

Meeting of the Federal Open Market Committee

February 7-8, 1989

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, February 7, 1989, at 3:00 p.m. and continuing on Wednesday, February 8, 1989, at 9:30 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Black
Mr. Forrestal
Mr. Heller
Mr. Hoskins
Mr. Johnson
Mr. Kelley
Mr. LaWare
Mr. Parry
Ms. Seger

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

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

Mr. Kohn, Secretary and Economist
Mr. Bernard, Assistant Secretary
Mr. Patrikis,¹ Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Beebe, Broaddus, J. Davis, R. Davis, Lindsey, Siegman, Simpson, and Ms. Tschinkel, Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account
Mr. Cross, Manager for Foreign Operations, System Open Market Account

1. Attended Wednesday session only.

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Ettin, Deputy Director, Division of Research and
Statistics, Board of Governors
Mr. Promisel, Senior Associate Director, Division of
International Finance, Board of Governors
Messrs. Hooper,² Madigan,³ and Stockton, Assistant
Directors, Divisions of International Finance, Monetary
Affairs, and Research and Statistics, respectively,
Board of Governors
Messrs. Brayton,² Duca,³ and Rosine,³ Economists, Divisions of
Research and Statistics, Monetary Affairs, and Research
and Statistics, respectively, Board of Governors
Mr. Keleher, Assistant to Governor Johnson, Office of
Board Members, Board of Governors
Mr. Wajid, Assistant to Governor Heller, Office of
Board Members, Board of Governors
Mr. Gillum, Economist, Open Market Secretariat, Division
of Monetary Affairs, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of
Monetary Affairs, Board of Governors

Messrs. T. Davis, Lang, Rolnick, Rosenblum, and Scheld,
Senior Vice Presidents, Federal Reserve Banks of
Kansas City, Philadelphia, Minneapolis, Dallas,
and Chicago, respectively

Messrs. Burger and McNeese, Vice Presidents,
Federal Reserve Banks of St. Louis and Boston,
respectively

Ms. Krieger, Manager, Open Market Operations,
Federal Reserve Bank of New York

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2. Attended portion of meeting relating to the Committee's discussion of the economic outlook.
 3. Attended portion of meeting relating to the Committee's discussion of the economic outlook and its longer-run objectives for monetary and debt aggregates.

Transcript of Federal Open Market Committee Meeting of
February 7-8, 1989

February 7, 1989--Afternoon Session

CHAIRMAN GREENSPAN. I'd like to start by welcoming back Dick Syron, who I understand was here during the tranquil days of 1981 and 1982. I trust his return is an omen.

MR. SYRON. There's no information for forecasting in that.

CHAIRMAN GREENSPAN. We appreciate that and we thank you.

MR. SYRON. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. I guess you can't legally at this stage approve the minutes. You weren't there; you never heard them. Somebody else try it.

VICE CHAIRMAN CORRIGAN. I'll move it.

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. We'll start with the report on foreign currency operations. Mr. Cross.

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

CHAIRMAN GREENSPAN. Any questions for Mr. Cross? If not, may I have a motion to ratify all transactions undertaken by Mr. Cross since the last meeting?

VICE CHAIRMAN CORRIGAN. So move.

MS. SEGER. Second.

CHAIRMAN GREENSPAN. Without objection. We'll move on to domestic open market operations. Mr. Sternlight.

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

CHAIRMAN GREENSPAN. Questions for Mr. Sternlight? If not, may I have a motion to ratify his transactions since the December meeting?

VICE CHAIRMAN CORRIGAN. So move.

CHAIRMAN GREENSPAN. Without objection. Now we'll move to the chart presentation of Messrs. Prell and Truman.

MR. PRELL. Thank you, Mr. Chairman. You should all have a packet of charts here with a red title on it. [Statement--see Appendix.]

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

CHAIRMAN GREENSPAN. Thank you, gentlemen. Governor Johnson.

MR. JOHNSON. Just one question: On this first alternative forecast, what happens in a case where you don't have compensating money growth to try and stay on the base line real GNP forecast and you have an unchanged dollar?

MR. TRUMAN. Well, in that case, of course, you would get more current account improvement, a better performance of prices, and a little less--about 1/4 percent per year less--GNP growth.

MR. JOHNSON. What's the improvement on the price side?

MR. TRUMAN. Oh, the difference I think is about 0.2 percent a year for both years, 1989 [and 1990].

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. I have a couple of questions. First, you are showing compensation going up rather rapidly in 1990--plus 6 percent--but then you are showing personal consumption expenditures going up only 0.9 percent. What's happening there--the saving rate?

MR. PRELL. Well, job growth is much slower; thus, you're not generating the nominal income fast enough to offset the more rapid increases in consumer prices.

MR. HELLER. The 6 percent?

MR. PRELL. I'm not sure what the nominal personal income increase is.

MR. HELLER. No, no. From the charts it looks like compensation is going up 5.7 or 5.8 percent--whatever it is, I don't know.

MR. PRELL. But we have very slow employment growth.

SPEAKER(?). You get zero.

MR. STOCKTON. You get about 5 percent consumer price inflation as well as what's pushing down the overall growth in real disposable income.

MR. HELLER. The second question was: Foreign prices are falling rather rapidly in the forecast in 1990, and in view of the fact that foreign monetary growth right now is a lot higher than it is in the United States in virtually all countries except Switzerland what's their magic?

MR. TRUMAN. I think their magic is that with this slightly higher money growth they have had a lower level of [inflation] on average to begin with more recently--with a few important exceptions like the United Kingdom--and we are projecting a tightening of monetary policy in those countries. Also, for this two-year period, not including 1990, they get some benefit from the depreciation of the dollar that we're assuming in the forecast relative to their present underlying level of inflation. In addition, these are year-over-year comparisons, and they would be coming off these artificial factors

that in 1989 tend to boost the price level up in Germany and Japan. Therefore, the year-over-year comparison exaggerates the decline.

MR. PRELL. Governor Heller, just to clarify: those figures were compensation for hourly wages. We have total nominal disposable income rising just over 6 percent. If you take off just over 5 percent consumer inflation you're down to about 1 percent income growth in real terms.

MR. HELLER. Okay. The last question: On chart 18, the next to the last chart, you have a lot faster growth abroad under the unchanged dollar forecast. Presumably that would mean higher U.S. exports, yet the current account gets a lot worse?

MR. TRUMAN. Right, because it [unintelligible] it more than exports. There's no doubt about that: [faster] growth abroad does boost the growth of exports in this period. I might add--

MR. HELLER. But the two U.S. growth paths are exactly the same.

MR. PRELL. That's right.

MR. TRUMAN. That's right, but that's by assumption. To the extent that you get more exports, the easing of monetary policy required to keep the U.S. growth path on the same line is less; so that's part of this compensated--

MR. HELLER. No. I'm sorry, I don't get it.

MR. TRUMAN. To the extent that's correct--that without the dollar's decline there is more growth abroad--that by itself has a partial effect in that it generates more exports.

MR. HELLER. More exports?

MR. TRUMAN. Growth [abroad] itself does generate more exports. To the extent that that produces more demand for U.S. goods, the experiment offsets that by having less monetary expansion in the United States to compensate for the exports that would otherwise be there.

MR. HELLER. So imports--

SPEAKER(?). Net exports are falling a lot faster than the current account [unintelligible] U.S. GNP is held on track by offsetting [unintelligible] export increase with the exception of investments due to lower interest rates. But the real [unintelligible] decline of exports [unintelligible] increase of foreign real exports, but raise the GNP level. They measure this from--

MR. TRUMAN. Well, in fact, it puts the two factors together, Governor Heller.

MR. HELLER. I'm ready to give up.

MR. TRUMAN. The growth of exports is lower in this forecast even though income abroad is higher because they gain more on the price side than they lose on the income side.

MR. HELLER. It all goes on the price effects?

MR. TRUMAN. Yes. Prices are actually washed out. In fact, probably a better way of thinking of it is that the level of real exports is lower in the alternative than in the base line because that improved price competitiveness has a greater effect on exports than the gain in faster growth abroad.

MR. HELLER. Sorry. I thought I heard you say initially that exports were up.

MR. TRUMAN. No.

MR. HELLER. Now you're saying exports are [not] up--

MR. TRUMAN. A partial effect of higher income is to put exports up. A partial effect of a stronger dollar is to put exports down. The net effect is negative for exports.

MR. HELLER. Okay.

MR. TRUMAN. Sorry for the confusion.

MR. HELLER. I find it hard to see, but--

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Bob, I think the reason you have trouble with that is the same reason that I have trouble--because there is a basic inconsistency in the whole process, which makes all the results backwards to me. And that is, the faster money growth that you have there should be associated with a higher value of the dollar rather than the opposite. In other words, what we have here is the use of a construct that says in order to keep things the same you grow M2 at a faster rate. And by strange reasoning if you grow M2 at a faster rate you'll have a lower value dollar.

MR. PRELL. If you looked at the exchange rate implications, as I suggested earlier, of that faster money alternative that I have, that showed--

SPEAKER(?). If interest rates are fixed.

MR. PRELL. You have that dollar depreciation.

MR. JOHNSON. That's why I asked that first question.

MR. ANGELL. So, that makes everything backwards for those of us who had seen that relationship as the [unintelligible] one.

MR. JOHNSON. That's why I asked my first question about the result if we didn't compensate on the money side.

MR. PRELL. This is compounding degrees of uncertainty, let's say.

SPEAKER(?). Yes.

MR. HELLER. Well, it certainly succeeded.

MR. BLACK. You know, it certainly would help to have this [analysis] sent out a little ahead of time so that we could reflect on it a bit. That's a lot to digest in that short a period of time.

CHAIRMAN GREENSPAN. Bob.

MR. PARRY. On a somewhat narrower topic: I agree, Mike, that the nondefense capital goods orders are really good indicators as far as capital spending is concerned. But would it be better perhaps to try to take some of the lumpiness out of aircraft and parts as opposed to excluding it? Because it is an important factor with regard to capital spending. I know it's very lumpy but maybe if you averaged a couple of months you'd get a better picture.

MR. PRELL. I don't think so, President Parry, because I think the value of this indicator is relatively short run. The lags that one measures in the relation of orders to shipments tend to be a matter of several months. And in the case of aircraft, with the current situation being what it is, the lead times are so long that the placing of orders has no meaningful--

MR. PARRY. So it's not a lumpiness.

MR. PRELL. That's apart from the fact that there are lots of intermediate goods in there--parts [for example]--and a lot of that goes to exports. It's an even bigger problem there than it is for translating the other orders to business fixed investment. So, there's a great deal of slack for that.

MR. MELZER. Mike, is the main difference in terms of your deficit assumptions--I forget what chart that was on--

MR. PRELL. Second chart.

MR. MELZER. Second chart. Is that based on the difference in interest rates--primarily that 6.3 percent or whatever the former Administration had been using versus what we are projecting?

MR. PRELL. That is a good deal of the story. In 1990 that is worth roughly \$25 billion of the difference, all other things equal, between the Administration and Greenbook budget assumptions.

MR. MELZER. One thing that strikes me in looking at this-- and to some extent I agree with Bob Black that it's hard to absorb all the implications of these alternative forecasts--but you get the feeling that maybe our economic policy mix is really not what it ought to be. And that sort of puts you in a fog. I think this is a rhetorical question but, is there a way of positioning what we're doing that puts us in a better posture in that regard? Because there are a lot of things that come through in this that we could get blamed

for: the [unintelligible] deficits, stalling out of the trade adjustment, you name it. And the politics become very tricky.

CHAIRMAN GREENSPAN. Greatly. Governor Seger.

MS. SEGER. Maybe I'm missing something, but as you go through the alternatives is there one that would be comparable to, say, just freezing in place today's policy stance? I don't mean--

MR. PRELL. If you mean by that the federal funds rate, that is the "more money" alternative.

MS. SEGER. Yes. But I guess that wasn't quite what I was thinking of. And maybe I have the wrong view of what holding today's reserve pressures would do. I sense that that might put a little more upward pressure on rates. But maybe your "more money" alternative is going to be the status quo.

MR. PRELL. It was intended to answer the question: What if short-term interest rates don't rise?

MS. SEGER. Okay, thanks.

CHAIRMAN GREENSPAN. That's all right. I didn't know whether you were finished or not. President Keehn.

MR. KEEHN. Mike, a question on chart 5 on the consumer durables: Is the decline in the red line solely attributable to a decline in car sales from, say, 10.6 to 10.2 million units, or in fact does the slump of that line also imply some pickup in [unintelligible] of consumer durables?

MR. PRELL. We have non-motor vehicle durable goods increasing 3 percent in 1989 and then flat in 1990.

MR. KEEHN. What comprises the end of 1989 number?

MR. PRELL. Within the durables? We have not done a greater level of disaggregation on this.

MR. KEEHN. I guess the question is: With home starts down, does that fit in it?

MR. PRELL. It fits in to some degree. There is some relationship there, though if you just look historically to the simple econometric relation you find it's pretty loose. In 1988 we had 6 percent growth of durables other than motor vehicles. So that [1989 rate] is a significant slowing. This level of housing activity is still enough to generate some reasonable demand and then there is all the replacement demand for appliances and furnishings and so on. So it wouldn't fall entirely in that type of--

MR. JOHNSON. One last question: How much of the base line forecast for real growth is accounted for by net exports? Do you know?

MR. PRELL. In 1989 it's a very small part; in dollar terms net exports improve \$22 billion and GNP is improving \$122 billion-- that's roughly 1/2 percent on GNP. In 1990 net exports are accounting for roughly 3/4 of that 1 percent growth.

MR. TRUMAN. The actual increase is not as much as implied for--

MR. JOHNSON. I've forgotten: what's the implied dollar depreciation?

MR. TRUMAN. Over the entire 8 quarters it's 13 percent in nominal terms, 10 percent in real terms.

MR. PARRY. Most of it in the second [year]?

MR. TRUMAN. Well, a little more in the second year because the first quarter is gone.

MR. SYRON. Mike, given what Ted has said in here and what was said about oil prices in the Greenbook that we got earlier, one always makes point estimates but what's your view of the symmetry of the risks on the inflation side? Particularly, I'm referring to the staff inflation projection and the forecast for compensation in the first and second halves of 1989 given what was [happening] in the last half of 1988.

MR. PRELL. I must say that in terms of absolute levels these movements in the compensation numbers over 1988 give us some real problems in judging where the takeoff point is. There was an extraordinarily low increase in compensation per hour in the first quarter of the year; whether the fairly sizable numbers in the second half were just offsetting a seasonal adjustment problem we can't say. In essence, we are discounting the level at the end of the year, and we have a very mild acceleration, as we perceive it, in compensation per hour over the forecast period. As I said, we think this is a reasonable forecast. I guess I would see the tail of the distribution being longer on the up side than on the down side at this point. It's hard for us in this kind of economic environment to see a sizable shortfall from this compensation forecast. But one can see a larger range of risks, I think, on the up side. As a best estimate, this is our shot.

MR. STERN. Mike, with regard to the slowing in auto sales that you have in here: Is that due principally to a squeeze on income or is it the effects of the age of the stock of vehicles on the road?

MR. PRELL. Well, a lot of cars have been bought in recent years but that hasn't brought the average age of the stock down to low levels by any means. I'm not sure we totally understand the scrappage rates that we're seeing--whether there really has been an improvement in the quality of automobiles and they last longer or what. I think we have a fairly sizable decline. The automobiles are declining more than light trucks and vans, which we have not yet incorporated in our tables and are now almost half as large as the car sales. So that's something worth recalling. The main factors are the slower income and employment growth. One couldn't point to the interest rate increases we have here as having a tremendous effect on automobile sales. It's

more the general atmosphere of confidence and the growth in purchasing power that is behind this decline.

MR. FORRESTAL. Mike, one of the assumptions you made was that the weather will cooperate and that crop yields will be normal. In the event that didn't happen and we have a drought situation similar to the one we had this year, would 1990's GNP drought adjustment likely be negative?

MR. PRELL. 1990's or 1989's?

MR. FORRESTAL. Well, 1989.

MR. PRELL. If you had a crop year like 1988 in [1989 or] 1990, all other things equal, it would subtract 0.7 of a percent or so from output and would get you very close to zero. I think the bigger concern--one that we just don't know how to cope with in terms of inserting something in this forecast--is that in many areas, although it's spotty, there seems to be a shortage of soil moisture. The reports about winter wheat are not particularly encouraging. And with inventories of many of these grains and soybeans and so on as low as they are, we can't afford to have anything like the 1988 crop if we're going to stay anywhere near this inflation path. It's likely that we will see much more sizable food price increases than we saw in 1988. So I think it's something that's hard to cope with in monetary policy terms and economic forecasts here. But it is something that one could be concerned about.

CHAIRMAN GREENSPAN. Well, we can supply liquidity!

MR. PRELL. That observation seems to have closed down all the discussion. I want to express my appreciation!

SPEAKER(?). You want a second or what?

CHAIRMAN GREENSPAN. I no more believe that than you do. I think maybe I--

MR. ANGELL. Mike, I guess I'm a little surprised at the food inflation in '89 and '90, given normal crops and normal weather, because with the decrease in set-asides ordinarily food price inflation in the year after the drought should be lower than in the year before the drought.

MR. PRELL. The rate of increase?

MR. ANGELL. I would have thought that somewhere there should be a downward move in food prices--offsetting the '88 upward move--in order for that historical relationship to hold true.

MR. PRELL. Well, as you know, we have about a 3-3/4 percent increase in food prices this year and next. And we're looking at, for example,--

MR. ANGELL. I'm sorry, I thought it was 4 percent but maybe I'm wrong.

MR. PRELL. I'm splitting it more thinly; it's a little below 4 percent. We're talking about consumer prices, excluding energy, rising 5 percent or more. That is a considerable differential and not out of line with that historical pattern to which you referred of the relative movement in these inflation rates. Beside the drought effects there was already in train some tendency toward reduction in cattle herds; and we're likely to see some considerable pressure on meat prices that offsets the relatively small benefits you can get from additional grain supplies, given the very large labor component in most of those food prices.

MR. ANGELL. Well, because of this discussion, I now hope that the rainfall is normal so we can find out who's right. But that's my only reason for wanting normal weather.

CHAIRMAN GREENSPAN. Let me put forth the other side of the question. New crop [unintelligible] positions in feed grains and in food grains are well above normal. And built into the price structure at this stage is still subnormal soil moisture. What happens to the forecast, including the cattle cycle effect, if in fact from here on in we get above normal moisture and it brings the forward prices down? Does that make much of a dent in the consumer price structure or is the cattle shortfall already enough to make that a likely occurrence?

MR. PRELL. I think that's largely there and that it would really take some tremendous moves in crop prices to move these overall food price measures around. I think that's evident in what happened last year.

CHAIRMAN GREENSPAN. In other words, what we're really looking at is more the unit labor costs in the distribution channels than the feed grains that filter into the cattle-meat cycle.

MR. PRELL. That's a very large ingredient. I think that's the case. We have an authority here on the subject. John Rosine, do you have anything you want to add?

MR. ROSINE. Well, it certainly would not be enough to drive food price changes down into negative territory. If we had a very good crop year I think we could possibly have a drop in all grain prices but a CPI food price increase, say, on the order of 1 or 2 percent, give or take a little--not enough to affect the overall price outlook very significantly.

CHAIRMAN GREENSPAN. So, at most, on your total index it's a couple of tenths?

MR. PRELL. A couple of tenths. And that's essentially what we got in 1988.

CHAIRMAN GREENSPAN. I don't want to force the conversation, but has everybody completed their questions? If so, we can move on to Don Kohn--if you're prepared, Don.

SPEAKER(?). We are [unintelligible]--

CHAIRMAN GREENSPAN. My schedule reads differently from what I think the Secretary's schedule shows. [We should] go to our discussions on the economy. I thought that came [before] you.

MR. KOHN. Well, I'll be happy to get [my report] over with.

CHAIRMAN GREENSPAN. No, that would probably confuse us. Who would like to start off? Bob.

MR. PARRY. Mr. Chairman, the Twelfth District economy remains strong. For example, the District's unemployment rate is below the national average. However, Arizona is slumping because of the construction downturn, which is likely to extend at least through this year. In addition, there are signs of slowing during 1989. For example, labor shortages are slowing [output in] a few industries; I guess the most extreme example of that would be in aircraft manufacturing. Concern about the lack of rainfall is mounting in our District, especially in California. Another year of drought would really seriously hurt the District's agriculture. I think we have a little different situation working in our District. Last year we benefitted from the drought because we had almost all of our agriculture handled through irrigation. But we have had two years of drought and a third would be quite serious because the reservoir levels are so low at the present time--and we're already halfway through our rain year--that it actually could result in reductions of water availability of 25 to 40 percent. So, we're looking rather closely at the water situation, at least in the state of California.

The national economy, it seems to me, continues at a level of activity above its sustainable potential. I believe that the recent employment reports indicate upward pressures on wages and that the underlying inflation rate seems likely to continue to build. Moreover, if there is a depreciation of the dollar this year and next, as is incorporated in the Greenbook forecast, that will add to inflationary pressures as well. Our outlook for growth for the two-year period is very similar to that of the Greenbook, although we may have somewhat of a difference in the yearly pattern. In any case, this growth and what I would say is a worsening inflation prospect argue strongly, in my view, for continuing our recent strategy of steadily tightening policy. Thank you.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, our projections for 1990 pretty closely parallel those of the Greenbook. We do expect slightly more growth, but not quite enough to put us in the outlier column as has sometimes happened in the past. And we expect a tad more in the way of an increase in the consumer price index. As Mike Prell suggested very well a while ago, more important than the specifics of the forecast are some of the things that underlie it. And as we read the economy the pressure on U.S. productive resources looks very, very strong to us. This is evident, I think, in most recent statistical data: real personal consumption expenditures ex-automobiles, for example, were very strong; the nonagricultural employment figures for January were very strong; and the theme report that we got on business capital expenditures, which I found extremely helpful this time, seemed to indicate strength. We're getting the same sort of

grassroots information from our contacts around the District. To us, one particularly interesting thing this time was a comment of who has been in the department store business

says that business is really booming.

so it came as something of a surprise to us. Now, if we have this strong demand, as is apparent to us, that naturally is going to put some upward pressure on real interest rates. And any attempt on our part to resist that pressure through monetary policy is going to risk getting inflationary pressures. So we've assumed, like the staff, that our monetary policy will not resist these things; rather we predicated our forecast on the assumption that there will be a significant further increase in short-term interest rates, and specifically some increase in the relatively near future. Now, if we do allow that increase to occur then we think the risks are about equal on both sides. If we don't let that increase occur then we think the risks are on the up side of more inflation than the staff has projected.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Our forecast this time falls within the parameters of the central tendency, which is a little unusual, I think, for us in recent years. We're at the low end on real GNP at 2-1/2 percent and at the high end on the CPI at 5 percent. But we're modestly higher in terms of unemployment at the end of the year. Looking out into 1990, our forecast would be quite similar to what we've seen from the Board's staff with maybe somewhat stronger real growth--at about 1-1/2 percent--and the CPI continuing to be somewhere around 5 percent. So, no declines. Looking out beyond that, even though we didn't do projections, I think we'd expect the CPI to begin coming down. The big difference, however, between our forecast and the Board staff's forecast is that we've assumed M1 growth of somewhere in the 3 to 5 percent area to produce these essentially similar results, whereas the Board staff's forecast I think has M1 growth of zero in 1989 and I'm not sure about 1990. Based on that, I think I'd have to say that we view the risk in the Board staff's forecast to be on the down side in terms of real growth. Using our methodology, if we drove that kind of assumption through [our model] we would definitely have weaker growth--in fact, a recession.

In terms of what's going on in the District itself, we have seen some growth in nonag employment for the most recent three-month period and for the year. For a long time I was reporting that our employment was actually declining, so there has been some pickup. But [our growth rate] is still sluggish--about 1-1/2 percent versus 3 to 3-1/2 percent nationally. Manufacturing employment has picked up a little more strongly but it's still slower than the national [average]. Residential construction has shown some strength recently, as has nonresidential construction, particularly in St. Louis commercial office building construction. But on a year-to-year basis that's down quite significantly. Reports on the retailing side indicate, as expected, when we plot [them versus] a year ago that nominal gains were about 6 to 7 percent. I guess that's really all I have to say.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Well, Mr. Chairman, in the Eleventh District I think you have to look at the Louisiana portion by itself because it does seem that Louisiana is continuing to deteriorate, with the unemployment rate there rising to about 10.4 percent in December. If you shift over to Texas and our part of New Mexico you continue to see some improvement; it's modest and slower than the rest of the nation, but at least it's going in the right direction. On a sectoral basis the split is equally pronounced, with the energy and construction industries still pretty weak and manufacturing and services continuing to improve. The energy industry is performing as though the expected price of oil is in the \$15 to \$16 range rather than the \$17 to \$19 trading range that we've seen over the last 8 weeks or so. The downturn in our construction activity now seems to be centered on the nonresidential construction. As for agriculture, there is some mention of concern about drought. I guess we did not suffer quite as much last year but we are beginning to have a little concern. Our winter wheat is already hurt and we're hearing fairly pessimistic reports from out in the farm areas. Overall, manufacturing continues to improve. In the first three quarters of last year, most of the gains were centered on the more trade sensitive industries; we've now seen that the less trade sensitive product lines are improving. Retail sales have been improving in both autos and other goods. Overall, we're looking for some strengthening of the regional economy in 1989 relative to 1988. So, that does make us feel a little better.

On the national scene, about the only place we really have any difference with what Mike was saying is on inflation. We feel there certainly is a little more inflationary pressure now and in prospect than the staff is seeing.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, with regard to the District, things are very much unchanged since my report at the previous meeting and that in itself may be significant. The outlook certainly continues to be positive. No one that we talk to in any way thinks that we're likely to have a recession this year. There are some early comments about the possibility of a recession in 1990 but those are the same kinds of comments that we heard last year about 1989. Alternatively, the general attitude is that we will not experience any particularly rapid acceleration in growth either. I think the inflationary picture continues to be very difficult to assess. The common wisdom is that we are going to see some escalation, particularly on the wage side; yet the reports I get from companies are not necessarily consistent with that common wisdom. The labor market continues to tighten. We are continuing to hear comments about shortages of skilled labor. But despite that, I'm surprised by how favorable the contract settlements continue to be--[increases in] wages and fringe benefits of 3 to 4 percent on an annual basis. And though labor attitudes certainly are hardening, they have at least not yet begun to evidence themselves in significantly higher settlements. The price side of the picture, I suppose as always, is quite uneven. Steel prices have now begun to moderate. At this point many companies report that steel prices are only now back to the prices that they were paying in 1980 and 1981. So, though we've had a big escalation over the last two years, we're now getting back to those levels that we experienced earlier in the 1980s. But nonferrous prices are now beginning to accelerate again, particularly copper, nickel, and to a somewhat lesser extent,

aluminum. Chemical prices are moderating following the big increases that we had over the last year or two, but pulp prices are beginning to escalate pretty rapidly. I don't sense any consistent pattern in these materials prices. At one company that I talked to--it isn't a very large company but it tracks these things very carefully--their material price increases for 1988 came in about 2 percent higher than 1987. For 1989 they had been forecasting an increase of .4 percent. They very recently increased that from .4 to 1.3 percent, and that increase is entirely in the nonferrous area. But despite the increase, it is still lower than what they had in 1988. Virtually everybody continues to report very competitive conditions in the marketplace. For finished products there are competitive pressures that really make it difficult to pass price increases along, so there seems to be some continuing pressure there.

With regard to the national outlook, our forecast is a bit more modest than the Board staff's but pretty consistent with the central tendency. I think our difference with the Board staff's forecast is partially timing, but a bit of it is also in this nonauto durables area that I asked Mike about. I continue to think that the risks at this point are on the inflation side--continued upward pressure on prices and, I do expect at some point, on wages. As a consequence, as we get into the policy deliberation we're going to continue to need to exert more pressure to deal with that. But having said that, I also have the feeling that, given what we have done so far, we are not necessarily behind the curve in dealing with the inflation problem.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, the Sixth District's economic activity is not very much changed from the last time I reported. We are still showing strength in industrial production, as we have for some time, but in addition we now have some strength in the retail sector. The construction area remains pretty subdued and is weak. The chemical, aluminum, and paper producers are operating at very high rates of utilization, in many cases due to strong export orders. We're expecting a new aluminum plant to open in Georgia and that's rather an exception because most of the other producers we're looking at seem reluctant to add very significantly to capacity. And in some cases, such as in chemicals, they are actually looking for imports to meet strong domestic demands. Paper producers are fairly substantial purchasers of modernizing equipment but are not adding significantly to plant size. While we've seen some price increases announced, particularly for chemicals, paper, and aluminum, it's not clear that they are going to stick because there has been some customer reluctance to accept them. So, we may see a rollback of some of those price increases.

On the retail side, sales appear to have remained very strong in January after what turned out to be a surprisingly good Christmas season. Price discounting in the District was less prevalent than last year, particularly in the post-holiday period. And inventories are now quite lean. While retail demand is good and was good during the holiday season, we did have over-expansion in this area and that has led three chains in the Atlanta market to close during the last few months. Office vacancy rates in the District seem to be a little lower than elsewhere in the nation but on the housing side we are

seeing weakness both in starts and in sales. That's evident in several cities around the Southeast but especially in Atlanta. Migration has proceeded at a lower pace than earlier in the expansion due to strong labor markets elsewhere in the country; and builders who had been planning for stronger population growth are now having some difficulty. The weakness in demand for lumber resulting from the housing weakness has been offset by stronger export sales that have helped to sustain activity in the lumber industry. We're hearing reports that wage gains are expected to be in the 4 to 6 percent area, and there are going to be some important labor contracts up for renewal this year. And we hear, as most other people do, that the sharp increase in the cost of benefits is putting quite a bit of pressure on costs generally. On the agricultural side, we too are getting very nervous about the water situation. We've had a drought in the Southeast basically for the last four or five years. And, we have not had winter rains as we should have had and that is making farmers and others extremely nervous. This is anecdotal, but I've also heard reports recently about increases in export prices by manufacturers who seem anxious to take advantage of the profit situation rather than to seek to expand market share. I think that's somewhat disturbing and [would concern me] if that were to become a national trend.

On the national scene we have very few differences with the Greenbook forecast. We might have some divergence in 1990 but not very much. We continue to think that there is momentum in the economy, that we are operating above our potential, and that the vulnerability is on the inflation side. So, while our inflation forecast for 1989 is roughly the same as the one shown in the Greenbook, my own personal view is that the economy is vulnerable to higher prices rather than to lower.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. With regard to the District economy, the expansion in the District remains very solid at this point in time. The fourth quarter probably turned out better than many people had expected. Retail sales--these are [reports] from a major retailer--were distinctly stronger in December and in January than we might have expected. And there is, by the way, a major expansion in the paper industry underway in the District in a variety of locations.

Looking at the national economy, if I compare our model's forecast to the Greenbook I would have to say that our model's forecast is more favorable in the sense that it has somewhat more rapid economic growth with basically stable rates of inflation--at recent levels--and stable interest rates. Having said that, I think there is a message there that's similar to the Greenbook message: that is, that if you want to get the rate of inflation down it's going to take more than prevailing interest rates to accomplish that--or at least there is a relatively high probability that that's the case. If I look at the data as the Greenbook does on compensation, producer prices, consumer prices, and so on for the last year I think there clearly was a deterioration in the cost and price picture. My concern is that that might well continue. I would admit that to date we have had less inflation than I would have expected, given the growth in the economy and pressures as I perceive them on capacity. But having said that, we still have more inflation than I would like to see.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The middle Atlantic states continue to be characterized by a high level of economic activity. Labor markets are getting tighter. Even in Pennsylvania the rate of unemployment is well under the national rate for the first time in a long, long time; New Jersey and Delaware have been there now for several years. Wage increases tend to be higher than in the nation as a whole, particularly I think at the lower end. The most noticeable area of softening is in the real estate area.

As far as the nation is concerned, I think the economy is growing too rapidly. It has more of a head of steam than I thought a couple of months ago and perhaps hoped a couple of months ago. As a result, the vulnerabilities to inflation seem higher to me now than they did just a meeting or so ago. I think this kind of a situation does require a response from us, but that's the topic of tomorrow. As for our forecast, we're within the central tendency although at the upper side of that.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. It seems to me that the most noteworthy development in the U.S. economy has been the slow growth of the money stock--no matter what measure you use--over the last two year's time. Having watched those figures for many, many years it seems rather unusual to have--if you take the staff's forecast through February, for example--the growth rate [of M2] over a two-year period at an annual rate of about 4.3 percent. The growth rate over the last full year was about 4.3 percent and the growth rate over the last half year was about 3 percent. I just have never seen such stable money growth of M2 in years of observing it. I recall that in 1986 there was considerable talk about whether or not the fast money growth was actually going to offset the deflationary experience that we had. I think there were quite a few of us who believed that it would. Maybe it took a while to do it but when it did, it did it with a clear impact upon both exchange rates and commodity prices. This time around it seems to me that the flow of money growth is being reflected in exchange rates much more rapidly, of course, than it is being reflected in commodity prices. It has been a very puzzling experience. As Don and Ted very well know, my own view is that if we continue with growth of the money stock as we are forecasting, the problem we may have in that environment--with regard to exchange rates--is too strong a dollar. But I would think that that dollar strength, in terms of overall economic developments, might provide the slack needed; that might very well be the antidote that is needed. Even though the drought maybe added not so much to the grain prices but somewhat more to the vegetable and fruit prices, it seems to me that the impact of the drought on commodity prices has delayed any turning point signal by commodity prices. It looks to me as if we're now getting a leading signal in commodity prices in that we're finally getting a declining rate of change. I don't mean by that that I think monetary policy ought to be adjusted because, indeed, unless commodity prices come down from the level where they now are I think we're quite likely to build in a much higher rate of inflation in the wage patterns that prevail. The only way to escape that is probably by having some decline in commodity prices. But I guess I'm somewhat encouraged by the trend of substitutes, such as ownership of other

currencies or ownership of gold. Frankly, I would feel still better if the price of gold reaches \$350 an ounce.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. The fourth quarter in the Fourth District really was no surprise at all; it was similar to the rest of the year. It has been a very consistent story throughout the year; our economy didn't slow much during the summer and it didn't slow early in the year. Much like the situation in the unemployment rate there are [unintelligible] for all of them for the first time in a long time. That means service jobs but some on the manufacturing side. In discussions with manufacturers in the District we hear that they are operating at very high levels but are very reluctant to add new capacity. They are willing to run with higher inventories because they are operating at levels that are going to result in more breakdowns. But they are not ready to make the investments yet. The only weakness in the District is in Cincinnati and that was the football team!

MS. SEGER. But look at what it did for the economy.

MR. HOSKINS. Pardon me?

MS. SEGER. Look at what it did for the economy--all the beer sales!

MR. HOSKINS. We don't have much to say regarding the Greenbook forecast, which is very similar to ours, particularly for 1989. In 1990 we have a somewhat lower inflation rate than the Greenbook because we think a change in compensation practices as well as a continuous clearly announced policy with respect to inflation [unintelligible]. As we look at it now, we think that will have some favorable impacts in 1990 and going forward [if we] can do what the Greenbook implies when dealing with interest rates.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. My general view of the economy, Mr. Chairman, hasn't changed at all from what it has been at recent meetings in that I still think the risks are distinctly asymmetric on the side of too much growth and too much inflation. I still don't see any compelling evidence--as a matter of fact I don't see much evidence at all, at least at this moment--of the much needed moderation in the rate of growth in the domestic economy in particular. In terms of the outlook for 1989, our forecast is very similar to the Greenbook forecast, even in most of the details, insofar as real GNP growth is concerned. Our inflation rate is higher and indeed is a tad outside the central tendency as listed in the charts. [Our forecast for] 1990 is a very different story, which I'll come back to in a minute. But leaving aside 1990, when I look at the situation right now I guess my anxiety level is up a bit. It is up a bit really for two reasons, and they both relate to things that one could say about the economy and so on in public and other forums. For example, I got very used to saying, when asked--and I thought I could say it without my nose growing--that the underlying inflation rate was in the 4 to 4-1/2 percent range. I don't think I can say that anymore without my nose growing. When I look at all of the wage and price data, especially

from the fourth quarter, I think we now have to say that the inflation rate is, at best, in the 4-1/2 percent range. But certainly you'd have to drop that 4 to 4-1/2 percent out of that statement to have any credibility, much less--at least by my standards--intellectual honesty with yourself. Indeed, I think the range of the compensation-type statistics, again with some emphasis on the fourth quarter, are particularly [alarming] in that regard. The other thing that I think we all parroted with some frequency in the recent past is a sense of comfort with respect to the external adjustment process, both in terms of what has happened and what lies out there in the future. And this is where 1990 is looming very large in my thinking.

I don't consider that there's any such thing as a true forecast for 1990, with all due respect, Mike. I think we can all go through some arithmetic; and I think of it more as arithmetic than a forecast. But if you look at the arithmetic that was done in New York versus the arithmetic that was done here for 1990 you get a very, very dramatic difference. While we have an economy that's growing at a somewhat stronger rate than the Greenbook, we have the trade account and the current account adjustment process not only stopping but reversing: the trade deficit actually increases and the current account deficit actually increases. Now, in an approximate sense, the arithmetic reasons for that--I emphasize the arithmetic as opposed to the forecasting--are fundamentally due to two things. Our foreign growth assumptions are almost identical. We do have a relatively small difference in the exchange rate: we have the real exchange rate unchanged whereas Ted, I think, has something like an 8 percent real depreciation. But that's not what really drives the thing. The big difference is that in Ted's and Mike's numbers for 1990 they have a very significant slowdown in the U.S. economy. When you look at their numbers versus our numbers, it's not the exchange rate and it's not the foreign growth that really makes the decisive difference in terms of whether that external adjustment process can continue with at least the right algebraic sign in 1990. That to me raises an even larger question, which Tom Melzer touched on a bit when he made reference to policy. And the question is: With anything roughly resembling the kind of exchange rates that are in either of those sets of arithmetic, can you get material progress over the next several years on an external adjustment process without a significant slowing in the rate of growth of the domestic economy? And if you can't, what does that imply in terms of the risks of a significant accident of one kind or another developing over that time frame? I really think that the horns of that dilemma are getting sharper and sharper, because if you think of it in terms of the exchange rate it's quite clear what it seems to imply. But the implications of that implication can be pretty nasty in their own right in terms of domestic interest rates and domestic financial market conditions. You can put it in the context of financing requirements; even with Mike's and Ted's combined 1989-90 current account deficits of \$240 billion, we end up 1990 with net external liabilities in balance sheet terms of something like 13 percent of GNP. Those numbers are getting very, very large. So, Mr. Chairman, I don't know the way out of this box but when I think out beyond 1989 in the context of the kinds of issues that I just raised I must say that I'm not as optimistic as others about the inflation outlook. As I said, my anxiety level is getting pretty high.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. On the District level, the District economy has continued to improve but at a slow pace-- slower, certainly, than the national average. The recoveries in the agricultural and manufacturing sectors continue and the higher oil prices that have fallen out of the late 1988 OPEC agreement have provided some stability to the energy sector. In agriculture we are concerned about another year of drought; a more immediate concern is this cold weather. For those livestock producers that rely upon farm ponds, for example--since they were not replenished during the past year and with the very cold weather those freeze solid--that means there is no water. As a result, some livestock will be sent to market under those conditions, which will accelerate this drawdown on the red meat supplies in the future and push up prices perhaps.

With regard to the energy sector, while prices have firmed somewhat, the uncertainty surrounding whether or not OPEC will be able to fulfill the agreement still scares people away from investing substantial sums and putting down new wells or exploring for new reserves. In the manufacturing sector there are two really notable developments. One is in the automobile manufacturing assembly area where all of the plants--and Missouri, for example, would be the second biggest assembly area in the [country] after Michigan--are operating at a full two-shift operation. And there appears to be no slowdown in demand. On the other hand, general aviation concluded 1988 with significant increases in their billings, generally as a result of export demand for general aviation products. The interesting report on construction in the District is that the value of nonresidential construction in the District rose rather sharply in December and was about 33 percent above the year-earlier level. On the other hand, residential construction has fallen slightly and is somewhat below the year-earlier level. By and large the financial economic activity within the District is rather good with the exception of those areas such as Oklahoma that have been depressed; they are still sort of on the bottom with respect not only to employment but also to overhang on nonresidential construction-- commercial building, for example. But by and large the District is in pretty good shape and continues to improve.

With respect to the outlook for the national economy, adopting the interest rate projections that are used by the staff, we come out virtually identically, with some minor differences. We have consumption a little higher and inventories a bit lower during 1989. But by and large we would be in the middle of the projections for the Committee members as a whole. There is a concern, at least on my part, with respect to prices--that is, inflation in the period coming up. In the services sector, for example, the benefits tacked on to otherwise projected wage increases give a strong indication that the risk is for higher prices rather than lower prices. I'd rather be ahead of the curve than behind the curve. And the increase in interest rates that is incorporated in our outlook as well as in the Board staff's outlook seems to be quite reasonable to me.

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. Thank you. I think we should probably look a little at the longer horizon because we have to set up long-run targets. In the outlook projected in the Greenbook, about a year from now you see a very, very [pronounced] weakening of the economy in

virtually every single sector except exports, which are still holding up. Growth slows down to the less than 1 percent range, close to a zero rate. The simulations that we've run also show that that holds true as a pattern even if you hold current policy very much constant. I agree with the comments made earlier that we are not behind the curve as far as the financial markets are concerned. We have a very strong dollar; we have some significant commodity prices actually dropping; we have a yield curve that points to low inflationary expectations. So that, combined with the very low monetary growth, which Governor Angell already talked about at great length, makes me think that we're actually looking at a significant slowdown a year from now, or for the horizon that we can still influence--the next quarter or two being in the bag. I have one other observation and that relates to foreign concerns, especially in Europe. There's a lot of concern about our tightening probably too much and the dollar becoming too strong over the immediate period ahead, thereby impairing the external adjustment process that is important for that. Thanks.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. I have a perspective similar to Governor Heller's. I'm just looking at a lot of different things here. First, on the unit labor cost side, I realize we've had some acceleration this year; but looking at the charts on the handout we're not at the rate that existed at the end of 1986. And then there was a deceleration in 1987 with some fairly strong growth in the rate of unit labor costs. So I don't think there's anything given about an acceleration in unit labor costs. If you look at the pattern, it has been fairly sawtoothed since 1984 on this chart; it doesn't show any sign of any particular direction. Compensation is up because of non-wage compensation but I don't know whether that will continue. Wages are still in pretty good shape, so I don't think there's any accelerating trend on the wage front if non-wage compensation doesn't continue to accelerate.

On the employment side, we've had some strong employment numbers. But I went back and looked at some of the previous periods and turning points. The obvious one is in 1984 when growth was very strong in the first half and then the economy slipped down to 2-1/2 percent and then below 2 percent in the second half of the year. We had payroll employment growth averaging over 300,000 all the way through November, even after we hit the turning point; so I'm not sure we're going to get any leading signals out of the employment numbers. And there is something else interesting: over the two-year period in which we averaged about 2-1/2 percent real growth average payroll employment was about 240,000 per month. Now, that doesn't say a whole lot for productivity growth, I admit; but still, I'm not sure what we can read out of the employment growth numbers.

There are some other signs of slowing that I see even looking at the charts. We have a much slower pattern of new orders, looking at the charts in the nondefense capital goods area; I know that excludes aircraft, but that's a volatile element we're assuming aside. Vender performance has been improving. Export growth has slowed, thank heaven; it has slowed from a rapid pace, but it certainly has slowed. Surveys of plant and equipment spending for 1989 are lower and that's showing in the numbers; from purchasing managers' reports it certainly looks like things are slowing. And surveys of other

outside forecasts that have been made indicate that they're similar to the Greenbook's, with some even a little weaker. But the important thing is that most of them assume lower interest rate patterns even from here. They certainly don't assume the interest rate path that we have built into the Greenbook. The Bluechip forecast, which is sort of a consensus forecast, has a similar pattern of growth in inflation but that forecast actually has the funds rate declining later this year. So, you get a similar path with a totally different set of interest rate assumptions than ours.

Other people have pointed out the financial indicators. Real M2 growth and nominal M2 growth are both very modest; real M2 growth is even negative. The yield curve is inverted. Long bonds are quite well behaved; long-bond rates are well below the funds rate, especially on a coupon basis. There are certainly no signs of accelerating inflationary expectations in the financial markets in commodity prices, bonds, or the dollar. One thing that worries me a good bit, too, is the fact that a critical part of the Greenbook forecast is the dollar forecast. That depreciation in the dollar, as I said, [accounts] for three quarters of a percent of the growth rate in 1990 and that's assuming about a 10 or 13 percent dollar depreciation. And that is assumed in spite of the fact that we're assuming about a 1-1/2 percentage point appreciation in short-term interest rates from current levels. Not only that, but the interest rate appreciation we assume is not matched by foreign interest rates. So I see no way, with relative interest rate appreciation in the United States compared to other countries, that you can possibly have a dollar depreciation with that kind of pattern of interest rates. I think if you turn that dollar path around you get a totally different picture out of the Greenbook forecast. It was pointed out in some of the alternatives--if you look at the one that assumes no change in the dollar, and I wouldn't even bet on that with the kind of interest rate path we have built into the Greenbook--that if you don't accelerate money growth to offset the impact on the real sector you get substantially weaker growth and moderation in the inflation rate from these levels. That's a scenario that looks more plausible to me than the one we have built in there. So I would say, trying to take into account those lags and being conscious of some of these other possibilities, that we ought to be very cautious about them.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I have some concern about becoming too much of a Johnny one-note in this Committee when I speak but I would like to reiterate my point that we [should] look at monetary policy in a very broad context of the overall picture of the United States--its social and political and indeed international course and the economic mix. I think there are some very major problems in the United States, and indeed in the world, that could be severely exacerbated if we are too aggressive, too fast: S&Ls, LDCs, the budget deficit and what could happen to it under several different kinds of scenarios. And I think that our anti-inflationary efforts, to which we all subscribe, deserve to be considered in that larger context. In the meantime, for now it seems to me that as far as inflation fighting goes there are some pretty good things going on. The dollar is behaving very well; the aggregates continue to be very slow, which is good; everybody, I believe, is pleasantly surprised at the sluggishness of inflation relative to what they might have expected

given what they saw going on a few months ago. I'm not necessarily convinced that it's baked in the cake that we won't continue to be pleasantly surprised. In short, I think we very well may need to do more as time goes on and, of course, we should watch that very carefully. But for the moment it seems to me that things are going as well as they could and we should be quite careful not to create more problems than are already out there in the world, perhaps influenced by this body but not directly under the aegis of this body.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I just want to add a couple of points to those made by Governors Heller and Johnson along the lines that some of the forecasts of people on the outside seem to be somewhat different from ours. The purchasing managers' survey and the Bluechip forecast were mentioned before. This morning I had breakfast with some business economists representing a wide range of companies-- forest products company, a large energy company, two chemical companies, these kinds of outfits--and to a person they don't see the capacity shortages that we all wring our hands over. They also certainly are pleased that their businesses are doing well but they don't sense a [boom] taking place. They are expecting prices of the raw materials that they will purchase this year to increase but at a mere fraction of the increase of last year. And they also are expecting some slowing down. One fellow who couldn't attend, the chief economist of sent me a fax. I mention this because we often mention as an example of a rust belt outfit that shaped up and is now doing well. I'm certainly not going to read the whole fax but let me just read selections. He said business has slowed down and is declining in housing-related construction, with about one-third of models on allocation compared to well over one-half early last year. The allocated models are large machines associated with a worldwide mining boom. Industry is never tooled for these peaks; it would leave too much idle capacity in softer times. It's customary to stretch delivery. Then he says that sales outside the United States are up 33 percent over the last year but that business is beginning to slow down in Europe. Then he talks about materials prices being up less than the PPI and he expects that to continue; suppliers are asking for bigger increases but their target is less than national inflation.

Also, I got something from the National Association of Home Builders. They have a forecast of housing starts of 800,000--a figure 800,000 below ours for 1989--and a proportional decline in multifamily versus single-family starts. And they are only assuming an additional 1/2 percentage point increase in long rates, specifically mortgage rates. The third thing that I haven't heard people mention is the impact of the restructuring. It seems to me that I read that General Motors is going to be closing a plant near Boston, so maybe that will help the labor shortage there; that's going to throw about 3,000 people in [the labor pool]. And it takes 6 hamburger flippers to be equivalent [in pay] to one of the jobs of those laid off. Xerox will be laying off 2,000 in Rochester; that ought to help Jerry's area. Also, I haven't heard anybody allude to the thrift mess and the impact that might have on the overall economy. I can't prove it, but I sense that if it isn't handled promptly and smoothly there could be a negative impact. Furthermore, as Mike Kelley suggested, if we tighten too much--if interest rates move still higher--we could also make the mess worse than it now is, taking some of the modestly solvent and

profitable thrifts and throwing them over on the other pile. Also, to reiterate, the monetary growth numbers are good; at least as I read them, they are about the best since I've been here. I haven't been able to quantify the impact of higher interest rates on monthly installment loan payments as more and more variable rate loans are used, but I just cannot imagine that it's not going to take place. We now have had enough of a rise in the short rates to which many of these instruments are tied that I would think [the rate adjustments] would start kicking into effect and would produce higher monthly payments. Maybe everyone who signed on to one of these instruments had their monthly incomes advance as fast; if that's the case, they're lucky. But for those who didn't, they aren't represented by

in their negotiations. Perhaps they will have to cover their higher payments on these loans by cutting back on something else. So, I guess I'm just not convinced that the forecast in here is in the bag. Thank you.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I agree with large parts of what several people have said here. I share the skepticism with regard to how the dollar can depreciate to the extent that it is forecasted to do, given the kind of interest rate scenario that we've adopted. And in that context then one begins to get worried about whether we can continue to make the favorable progress in external adjustments without that trend from the dollar. I agree with most of what Governor Johnson said, but I'm a little more worried in that I think there has been some lag with regard to prices and wages that we're beginning to see bubble up. And I get worried that we may not be staying ahead of the curve anymore in that connection--that we may see some real inflationary pressures emerging from wages and prices that are now beginning to come up as a result of things that have happened before. So, that would argue for the constraint that is argued for here.

On the other hand, I'm very concerned about the fact that there are some significant signs of a turndown in parts of this operation. I think that the energy price forecast--and Ted and I have talked about this several times--is a little dicey. That could be higher. I'm concerned about the things that Mike [Kelley] talked about; he and I have sounded kind of like a broken record in the discussions between us over the last several meetings of this group on those issues. The thrifts are not only going to get hit with this interest rate increase but on top of that they are also going to get an increase in their assessment under their insurance operations. So I'm very concerned that in our zeal to try to reverse inflation that we don't unconsciously create stagflation with a very low growth rate or maybe even a negative rate, while at the same time we have these other factors catching up with us and we see some real upward pressure on prices and wages. So I'm with Governor Johnson; I think we ought to be very cautious about what we do at this particular moment in time.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Let me start out with the thrift issue. First of all, I think the point is well taken in terms of the effect of rates in the short run on thrifts. Figures I looked at for the savings and loan industry as a whole show about a negative 17 percent gap. So a

50 basis point increase in rates roughly costs them about \$1 billion of their capital. One could assume, under current circumstances, that that translates roughly to what has to be done in terms of giving assistance. But I think that there is a difference between the short term and the long term in the sense that it doesn't obviate our need to take steps that prevent inflation from getting further out of hand as time goes on because--and I'm sure the staff has done some work on this--you have the linear function of what it costs the thrifts as rates rise. Also, many of the largest thrift institutions have hedges that are humped in the sense that they may be feeling well protected going out 150 - 200 basis points even when they get into residuals going back, say, for 100 basis points. But these hedges fall off a cliff if one gets into a situation where you get very dramatic increases, or decreases for that matter, in rates. So I think that's something that has to be factored into the equation when you're looking at the thrifts.

What I have to say about our view of the real economy is probably quite redundant to what many other people have said. We have very little difference with the Greenbook forecast. We do come out somewhat higher on the inflation side; we come out actually slightly out of the central tendency area on that. That has to do with the impact we expect the rate of growth will have on the unemployment rate. But to be honest, that's probably related in part to our own experience in the region. We do feel that the risks are quite asymmetric--that's the New England pronunciation for asymmetric, I guess--but they're doubly asymmetric in the sense that we may get more inflation and then we think the difficulties of dealing with these issues may be harder if we get into an inflationary situation. But this is to be discussed tomorrow.

As far as the region goes, we are seeing some softness, relatively, in New England. Not to contradict what I said before, but I think the reason that we're seeing some softness is because we really had a boom for a long period of time. If you look at Massachusetts for example--and Massachusetts is half of New England--per capita income in the state now is 123 percent of the national average whereas in 1975 it was 103 percent. If you were to adjust for relative costs it really would have been below that. Consistent with that, wages have been rising quite rapidly. When Bob [Boykin] talked about Louisiana [I was reminded of] some work we had done looking at manufacturing cross sectional data on hourly earnings versus the unemployment rate in manufacturing. States that are the highest are all the New England states. Louisiana has to be one of the states that was lowest, consistent with what he was saying. And the local price level, if one wants to assign any real weight to that given the smallness of the sample, shows that prices are rising at about a 6.3 percent overall rate in the greater Boston area. Now, I think it's interesting that southern New England is doing much more poorly--or it's starting to do more poorly--than northern New England, which experienced some of this relative prosperity later on. The only industry that we have right now in southern New England that is doing better than nationally is the construction industry, which happens to come fairly late in the regional business cycle. And we do have a quite soft real estate market. But the lessons--if there are any--that I draw from this for the national economy are that the problems that we have in the region are the result of having grown very, very strongly for a period of time at a pace that was not sustainable. And

maybe that influences our view of the approach one should take to policy nationally.

MR. LAWARE. I'm certainly glad you didn't pronounce it [unintelligible].

MR. SYRON. I used to until last year.

CHAIRMAN GREENSPAN. Let me just add a few things relevant to the meetings of the G-7, which I think relate in part to some of the questions with respect to the international adjustment process. The thing I found rather surprising in the talk among the central bankers, especially the ministers, is what I would call a relatively laid-back attitude on the issue of the international adjustment process slowing down. When the issue of reversal surfaced they clearly thought that that would be a problem but few of them really were concerned about a reversal and none about a slowing down, from which I conclude that there is a fairly considerable willingness on the part of these countries both in their private and public sectors to absorb liabilities against the United States. And I think, as Ted mentioned, that they are sort of delighted with the surpluses and the effect of the claims, especially the buildup of the claims, in an almost mercantilistic power sense. I suspect, however, that a goodly part of that reflects the fact that the dollar instead of going straight down and creating large capital losses has been kicking around over the last year and has essentially been flat. It's a two-way street. And hence, the negative attitude toward holding dollar-denominated obligations I think has faded very dramatically. I think the two upticks in the dollar in the summer and again here have created a really clear change in the fears relative to the adjustment process. It's very obvious that it can't go on indefinitely, but I think it is an important short-term event which suggests to me that the type of crisis that Jerry is worried about is not [likely] in the short term. It's an intermediate problem and one which I think could lull us for a while; but I do think we have to be a little careful about it.

Secondly, as Bob Heller mentioned, there is some concern about the impact of the level of interest rates in the world--or more exactly the level of U.S. interest rates and, therefore, the strength of the dollar--because there is a vague laid-backness about the stalling of the adjustment process. But there is a latent fear that it could begin to reverse and I think that would accumulate into a fairly significant set of concerns amongst finance ministers, and to a much lesser extent central bank governors, who have been largely supportive of general strengthening. The process I think is particularly pronounced amongst the I certainly don't get it --clearly they have been foursquare about moving interest rates up very sharply--nor do I get it very much obviously in a number of the central banks. But there's a vague mild division that's beginning to emerge--leaving --between the finance ministers on the one side and the central bank governors on the other with respect to the issue of international monetary tightening. The central bank governors, I think pretty much uniformly, have been very supportive of us; whereas finance ministers, for reasons I don't have to get into, are less enthusiastic about interest rates. But at the moment the issue is really very mild; there are no strong reactions. The only strong reaction I saw in the G-7 meeting was when

But the rest of the session was relatively pleasant. So at the moment I would say that one finds a remarkable degree of tranquility in the international outlook as perceived amongst the industrial countries. And I do not get the impression from the governors that they are in an aggressively tightening mode--in other words, after the Germans moved on the Lombard and discount rates. One gets the impression that the sequence that occurred as a consequence of that has slowed down somewhat, at least if you listen to the oral remarks. I don't know how long that is going to last and what it's saying, but one does not get the sense of a continuous process moving. It's getting close to break time and I think we're pretty much on schedule, so I guess there's no reason why we cannot meet as scheduled at 9:30 a.m. tomorrow morning. So, unless anybody has a problem--

[Meeting recessed]

February 8, 1989--Morning Session

CHAIRMAN GREENSPAN. Let me start off by requesting that each individual President and Governor try to get a final revised forecast for the Humphrey-Hawkins series to us prior to 3 p.m. on Friday, February 10 if that's at all possible. If there is any difficulty--if there is some slippage, as I suspect is probable--let's try to get them in as quickly as we can. That will save a lot of trouble and work in the process.

MR. BOYKIN. Mr. Chairman, has the date of the testimony been set yet?

CHAIRMAN GREENSPAN. Yes it has. It's the 21st and 22nd. We are now to a point where Mr. Kohn will discuss the longer-run ranges for the aggregates.

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

CHAIRMAN GREENSPAN. Any questions for Mr. Kohn? Lee.

MR. HOSKINS. Don, in your discussion about the multi-year problem, which I think you laid out nicely in terms of whether we stick with 3 to 7 percent or go to something else, obviously there are advantages on both sides. One is that we can march down the aggregates--at least the top end--consistently over time to demonstrate to people that we're serious about our policy. But that doesn't fit very well with the interest-sensitivity of M2 these days. You might want to argue that if we get [unintelligible] centering the 1989 target on 2-1/2 percent and going from 1 to 4 percent or on 3-1/2 percent with 1 to 5 percent and then next year having to say that it's going to go back to 3 to 7 percent or something like that--we have to explain that. In that context, if we were to choose to go that way, did the staff consider going to multi-year targeting now instead of in July? We will do 1990, I think, in July. So, if we were to go that route, it might make some sense to put out two sets of targets. If we were going to go to one, would we adjust M2 to reflect the interest-sensitivity?

MR. KOHN. We did not consider that, President Hoskins. I think there is something to be said for looking out over longer horizons. On the other hand, I remember the Committee discussion of last July in which there was some resistance to setting ranges for the next year because of the uncertainties involved in specifying those ranges even 6 months ahead of time. So I think it cuts both ways. It's really hard to know where you're going to be at the end of 1989 in terms of setting ranges that might be appropriate for 1990, although we've taken our best guess in this forecast.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, Don did such an excellent job of outlining various alternatives and he answered most any question I might have. But I do have one little simple question that I'd like to ask. Do you personally, Don, have more respect for the price projections made by your big model or by your single-equation model that stems from that very excellent memo we got back in November of

last year? I guess that tells you which one I have the most respect for.

MR. KOHN. I have to see what's happening at my back here with Mr. Prell. But I actually--

MR. BLACK. When you're winning something--

MR. PRELL. I know where he lives.

MR. KOHN. I think in terms of the short run--over the next year or two--I would have more confidence in the staff's projections for inflation on the grounds that they take account of certain factors that are important. I think the reason that the P star [P*] model, as we call it, came in with lower inflation rates for the same money growth is that it didn't take account of factors that are important in the year-to-year rates of inflation. In this case I'm thinking of the energy price impact on the early part of 1989 and particularly the assumed dollar depreciation effect on prices in the latter part of 1989 and 1990. Those things clearly aren't taken account of in that P* model in which prices depend solely on money, adjusted for trend velocity and output. So, I would have some confidence in that model as giving some sense of where those money supplies might be taking us over extended periods of time. But if you asked me which inflation forecast I would have most confidence in for 1989 or 1990 I think I would say the staff forecast, given the additional information they bring to that forecasting process.

MR. BLACK. I wouldn't want to--

MR. PRELL. I would like to underscore that the comparison you were making was not totally accurate in that the base line, or what was presented in the Bluebook, is the staff's judgmental forecast.

MR. KOHN. Right.

MR. PRELL. We use the large models, in fact a combination of several models, to create all the alternatives from that base line.

MR. BLACK. Yes, I realize that. I didn't mean to oversimplify. I would have equal confidence for 1989 since they project the same inflation figures that I did; there was very little difference.

MR. KOHN. The lesson I took from the P* model was that if we had M2 growth like we were talking about--in the 3-1/2 to 5 or 6 percent range or something lower--we would be putting some downward pressure on the inflation rate over time more with strategy II than strategy I. But even the staff's strategy, which doesn't give you much of a payoff in the short run, is putting into place conditions that will provide at least some payoff over the long run. So when we ran that model, even though the results weren't the same, I took a little comfort in that, in my view, it didn't contradict the underlying thrust of the staff forecast.

MR. BLACK. They are pretty close.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Don, I noticed and was pleased that your long-run strategies really were based on M2, with hardly any discussion of M3 or nonfinancial debt. Have you and your staff given specific thought to dropping the M3 targeting?

MR. KOHN. We have not. I think in the past the Committee has found it useful to have more than one target given the different kinds of information embodied in the different aggregates. Obviously, [we would] if the Committee were to instruct us that it was their choice to go to one aggregate. But it seems to me that you would lose a little information that you get from the growth of a broader aggregate or credit or debt. I would hesitate to focus so narrowly on any particular aggregate in terms of announcing targets to the public, even though we have keyed our forecasting exercises off either interest rates or the exchange rate or M2 as a target variable.

MR. ANGELL. Mr. Chairman, I think I should stop now; otherwise, it probably wouldn't seem like a question.

MR. KOHN. Already I wonder.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, at your July testimony I recall a sense of the [Congressional] Committee that they wanted us to narrow the range and also to choose the range where the midpoint was equal to our forecast. How much pressure do you think there is for that and how do you personally feel [about that]?

CHAIRMAN GREENSPAN. Well, I think that may have been to a large extent Senator Proxmire. I'll find out in a couple of weeks. On the other hand, acquiescing to that would develop into a very tough request. Rather than even suggesting that we thought they were interested or even that we might try to meet that request, I would just as soon go up there making believe I didn't hear anything and then wait and see what happens.

MR. PARRY. Okay.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I want to make sure I heard right what you were saying about our long-term objective for monetary policy relative to what the Humphrey-Hawkins Act had in mind. Are you suggesting that we're not subject to their--

MR. KOHN. No, no, not at all.

MS. SEGER. Okay.

MR. KOHN. In fact, I was trying to use that to reinforce the notion that that's an appropriate long-run objective for the central bank. The Humphrey-Hawkins [language] includes reasonable price stability as one of the objectives of that Act.

MS. SEGER. But you said it doesn't have it as number one, which is the way I saw the Act also.

MR. KOHN. Unfortunately, I guess, from that perspective it says that one shouldn't necessarily hit that if it interferes with 3 percent unemployment. But it does list it in any number of places. The whole sentence--

MS. SEGER. Oh yes, I understand that. But it sounded as though we were departing from what they had in mind, but maybe it's just too early in the morning.

MR. ANGELL. But that would be nice.

MS. SEGER. Oh you really want to be popular! My second question is sort of a variation on my question yesterday about covering a standstill policy. You say that alternative "I" here would encompass the Greenbook forecast of further tightening, right?

MR. KOHN. That's correct.

MS. SEGER. In our list of alternative forecasts, Mike said that we had one that would be a continuation of the existing, or constant--

MR. KOHN. Constant nominal interest rates.

MS. SEGER. Yes, right.

MR. KOHN. He gave that in his briefing.

MS. SEGER. Okay. Where does that fit into these?

MR. KOHN. That would require faster money growth than even the strategy III. For example, I think Mike said 7 percentage points more M2 growth by the end of 1991, whereas this has only 3 percentage points more M2 growth by the end of 1991.

MR. PRELL. The number we have here is 3/4 of a percentage point faster in 1989 and 2-1/2 points in 1990 and then another 3-1/2 points in the next year.

MR. JOHNSON. What velocity assumptions go with that?

MR. PRELL. No velocity assumptions go with it, but one could calculate velocities roughly from these real GNP and price numbers that we have here. Doing it rapidly in my head it looks like a drift toward declining velocity.

MR. KOHN. My guess is that velocities would decline over the next year or so as offering rates caught up to the flat market rates, reducing opportunity costs and enhancing the demand for M2. Once that equilibrium was reached then M2 velocity would essentially be unchanged.

MR. JOHNSON. Right.

MR. KOHN. But it would decline over the--

MR. PRELL. Yes. I guess there would actually be a small velocity increase in 1990-91.

MR. KOHN. It's probably a function of the way the model cycles the offering rates and the market--

MR. JOHNSON. But a decline in the rate of change--in the growth rate of velocities--right?

MR. PRELL. Well, basically we've got stable short-term interest rates, so we don't get any meaningful velocity movement one way or the other. And as you look out over time--after you get through the lagged effects of past interest rate changes moving the velocity--as the stable rates are essentially reflected in the deposit rates, you wouldn't expect big movements in velocity.

MR. JOHNSON. I was just thinking that I would expect the rate of growth maybe to settle down to the zero rate.

MR. PRELL. Right.

MR. KOHN. Eventually it would end up there, yes. But first there probably would be an increase early this year, given the lagged effects. Then it probably would come off; I'm sure it would. It would have this humped shape as the offering rates caught up with the [market] rates. Possibly you'd find at some point a leveling off.

MS. SEGER. I still sense, though, that there's an option missing here. You have number "I," which is your base line, which is tightening, right? You have number "II," which is additional tightening.

MR. KOHN. Right.

MS. SEGER. And you have number "III," which is easing.

MR. KOHN. Number "III" was less money growth.

MS. SEGER. Well, at least that's what you read.

MR. KOHN. Excuse me, more money growth. I didn't have a constant interest rate option in here in part because Mike had one in his briefing. I thought rather than replicating the options I would have one that was somewhere in between constant interest rates and the staff's rising interest rate forecast. And that was my option three. It's easier than the staff forecast but it does not keep nominal interest rates unchanged from current levels over the near term, although the movements in rates aren't very large. There still would be some upward movement in rates over the year, but not much.

MS. SEGER. Thank you.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. I was just going to indicate my support for what Governor Angell was saying. But I'm wondering if the Humphrey-Hawkins wording precludes our focusing on one aggregate since it says "provide

for the rate of increase or diminution in aggregates" or something like that.

MR. PRELL. It says money and credit aggregates.

MR. BLACK. Aggregates.

MR. PRELL. You probably have to have a credit measure of some sort unless you could persuade them that it was built into this. It's in the text.

MR. BLACK. I guess, then, that you wouldn't have to have M3. I thought maybe you would since it says money and credit. If you had one of each I think you could meet the definition as such. I support it even--

MR. PARRY. Except last July they wanted us to add one. They didn't want us to subtract one last year.

MR. BLACK. Yes, I know. But I was just thinking about the correct thing to do [according to the Act], not what Congress wanted [in July].

MR. MELZER. You could swap the base for M3.

MR. BLACK. Yes, well--

SPEAKER(?). It could be M2 [unintelligible] and credit.

MR. BLACK. I would favor that.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Don, I have a question about your earlier statement with respect to the credibility of Federal Reserve policy. You said it was important that we have credibility and that we pursue it; you said that we probably gained some credibility along the way as judged by the financial markets. I guess I have some concerns about not picking a specific objective over time. My concerns are as follows and I'd like you to respond to them. We are asking the markets and the public in general to trust us on two levels now: on the objective and on how we're going to implement it. We have an objective out there someplace called price stability that we may trade off against anything else at any point in time. I think we might be able to increase our credibility to some extent if we could at least pin down the objective and then just ask them to trust us on how we implement it, because we're having trouble with the aggregates or interest rates or commodity prices.

MR. KOHN. I think we--the Chairman in particular in recent testimonies--put out a very strong statement about our objective and backed it with reasons why price stability is our objective, without necessarily saying [we plan to achieve that] by the year 1993 or something like that. In my view, it's a debatable point. I raised the issue in part to stimulate the debate. There are dangers in putting out various specific objectives--2 percent or 1 percent or even zero, whatever zero is in reality, by 1992 or 1993--because of the problems that arise when you miss it, and so forth. So I think we

can continue to make strong statements and back it up with actions. Ultimately, as someone was saying, credibility grows out of the barrel of an open market operation. It's what we do more than what we say-- read our actions rather than our lips--that sets scores on credibility. And as we act over time with that in mind I don't think there's a problem--or there's less of a problem.

MR. HOSKINS. Just one other comment. I think what Martha was alluding to, if I'm correct, was that we are not paying sufficient attention perhaps to the other parts in the Humphrey-Hawkins Act.

MS. SEGER. No, I was just picking up on what I thought Don said was in the Humphrey-Hawkins Act. I didn't write Humphrey-Hawkins, but as it was written they put a higher priority on the employment side of things and mentioned price stability. I was just saying from Don's comment that it sounded to me as if we were establishing priorities that were divergent from what Humphrey-Hawkins had. That's all I was saying.

MR. HOSKINS. I would say we're consistent with it. If we pursue price stability then we will pursue maximum employment. I don't see any inconsistency there.

MR. KOHN. That's the way it happens.

MS. SEGER. May I pick up on the credibility issue? It bothers me to hear over and over again that we somehow or other just have to satisfy the financial markets. I'm very respectful of the financial markets but it's a big country out there and there are a lot more Main Streets than there are Wall Streets. And I think the screaming meemees up there shouldn't be the ones who dictate to us. Establishing credibility is a much broader challenge. We have to convince all sorts of people above and beyond the financial market types even though they are the ones--

MR. HOSKINS. That was the reason I mentioned financial markets and the public.

MR. BLACK. Right. You should have said the public and financial markets.

MS. SEGER. Right.

MR. HOSKINS. I'll say it now.

MR. BLACK. You learned your lesson.

MR. ANGELL. Martha, this is the first time I've ever heard anyone here act as if Mr. Greider in The Secrets of the Temple has the right notion.

MS. SEGER. I don't know; I'm not Mr. Greider.

CHAIRMAN GREENSPAN. Are there any further questions of Don? If not, I would like to get the tour de table on people's views as to where we should come out. I just marginally prefer staying where we are, mainly, I must say because I'd like us to be able to go down again next year. I like the sequence of going down but I'm not sure

it makes all that much difference which of these two we choose. Would somebody like to start off? Governor Johnson.

MR. JOHNSON. Yes. I'll start off by saying that I prefer that same option for a couple of reasons. One is that it's still a full percentage point reduction in the midpoint of the range from what we had last year, which I think is a stronger statement than we normally make. Going from a 4 to 8 percent range to a 3 to 7 percent range is a strong statement by historical standards. I realize that M2 growth, certainly if the interest rate scenario that we follow ends us being close to the Greenbook forecast, puts us closer to the bottom of that range. But that interest rate path assumption is an extreme case, in my opinion. And that's allowed for in the 3 to 7 percent range; it still leaves us 1/2 percentage point above the [bottom of the] range, based on our estimates of M2 growth. I think it's possible that we may hit a peak in interest rates at some point this year short of what the staff has forecast. If interest rates stabilize, or even fall because of some weakness in the economy or whatever else we run into, we could see more M2 growth. Certainly that would be offset by the velocity adjustments to that and we would want to be able to allow for that. It seems to me that a 3 to 7 percent range accommodates all those specific concerns. As Don pointed out, the one thing it doesn't seem to accommodate is an even tighter policy than may be allowed for in the Greenbook forecast. In that case, I think we'd see much slower M2 growth. But I think that outcome is very unlikely and 3 to 7 percent or something like that fits clearly into my point of view. I even think that's a pretty strong statement in and of itself: 3 to 7 percent.

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. I agree with the Chairman. I think we should consistently, gradually, lower the targets. We shouldn't try to fine tune the long-term ranges. So I'd be in favor of the tentative targets, alternative "I."

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I would support the 3 to 7 percent as well. What would concern me about going to the lower range is if we had to raise it next year. I think that could be confusing to the public and the Congress, especially since the Greenbook forecast--and our forecast as well--is that inflation rates actually could be a bit higher in 1990. So it seems to me that we would maintain an extra degree of flexibility if we were to stay with the 3 to 7 percent range and try to explain after the fact why perhaps it does end up in the lower end of that range.

CHAIRMAN GREENSPAN. Yes, that's a good point. Governor Angell.

MR. ANGELL. I also favor the 3 to 7 percent, although I think one could make a case in the other direction. The reason that I would stay at 3 to 7 percent is that it seems to me there is some chance--I don't know whether the probability is 20 percent or what, but there is some chance--that we will encounter a commodity price deflation during 1989 or 1990. If that occurred we might very well have short-term rates of 9-1/2 percent and long-term rates of 8

percent. And I don't know how the monetary aggregates would respond in that environment. Don, do you know what would happen? We would get a slightly faster growth if we had that kind of twist, would we not?

MR. KOHN. Yes, I think so, right. In 1990 or some time?

MR. ANGELL. Well, I don't know when and I don't know whether; I'm just suggesting that possibility. And it seems to me that it's very important that we not get in the position of having to increase those ranges. I do believe that long-run price stability does require us at some point in time to move down to 2 to 6 percent and maybe eventually to 1 to 5 percent. But I really believe we [should] get there by a slow and progressive, sound, patient stance--not by one which in a sense tries to whipsaw the events. So, I believe there's a great deal of merit in our staying with the 3 to 7 percent. I would remark in regard to M3 that I believe that the 4 percentage point range that we now have provides ample room for the Committee to engage in its monetary policy actions. As far as I'm concerned, having multiple aggregates is simply a way of not being accountable. I can understand why the Federal Reserve at first did not want to be accountable in regard to having too narrow a focus. But I think it's misleading because I don't hear anyone who says that they believe M3 is all that superior to, say, M1. I do believe that we watch and monitor M1 and I'd prefer just to monitor M3.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, I come out somewhat differently on this issue. I'd like to go back to the credibility argument. It's apparent to me that our credibility is really very good, not only in the financial markets but with the public. I don't know how you measure the public en masse but certainly they are represented by those in the Congress and people in my District who really are giving us high marks for monetary policy. I think it's very important that that credibility be maintained and I think the Chairman's recent testimonies have certainly reinforced our credibility. It's very important that we continue to reaffirm our commitment to price stability over time and that suggests to me that we need to lower the ranges. Granted, we did lower them 1 percentage point with respect to M2 in July. But we have tightened policy since then. It seems to me, given the staff forecast for the growth of M2, that we could run the danger--if we have to tighten further--of being below a range of 3 to 7 percent. In order to have that flexibility my preference actually would be 2 to 6 percent, but that may be a bit extreme in the short run. Just as an aside, it seems to me that using the 1/2 points suggests a degree of precision that I'm not sure we have. So, 2 to 6 percent would be kind of an ultimate preference for me; but I'd be willing to accept what's described as alternative "II" in the Bluebook, 2-1/2 to 6-1/2 percent. I think that gives us two very important things: 1) flexibility on the down side given the projected growth of M2; and 2) reinforcement of our commitment to fighting inflation. That really backs up with action what the Chairman said earlier to the Congress. M3 I would leave at 3 to 7 percent, and I agree with Governor Angell that it probably doesn't make that much difference.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I favor the 3 to 7 percent [range for M2]. I have one comment: Don, you pointed out the language in the directive and I just don't know whether it's appropriate for us to be qualifying all the aggregates in the context of the longer-term ranges. I agree with what you said in terms of intermeeting [developments] and how you interpret them. But to some extent, that sort of runs in the other direction. In other words we have put M1 on the bench; and if somebody looks at this cynically, in effect, this language begins to put some of the broader aggregates potentially on the bench. I think we already have the flexibility, should it become necessary, to miss the target ranges--and that would most likely be on the low end this year--and to explain it. So I don't know whether I would add that language there; that is the question I would raise.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I think the case for alternative "II" is a strong one. Bob Forrestal made part of it: given the staff forecast of M2 and the GNP forecast and so forth, that does get us closer to the center of that particular range. That is, if M2 is going to grow something in the neighborhood of 3-1/2 percent, that range is just more appropriate in its own right. But beyond that, we've had modest growth in M2 in both 1987 and 1988. Against that background, it doesn't seem to me that an upper end of that range as high as 7 percent for 1989 is appropriate. I must say, finally, that as far as considering possible ranges for 1990 and what we might want to do next year, I don't know how that's all going to play out. But I think what we can say with some confidence is that if we're committed to price stability over time we're going to want to see modest growth in M2 again in 1990. I don't expect that we're going to run into difficulty. Therefore, if we move to 2-1/2 to 6-1/2 [unintelligible].

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Well, I think on substantive grounds it probably doesn't make a lot of difference whether it's alternative "I" or alternative "II" or something in between where we would lower the top end or narrow the range. However, for posturing purposes, I favor alternative "I" largely because I think it already has made a statement. Manley made that point and I also think alternative "I" makes a statement. It gives us room to move down next year, which I think is important for longer-term targeting. It just provides additional flexibility. On the issue of whether we ought to have fewer or more aggregates, we can have too many and have too few. I think we're better off not to limit ourselves to one. We've been doing this now for 13 or 14 years and over that period if we've found out anything it is that what looks good in one period doesn't look so good in another. As long as we can pick and choose internally it's easier, I think, to deal with that than to try to go out and explain why we add one or why we drop one. I think the last 13 or 14 years underscore the wisdom of having a bit of a buffet to choose from.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I think you put your finger on it when you said the question was really whether we would have to raise the range the next time we look at it. So, I don't feel very strongly about either one of these alternatives. But I do have some preference

for alternative "II" because I see the basic function of setting these targets as being that of reassuring the public about our anti-inflationary resolve. If we assume we have to have a 4 percentage point spread or something like that in the ranges because of the sensitivity of M2 to declining interest rates or rising interest rates, that suggests to me that what we're really after eventually is a range of about 1/2 to 4-1/2 percent or something like that. And I think we're in a position now that we could take that additional step. The upper part of the alternative "II" range would be 6-1/2 percent; and if we could take these figures at face value on M2 that should give us sufficient flexibility, even with a declining rate of growth and a drop in short-term rates in 1990, to still hit this 5 percent rate with some room to spare--and to hit the 6 percent in 1991 with some room to spare. Like Gary Stern, I don't think we would really have to end up raising that but it's not a do or die issue with me. I could go with either one, but I do have that preference because I think we can take a good step now without much risk.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. I favor 3 to 7 percent because of my personal weighing of the alternative risks. It seems to me, coming back to the credibility issue, that the damage to our credibility if we stay with 3 to 7 percent and come in below the range this year is far less--I shouldn't say far less--it is less than what the cost might be if we were to have to raise the range next year. In either case we would have to explain it. So, I would favor staying with 3 to 7 percent and if we felt that it was possible, given unknown changes of velocity and given what's going on in the financial markets, we might make a comment about the thrift situation in what's said [in the testimony].

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, for the reasons that I think have been well covered I'd favor the preliminary ranges under alternative "I." Having reduced the preliminary ranges as much as we did last July, it seems to me that to reduce them further at this point has a signal effect that may contain more than we intend. And if, as seems likely, we end up in the lower part of the M2 range for the year it seems to me that's an issue you can very well cover in your testimony.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Yes, I'd like to associate myself with the comments of Gary Stern and Bob Forrestal in terms of their preference for something like 2 to 6 or 2-1/2 to 6-1/2 percent. I am troubled by breaking with tradition; I think tradition is important. We've done a good job in terms of marching the upper end of the M2 range down year after year; I think there's a lot of value to that. But in terms of the substance of policy, given where the staff forecast says we've got to go--and I concur with that forecast--then the range is skewed in the wrong direction. I would be comfortable, I guess, with "III" if we were clear in the testimony that we were going to come out at the bottom end of that range. And if we don't come out at the bottom of the range we probably will not have tightened enough.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I think credibility is important. I think we've established credibility and it is important to keep it. As I look at what we did in July in projecting for 1989-- that is, taking a full percentage point off of both the upper and lower limits--I'm not persuaded that hitting it again at this point another 1/2 percentage point or so as, say, is suggested in alternative "II" is either (1) necessary or (2) desirable, given the staff's projections in the Greenbook. Lastly, it seems to me that the opportunity to move down somewhat again next year, given what we hope will happen, is important. And if we take that extra cut now I think it limits somewhat our ability to go down next year given the projection for somewhat greater growth in M2 through 1990. So I would stick with alternative "I," 3 to 7 percent.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, my preference would be for alternative "II," primarily for the reason that we feel we would be at the lower part of the [alternative "I"] range. If we really believe that, it seems to me we ought to establish a range that gets a little more centered. Also, my impression is that there has been less difficulty in explaining overruns than underruns. And, at least the way I look at the long-run strategies--if you look at what happens to inflation and if there is a relationship between money growth and inflation--then it seems to me we aren't really doing very much over the next three years or so where inflation is concerned. The comment was that the rhetoric has been good because [unintelligible] and look at what we do as opposed to what we say. It seems to me that if we also confirm what we say with what we actually do, then that enhances our credibility. Keeping inflation at the current levels, or even at projected levels as we're looking at it through 1991, seems to me almost to create the impression that we're accepting that as the norm. And I have problems with that. So my preference would be to go to alternative "II."

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I favor alternative "I." I think that with the 4 percentage point bands we have plenty of room to conduct policy either with number "I" or number "II." For that reason I wouldn't be upset with "II;" but in the interest of longer-term flexibility in the out period, as you suggested early on, I think it makes sense to move this in a more gentle manner. I would also restate what Governor Johnson said early on: if we do alternative "I" here we are lowering it by 1 full percentage point, which I think has plenty of message effect for now and leaves us the flexibility we'll need to do more easily what may be necessary as time goes on.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. Now that I know the actual results [for the economy] and also what happened to monetary growth in 1988, I'm willing to support the preliminary ranges, which would be alternative "I." For M2, of course, it does remove a full percentage point at both ends of the [1988] range, which in my judgment is a sufficient message to the doubting Thomases. Secondly, I would suggest that we're measuring from a point that is below the midpoint; the actual growth in 1988 came out below the midpoint of the range for last year.

And so it seems to me we're picking up a little there, simply in measuring from a lower base. On M3, again, taking a half point off from each end in conjunction with the full point off the M2 range should be sufficient to convince our followers.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I support alternative "I" for most of the reasons cited. But I can't refrain from making a comment on the credibility issue. I think we miss some of the environment here if we congratulate ourselves too much on the credibility that we presently enjoy and assume that that's because we are seen as fearless inflation fighters. We are seen and applauded for that only so long as nobody else gets hurt in the process of our fighting inflation. If we were to go out there and really beat inflation over the head and in the process increase the unemployment rate or dump the economy in some fashion I think that our credibility would disappear overnight. People would forget that we were inflation fighters and label us as the black knights who have ruined people's lives. So, I like the 3 to 7 percent range because I think it gives enough room for policy alternatives in managing all these different variables in a time when I'm still unconvinced, as I mentioned yesterday, about just what the tea leaves are really saying.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I would support the original formulation that you put on the table, Mr. Chairman, with one caveat. In round numbers--and Don you can help me with this--the midpoint of the range for M2 implies an absolute growth of M2 of something like \$140 billion. Is it something like that?

MR. KOHN. It must be something like that.

VICE CHAIRMAN CORRIGAN. The caveat gets to this thrift industry issue. The great bulk of money that was going to be disintermediated out of the thrifts as a result of the Bush plan was going to be brokered deposits. In fact, in the short run almost all of it would be brokered deposits. If those deposits are all in M2 because they're all under \$100,000 but they all come from Wall Street, I think it's quite likely that a very significant fraction of the money that comes out of the thrifts due to the shrinkage of deposits will not find its way back into depositories, or perhaps even into M2 instruments. And I think that somehow or other, Don, we're going to have to try to figure out a way to keep track of that because it does seem to me possible that if you think in terms of the absolute growth of M2 of whatever it is, \$140 billion--

MR. KOHN. It's \$160 billion or so.

VICE CHAIRMAN CORRIGAN. Pardon me?

SPEAKER(?). \$161 billion.

VICE CHAIRMAN CORRIGAN. --\$161 billion, whatever. It's quite possible, as I think about it, that that phenomenon could have a significant effect on the dollar change that's implied here. I don't

know quite what that means but if we saw \$30 or \$40 or \$50 billion that's now in M2 through brokered deposits--

CHAIRMAN GREENSPAN. That could easily happen.

VICE CHAIRMAN CORRIGAN. Yes.

MR. ANGELL. Here comes M2a.

VICE CHAIRMAN CORRIGAN. I don't like to be difficult, Wayne, but I think we've got to do something.

CHAIRMAN GREENSPAN. I think what you're suggesting is that in the Humphrey-Hawkins report and in testimony we ought to have a few sentences on exactly that issue.

VICE CHAIRMAN CORRIGAN. Yes. But, Don, I think we ought to try to figure out some way that we could try to keep track of that because it's conceivable to me that--

MR. KOHN. Well, we'll look into this a bit. To the extent that it went into money funds, of course--

VICE CHAIRMAN CORRIGAN. It's a big part of the implied M2 growth.

CHAIRMAN GREENSPAN. Well, a lot of that, I guess, would go into money funds.

MS. SEGER. Yes, but commercial paper wouldn't be picked up in M2 or T-Bills wouldn't be picked up in M2.

CHAIRMAN GREENSPAN. Oh no, no.

VICE CHAIRMAN CORRIGAN. Some money deposits are and some aren't.

CHAIRMAN GREENSPAN. Yes. A good chunk is likely not to go back into depository institutions, there's no question.

MR. KOHN. It's not clear what the preference was for. If they were looking for federally insured deposits then they would have to go back to a depository institution.

VICE CHAIRMAN CORRIGAN. Yes, but it kind of--

CHAIRMAN GREENSPAN. Well, they are looking at federally insured deposits at a certain rate. It's the equivalent of getting--

VICE CHAIRMAN CORRIGAN. That's why this brokered money facet of it, I think, is so important. I'm not sure that it's--

MR. GUFFEY. What are the alternatives other than money funds?

SPEAKER(?). Treasury securities.

MR. GUFFEY. Government securities.

MS. SEGER. Commercial paper, T-Bills.

CHAIRMAN GREENSPAN. Commercial paper.

MR. JOHNSON. If it's the savings part of M2 it could just as easily go into T-Bills.

MR. BLACK. Right.

MR. JOHNSON. It doesn't have to go into transaction accounts.

MR. KOHN. We have made a small allowance for this, indirectly, by presuming that the average offering rates on M2 remain damped. And the average offering rates include, obviously, the brokered deposit offering rates and we factored that through. I doubt that we've captured the full impact, as Jerry has implied, but--

VICE CHAIRMAN CORRIGAN. A lot of this stuff is not household money. It's broken up into \$100,000 pieces, but it isn't household money; it's hot money.

MR. BLACK. Well, I think it's amply true what Jerry was saying about those [depositors] who initially come out. But they spend that money buying something else; it moves into the hands of some other people. So you've got to go beyond that and ask: What are they going to do with that? And it might well come back into deposits in some form.

MR. ANGELL. But don't jump to the conclusion that all the \$100,000 money is going to go, because with the present spread between \$100,000 jumbo CDs and the others it is still lower cost money for institutions who really look at the brick and mortar costs of raising the other kind of CDs. So it's not all going to go in that--

VICE CHAIRMAN CORRIGAN. I didn't mean to discombobulate this discussion, Mr. Chairman.

CHAIRMAN GREENSPAN. Yes, but I think it's actually an important point.

MR. PARRY. I think that an adjustment has been made. At least in the quantitative work we did we got a faster growth of M2 just using the model. I don't know the extent of it, but I think there has been an adjustment made to reflect the fact that these deposit rates, in terms of offering rates on M2 instruments, have been very sluggish. I don't know if you quantified the adjustments you made but I think it was in there when you had the 3, 3-1/2--

MR. KOHN. We ran a couple different types of simulations of how these offering rates would behave and they all shaved about 1/2 percentage point or a little more off of our model forecast.

MR. PARRY. Right.

MR. KOHN. And that's the 3-1/2; it is about a half--

CHAIRMAN GREENSPAN. No, but Jerry's raising a different point. It's not an issue of what the forecast is; it's what the 3 to 7 percent means and how one interprets it. In fact, one of the elements involved in the forecast is that if we took M2 and grossed it up for the thrift thing it would be higher in the cone. And I think that we are interpreting the 3 to 7 percent to mean the grossing up--making the adjustment for the loss of brokered deposits. In other words, the question is: What is our target? Well, our target is 3 to 7 percent after we add back, I presume, an estimate of brokered deposits. That's what it means.

MR. ANGELL. Mr. Chairman, I would also like to be included among those who prefer a kind of strategy "II" with a 3 to 7 percent range. That is, it does seem to me that it's important for us to create expectations that--if conditions unveil as the staff has forecast--we do anticipate staying very close to the bottom of the range.

CHAIRMAN GREENSPAN. Well, before we vote, does anybody have any problem with the directive language on pages 20 and 21 in the Bluebook? Very specifically, what is the Committee's view of the alternative at the end of the middle paragraph on page 21?

MR. HELLER. What if you just drop it?

CHAIRMAN GREENSPAN. You mean the paragraph itself?

MR. HELLER. Yes. We didn't have a M1, so--

MR. KELLEY. It has been repeated many times.

MR. HELLER. Yes, repeated many times.

MR. ANGELL. Yes, I think that's a good idea.

MR. HELLER. So just drop it.

CHAIRMAN GREENSPAN. Anybody have any objection to dropping it?

VICE CHAIRMAN CORRIGAN. I have no problem dropping the M1 reference but I think the last sentence is still important.

SPEAKER(?). Yes.

MR. ANGELL. Well, we could say "The behavior of all the monetary aggregates will be evaluated...."

MR. JOHNSON. Yes, that's an important sentence.

CHAIRMAN GREENSPAN. Okay. Why don't we keep the last sentence but drop the--

MR. ANGELL. But do we want to say "The behavior of all the monetary aggregates will be evaluated in...."

MR. JOHNSON. Of the aggregates.

MR. KELLEY. That's the [unintelligible] language.

CHAIRMAN GREENSPAN. Plural?

MR. ANGELL. Right.

MR. HELLER. The capitalized language.

MR. KELLEY. Yes.

CHAIRMAN GREENSPAN. Taking a rough score it appears that there is a significant weighting towards alternative "I," so why don't I officially put that up for a formal vote.

MR. ANGELL. I guess I wonder why we're saying "establish." We've never "established." Why wouldn't it be appropriate to say that we lowered the ranges?

CHAIRMAN GREENSPAN. We don't do that?

MR. ANGELL. We don't say we've lowered the ranges, do we? This is the first time that we've really officially lowered the 1989 ranges.

CHAIRMAN GREENSPAN. Well, tentatively we had; we just published the 3 to 7 percent. Do you mean officially?

MR. ANGELL. Well, those July ranges were just tentative.

MR. BOEHNE. What about "[The Committee] reaffirmed its decision of last July to lower...?"

MR. ANGELL. I like that.

CHAIRMAN GREENSPAN. That's good.

MR. BERNARD. Reading, starting with the second sentence on page 20: "In furtherance of these objectives the Committee at this meeting reaffirmed its decision"--actually it wasn't in July it was in late June--so it's "of late June."

MR. HELLER. Well, just "its decision."

MR. BERNARD. Or "its decision to--"

MR. HELLER. "To lower."

MR. BERNARD. --"to lower the ranges for growth of M2 and M3 to ranges of 3 to 7 percent and 3-1/2 to 7-1/2 percent, respectively, measured from the fourth quarter of 1988 to the fourth quarter of 1989. The monitoring range for growth of total domestic nonfinancial debt was set at 6-1/2 to 10-1/2 percent for the year." And on page 21 I take it that the sentence on M1 will be dropped and the paragraph would continue: "The behavior of the monetary aggregates will continue to be evaluated in the light of movements in their velocities, developments in the economy and financial markets, and the nature of emerging price pressures."

CHAIRMAN GREENSPAN. Okay, call the role.

MR. HOSKINS. Point of clarification. In terms of your testimony, if we opt to put in this 3 to 7 percent is it with no caveats? Or is the testimony putting in the table and then [saying we expect to] come out at the bottom of the range?

MR. JOHNSON. I would prefer not to say that.

CHAIRMAN GREENSPAN. Say what? I'm just trying to--. I've forgotten what we've done in the past. Do we actually forecast?

MR. KOHN. We've often said that we expect growth in the middle of the ranges.

CHAIRMAN GREENSPAN. We have said in the middle of the ranges or instead of--

MR. KOHN. Well, in the past when we put ranges out we have--

CHAIRMAN GREENSPAN. Well, one of the problems in forecasting where we expect M2 to be in the range is that it enables somebody to work backwards to what our funds rate projections are. And I'm not sure we want to do that.

MR. JOHNSON. Well, let's--

MR. PARRY. Why don't you just spend a little time talking about the potential impact of developments: the savings and loan industry--

CHAIRMAN GREENSPAN. Yes. I think that would be done in any event. But I think Lee is raising the question as to what we are forecasting in the ranges that we're adopting.

MR. PRELL. Mr. Chairman, one could remark that we're low at this point in part because of the lagged effects of previous interest rate changes. So that might give you some leverage to get some of that--

CHAIRMAN GREENSPAN. Well, I think that in the testimony we will be discussing some of the aspects of where M2 is going. But I don't think we want to be all that specific about where it relates to our forecasts of policy from here forward. Now to the extent that there are lagged effects, Lee, I think that does suggest that we're in the lower end in the beginning no matter what. But I don't want to go much beyond that.

MR. JOHNSON. You can always say that if it's necessary to take interest rates higher we will end up at the low end or if interest rates stabilize or go lower we'll end up in the upper part.

SPEAKER(?). Why say that?

MR. JOHNSON. Well, we don't have to say it. But I'm just saying that we could say there's some basis for why we would end up in different places.

MR. KELLEY. That explains why you have ranges in the first place.

VICE CHAIRMAN CORRIGAN. Having watched the Chairman on [TV] the other night, I'm quite confident that he'll be able to--

MR. JOHNSON. I'm not worried.

CHAIRMAN GREENSPAN. I'll mumble my way through!

MR. ANGELL. Mr. Chairman, there's one other phrase that I'd like to call to the Committee's attention--the very last phrase that Norm read--"and the nature of emerging price pressures." That statement, it seems to me, is a very defensive statement. I would prefer that to read "and progress toward price level stability."

CHAIRMAN GREENSPAN. I think that's an excellent suggestion.

MR. BERNARD. "Progress toward price level stability"?

MR. ANGELL. "And progress toward price level stability."

MR. HELLER. Well, since we're discussing it, don't we want to move that further to the front end of that sentence?

CHAIRMAN GREENSPAN. No, I think that--

MR. ANGELL. I think it has the finishing--

MR. BLACK. [If it is] first in the operational paragraph, Bob, that may be sufficient. I agree with your sentiments, but in the operational paragraph--

MR. HELLER. Well, just to make it consistent.

MR. BOYKIN. It seems to me that if we do that, which I would favor, then on page 20 that very first sentence should say "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability"--we say "over time." Why don't we strike "over time"? Our objective is to foster price stability. And then with what Governor Angell is suggesting that confirms it because here we are setting our objectives. As for that "over time" we've been at it a long time.

SPEAKER(?). Time is running out!

CHAIRMAN GREENSPAN. I'd buy that.

MR. ANGELL. I buy that, too.

MR. BOYKIN. Really, we prefer--

CHAIRMAN GREENSPAN. Can we take a formal vote?

MR. BERNARD.

| | |
|------------------------|-----|
| Chairman Greenspan | Yes |
| Vice Chairman Corrigan | Yes |
| Governor Angell | Yes |

| | |
|---------------------|-----|
| President Black | Yes |
| President Forrestal | Yes |
| Governor Heller | Yes |
| President Hoskins | No |
| Governor Johnson | Yes |
| Governor Kelley | Yes |
| Governor LaWare | Yes |
| President Parry | Yes |
| Governor Seger | Yes |

VICE CHAIRMAN CORRIGAN. That's an easy one.

CHAIRMAN GREENSPAN. Don, will you take up the short-term part?

MR. KOHN. You want me to take you to the coffee break.

CHAIRMAN GREENSPAN. We could manage to do that.

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

CHAIRMAN GREENSPAN. Okay. Thank you, Don. Let's break for coffee and then resume after a short break.

[Coffee break]

CHAIRMAN GREENSPAN. I'd like to start off with--

MR. MELZER. Could we ask questions of Don?

CHAIRMAN GREENSPAN. Oh, I'm sorry! Certainly.

MR. MELZER. I didn't mean to cut you off. I just wanted--

CHAIRMAN GREENSPAN. It was unintentional.

SPEAKER(?). Carry on.

SPEAKER(?). Forget your question?

MR. MELZER. Maybe I should!

SPEAKER(?). I hope this is a good one.

MR. MELZER. Don, you talked about the instability of the borrowing function. You mentioned that normally there's about a \$400 million difference per 100 basis point difference--in terms of what's transpiring now versus what historical relationships might have produced. My question is: What is the potential for somehow really getting a surprise? In other words, I think the Desk has dealt very effectively with the kind of instabilities we have had, but what is the prospect of something much more dramatic than that in terms of a change in the propensity to borrow? I wonder because the spread may get to the point where banks figure, what the heck, we haven't had a problem with discipline at the window. Do you worry about that at all?

MR. KOHN. Well, not in the last six months or so. The borrowing has been so low for wide spreads that for whatever reasons--and we talked about this last time--it is particularly the small banks that are most surprising in the way they are staying out of the window. Whether it's their liquidity, whether they're concerned about the thrift crisis and do not want to be seen at the discount window given concerns about depository institutions, or what, I don't know. But I guess I don't have any expectations at all that that's going to reverse on us with a big rush or that if it began to reverse we wouldn't detect it pretty quickly and be able to take it into account.

MR. MELZER. So you're not overly concerned about that prospect?

MR. KOHN. About a big rush of borrowing at the discount window? No.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. Would it be possible to make the case at this point, given this continued uncertainty about the relationship, that we should engage more directly in targeting fed funds rather than having the flexibility in operations of the Desk?

MR. KOHN. Well, I would say that that's a decision for the Committee. My proposal was that this flexible approach, which in effect is a blending of the two approaches, continue. The Desk has reacted, I think, when funds have gotten way out of line from Committee expectations. But it hasn't [zeroed] in very closely on a very narrow range for fed funds; it is also paying attention to the borrowing function. But it isn't captive to it if it looks like it's going to push the funds rate way out of whack with what the Committee expects. So, it's an approach that I think has enabled us to have more flexibility than the very narrow focus on the funds rate might allow but at the same time hasn't gotten us too far away for too long from what the Committee expects. Federal funds, as Peter said, have been running the last couple of maintenance periods a bit over 9 percent. I think the last Bluebook said 8-7/8 to 9 percent; we're talking about a difference of 10 or 15 basis points here, maybe. So I don't think that's too far out of line.

CHAIRMAN GREENSPAN. Any other questions? Well, why don't I start us off on the current policy recommendation problems. Having looked at the economy for many years, I frankly don't recall an economy that at least on the surface looks more balanced than the one that we have--in other words one which is characterized by very little evidence of excess inventory accumulation. We're not getting big bulges in capacity or construction which would tend [unintelligible]. Order backlogs are relatively high and there's a certain momentum in the economy that is very likely to carry us quite a good way. And I must say to you that it's relatively rare, I think, that the outlook is as favorable as it is at the current moment. One major worrisome issue is clearly the acceleration in wage and salary costs that emerged, really, in the fourth quarter and was partly confirmed in the average hourly earnings index in January. Considering the fact that the intermediate product gains in the wholesale price index, excluding food and fuels, were running .6 or .7 percent but were not passing through into the final goods prices--very largely because unit labor

costs as a major part of the markup between intermediate materials and final goods prices were suppressed, and the unit labor costs were suppressed largely because nominal wage and salary rates were soft--it is possible that the last several months' movements in wages are an aberration. But one obviously can't assume that in the context of the unemployment rate and the tightness of the labor market where it is.

Nonetheless, we do find some interesting signals that are a little puzzling. I think the economy clearly accelerated through December; but in the last several weeks there were at least some signals that are not consistent with the follow-through that we're looking at. First of all the 408,000 employment increase, judging from the seasonal factors employed in both construction and retailing, is probably closer to about 250,000. If we make that adjustment we may find that perhaps the February or March employment figures will reverse and actually will [seem] weaker than, in fact, they really are. Nonetheless, 250,000 is not a bad increase. It's solid and I think consistent with all of the other elements. And we will be publishing an industrial production index with an increase of about 1/2 percent for January. So, looking on the employment data side the first quarter really looks, if anything, stronger than in the Greenbook. But if you look at the January GNP from the product side it clearly is a good deal weaker: we're not getting anything resembling the income side, which is consistent with the employment side. In other words, the income side in the GNP in the first quarter is much stronger than is confirmed on the product side. And it's not clear just how that is going to be resolved. I've been particularly puzzled by the National Association of Purchasing Managers [NAPM] January survey, which shows a relatively sharp decline in the rate of increase in [coming] quarters. As best I can judge, that is not being picked up in any material I see coming in from the various contacts of the Banks. Nonetheless, that survey has been very reliable in the past and has often been the first indication that we have had that the climate of the economy is changing. I think that's really just too little information to say very much about it. But it cannot be dismissed very readily. Similarly, the insured unemployment data are a little weaker. The figures that came out today showed a further increase--

MR. PRELL. They didn't come out today, Mr. Chairman.

CHAIRMAN GREENSPAN. They didn't come out today? That's a forecast? They will come out when?

MR. PRELL. Tomorrow.

CHAIRMAN GREENSPAN. Tomorrow, sorry.

MR. TRUMAN. And they will be weaker.

CHAIRMAN GREENSPAN. The ones that are scheduled to come out tomorrow do at least turn around the extraordinary tightness that these data had suggested for much of 1988 through fairly recently. So, we're in a position at this particular stage, temporarily at least, where we're seeing no signs of general overheating in the sense that lead times on materials are actually shortening. And, aside from the wage pressures, which I indicated before are quite worrisome, we're not yet getting any evidence of inventory acceleration or

anything that suggests that we're getting close to the peak of an overheated economy that is about to tilt down.

My own impression is that we still have a way to go in tightening. I think the evidence is much too premature to suggest--leaving the forecast mechanisms aside and just looking at the current state of affairs--that this cycle of tightening that we've been through is over. But, as Don mentioned, we are running into an odd problem of limits to our policies--specifically, the fact that as our credibility builds up and there is a general expectation that inflation will not emerge despite some of its signs and what we are getting is a nominal long-term rate that hasn't moved, a real long-term rate that probably has moved up only very modestly, and a problem in that, in effect, we are restraining the economy very largely through higher real short-term interest rates. It's very clear that we are restraining inventory accumulation, which is a short-term decision. We obviously are restraining some elements in the capital goods markets. But I'm not sure how much we are restraining (1) the housing mortgage market or (2) the capital goods markets, because the real cost of capital has not gone up that much. In part, that is a reflection of an expectation both with respect to inflation premiums and instability premiums that we will in fact contain inflation. And that's in an odd way unfortunate in that to the extent the markets believe that what we're doing is right it is making it more difficult for us.

We are also running into problems with respect to how rapidly we tighten because of the pattern of M2 growth with or without adjustment for the thrift problem. The slowness of M2 is corroborated by exchange rate pressures and the strength in the dollar which, by any measures that we are involved with, should be somewhat less. With the types of trade balances we are getting one would assume the dollar should not be exhibiting the type of strength that it is. What this all suggests is the crucial importance of getting the federal budget deficit down to assist in the process of economic policy--to suppress the effect of demand elements that are involved and to enhance the international adjustment process. This issue of getting the deficit down is becoming increasingly mandatory, as we begin to run into problems where it becomes clear that monetary policy cannot be the sole tool with which we are functioning.

I conclude from all of this that the appropriate stance for the next short-term period would be to start off with alternative "B," asymmetric, but with a recognition that, if the pressure on the dollar that is now there stabilizes or falls and if the current mixed signals such as the NAPM survey and the insured unemployment numbers do not indicate early deterioration--in other words, if those signals are reversed which is probably more likely than not--it would be wise for the Desk to be instructed to move [borrowing] up \$100 million maybe in a couple of weeks or so. In any event, the period until the next meeting is seven weeks and I think this [outlook] is sufficiently uncertain that I would request that we schedule a telephone conference at the end of this month to review where we are. And it would be helpful, if events are changing in a manner that requires a conference earlier, perhaps not to wait as long as that to do this. But I think we are at a point where--just judging from the analyses that I heard here yesterday--there are enough differences within this Committee with respect to the issue of fact as to what's going on that in a

period such as this more frequent consultation is important. I think it is very important for the credibility of this Committee to try to find some consensus as best we can, because even though there's a large bimodal distribution out there I think we're not that far apart. And I think it would be very useful if we could find a means to accommodate each other in such a way that we can have a policy that we all can essentially go along with, though we all may not feel fully comfortable with it. So, I've said my piece, and I throw it out as a potential set of motions which I'd be curious to get reactions to. President Syron.

MR. SYRON. Mr. Chairman, just a clarifying question if I might?

CHAIRMAN GREENSPAN. Yes.

MR. SYRON. In what you've essentially proposed--alternative B in the Bluebook--the Bluebook notes that under that alternative some of the recent rate increases might in fact slip back; we might see some decline in rates under alternative B. I take it that in the approach you're talking about that you would not want that, absent some signs of weakening in the real economy or some other events in the international markets--

CHAIRMAN GREENSPAN. Exchange rates.

MR. SYRON. So I can say that under your proposal you would not want to see a decline in rates in the short term?

CHAIRMAN GREENSPAN. Do you mean the funds rate?

MR. SYRON. Yes, the funds rate.

CHAIRMAN GREENSPAN. No, I would not.

MR. SYRON. Okay.

MR. ANGELL. But that's not a commitment to fed funds rate targeting is it?

CHAIRMAN GREENSPAN. No, no.

MR. BLACK. He's just saying in the case of inconsistencies between the borrowing level and the funds rate resolve doubts on the side of borrowing.

MR. SYRON. That's essentially correct.

CHAIRMAN GREENSPAN. Yes. I think the markets would misread a signal of that particular kind.

MR. SYRON. That's my concern.

MR. MELZER. The funds rate would be 9-1/4 percent roughly? What funds rate level would that be?

CHAIRMAN GREENSPAN. I'm sorry. What?

MR. MELZER. Slipping back from what level?

CHAIRMAN GREENSPAN. Where we are right now.

MR. MELZER. 9-1/4 percent?

SPEAKER(?). 9-1/8 percent.

MR. JOHNSON. 9 to 9-1/8.

CHAIRMAN GREENSPAN. I would say probably 9-1/8 percent would be closer. But Governor Heller has the floor.

MR. HELLER. No, let that discussion finish first. I have no question but--

CHAIRMAN GREENSPAN. Did we clarify that?

MR. MELZER. Yes.

MR. HELLER. I just want to support the same position, basically. I think real rates are already very high. Money growth is slowing and we should be patient to see that through. The one area where I may disagree with you just a little, if I heard you right, is that you were expressing disappointment that investment wasn't slowing faster than it actually is.

CHAIRMAN GREENSPAN. Capital investment.

MR. HELLER. Capital investment isn't slowing faster.

CHAIRMAN GREENSPAN. Well, you know--

MR. HELLER. Actually, I like to see high capital investment because that fills the additional capacity that will hold down inflation in the future.

CHAIRMAN GREENSPAN. Well, there are two ways of looking at it. There's good GNP and bad GNP.

MR. HELLER. I think that's good GNP and the more of it the better it is. Otherwise, I fully agree with what you said.

MR. BLACK. Our special theme reports suggested that would be pretty strong, really, if I read that [right]. Is that the way you read it? I was very much encouraged by what that seemed to say.

MR. HELLER. Yes.

MR. BLACK. And that's good GNP.

MR. HELLER. And that's good GNP.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. Well, this is a tough one. I think part of this question of Federal Reserve credibility that has been talked about an awful lot here is related, at least as I see it, to

what I'd like to call institutional harmony. In the interest of institutional harmony I don't want to rock the boat unduly and I think I can support the spirit of what you've suggested. My druthers would be rather distinctly to firm policy right now. But as I said, for reasons of institutional harmony, I am prepared to try to support the spirit of what you've said. But, for purposes of my conscience if nothing else, let me just elaborate a bit further on my underlying position. As I've said in the past, I try to view the process of making policy here as a matter of balancing risks. That's the only way you can do it. Now, I think it is possible, for example, that the economy could slow down kind of on its own to a path that, even with current policy, would be broadly consistent with Mike's forecast. If it did that I think it would signify that we are lucky as well as good, because in my judgment it would take a clear stroke of luck to produce that result--in the sense that I think the risks are on the other side.

The second point that I feel I must emphasize is the following: there has been a great deal of discussion around this table about price stability and moving toward price stability. But as we sit here the algebraic sign on the inflation rate is unambiguous--it's plus. It's not neutral, it's not minus, it's plus. The inflation rate is going up. And Mike's forecast, which is undoubtedly the most rigorous that is available to any of us, is saying that as best they can judge, with current policy the inflation rate is going to go up more. That's what the forecast says. We can all, and we do, have our differences of judgment about it. But that's what it says. Now, I have a bit of trouble reconciling the algebraic sign on the current inflation rate as being plus. Mike's forecast is on the side of rising inflation. I look at the financial variables and my problems get more severe. Take the exchange rate. It seems to me that if you either want or you have a strong dollar, given where we are right now, then something else has to give at some point, because in my judgment the external position that we have and that we have prospectively is unsustainable. If it's not the dollar something else has to give. Now what is that other thing going to be? It's going to be the economy. Indeed as I said yesterday, taking the long view, I have a real question in my mind as to whether we can make sustainable progress on the external adjustment side given any broadly acceptable pattern of exchange rates without a significant and sustained slowdown in the rate of growth in the economy. Now, we don't have to answer that question today; but I think it's out there and it's going to have to be dealt with sooner or later. So the exchange rate, at least as I see it, creates quite a conundrum for us right now.

Then I turn to the yield curve. And I, like everybody else, take an enormous amount of comfort from the yield curve and for what it seems to imply about Fed credibility--both on Wall Street and Main Street, in my judgment, Martha. But the crucial question about the yield curve is: What does it tell us prospectively? What does it tell us about the future? And I'm just not sure of that. I've looked at yield curves over a period of time in the United States and in all the other industrial countries and I'm just not sure. But I think the crucial question that arises, whether it's based on experience in the United States or elsewhere, is: Are recessions typically inflation induced? In other words, does the responsive pattern of recession that we've seen here and in other countries presage the recession? Are they inflation induced in that it's the rise in the inflation rate

that gives rise to the tightening of monetary policy, etc.? And is that what ultimately trips the economy into recession?

CHAIRMAN GREENSPAN. Excuse me. There's a significant inventory acceleration accumulation component in it.

VICE CHAIRMAN CORRIGAN. That is correct. But the crucial question in my judgment--if that is correct which I think it is--is does the yield curve in any reasonably satisfactory way tell us anything about future inflation? And I think the answer is no it doesn't. The yield curve either in the United States or elsewhere has not been a reliable indicator of future inflation. Indeed, the evidence seems to cut the other way. And if it has not been a reliable indicator of future inflation and most recessions are inflation-induced I am not prepared to bet the mortgage on the signals that the yield curve are giving off right now, even though obviously they are very welcomed, at least as we see them. So, I'm sure the yield curve is telling us a lot of important things. I'm sure we can and should both benefit from [unintelligible] but I don't think it's reliable enough historically or intellectually to give me, at least, enough confidence in terms of [extrapolating] from it to the inflation rate and to other variables.

Now, the one variable on the financial side that I do have some confidence in is the money supply, however defined. It is intellectually not easy to look at the pattern of money growth that we have had for basically two years now--I guess it's more than two years--and say to yourself: Is that a pattern of money growth over a long period of time that is likely to be associated with some further dramatic escalation in the inflation rate? I think that is what is giving me some pause. But as I said, Mr. Chairman, overall I can support your position. But my assessment of the risks is that they are a bit asymmetric in that direction; that, I think, is clear.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. Thanks. I also support what the Chairman said. I'm comfortable with maintaining current policy but in an asymmetric way. I still think the risks potentially are on the up side. I just think that with the existing information there isn't any basis at this time for further tightening. We may have to tighten further but I think we ought to leave that to some sort of discretion, some sort of judgment about how events unfold as time goes on. Based on today I certainly don't see that as necessary, for a lot of the reasons that I said yesterday which I won't go back over again. I do have a view, though, that on the long end of the yield curve--even though the nominal rate has come down--we have had a fairly significant appreciation in long-term real rates. Now, there are different ways to look at that and I don't want to suggest that any one way is better than the other. My general view, though, is that there has been a significant rise in long-term real rates. If you follow the Hoey survey, it suggests that the 10-year bond rate has gone up 2-1/2 percentage points in real terms since mid-1987. And I don't think that's insignificant. It depends on how much stock you put in the Hoey survey; it's just one particular measure. But I think Don made a good point in his briefing that the slowdown in corporate bond issuance is also a pretty good indicator that long-term real rates are not completely neutral in this whole process. People wouldn't be

cutting back on corporate bond issuance if they thought their internal rate of return was better than the existing long-term yields. So, I think that's a good point. I don't think there's anything sacred about the yield curve in terms of inflation expectations. I think basically all that says is that the markets are betting that short-term rates in the future are going to be lower than they are today. I think you really have to isolate more on the long bond itself to get some sort of notion of what they're thinking. It doesn't necessarily mean lower inflation expectations; it does mean that they think the short rates are going to be lower in the future for various reasons. Maybe it's just that they think they are not going to keep up with movements in the short rates. It's not the be-all/end-all of the evidence; there's no doubt about that.

Putting it all together, I think you're absolutely right, Jerry, about the dollar. Something does eventually have to give if the dollar keeps appreciating. But I think the central point there is that if the dollar does keep appreciating what will ultimately give is the current account and the economy, to some extent. My point is that if the dollar is going to be appreciating I don't see the scenario that's in our Greenbook forecast. You would have a much weaker economic picture under that kind of a scenario than you would under one with dollar depreciation--and totally different implications for the domestic economy and inflation rate. And that certainly leaves you with a worsening current account in exports under those conditions. That's some risk. But that leads me to want to be very cautious at this time. And I think an asymmetric position is probably the best one.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I would agree that there are substantial uncertainties associated with economic prospects. But I think there is enough certainty to support alternative C. I believe that the level of economic activity is in excess of the full employment [level] at the present time. I think that a constant level of interest rates, even if it is for the next month or so, would assure that for an even longer period. It seems to me that in that kind of environment we know that inflationary pressures are building. As a result, I would say that we ought to get about our business promptly. It seems to me that it also would be much more difficult to characterize monetary policy as being ahead of the curve if we were to take no action now or, for that matter, over the next month. Thank you.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, you very well described what I think is a very complicated and difficult current and prospective situation; and in a broad context I'm in agreement with you. But having said that, at the margin I think I'd have a modest difference. I'm not saying that we are targeting fed funds. Nonetheless, if we have an objective currently of, say, 9 or 9-1/8 percent, I think I'm hearing from Peter and others that there is a market tendency to move higher--I would think 1/4 or 3/8 percentage points in that direction. If there is that kind of tendency in the market I think we ought to support it and move up as those pressures continue to move up. There is general agreement, certainly, that the risks here are on the side

of inflation. The magnitude of the risks is something we can argue about, but I think Jerry stated it very well: the risks are on the up side. The underlying rate of the economic expansion is strong, I think, and sustainable; therefore, I wouldn't necessarily do anything that would hurt here but I sure would move up to the extent that we can, consistent with what I think is an underlying tendency. Therefore, I'd probably come down someplace between "B" and "C" and would be inclined to move a little on the borrowing level now if that would basically support this upward tendency in the fed funds rate.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, I think the point you made about a consensus of the Committee is very important. And for that reason I would entirely support your prescription for the economy over the short term, particularly the asymmetric part. Having said that, my preference would be to move at the present time. I happen to believe this forecast that the staff has come out with. And the inflation projections through 1989 and 1990, in my judgment, represent an unacceptable level of inflation. And achieving that level of inflation implicitly suggests some tightening. What I'm concerned about is that we're going to have to tighten down the road. And that tightening might be more than we would like to have happen to contain inflation. In other words, it seems to me the longer we have this run without taking more decisive action the more difficult our task is going to be in the future. But at the moment I am content to agree with your proposal.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. Yes, I can support your recommendation, sir. I won't tick off all my reasons because most of them have already been stated by someone or another. I would just add one, and that is that if we were to tighten further I think there would be copycat actions coming from other countries. And I'm not sure that that would benefit all the economies in the world long term. Also, with the dollar so strong at the moment and our strenuous efforts to lead it down, it just doesn't seem sensible to be putting further upward pressure on interest rates at this moment. So I would back your alternative, which I believe is "B."

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. I have to ask myself, as I think everyone else around the table does, where the risks are in this situation. What is it going to cost us two years from now if we make a mistake now? And is the cost greater for being overly easy now relative to being overly tight? I don't see one structural problem--in the Southwest or with the thrifts or internationally--that would be helped by having an inflation rate of 5.7 percent, which I think is the rate for the CPI, excluding energy, that Mike has in his forecast. It seems to me those problems will be made substantially worse. We'll have to move much more aggressively with much higher interest rates. In my view, it would be simply a repeat of policy mistakes that we have made in the past. It seems to me that we could undo the cost of being overly tight now relatively quickly if we needed to. We can't undo the other. It gets built in. It's serious and it's unacceptable--not just in the sense of the current inflation. What we're trying to do

is get the maximum output for this economy. There is not a trade-off between real growth and inflation. There isn't. It's [unintelligible] in the very short run. So it just seems to me that we ought to ask ourselves about those risks and then come out on the side, at least from my perspective, of moving away from the approach where the costs are enormous. I think now is the time to move. I'd be in favor of alternative C.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I'm very close to Jerry Corrigan and very close to Lee Hoskins. A while ago I appeared to be complimenting Don Kohn unduly at the expense of Mike Prell. But I'd like to say that I think that Mike's forecast for the economy--the need for increasing short-term rates--is probably absolutely accurate. And I favor sooner rather than later. But there's always this risk that we could do too much now. As far as this yield curve is concerned, one reason it's the way it is [relates to] an expectation on the part of knowledgeable observers that we probably will do some further tightening fairly soon. So, I clearly come out in favor of "C." But there is this matter of institutional harmony that Jerry mentioned a while ago. And given your commitment, Mr. Chairman, to move to this in a couple of weeks or so I can go along with that. I'd rather do it now but I can vote for that.

MR. HOSKINS. I want to clarify that. Is it a commitment to move in a couple of weeks or to reconsider in a couple of weeks?

SPEAKER(?). No, it's not.

MR. BLACK. Well, I meant to consider a move depending on what the data say. And if they point in the other direction I wouldn't want to move; I think it is very "iffy" right now. I'm less convinced than most of my colleagues in Richmond that this has gotten quite as far away from us as some people think.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Well, let me comment a little further about the risks as I see them. I don't see much risk at this point in time, with one caveat, to some further tightening. I personally wouldn't go all the way to "C," but I would be inclined to go to \$700 million [borrowing] immediately. The only risk that I can really see of doing that relates to external factors--the issue of external balance. And I think the solution to that ultimately lies with a change in fiscal policy rather than anything that we can do. Beyond that it does seem to me that something between "B" and "C" is appropriate here and now. As I say, I don't see much risk to the real domestic economy from such a move. While I personally feel that inflation is already excessive and probably will rise, we may be pleasantly surprised here; I'll acknowledge that. But I don't see that an additional small move at this point in time is going to [be harmful]; if anything, it's simply going to help [produce] a pleasant surprise if we're fortunate. And at best it will turn out to have been an appropriate action. I don't place a lot of weight on it but there apparently is some expectation in the market that some further tightening is imminent. And I don't think we want to see rates slide back from where they are now.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Well, first of all, I'd like to make up for that rude question before. I'd like to reiterate the position I stated earlier: first of all, I think inflation is too high; and secondly, I think it's going higher. On the other hand, I don't think it's getting away from us or that it's going to get away from us if we stay on this course of monetary restraint that we've been on. In addition, I feel that the only shot we have at long-term price stability--and I would agree with Lee that that should be our goal in the long term--is if we can get there with a more or less stable real economic performance. In other words, I don't think we're in a situation now where it will be productive in terms of the long-run inflation fight to run too close to the line in terms of a recession.

In formulating this view I think that, in a sense, it's all too easy to ignore the narrow monetary indicators; that's not something that gets a lot of discussion around the table. As a result, there's a great temptation for [unintelligible] most recent numbers we see and so forth. Obviously we should be looking at those. But I think at inflection points that can really result in procyclical policy, in easing too long or tightening too long. Having said that, if you look at the reserve base and M1 as well as M2, we've been looking at slow growth rates for two years with further slowing in the last six months or so--and particularly in recent months. In the fourth quarter we had reserve growth that was barely positive; I think the Bluebook showed that in the period from November through January we were actually looking at a negative growth rate of 5 percent. And the Board staff's forecast is assuming 0 percent reserve and M1 growth for all of 1989. Now, in my own view, that kind of policy is very restrictive and I think there's a reasonable likelihood that that will put the economy in a recession in late 1989 or 1990. As I say, the reason I'm concerned about that is that the response in the other direction is going to put us so far off of a sustained path of monetary restraint that it could take us years to get back to the position I think we're in right now. I want to be clear on this. I'm not afraid, in a sense, to take a recession if that's what we have to do. I don't think you ever like to do that, to make that judgment. But obviously if things have gotten out of control, in the end we have to be willing to run that risk for the very reasons Lee said. And it becomes difficult later. But, as I said, I don't think that's where we are. There has been a lot of discussion but it seems that important financial markets don't think that's where we are either. Otherwise, why would the dollar be doing what's it's doing, and gold doing what it's doing, and long Treasuries doing what they're doing?

My final point, which is more or less an aside, is that I think the FOMC has done an excellent job in this period in terms of moving early. But I wouldn't necessarily say that we have led the markets. I simply want to point out that if dramatic additional tightening is undertaken at this time, we certainly don't have the fact that the markets are calling for it. The constituencies, if you will, that are represented there are supporting it. In a dramatic move here--and I know that's not really on the table--in effect, we would be really stepping out in front, which I don't think we've done. Obviously, in pursuing a path of tightening there always are going to be constituencies that are against that, as Governor LaWare referred to before. But in this case where investors feel inflation is getting

away I just think one is in a better position--if one is responding to pressures either in the foreign exchange markets, presumably backed up by our foreign trading partners, or behavior in long-term securities markets--to move against that background. Obviously, there's the chance of doing that too late and never catching up; I understand that. Anyway, that would lead me to a position where, really, I would support "C" as stated--not "B" as stated.

MR. HELLER. You woke us up.

MR. MELZER. I figured I would.

CHAIRMAN GREENSPAN. President Boehne.

VICE CHAIRMAN CORRIGAN. That was the apology.

MR. BOEHNE. Well, the issue is clearly one of weighing the risks of too much versus too little tightening. Reasonable people can differ on that and that's what we're seeing around the table. I don't think any of us can be overly sure, whatever we do, that it is the right thing to do. Therefore, I think it is very relevant to ask the question: What are the implications of whatever we do today if we're wrong? It is possible that we could do the wrong thing today. And it comes down to this: Is it more costly to unwind too much tightening or is it more costly to make up for too little tightening? I think that this Committee has been in existence long enough and that there's a pretty clear historical record, even though this group is much wiser than our forefathers and mothers, that [the answer] is very, very clear. It is more costly to make up for too little tightening. It is relatively easy to lower interest rates. If you lower interest rates you don't cause a lot of unhappiness. Given the uncertainty, and on top of that my assessment of the risks, I would move toward alternative C fairly promptly. I think it's a mistake to let interest rates fall at this point. Temporizing makes sense for institutional harmony for now and I think that's worth something. But I must say that it makes me very uneasy about the future because I think temporizing can be quite costly.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I think this has been an excellent discussion; there is a great deal to be said on both sides of these issues. It's not surprising in the light of all the ambiguity out there; I think it's rather what one would expect. As I consider how to come down on this issue, I'd have a great deal of concern if we were doing nothing now--as everyone here would. But I don't think that's the case. For one thing, as I understood our expectations at the last meeting we were expecting the funds rate to settle basically on the shy side of 9 percent. In fact, it has been on the plus side of 9 percent. So, to some extent, you could say that we already may have gotten one extra tranche of tightening than we had expected to get at our last meeting. And I fully support that. I think it was entirely appropriate and was well done. Nevertheless, it has been there. The aggregates are growing very slowly and I think that's entirely appropriate; but I would be concerned if they went very much slower than they are. I think it makes some sense to try to hold them around where they are. The dollar has implications when it goes in both directions but I think the way it's going now it is on the strong

side and supports an anti-inflationary stance. Whatever the yield curve may be telling us, it is inverted enough that it is clearly on the anti-inflationary side. So, I think we are moving cautiously and appropriately and I am very comfortable supporting your proposal.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. I think, as Ed Boehne said very well, that we are in a period of some substantial uncertainty and that one has to weigh the symmetry of the risks. I fully agree with his analysis that it is always easier to loosen later on than it is to tighten later on. The staff forecast, which seems to me as good a forecast as one is going to find any place, does have some worrisome implications in terms of inflation, excluding energy, as one gets out beyond the forecast period. So, in an unconstrained world I would tend to favor an approach somewhere between "B" and "C." But I do agree strongly that it is important to communicate institutional harmony at this point in time given the number of things that are going on. And I would be comfortable with your position, given that you suggested that there would be a consultation within a matter of a couple of weeks and that there would be no decline, effectively, in market rates in the interim period--that we wouldn't have sent a signal that we were going in the opposite direction when that might have to be reversed within that couple of weeks.

CHAIRMAN GREENSPAN. That would be a bad mistake.

MR. SYRON. So, I prefer a "B-" but am comfortable with "B."

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Well, Mr. Chairman, I find myself in the usual dilemma when it comes to this point, given where I live all the time except for a couple of days every seven or eight weeks here in Washington. It's hard for me to rationalize being a little more restrictive or a little tighter, given the risks of what that might do to the Southwest since it seems that most of the problems have been and are still pretty much centered down there. The arguments, I think, have been well stated on both sides of the issue. Intuitively, I would be in favor of moving toward "C" now. I'm not so confident of that, though, that a two or three weeks' delay to get us a little better reading on what's going on is that important. But I remain concerned, as I indicated earlier in the meeting, about the level of inflation and what appears to me to be a fairly timid approach to reducing that in a fairly significant way. I just think it's too high. But I would be supportive of the proposition that you put out.

CHAIRMAN GREENSPAN. Well, we still have President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. Coming into the meeting this morning I guess I was looking for something between "B" and "C" on the short run, with some immediate movement toward "C" following this meeting. In view of your plea for accommodation, although I'm not a voting member, I could almost interpret your proposal as being a "B-C" stance--taking a look at it again in a couple of weeks. And from that standpoint it would be very acceptable to me. I'd just like to lay on the table the way the tightening might take place in the period ahead. I understand that using the discount

rate probably doesn't meet with much favor among those who have to vote on it--that is, the Board members--given the comments that have been made the last couple of days. But there is a time beyond which I think we will not be able to move the discount rate and close any gap, if that's a concern to anybody. When I talk about "B-C," a bit of snuggling now, I would like to consider that we could deal with a discount rate [increase of] 1/2 percent and not let it all show through--in other words, come to a funds rate level of something like 9-1/4 to 9-3/8 percent. The further you go, if indeed you believe the staff's forecast, you've neutered yourself on using the discount rate as an instrument, I think. And if we're ever going to do it, now would be the time to do it, given the projection that I think most of the people around the table believe.

CHAIRMAN GREENSPAN. I'm still missing Governors Angell and LaWare. Would either one of you--

MR. ANGELL. I've never gone last.

MR. LAWARE. I have the view of last time.

MR. ANGELL. I've never gone last yet.

CHAIRMAN GREENSPAN. You want to go last?

MR. LAWARE. I support your recommendation, Mr. Chairman. I am skeptical about the possibility of unwinding some of these other rates simply because we keep the present level of pressure on. I suspect that in two or three weeks when we discuss this again we probably will want to cinch it up a little. But I think that the current suggested approach is a sound one.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Yes. The staff's forecast, as I understand it, is for a funds rate 150 basis points higher in the fourth quarter of 1989 than in the fourth quarter of 1988. Is that about right?

MR. PRELL. About 150 basis points by a year from now.

MR. ANGELL. A year from now. If that does turn out to be the path that we end up on, it seems to me that it would be somewhat desirable somewhere in there to have a discount rate move. I would not share Roger's enthusiasm for a discount rate move not showing through. I tend to prefer to have discount rate moves really show through the full amount when we do them. So it seems to me that's an alternative that ought to be looked at. I do not favor that now, even though I favored that in November and December; to me it's a question of timing. And I just don't quite understand how matters of weeks are that significant in regard to the long-run impact on inflation. Most of what we know about inflation suggests that it takes quite a while for it to show through. Indeed, if our analysis of commodity prices is correct at all, we really can expect the CPI turning point some 7 to 9 months after we get a turning point in commodity prices. And any turning point in commodity prices at this point is somewhat tentative; it is not in the bag. So, I think we have a period ahead of us that's going to be a period of some travail. I don't know where I'm going to be at the end of the month. I would prefer, Jerry, to tighten when we

have some lack of super-strength in the dollar. It seems to me that it would be somewhat more desirable to get our economy, in a nominal GNP sense, to slow down by domestic [factors] rather than to get it done by a lack of improvement of the external [side]. So, I believe it's important that all of us keep something of an open mind as to where we are at the time of the telephone conference call. I know I'm going to. And if the conditions are such that we can make a move at that time--and we're getting closer to impacting the second quarter's money growth rather than the first quarter's money growth--and it would appear that we're not running the risk of driving M2 to zero, then that's the time to do it. I believe it's a long-term patience struggle. It is clear that I am more confident than some that the monetary restraint, if in place, is the real measure. I just do not know when interest rates are high or when they are low; I do feel very confident about our maintaining a 3 percent growth path for M2. And I'll be prepared under those conditions to vote restraint if it appears that is what's necessary to keep M2 growth at the bottom of the range. Thank you. So, my vote is yes for "B."

CHAIRMAN GREENSPAN. Why don't we vote on that proposal, but let's see if this language is correct.

MR. BERNARD. It reads: In the implementation of policy for the immediate future the Committee seeks to maintain the existing degree of pressure on reserve positions. Taking account of indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, 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 growth of M2 and M3 over the period from December through March at annual rates of about 2 and 3-1/2 percent, respectively. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 7 to 11 percent.

MR. HOSKINS. Can I clarify one thing? In the interest of institutional harmony, when we meet in two weeks will a vote be taken?

MR. ANGELL. Two? I thought it was the end of the month.

MR. HOSKINS. Well, end of the month.

CHAIRMAN GREENSPAN. The telephone conference will be toward the end of the month. The issue of a vote depends on whether we have to change the directive. If we don't have to change the directive then there isn't a vote. But that's the purpose of the conference call: to develop--

MR. BLACK. If we say "maintain" would that preclude our letting the federal funds rate move up?

CHAIRMAN GREENSPAN. Not that I know of, it wouldn't.

MR. JOHNSON. I assume that there's an implied management approach by the Desk that goes with "B." It's what Don reported on.

Now, I don't know what that means. It means being more sensitive to the funds rate but obviously there's some play in it.

CHAIRMAN GREENSPAN. There has to be some play in it.

MR. JOHNSON. It doesn't mean any persistent upward pressure. But I think everybody agrees it doesn't mean a decline in rates from the current level.

MR. BLACK. And "maintain" would permit us to raise the borrowing target \$100 million?

CHAIRMAN GREENSPAN. The answer is yes; the instruction to the Desk does permit the Desk to raise the borrowing target to \$500 million in that the asymmetric language allows that to occur.

MS. SEGER. But not until it's discussed at the conference call, right?

CHAIRMAN GREENSPAN. No, the conference call is scheduled basically later than that, unless we need to consult earlier.

MR. ANGELL. Look, I don't think we ought to be trying to pin [the Chairman down]. If something happens and the Chairman agrees we ought to have a conference call before the end of the month I think he ought to call one before the end of the month. It seems to me this is asymmetric language and asymmetric language should give the Chair some freedom between now and a conference call.

MR. JOHNSON. That's what's in there.

MR. BLACK. I wanted to make sure that we didn't preclude a decision to raise the borrowed reserve target if the data indicated, simply because we said "maintain" in here. And the answer is no.

CHAIRMAN GREENSPAN. No. This language provides for it.

MR. JOHNSON. Asymmetric language always means that.

MR. BLACK. I just wanted to be sure on that one.

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

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|------------------------|-----|
| Chairman Greenspan | Yes |
| Vice Chairman Corrigan | Yes |
| Governor Angell | Yes |
| President Black | Yes |
| President Forrestal | Yes |
| Governor Heller | Yes |
| President Hoskins | No |
| Governor Johnson | Yes |
| Governor Kelley | Yes |
| Governor LaWare | Yes |
| President Parry | No |
| Governor Seger | Yes |

CHAIRMAN GREENSPAN. The next regular meeting date is March 28th, but we'll be talking, obviously, before then.

END OF MEETING