday of this week. I think it is going to be important in your speeches and comments in the coming weeks and months that you once again prepare the market for what you said was a high probability of a tightening move--you indicated a 50/50 probability for July and a very high probability for August--because I think there is likely to be some confusion when that symmetric directive becomes public knowledge later this week. I think you carried out this educational effort very effectively earlier in the year, and I am sure you can do it equally effectively now.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I support your recommendation.

CHAIRMAN GREENSPAN. Would you read the directive that would encompass "B" asymmetric?

MR. BERNARD. I will be reading from page 13 in the Bluebook. There are several charts that come before it, so when you get to page 12 you will have to go several more pages. "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the

intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.”

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD:

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Broaddus	No
President Guynn	Yes
Governor Kelley	Yes
Governor Meyer	Yes
President Moskow	Yes
President Parry	Yes
Governor Phillips	Yes
Governor Rivlin	Yes

CHAIRMAN GREENSPAN. Our next meeting is July 1 and 2. Let's go to lunch.

END OF MEETING