

Meeting of the Federal Open Market Committee

August 21, 1990

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, August 21, 1990, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Boehne
Mr. Boykin
Mr. Hoskins
Mr. Kelley
Mr. LaWare
Mr. Mullins
Ms. Seger
Mr. Stern

Messrs. Forrestal, Keehn, and Parry, Alternate Members of the Federal Open Market Committee

Messrs. Guffey, Melzer, and Syron, Presidents of the Federal Reserve Banks of Kansas City, St. Louis, and Boston, respectively

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

Messrs. J. Davis, R. Davis, Lindsey, Rosenblum, Siegman, Simpson, and Stockton, Associate Economists

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

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

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Ettin, Deputy Director, Division of Research and
Statistics, Board of Governors
Mr. Slifman, Associate Director, Division of Research
and Statistics, Board of Governors
Mr. Hooper, Assistant Director, Division of International
Finance, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of
Monetary Affairs, Board of Governors

Mr. Monhollon, First Vice President, Federal Reserve
Bank of Richmond

Messrs. Balbach, Beebe, Broaddus, T. Davis, and Scheld,
Senior Vice Presidents, Federal Reserve Banks of
St. Louis, San Francisco, Richmond, Kansas City,
and Chicago, respectively

Messrs. Fieleke, Meyer, Miller and Ms. White,
Vice Presidents, Federal Reserve Banks of
Boston, Philadelphia, Minneapolis, and New York,
respectively

Ms. Rosenbaum, Research Officer, Federal Reserve Bank
of Atlanta

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CHAIRMAN GREENSPAN. Good morning, everyone. We'll start with a controversial issue: approval of the minutes.

SPEAKER(?). So move.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Sam Cross.

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

CHAIRMAN GREENSPAN. Questions for Sam?

MR. HOSKINS. Sam, was the unwinding of the DM warehousing related to any collateral problems that we have with respect to notes? Why did the Treasury do that? What reason did the Treasury give?

MR. CROSS. Well, I think the Treasury is interested, as we are, in not having these [warehousing] amounts continue indefinitely and be too big. So, when the conditions were such that it was possible to make some arrangements in order to bring those holdings down, they were not reluctant or hesitant to do this. It's not envisaged as a continuous or perpetual facility.

MR. HOSKINS. Are we looking to bring ours down?

MR. CROSS. Our mark holdings?

MR. HOSKINS. Yes.

MR. CROSS. We don't have any plans at the present time.

CHAIRMAN GREENSPAN. Any other questions for Sam? This is the first time I recall in an extraordinarily long time when there have been no transactions. When was the last time there were no transactions during an intermeeting [period]?

MR. CROSS. Well, I don't think we had any intervention transactions in the last period.

CHAIRMAN GREENSPAN. We had to ratify some.

MR. CROSS. I'd have to look it up, but there hasn't been any exchange market intervention for some months.

CHAIRMAN GREENSPAN. Well, of that I'm aware. But quite frankly, it's the first time I recall in a very long time that there has been no [need for] ratification.

MR. CROSS. We'll check the date.

CHAIRMAN GREENSPAN. The same, of course, does not apply to Peter Sternlight's [area].

MR. STERNLIGHT. Shall I proceed?

CHAIRMAN GREENSPAN. Yes, please.

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

CHAIRMAN GREENSPAN. Questions for Mr. Sternlight?

MR. PARRY. Peter, what do you think the number of primary dealers will be a year from now? What is basically happening? I assume these pressures are not likely to get any better in terms of profitability.

MR. STERNLIGHT. Well, the experience of the opening five or six months of this year is a little better than last year. I wouldn't be surprised to see some further decline of several dealers. There are still more than enough, certainly, to serve our needs and the needs of the market. We got along nicely for a decade or so with a number that varied in the mid-30s, and I think that would be a very satisfactory kind of number now.

MR. PARRY. So we may get back to that?

MR. STERNLIGHT. It's possible that we'll have some further decline [in the number of primary dealers], yes.

CHAIRMAN GREENSPAN. Further questions? If not, may I have a motion to ratify the transactions since the July meeting?

MR. SYRON. So move.

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. We'll now move on to the staff report on the economic situation. I'd like first to call on Mike Prell.

MR. PRELL. Mr. Chairman, I was away the last three weeks and missed much of the excitement. For that reason I've asked Dave Stockton, who was here for it all to reach the exciting conclusion, to present the domestic side of the outlook.

MR. STOCKTON. Thank you. [Statement--see Appendix.]

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

CHAIRMAN GREENSPAN. Thank you. Questions for Messrs. Stockton and Truman?

MR. SYRON. In Part I of the Greenbook you talk about the revision in your inflation forecast and say that it's primarily because of the oil outlook. I was just wondering, since we did have some other figures that came in before that--this is an exercise of speculation, I realize--if you had been redoing the Greenbook and [the invasion by] Iraq had not occurred, what rough estimate would you have had in terms of the forecast for the change in inflation?

MR. STOCKTON. I think we were going to estimate something roughly on the order of .1 or so higher price inflation both in 1991 and 1992 as well, if we had not made other changes to the outlook path to offset that. The dollar obviously was going to be providing a little more boost to domestic prices. And the downward revision I mentioned that we have made to our estimate of potential output, and part of that is a downward adjustment to trend productivity, also would have implied a bit more pressure on prices than we previously thought.

MR. SYRON. Can I just follow up on that, in terms of the downward revisions? You revised down by 1/4 point, I guess, your estimate of potential. But the revisions we saw in the actual data were pretty disturbing to say the least. Were there any special factors that caused you not to revise down further? Or was it just that your model came out with about 1/4 point decline in potential given the data that we have? I was a little surprised that there wasn't a greater decline in potential, given that the unemployment rate remained the same.

MR. STOCKTON. This is a very imprecise calculation. But the important point to remember about the downward revision to potential output is that we extended that downward revision to potential output all the way back to 1980. Therefore, the cumulative effect on the level of potential output by the time we get to 1990 is quite large. Essentially, what we're trying to do is this: Every year when we receive the GNP revisions we try to feel around to [determine] what sort of underlying trend productivity would best explain the course of activity over the entire business cycle. In the absence of any particular reason for assuming that there had been a pronounced break in the growth rate of potential output just in the last two years, we essentially adjusted the entire path down extending all the way back to the previous peak. So, in terms of the level of slack one ends up with, while it appears to you that we just have revised down 1/4 of a percentage point in the last two years when the real GNP figures were revised down much more, that might have implied that even then there would have been somewhat greater slack. The cumulative effect of having revised that trend down over 10 years implies that [when] we get to the end the slack is not too much different, but we've--

MR. SYRON. How sensitive is your model to short-term changes in demographics--the composition of the labor force?

MR. STOCKTON. It's not sensitive to that at all.

CHAIRMAN GREENSPAN. What is a concern in a sense is that there's very little chance that the demographics are wrong in that you get pretty much the same pattern if you [unintelligible] the labor force or if you construct the labor force out of the payroll data and the insured unemployment. They both show the degree of tightness that has been exhibited by the sample surveys which, from the evidence that we see, suggests that this is not a statistical anomaly that's going to get revised next year.

MR. PRELL. We will be taking another cut at this when we get the revisions on the employment data next month. We may have something additional to report then.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I have two questions. Dave, at the FOMC information call Ted Truman gave us some useful rules of thumb about the effects of a change in the price of oil on real growth and also on the CPI inflation. It seems to me that the effects on inflation are rather substantial; I was struck by what you show as a very sharp decline in the fixed-weight deflator for the fourth quarter from 4.7 to 4.0 percent. I know the impacts on the fixed-weight deflator are different from those on the CPI. But even taking that into account, it seems to me that that is a very low number. Could you explain that and indicate what contribution oil is making to that number?

MR. STOCKTON. For the fourth-quarter fixed-weight number? Well, the principal reason the fixed-weight deflator does not show as large an effect as the CPI is that, while obviously we consume more energy than we produce, the weights for energy are several percentage points different in the CPI and the GNP fixed-weight. And that is the principal reason for the difference. There may be some slight differences in what we assumed about the fourth quarter as well. We have a very low increase from the federal sector in the fixed-weight deflator in the fourth quarter, which is helping to pull things down.

MR. PARRY. So, it's just across the board--smaller increases in quite a few sectors?

MR. STOCKTON. I would say that's true, with the difference in weights between the energy share in the CPI and the energy share in the GNP being the biggest factor.

MR. PARRY. Yes, I heard. The second point is that I was really struck by the Commerce Department revisions of compensation per manhour in the nonfarm business sector for 1989. In the period from 1984 through [the end of] your forecast the lowest compensation per manhour, excluding 1989, is 3.7 percent; in the forecast it's about 5.1 or 5.2 percent. During the whole year [1989] the increase was in the 2 percent area. It just seems very difficult to understand what happened in 1989 that would make those numbers believable.

MR. STOCKTON. Well, the first thing to mention is that, as Mike pointed out, we have not yet received benchmark revisions to the employment or hours data. We'll receive those in September. Typically, those [benchmark revisions] occur in May and June and by the time the revised compensation per hour figures would come out [the Commerce Department] would already have incorporated those revisions. They had to. And as a result, we really didn't even wish to discuss those figures in the Greenbook because we think at this point they are pretty meaningless.

MR. PARRY. Okay.

MR. PRELL. We don't want to offer you the great hope that that's going to eliminate all of the peculiarities in these numbers. This series just seems to move in ways that are inexplicable at times. And we think the ECI data are a more reliable guide than--

MR. PARRY. It certainly seems to be that way at this point.

CHAIRMAN GREENSPAN. The ECI data are far more comparable with the monthly average hourly earnings numbers; both the numerator and the denominator are comparable.

MR. PARRY. Yes.

CHAIRMAN GREENSPAN. I guess the revision would be horrendous on the compensation numbers.

MR. PARRY. I think so. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Let me compliment you on your report. I think you and Ted did an excellent job on what is a difficult situation to get a hold of. Our whole approach has been one of gradually opening up some excess capacity and hoping that that will dampen prices. To date, at best we've kept prices from accelerating. But if we disaggregate prices, we find more progress in the goods sector than we do in the services sector; and the goods side of the economy is more responsive to monetary policy. That raises a very fundamental question as to how much excess capacity one really has to open up in the economy to generate the kind of anti-inflation progress [we hope for] on the services side. I'm wondering, now that we are, say, a year and a half or so into this strategy, if the staff has given any thought to whether the whole thing is just more complicated than this fairly simple notion of opening up some aggregate excess capacity-- that it may not be all that simple and that the fundamental strategy may have some flaws to it.

MR. STOCKTON. I guess my basic reaction, of course, is to agree with your statement that the process is considerably more complicated than just opening up slack and having inflation change in some mechanical way. The labor markets are extremely complex phenomena, so it is going to be more complicated. On the other hand, I would look at events of the last several years as more a confirmation of that basic underlying paradigm than a contradiction. That is, wage inflation in particular had been on a downtrend through 1986 with the unemployment rate above 6 percent--really in some sense it was somewhere in the 7 to 6 percent range. As the unemployment rate moved below that, wage inflation turned around. And over the last year, we've had the unemployment rate at 5-1/4 percent and we've seen some mild acceleration. We have yet really to create, at least on the labor market side in our view, any slack that would be sufficient to reduce those trends. Now, another point that you made that I think is correct is that we have seen progress in moving [inflation] back down again on the manufacturing side as slack appears to have opened up in terms of capacity utilization. So, I think the recent events have been relatively kind to that particular paradigm, recognizing that there are developments in the agricultural sector, the energy sector, and movements of the exchange rate that at times clearly influence the pattern of overall price developments. But at this point I wouldn't see any compelling reason to abandon the basic paradigm while recognizing that the confidence [intervals] one can place around the estimates of what slack is or what any particular level of slack might actually lead to are quite wide.

CHAIRMAN GREENSPAN. Well, actually, the error here is in participation rates in the labor force. If you substitute historical forecasts of labor [unintelligible] participation rates, the unemployment rate opens up with the same growth. Presumably, the wage rate following previous patterns does precisely what the model would suggest. So I think the problem we're looking at in an arithmetic/analytical sense is: What is going on in the participation rates in the labor force that we do not understand? I'm not saying that's the sole issue but, unless we can answer that question, we're caught in the dilemma whereby at these growth rates we don't get any loosening in the system.

MR. PRELL. We also have to keep in mind the possibility that some of those phenomena that might be affecting labor force participation suggest that the unemployment rate may not capture all of the elements that are affecting wage behavior. If labor force participation is falling off because people don't feel the job opportunities are there, that's a somewhat different kind of slack in the system that could moderate wage increases. So, it's a very complex system. But I would underscore the point that there doesn't seem to be evidence contradicting the basic view that slack will diminish inflationary pressures. Indeed, there are few other channels available to us that would seem really to affect the inflation rate.

MR. BOEHNE. Well, there's a fair amount of history in this country and other countries [suggesting] that a recession will bring noticeable relief on inflation. But there is not a lot of evidence that suggests that this gradual approach of opening up slack but not having a recession will result in very much.

MR. PRELL. That's true because we haven't had extended periods of slow growth. So the question is: Is it the slack or is it the sudden shock of a decline that one sees in a recession that really explains that?

MR. BOEHNE. Right.

MR. PRELL. We noted that fact last fall when we had a presentation on inflation--that there was uncertainty about whether there was some sort of nonlinearity in the system.

MR. TRUMAN. I wouldn't want to overinterpret the information, but the current Canadian experience is that they have had slow growth for an extended period of time, not a recession, and their consumer price inflation has begun to bend down. The year-over-year rate has declined by about 1/2 percentage point. They have been helped, if you want to put it that way, by a depreciating dollar. I'm not sure how accurate that [linkage] is, but it is an example where a basic strategy that is essentially the same--maybe a little more so--seems to be producing some results along those lines.

MR. FORRESTAL. How long have they been following it?

MR. TRUMAN. They've been at it for, depending on how you count these things, about a year and a half or so.

MR. FORRESTAL. Longer than us?

MR. TRUMAN. Yes, a little longer. They've had slower growth; they have come down from a higher growth [rate] to [unintelligible]. So in some sense there has been more deceleration of growth in the period and their unemployment began to turn up in about the early part of this year.

CHAIRMAN GREENSPAN. But their unemployment rate was much higher?

MR. TRUMAN. Well, as I said, I don't want to overinterpret this. It is generally accepted that they have a much less flexible economy than ours and, therefore, their natural rate of unemployment should be higher. Their market mobility and so forth is tighter and they have complicated laws; that is one explanation for why they started out with a somewhat higher inflation rate.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. The budget deficit numbers that Peter mentioned, particularly the \$300 billion, are a little higher than I had heard. That is a combination of lower revenues and higher expenditures, I presume. On the expenditure side, is it mainly the RTC-related expenses or are there other categories that are also going up? If you take that higher number, is there any way that we can finance that without having big upward pressure on rates?

MR. STERNLIGHT. Maybe I shouldn't respond because I haven't seen official estimates on that anywhere in that area. But as I said, that assumes a soft economy--skirting along the edge of recession or in some of the private estimates an actual recession--so there is definitely a weakening of revenues. No budget package had the thrift bail-out expenditures greater than in this current fiscal year.

MR. PRELL. Let me try to put this in the perspective of our forecast. For fiscal 1991 we have a \$35 billion deficit reduction. That's smaller than the \$50 billion they still are talking about but perhaps some of the people who are concerned by recent developments would think that maybe even \$35 billion is in question at this point. As Dave indicated, just before the last meeting all the talk was leading us to think that maybe \$35 billion was too pessimistic. At this point, it looks like a healthy adjustment given the political situation. But if you take some of that out, we could begin to move closer to a \$250 billion deficit, including \$70 billion of RTC-related [expenditures] in fiscal 1991. If you overlay on that a weaker economic picture--say, with no growth or a mild recession over the next year--then it could easily move toward the \$300 billion level. So this discussion of a \$250-\$300 billion deficit is not inconsistent with the kind of picture that we've depicted in the Greenbook.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Well, Si Keehn just asked my question about the budget, but perhaps I could also ask Ted about the \$25 oil price assumption. Does that assume increased production by the Saudis?

MR. TRUMAN. Yes. As Dave said, we assumed essentially a shortfall of 4-1/4 million barrels a day from Iraq and Kuwait. And then we assumed an offset of 2-1/4 million barrels a day. Partly just

because we felt it was useful to write down figures so we could in some sense check our assumptions--and I emphasize assumptions--later on against the realities, we assumed 1-1/2 million barrels a day in Saudi Arabia, [300,000] barrels a day in Venezuela and 200,000 barrels each, I think, in UAE and Nigeria just to spread it around.

MR. FORRESTAL. Also, in your description of the real GNP targets, you said something about a 50 percent decline in--

MR. TRUMAN. No, 50 basis points.

MR. FORRESTAL. I'm sorry, a 50 basis point decline in the funds rate. I didn't quite catch what you said. Could you say that again?

MR. TRUMAN. Well, in order to achieve this real GNP target, the model made us, if I can put it that way, reduce the funds rate by 50 basis points in the third quarter. That was sustained and then gradually the gap between that and the baseline [unintelligible]. I should emphasize [unintelligible] we're dealing in a quarterly model, so we moved Iraq back to [3.0 million barrels per day] in some sense.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Let me go back to the budget. In looking at developments in Iraq and Kuwait and trying to understand the economic consequences of that in the forecast, the one thing that surprises me is that I, at least, don't catch anything on the military outlays and what that is likely to mean for the outlook.

MR. PRELL. Well, I think you're correct. There isn't much in here. We have really a trivial increment to defense spending in this forecast over the next few quarters, partly consistent with the oil price assumption that things are presumably--

CHAIRMAN GREENSPAN. Well, one thing that is happening is an increase in the cost of fuel and bottled water.

MR. STOCKTON. Some chartered airline flights as well.

MR. PRELL. I think there is also some effect on suntan lotion prices--the sunblock effect! At this point, it seems largely to be a matter of taking some things out of inventory, shifting expenditures, and so on. If this results in major deviations from what we had anticipated in overall personnel and additional munitions and [supplies], if we maintain a significant presence in the Middle East over the coming quarters, then we might begin to talk about at least several billions of dollars. One could read into comments made by the President yesterday that some of the defense reduction that people had been looking for might not be achieved. That then perhaps would begin to chip away at our fundamental fiscal assumptions. So, there is clearly upside potential here on the fiscal front for some lesser restraint than we have embedded in this forecast. I think that's a clear risk.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. Your answer on the defense spending is that the increment is less than a couple of Texas S&Ls, presumably?

MR. PRELL. That's true.

MR. MULLINS. I'd like to get some insight, Dave, into your view of consumer spending. You mentioned that the second-quarter retail sales were a lot better than we initially had thought and that one reason was that when you start from a small enough base it looks a lot better when it comes up to--I guess it was minus .9 for the quarter and was marginally positive in July. You mentioned in the projection that household real consumption will fall but not quite as much as the reduction in real income. Why did you make that assumption and how do you feel about the impact of this event on consumer confidence and whether consumers view this as transitory or more permanent?

MR. STOCKTON. At this point we made the assumption that most but not all of the decline in real income is reflected in the consumption in the second half because we assumed that some households will be uncertain about the permanence or transitory nature [of the decline] and probably will be assessing and adjusting their consumption plans accordingly. That is, some households clearly will think that this is transitory and others that it is permanent and that combination will result in only a partial reduction in consumption in response. I should say that the reduction in the saving rate that we have as a consequence of this is pretty small; we have taken most of the reduction in real incomes out of consumption. On the goods consumption side, things have been quite weak and we expect them to get weaker in the second half. If you look at the past year and take that as the underlying trend relative to the second half--which shows the averages through the ups and downs of the automobile sector in the third and fourth quarters of last year as well as early this year--the place where we would expect to see a particularly sharp hit is in the automobile sales area in the second half of the year. The only support that we really are getting in consumption is on the services side, where in our view it's a little harder in the short run for households to adjust consumption of housing services or medical services to fluctuations in income. And that in essence provides somewhat of a base on the consumption side on which we get relatively meager increases--about a percentage point in the second half--in consumption growth.

MR. MULLINS. What are the chances that this, on top of the other shocks we've had to consumer confidence in residential real estate values and the like, really could cause consumers just to put their pocketbooks away for a while?

MR. STOCKTON. I guess that is clearly a risk in terms of the projection. As we reported in yesterday's briefing [to the Board], we did receive some weekly information from the University of Michigan on consumer confidence. That showed a very precipitous fall-off in the few days right after the Iraqi invasion of Kuwait and then some rebound throughout the course of the last couple of weeks to a level that is still below where it was prior to the invasion. But it is not an astronomical fall-off at this point.

MR. MULLINS. But do you think that evidence would be roughly consistent with what you forecast in the Greenbook or marginally more pessimistic or--?

MR. STOCKTON. Given the accuracy with which one can use those survey data to predict consumption--and the link is very, very weak--

CHAIRMAN GREENSPAN. You do have a proxy that is almost as good and probably even better than that, which is the 10-day [auto] sales figures. In a period like this, to the extent that you get consumer shock, it is going to show up in those numbers. Indeed, if you believe our seasonals, as distinct from BEA'S, there was really quite a significant fall from the last 10 days of July to the first 10 days of August. Was it 6.1 on our seasonals?

MR. STOCKTON. 6.1 or 6.2. The 10-day auto sales figures have the advantage of being very timely. They have a disadvantage, of course, in that they can move around for reasons of seasonal adjustment problems or other reasons that make them a little difficult to interpret. We did call around to auto dealers in the wake of the price increases and didn't pick up any major stories about a significant reduction in showroom traffic, so--

MR. PRELL. There has been a consistent drop-off from the last 10 days [of a month] to the first 10 days in these seasonally adjusted figures.

CHAIRMAN GREENSPAN. [On our] seasonals?

MR. PRELL. I think on ours as well. I just don't think we've found a way of capturing the pattern, particularly in the transplanted sales. They have this tendency to be very strong in the final--

CHAIRMAN GREENSPAN. Well, I'll wait for the second 10 days.

MR. MULLINS. I think it's pretty reasonable that people might not want to buy a car.

MR. PRELL. Well, it's not entirely clear. We have looked at the historical evidence on these oil prices, and whether people don't buy cars or whether they shift the kind of cars they buy is not as clear as one would think.

MR. STOCKTON. One of the reasons that we delayed the fall-off in auto sales in the projection is that we think, almost no matter what happens to automobile demand, that the auto makers at this point will make it through incentive programs [unintelligible] to clear out the 1990 models. And that helps hold up sales a little in the near term; but by the fourth quarter we show a bigger fall-off.

CHAIRMAN GREENSPAN. They don't have much inventory.

MR. STOCKTON. They don't have much in inventories and that [unintelligible] they won't have any buyers. Our current assumption is that there isn't going to be a precipitous fall-off in sales in the near term that would require them even to have to go through some kind

of major increase in incentive programs. But if that were to occur, it seems quite likely that they would use incentive programs to [work off] whatever inventories they needed to.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Yes, I want to get back to your simulation. If I understand it right, you have a neutral policy going forward to generate essentially the same nominal GNP. It's just that the components would differ; you would have lower output and higher inflation. You open up slack in the economy and the inflationary surge is temporary. You say that you don't take account of expectations; you haven't talked much about that. I think one could argue that with interest rates going up around the world--every place, really, except the United States--we could see a deterioration in inflationary expectations. My question is: What do you think about that? And secondly, what does that do to your real forecast?

MR. TRUMAN. Obviously, the neutrality of oil prices is a feature of the model. Whether or not it's a feature of history, at least it's captured by the model. And there's no particular theoretical reason why that necessarily has to prevail at least to the degree it has; maybe it [unintelligible]. As far as the model goes, you're correct that there are not forward-looking expectations in the model, though it's not quite clear to me in this world with which we are dealing what you would ground forward-looking expectations on because you have to have expectations about, among other things, the oil price scenario itself. And, as has been discussed, that could go a variety of different ways. When we ran the simulations, we did adopt at least, again as a mechanical feature, slightly different monetary policy assumptions abroad. And that does produce some depreciation of the dollar and gives us some impetus to consumer price inflation from that source. So it does wash through this way; you don't get a very dramatic impact. As I tried to lay out our judgment about policy responses, I'm not so sure that other than in Japan we are going to get any particularly pronounced policy responses. I think it is true that the market is expecting a more--and I should underline "a more"--vigorous resistance to inflationary impulses from the Bundesbank at this time. Our judgment is that the market is wrong or maybe overdoing it. And in some sense, that's what we built into the forecast. To the extent that we do get more [policy restraint] abroad, then we would have a more vigorous resistance to the inflationary impulses from higher oil prices. I think that would manifest itself in the first instance in exchange rates, and that clearly is a risk to the forecast.

MR. HOSKINS. Let me follow up: Assume that inflation expectations got worse and go back to the real side of the economy. Presumably, you'd be forecasting higher unemployment?

MR. PRELL. Well, it depends on your--

MR. HOSKINS. Right. Well, suppose we don't accommodate those expectations.

MR. PRELL. In a sense, the only thing that would change is inflation expectations and that would drive down perceived real interest rates. That would affect demand for goods and services in a

stimulative way, conceivably. It's a very complex process and it's going to depend on your response to those--

MR. TRUMAN. Well, I think the point you're getting to is that if you drove that process far enough, that would be one interpretation. It might even be minor. But in the 1970s process it would result in circumstances in which, although in the short run the mechanics of the model would generate lower real interest rates and so forth and so on, in the longer run you would have a higher built-in level of inflation and all the associated dislocations that we believe underlie that. So it could get us on a higher plateau of inflation [and a lower] long-run potential of the economy under those circumstances [than we] would assume, even though in the short run it might have stimulative effects as Mike described.

MR. PRELL. I think the third alternative illustrates this to a degree by showing the higher level of inflation that we would have.

MR. TRUMAN. So it's relatively optimistic because, as Dave said and as President Boehne's question implied earlier, in some sense the fundamental forecast accepts that the amount of slack that's built in the underlying forecast--given no further shocks from further oil price increases--is enough to begin to bend down inflation. But it's postponed and it's at a higher level.

MR. KOHN. If you moved to contain nominal GNP growth under that alternative, two things would be pushing up nominal GNP growth--both prices and output. And if you tried to hold nominal GNP growth, then you'd have more price with the adverse inflation and [unintelligible] less real growth for that nominal GNP growth.

MR. HOSKINS. Well, I agree with what you said. I guess what I'm getting at is that markets may now behave somewhat differently with respect to expectations perhaps than they did in the 1970s in that they in fact are not fooled. And when we have higher real rates, the implication seems to me to be higher unemployment quicker. And if we want to avoid going back to the 1970s [experience], one policy response would be to signal the markets that we're not going to accommodate it and in the long run that could lower our costs [unintelligible].

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I have a different question about what I guess I would call a worst-case scenario or "what if" games. Did you try in your model to see what the impact would be if we had one of these horrendous sequesters that I hear kicked around town--if they knock off \$100 billion and send pink slips to the federal employees and things like that?

MR. STOCKTON. We have not yet run through the model something as acute as a sequester of the size that could occur under current legislation. The reason we have not yet done that is that the dislocation would be so enormous that at this point it's very difficult to imagine politically in the weeks before the election that either the Administration or the Congress would wish to have a sequester of \$100 billion, which is about the size that we're talking about here, go into effect. In fact, at the mid-session review Mr.

Darman issued a report outlining all the things that would occur if this sequester were to go into place, including that 30 percent of the prison guards would be sent home and people would be let out of jail because there wouldn't be public defenders and they couldn't get access [to the courts]. It just seems so extreme that I guess we feel fairly comfortable that something will occur in the time [before] the sequester to delay, if nothing else, our decisions until after the election.

CHAIRMAN GREENSPAN. You will admit that the government would improve under such conditions! [Laughter.]

MS. SEGER. What is the decision date for this? Is it by October 1 that something has to be done under Gramm-Rudman? Is that the magic time?

MR. STOCKTON. By October 1st they have to issue their sequester report and by the 15th, I think, the cuts actually have to be in place.

MS. SEGER. With the existing Gramm-Rudman law, what would it take to derail it? Is it a forecast of two quarters of real GNP growth below 1 percent?

MR. PRELL. A forecast of recession or the experience of two quarters of less than 1 percent growth.

CHAIRMAN GREENSPAN. And we're not going to get less than 1 percent for Q2 and Q3.

MR. PRELL. Either OMB or CBO, I believe, can make that forecast.

CHAIRMAN GREENSPAN. Are you sure about that? Are you sure that CBO could unilaterally, by just an arbitrary forecast of a recession, derail Gramm-Rudman?

MR. STOCKTON. It doesn't derail it; it simply allows Congress--

MR. PRELL. It allows for a suspension.

CHAIRMAN GREENSPAN. In other words, it automatically puts a vote on the table for suspension?

MR. PRELL. I'm not sure that it's automatic, but it does provide for the Congress to temporarily suspend [the Gramm-Rudman cuts]. They have to make that decision.

MS. SEGER. My second question in regard to worst-case scenarios involves oil prices. Having remembered the difficulties of the 1970s and 1980s in getting even the direction of oil prices right, what would be the impact on the economy of, let's say, a tremendous additional acceleration in oil prices to \$35 a barrel because the Iraqis also take over Saudi Arabia or some other major producer? Have you tried any of these scenarios in your model? I'm not saying these are terribly likely outcomes or high probability assumptions but--

MR. TRUMAN. Well, there are some nonlinearities involved in this, but in that range the models will tell you that you would get proportionally the same kinds of responses or a little more. Instead of losing 1/2 percentage point of growth, we would lose another 1 percentage point plus of growth over the next four quarters--at least abstracting from the dislocation effects, which I would argue and I think you would argue probably would be there. So, the models would suggest that a \$35 oil price rather than a \$25 oil price for a sustained period is going to cut another percentage point or more off of growth. And given the level of growth that we have, that would put us near zero or below. We all know that when we make up numbers, a smooth forecast will show something like zero but that probably is going to mean several quarters of negatives--on that order of magnitude.

MS. SEGER. What else could we face that would throw our forecast into the trash can?

MR. PRELL. Put it in the file cabinet? [Laughter.]

MS. SEGER. Trash can is more appropriate.

MR. PRELL. There always are innumerable uncertainties. I think we've just layered over the normal ones. There are some very, very big imponderables at this point. I might just say--and this might seem silly normally, but just to close the loop entirely on this Gramm-Rudman issue--if there were a declaration of war, that would suspend the Gramm-Rudman [provisions].

CHAIRMAN GREENSPAN. And the probability of that is not zero.

MR. PRELL. That's why I raised the point. It's not inconceivable.

MS. SEGER. Well, thank you for playing my game with me.

CHAIRMAN GREENSPAN. If there are no further questions, who would like to start the Committee discussion?

MR. GUFFEY. Mr. Chairman, I would like to ask a question of the staff with respect to the forecast that has been laid out. To give us the export numbers that are contained in the staff's forecast, it seems to me that the forecast assumes that growth in other industrialized countries will continue fairly strong. I know there has been discussion of it already, but given the uncertainty about the oil situation and the reactions of Germany and Japan for example with respect to their interest rates, how comfortable are you that we will maintain exports at the level that you are projecting?

MR. TRUMAN. Well, that's one of the conditional dimensions of the forecast. We're reasonably comfortable, given the particular oil price scenario that is built in here. In the baseline scenario we think there would be a spurt in inflation, some reduction in growth, and some reduction in exports in the short run--over the next several quarters. But then these economies--at least the continental European economies and Japan--in general would be relatively robust. There is still the phenomenon of rebuilding in eastern Europe and East Germany that is driving those economies and it should help sustain exports.

In Japan in particular, as I mentioned in my presentation, there has been quite a lot of rise in short-term nominal interest rates, so they call it monetary restraint and as always there's a question of calibrating the extent that that is going to bring about adjustments. And the big drop in the stock market in Japan [unintelligible] as well. So I suppose we could see--it's not outside the realm of possibilities--half the growth that we now expect in Japan. That would have some implications for the forecast. But I think it's no more uncertain than anything else that we put before you in this export [unintelligible] policy.

CHAIRMAN GREENSPAN. Who would like to start off? Si.

MR. KEEHN. Mr. Chairman, reporting first on the conditions in the District prior to the Middle East events, I must say I certainly was surprised, positively, by the resilience of the Midwest and the ability of the District economy to rise above the national trend, at least so far. Certainly, the GNP revisions reduced our baseline forecast at least somewhat, but pre-Middle East events we continued to have a positive expectation for the economy. We forecast continued improvement this year and into next year.

I have a couple of specific comments. The steel business continues to be good. A company I talked with is currently operating at a level of 85 percent of capacity; their order books are full for the third quarter; the fourth-quarter orders are coming in well; and they have not experienced the normal summer slowdown that they generally do each year. They continue to look for shipments this year of 83 to 84 million tons, which is about equal with last year. And even prior to the Middle East events, there was something of a boomlet going on in steel used in energy-related activities. Demand for sheet and bar continues to be good. The only significant change in their order book is that they do see a downturn in the demand for heavy structural items that would go into commercial construction. Recent price increases in the steel industry have been sticking, but on average they are still at this time some 6 percent under last year. In the construction area, on a year-to-date basis both nonresidential and residential construction in the District have been comparatively strong. We've had plus numbers in both categories versus negative numbers on a national basis. And just one item, the backlog for cement shipments, currently is running some 40 percent higher this year than last year, at least for one shipper. But having said that, I do sense in a more current perspective that there are not only postponements of some major commercial projects but some outright cancellations. I think within the last couple of weeks even in the Midwest there has been a change of attitudes there. One supplier to the commercial construction business tells me that their attitudes are rather worse now than they have experienced since 1981 or 1982.

The auto business continues to be a sector of enormous uncertainty. But I did talk to one company as late as last Friday and they continue to hold to a sales forecast for cars and light trucks together of 14.4 million for this year. And they're looking at 14.3 million for next year. While those numbers, at least in my eyesight, look pretty good, their baseline number is 15.4 million. So, when they're under that baseline number by that amount, they think conditions are pretty negative. Third-quarter production schedules this year are up 17 percent over last year; fourth-quarter schedules

are up 10 percent over last year. But, clearly, the production risks at this point are on the down side. And even this late into the third quarter the projected pickup of 17 percent is likely to be erroneous. Meanwhile, auto dealer attitudes are very negative. One would expect some pickup in orders because of the possibility of a strike; despite that, dealers just aren't ordering cars. But again, for the company that I talked to, 27 percent of their dealers are operating at a loss, which accounts for the negativism. The heavy truck business is bad. One manufacturer we talked to is looking for shipments of class E trucks, the heavy trucks, this year of 125,000 units; that's lower than others that are at 133,000 to 135,000. Again, that's against the baseline number of about 160,000. So, clearly, they're having a very bad year.

In the agricultural sector, growing conditions continue to be very good, but because of late plantings and the reasonably cool summer that we've had so far, crops are a bit slower [coming in] than normal. The yield is going to be determined largely by the timing of the first frost. If we have a reasonable break on that first frost, production could be excellent and, indeed, farm income will be high. There's a shot at least at having a record farm income.

With regard to credit and lending conditions, I continue to think that this is really a phenomenon caused by the banks themselves going through a self-correcting process. I think they've raised their lending standards. But even with the increases in C&I lending by the District weekly reporting banks lower this year than last, the numbers are nonetheless positive. And C&I lending by small banks in the District is higher this year than was the case last year. So, maybe we're seeing a bottoming in this trend--at least in genuine C&I lending, taking out merger-related activity and the like. I am reassured by the bankers that for good credits--they do emphasize the word "good"--there is plenty of money available. But they do all say that they have raised their credit standards.

Shifting to a post-Middle-East-events comment and a look at the national economy, I think it's just too early to assess the damage that we're likely to experience. Having said that, I haven't talked to anybody so far who specifically has changed their business pattern or what they are doing in the way of operations. Some companies are going through their capital budgets, but there are some contradictory [comments] on that. Some companies are planning to pull back on their capital spending programs, but I did talk to one company that's doing quite the opposite. They are now in the process of accelerating their capital spending because they sense that the level of inflation will be higher and, therefore, they want to get their expenditures in before that occurs.

Now, I continue to have a feeling, at least in an intuitive sense, that the economy is operating at a very moderate level and that the Middle East events certainly are a negative in all this. But it's awfully hard to judge the outlook at this particular point. And, therefore, certainly in the monetary policy sense, it's a very awkward period.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, in the Twelfth District, employment growth continues to exceed that of the nation, although the rate of growth has slowed more in recent months than has been the case in the nation. For example, if you go back a year ago, our growth of employment was about 1-1/2 percent more than the rest of the nation; now it's running a little under 1 percent more. Following the national pattern, employment in manufacturing and construction has fallen in recent months, but it has fallen at a rate that is less than half that for the rest of the nation. Growth of trade and services industry employment is below that of a year earlier, but the growth rates continue to be in the area of 3 to 4 percent, which are not bad increases. Agriculture is performing well in the District as a result of high crop prices and yields and also high livestock prices.

If I can turn to California, since California got some attention in the Greenbook as well, economic growth has slowed from last year's pace; there's no question about that. But the state's employment is growing at a steady rate of just under 2-1/2 percent on a year-over-year basis. Defense and aerospace layoffs are [slowing] and will slow economic growth. But even in LA and San Francisco, where the bulk of the layoffs will take place, the loss of jobs in these sectors will be small relative to what are expected to be healthy gains in other nonmanufacturing sectors. Real estate activity is slow. There's no question that sales and permits are off significantly. Median home prices indicate the drop in home prices but, as was indicated in the Greenbook, most of the decline reflects a shift in the composition of sales to lower priced areas, particularly Sacramento, Riverside, and places like that, and also to smaller homes.

Turning to the national economy, although the risk of recession certainly is real, the upward revisions in retail sales for May and June, the June drop in the inventory/sales ratio, and the favorable report on June net exports are certainly encouraging. It appears as though, with a better balance between inventories and sales, positive real growth in the second half is quite likely. Although the Greenbook's oil price assumptions are reasonable, I believe that the effect on inflation in the second half of the year will be larger than that indicated in the Greenbook. In addition, the impact of higher oil prices in stimulating business investment could turn out to be a bit greater than implied in the Greenbook forecast. Finally, although a future drop in oil prices is assumed and certainly would help to moderate inflation, I don't think we should forget the effects of the dollar depreciation, which has been quite substantial. The latter, plus continued upward pressure on wages, should prevent a significant decline in inflation next year. Thank you.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. In the Atlanta District, Mr. Chairman, with the exception of exports, the tone of the reports that we're getting is very, very negative. The list of the weak or the weakening sectors that I talked about at the last FOMC meeting is unchanged. And I suspect from reading the Beigebook that these weak areas are very much the same as those around the country. Construction activity is particularly sluggish at the present time and, unfortunately, there is a large unoccupied stock that will have to be worked off before any new activity is justified. I don't hear very much about the [credit]

crunch anymore. Clearly, the banks have tightened their underwriting standards. What we are seeing, though, is a decline in consumer loans rather than construction loans. And I suspect that that's more a function of demand than supply. Before the Middle East problem arose, the oil and gas business in the District was beginning to expand, but the industry has been constrained by labor shortages. The workers have left the area, particularly Louisiana and the Mobile area, and are not returning. At the moment it's still too early to tell how much stimulus the oil component sector will get from the recent price increases. The important regional industries that are maintaining their level of output are doing so only because their exports are replacing domestic sales. And in this category I certainly would include wood and pulp and paper producers. Agriculture is strong in the District, and sales of farm equipment are rising pretty rapidly both because of a good year domestically and also because of rising export sales. In an overall sense, the slowdown may be a little more pronounced than it was in July, but I don't see any new areas of weakness emerging.

One other comment that I picked up from a number of contacts, particularly people in small businesses, is that they are seeing a growing problem with receivables, which have been much harder to collect. As a result, these firms are in effect financing these slow-paying customers. Sentiment is very negative, I would say. And, Governor Mullins, consumer confidence is very low in our District--and it's getting lower as a result of the Kuwait and Iraq situation.

With respect to the national economy, I find myself in agreement with the Greenbook generally. In the interest of full disclosure, I would say my staff is a little more bullish on consumer spending than I am. I must say that I am increasingly pessimistic, and I was pessimistic before Kuwait, about the budget accord. I would like to think that something will happen, but I'm not at all sure that's going to be the case. Overall, I think that we may avoid a recession; but I am more concerned about our falling off the edge than I was at the time of the last FOMC meeting.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, as seems to be the case for the nation as a whole, economic conditions in our region are showing signs of slowing. There are special factors here and there that keep the overall growth numbers positive. After fairly strong employment gains in the first quarter of the year, our three-state District would have experienced employment losses in the second quarter had it not been for a strong growth in government jobs. Our manufacturing employment had been growing slightly while conditions nationally deteriorated. In the last few months, however, manufacturing employment has declined in each of our three states. Weakness has been concentrated in transportation equipment--mainly defense-related--apparel, and electrical equipment. While employment gains were experienced in chemicals and petroleum refining, we expect some slowing in these industries with the higher price of energy-related input. Employment in the services sector has been extremely weak outside of government employment. The government employment gains were for all government entities and were not just related to federal census workers.

In private services, the main areas of strength were in transportation and public utilities, both of which will be adversely impacted by higher energy prices. The one area where higher energy prices should help the District economy is in drilling activity, but any positive response that does occur will be with a long lag time. First, inflation-adjusted oil prices are only about half the peak level reached in 1981, and the rig count is highly correlated with real oil prices. Second, almost half the drilling activity in the Dallas District is for natural gas which has a long way to go before gas prices catch up with oil prices. Third, drillers have to be convinced that higher energy prices will persist for several years. And lastly, even if everything on the price side fell in place--and as Bob Forrestal found out--we simply do not have the capacity to increase drilling activity since about half of that capacity exited the industry over the last four years. I did see on local TV that they reinstated a rough-neck school out in west Texas to teach people how to drill oil wells. So, somebody has a little optimism. In the short run, the negative effects of higher energy prices in the District will predominate over the positive effects. I might add, however, that the weak picture for retail sales that has existed lately should be helped somewhat by the sharp boost in royalty and partnership income which is proportional to oil prices.

Following the Iraqi invasion of Kuwait, we did do another round of Beigebook contacts. As a result, the anecdotal evidence has shifted from [an outlook for] slow but steady growth to one of great uncertainty. Even the focus of agriculture down our way has shifted from too little or too much moisture into marketing uncertainties in the new environment. With respect to the national picture, I really don't have views that would be considered different from the Greenbook forecast.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Well, since we met in July there has been some further softening in an already soft Philadelphia District economy. The sluggishness is widespread, including manufacturing, retailing, construction, and capital goods. Some areas of the District that have experienced labor shortages for the last several years now report the number of job applications rising. And in banking, I sense that our loan problems, which heretofore have been concentrated largely in New Jersey, are now floating across the Delaware, much as George Washington did some years ago. And I think we're going to see some of those loan problems in Pennsylvania as well. The chemical and plastic firms are the two that I have talked to most, and both of those industries already report substantial cost increases from the Middle East problems. I also noted that attitudes have turned very, very cautious. For the first time in a number of years I'm hearing more talk about recession in the outlook and, although I think that is still a minority view, it's a growing minority view.

On the national outlook, my sense is that we probably will see some negative real GNP by the fourth quarter. Before the Middle East shock, we had increasing downside risks stemming from weakening demand in most sectors and tighter credit conditions. And with the Middle East problems, I think we'll have still worse downside risks. My hunch is that the Greenbook is underestimating the negative impact on consumption. I think that consumer confidence has been on thin ice

for a while and with the cumulative impact of economic concerns that were building, and as this Middle East situation drags on, I think we will see more of a negative impact there. And that's going to affect business confidence as well. I think the key issues for us are: How much slack is enough and how much downside risk are we willing to tolerate to provide a reasonable prospect of keeping the impending bulge in oil-related prices from working its way into the core rate of inflation? And that's the next part of the meeting.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Mr. Chairman, the gloomy news continues to track the people from the Northeast. The New England economy, I think, has continued softening at a somewhat faster rate than it had before--even in the pre-Saddam period. That will be exacerbated to some extent by the Middle East problem--at least in terms of peoples' expectations--in that as a share of energy provided we rely about 50 percent more on petroleum than the nation as a whole. But the number of BTUs per dollar of output is only about 80 percent of the national output. So, it tends to offset itself somewhat but not completely.

In the District, the most pressing immediate issue continues to be a further softening--and almost a free fall in some parts--of the real estate market. I don't know whether you've sold your house or not, David. While we haven't heard anything about it yet, the oil situation could have an impact on vacation homes similar to that in 1973 and 1979, when people did not want to buy them because of concern about the greater cost of getting to them, and that's why we had a lot of softness in condos. At that time--though it isn't true this time--there was a concern about the supply of fuel to get to vacation homes. Even before this came up, though, we really had a quite poor tourist season.

Construction employment, of course, has fallen very strongly, but it still has a way to go. Even though the level of construction employment has fallen very significantly, it is still above the 1981 level; so we think that will continue to be a drag. Beyond that, we've seen weakness now spread to the services and trade sectors. In the trade sector particularly, we've seen fairly significant declines in employment. As for consumer confidence in the region, the Conference Board data show that even before this oil situation confidence had fallen 55 percent July-over-July. I don't know how good these regional measures are, but several months ago New England was the only declining region. Now it's striking that only three of the nine census regions--relatively small regions at that--show an increase in confidence.

In terms of the less dim, if not bright, areas of the region's economy, I'd have to say that's in manufacturing exports. I find a quite distinct pattern for manufacturers between their domestic business and their export business. For the domestic business, our survey shows them about flat to down 10 percent; but their export side is up about 5 to 20 percent. Interestingly, and I think this reflects something that Bob Parry said, we've started to see some turndown--and we have secondary suppliers--in the aerospace industry and we've started to be greatly concerned about how soft things are. But we're beginning to see some hope that defense cutbacks won't be as great [as anticipated]. In fact, at Raytheon, one or two contracts have been

continued that were expected to be dropped. Credit availability continues to be much talked about and I think is a somewhat broader problem. A relatively small thrift operator came in and said he has told his loan officers: "If it isn't gold, don't bring it in to me." I don't say that that's a particularly widespread view, but I think it reflects something about the people in general working out problems.

As far as the national economy goes, it's far too early into this whole situation to know what the impact is going to be in terms of disruption. We need to look at things in terms of before Saddam and after Saddam. My own reaction is that I am quite struck by any overreaction to it. I'll admit that I was struck by the revisions on the GNP numbers--that what we saw when they came out [differed so much] from what [we thought] had happened before. And on the basis of that, I myself have some concerns about confidence and a little concern that the Greenbook forecast might be a bit on the strong side, actually. However, I also have--maybe it's a reflection of being a [unintelligible] from the Northeast--an increasing concern about this issue of financial fragility in almost all of our large institutions. Thus, on balance, I would have thought the economy seemed somewhat softer before the Iraqi business, though perhaps not to the point of dictating a policy change. I don't know if we know enough yet to determine what's going to happen. With the degree of [military] buildup that we're going through, it seems to me entirely possible that--even short of an absolute shooting war--before too long we could get to a point where we will get some stimulative effect on the economy, particularly if the reserves are called up. We have had, as everyone has, some reserves called up already in our District. I also am somewhat concerned about the patterns in consumption and the steepening of the yield curve in the context of the international situation. So, I think the discussion in the policy section is going to be very lively indeed.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Well, as far as the District goes, it's more of the same. Growth is unspectacular but it's steady. We continue to do a bit better than the nation; of course, that's not a very remarkable statement these days. But most of what has been happening in the District reflects a continuity of what has happened over the last several months. Agriculture remains good; tourism has been good; most of the natural resource related industries are doing well; and the diversified metropolitan areas continue to do well, all things considered. I would say that we're not likely in my District to continue to outperform the national economy much longer, but at the moment anyway things are still going a bit better than at the national level. The run-up in oil prices as a result of Iraq and Kuwait occurred too late to stop the bikers from descending on Sturgis [unintelligible]. So that turned out to be a successful event and injected a lot of income into the South Dakota economy.

With regard to the national outlook, somebody used the word "dilemma" earlier and I think that captures it. Even before the invasion of Kuwait, we were looking at slow growth and we were looking at that simultaneously with a lack of progress in bringing down inflation. And it seems to me if that was the dilemma, it has only been sharpened by what has happened in the Middle East. Obviously, I can't assess magnitudes, but I think it's fair to say the dilemma has

been sharpened. My own judgment is that on top of all that--and one could probably point to some other things that have gone wrong--the likelihood of any progress on the budget has diminished as a consequence of this. I would guess, although this is a double-edged sword, that we will see some kick to military spending before this is all said and done. Now, that may help the real economy a bit, but I just have a sense that there's an awful lot of turmoil out there and that the dilemma, as I say, has worsened.

CHAIRMAN GREENSPAN. Vice Chairman Corrigan.

VICE CHAIRMAN CORRIGAN. Well, first of all, in terms of the national outlook, I think the staff has done as well as anybody could possibly do in terms of trying to capture what might happen and what the contingencies are. For what it's worth, both our baseline forecast and our alternative forecast are really quite similar to the kinds of things the staff is talking about. About the only material difference is that in the next two quarters we probably have the real economy a bit softer and the inflation rate a bit higher. But over the forecast period as a whole, the numbers both internally and externally (on trade) are really quite similar to the staff's baseline forecast. There are multiple risks. In the very short run the greatest risk or uncertainty, of course, is that the Iraqi situation will turn into a shooting war. I've talked to some people who know something about the oil infrastructure in that part of the world and the impression I get is that even if it were a very short armed conflict, a guy like Hussein could do one heck of a lot of damage in a very short period of time to the oil infrastructure in terms of pipelines and that type of thing. So, again, even if a shooting war were very short and very decisive for the good guys, the damage that could be done to the oil infrastructure in a matter of days is quite substantial, I gather.

CHAIRMAN GREENSPAN. It's all concentrated in a relatively small area south of Kuwait.

VICE CHAIRMAN CORRIGAN. All the pipelines I gather are above ground even when they're far removed from Iraq or Kuwait itself. So, they are just sitting there. And the potential for substantial damage when you have a crazy guy like this guy is quite real.

CHAIRMAN GREENSPAN. When you say crazy [unintelligible] get it back to work and functioning within a year.

VICE CHAIRMAN CORRIGAN. All of that would, consistent with what Gary says, involve some substantial stimulus from a lot of sources. Anyway, I think the staff's effort to try and capture both the baseline and some of the contingencies is as good as one can do it in these circumstances. Leaving that aside, an interesting way to think about this is to ask what was going on pre-Iraq and what superimposing Iraq means. I have to say that my impression is that even prior to the Iraqi invasion the attitudes in the business community--both big business and small business--were souring. My sense is that the economy, if anything, was softer rather than stronger and that even before the very latest CPI number the inflation rate was higher rather than lower--not in any decisive way, but certainly the hopes that the inflation rate was going to bend down, I think, were fading. I agree with some of the others who said

that--again, even before the Iraqi invasion--expectations had soured quite significantly in terms of the prospects for any kind of a meaningful budget compromise. Obviously, the Middle East situation has made all of those things worse, at least in the short run. What I hear now is not only more overt talk about the risks of recession but a crescendo of opinion about a vicious form of stagflation in which the inflation rate, at least for the foreseeable future, could be significantly higher in a context in which the economy is just sitting there. Now, the good news in all of this that I detect rather overtly in many instances is that there is a recognition in the business community and maybe even on Main Street that, at least in the short run, it's not something that is subject to any quick fix by monetary policy. I think there is a recognition that all of this does put quite a constraint on monetary policy. Indeed, I'm even surprised about the number of people who talk overtly about not making the same mistakes that were made in the 1970s when, in the eyes of many people, oil prices and energy shocks were allowed to feed into the general pattern of wage and price setting. So, there may be at least that element of realism there. Nevertheless, I have the impression at this point that things are very much on the gloomy side.

One quick footnote on the real estate situation: You can get many different stories there; it depends upon whom you talked to last. But what I'm impressed with is that my examiners--who I think are pretty darn good, especially in real estate--are very much of the mind that the situation had to get worse before it was going to get better. And again, that was before any further problems were superimposed on that situation.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. For the District, the most recent numbers, which are second-quarter numbers, show a decided shift. Generally in recent months I have been reporting that we have been out-performing the national economy; in the latest period both absolutely and relatively there is weakness in employment and weakness in non-residential and residential construction. In talking to our directors and others around the District, I have not picked up any sense that they have noticed anything dramatically different. What's interesting is that, despite reporting that things are pretty much as I have described them in recent months, there is a lot more anxiety. Last week I had our staff do a survey of business contacts throughout the District, which was rather interesting. In general, it supported an outlook for continued, albeit somewhat slower, expansion for the balance of 1990. One surprising part of it to me was a good deal of optimism in terms of retail sales, which either met or exceeded expectations. And those sales were obtained without unusual price cutting; their inventories were in good shape. Basically, 7 out of 9 retailers contacted reported that their outlook was good or optimistic for the balance of the year.

CHAIRMAN GREENSPAN. This [survey] was taken when?

MR. MELZER. Just last week. Now, we have relatively sluggish job growth and some layoffs coming in the aerospace industry --in St. Louis in particular--and in the defense industry. So, whether or not that optimism by retailers holds up in the face of slowing or maybe even declining employment growth and lower incomes

remains to be seen. Based on this survey and the views of our people, in general we would expect weakness in autos and construction and some strength in services, agri-business, and mining. That pretty much sums up the results of that survey.

On a national basis, I would be in general agreement with what the staff has forecasted. What's very tricky, if we come to grips with monetary policy, is that there's an assumption in that forecast of an essentially unchanged monetary policy in terms of the funds rate. And, of course, given our operating procedure, an unchanged funds rate in a slowing economy could in fact create a tightening--from the perspective of monetary stimulus. And I think that's something we have to watch pretty carefully. Now, I've personally been encouraged by the pickup in money growth recently and what's projected for August and so forth, but we have to watch that carefully. The other general comment I would make is that I think the July experience sort of showed us that we're not in an environment, given the concerns about inflation, in which we can try to lead the market lower. I think we're in a position where we have to follow behind market expectations in terms of policy actions.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. Well, [economic activity] in the Tenth District is not a great deal different than reported in prior meetings. We continue to have moderate growth with mixed performance in individual industries within the District. However, the higher oil prices will likely slow job growth in the District, particularly in states such as Missouri, Nebraska, and Colorado. And that will not be offset in our opinion by the District's increase in energy production in states such as Oklahoma, Wyoming, New Mexico, and Kansas. In the energy area, the District rig count did increase before the Middle East situation; the rig count went up from 266 in May to about 290 in June, largely in the natural gas area, however. That level of 290 in June is only about [20] percent of the level in the peak years of 1982 and 1983 when the number of rigs operating in the District was something over 1500. Automobile manufacturing has been curtailed within the District, principally in Missouri, as has been reported. For example, the GM plant has been closed for two weeks' vacation related to a lack of parts. There is some suspicion that it's simply because the dealers just don't want to take down additional inventory. On the other hand, Ford has closed its plant for a week because of the slow orders from dealers.

In the agricultural sector, there has been a very large wheat crop, as I think everybody knows. Prospects for corn and soybeans and other feed crops have been very good. As reported earlier, because of a wet spring and late planting there is a good growing season, and it appears that we will have a very good crop in all of these different commodities providing we don't get an early frost, which would kill off this late planted corn and soybean crop. One interesting thing that I'd like to report on is a second-quarter survey of farm land values, which showed a continued increase of 3 percent overall. But that's a slowing in the rate of increase of agricultural land prices. For example, in the same period in 1988 the year-over-year increase was 5-1/2 percent; for the same period in 1989 it was up 4 percent; and this year the increase slowed to about 3 percent.

Given all of that, we don't see any great deterioration of economic activity, which is very much as it has been in the past. What will happen with respect to the energy sector as a result of oil prices is still uncertain, obviously. But as also reported earlier, we will not be able to get back into a boom condition of drilling oil wells simply because the level of skilled labor has vanished since that earlier period and there is not the equipment to put in the field to bring forward new wells.

With regard to the national outlook, as Bob Forrestal said, in the interest of full disclosure I should report that our staff believes the outlook is a little weaker than shown in the Greenbook, marginally so. However, I'm more supportive of the Greenbook forecast. And it does show, of course, the kind of outcome that we would hope for. That's all given against the background of the great uncertainty of the Middle East situation. Talking about a recession, given what's going on in the Middle East and the prospects for a shooting war, I don't know that we have any history of going into a recession during a shooting war. As a result, this adds a bit more uncertainty, but I come out [with the view] that the Greenbook forecast is very believable.

CHAIRMAN GREENSPAN. First Vice President Monhollon.

MR. MONHOLLON. We think the baseline projections in the Greenbook make up about as reasonable a scenario as anybody might come up with, given the additional uncertainties created by the Middle East crisis. The key assumption underlying these projections is that the oil shock will be relatively brief and relatively mild. That may or may not turn out to be correct, but it's certainly a reasonable assumption given what we know now. But even the stronger and more persistent shock assumed in the staff's alternative scenario produced only a moderately different outcome. As has been discussed here, we agree that the [range of] confidence around these projections is obviously wider now than it was a month ago. And the probability of a near-term recession is correspondingly higher.

As a matter of fact, slowing economic activity in our own District and rather pessimistic recent comments by some of our directors and other contacts led us to think that the probability of a downturn had risen a bit even before the Iraqi invasion. But we think it's important not to exaggerate the downside risk to the economy. Several points, some of which have been mentioned, come to mind in this respect. First, the upward revision in the second-quarter retail sales figures suggests that final demand in the second quarter was stronger than we had thought, and the healthy increase in hours worked by production workers in July indicates that the payroll employment data may have overstated the weakness in the early part of the third quarter. Secondly, both the United States and the rest of the industrial world are better positioned, for a variety of reasons, to absorb an oil shock now than in the 1970s. Third, the prospects for continuing pretty strong growth in Japan and the European community should hold up export growth to provide a partial offset for softening domestic demand. Fourth, the absence of any widespread inventory imbalances implies that if we do get a recession, it should be fairly mild. And finally, the projected acceleration in M2 growth in August holds out some hope that the extraordinary weakness in the growth of the money supply in recent months may be ending. These observations

are certainly not intended to deny that the downside risks with respect to economic activity have increased. But the purpose is to help keep these things in perspective.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Business conditions in the District really have not changed much from the reports I've given you before, and we continue to operate at high levels of economic activity. What has changed, obviously, is what everyone has mentioned here already and that is the uncertainty that people have going forward. In response to that [uncertainty, the comment I heard] when I dug around a little was that firms were not planning to reduce production now or to curtail capital spending plans. Their plans had more to do in some sense with anticipating slower growth out there and preparing themselves for reductions in their labor force in the future. The responses that some people seem to be making to the uncertainty about the fourth quarter included: using overtime as opposed to adding new people; letting attrition run down the work force a little; and using contracted help. One response from a steel company executive was to protect the company in the fourth quarter by exploiting opportunities in Europe where steel demand is very strong and mills are booked out through December. He has the opportunities for business in that area. The only cancellation, or at least deferred sale that I know of, is at a steel company that had a transformer on a ship to Iraq. I don't think they're going to complete that sale for a while!

MS. SEGER. Iraq really needs it, doesn't it?

MR. HOSKINS. They'll need it more later. In terms of the national outlook, it's obvious what we face. The oil shock has given us two outcomes for the economy: higher inflation in the near term and reduced output. It seems to me also that one could argue that real interest rates need to be--and probably are--somewhat higher to ration or reduce the supply of output over time. With respect to monetary policy, I think there's little that we can do constructively to get more oil. And there's not much we can do constructively to lower real interest rates. There is one thing we can do and that is to keep the long-term inflation expectations from being built into this economy.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. It does seem that looking at the real economy provides some benchmark that we can use to make our estimates about the future. But, certainly, the latest revisions make it very clear that, when some quarters in 1989 that were originally around 3 percent are revised to 1.7 percent, we have to be very careful about thinking about that kind of precision. I am somewhat optimistic about the real economy in regard to the performance of net exports. I think the strong current dollar net exports in the second quarter will certainly switch to very strong real net exports in the third and fourth quarters, as the price patterns in the second quarter reverse.

The monetary aggregates now have fallen into the category of being interesting. I used to think they were much more than interesting, having had four years in which the growth of the aggregates has been down, with M2 below 5 percent. Whether you're measuring M2 over four years, three years, two years, or one year, its

growth is very close to 4-1/2 percent. But the fact of the matter is, according to the staff forecast, we're probably going to end up with the highest year-over-year CPI inflation since 1981. That means the results in nine years have been better than the results this year. Certainly, for an old fashioned monetarist that gives one pause. Now, that doesn't mean that the monetary aggregates are not important; it probably just means that we have to look to somewhat lower M2 growth rates to achieve our objective than we first thought necessary. We can also look at real interest rates, which I think are a very crude check in regard to distinguishing between periods in which monetary policy is apparently very easy, as it was in the 1970s, versus the real interest rates that prevailed in the 1980s, which in general were in the 4 to 4-1/2 percent range. Certainly, it seems likely, given the tax changes with regard to the deductibility of interest, that those real interest rates are consistent with inducing a change in household savings patterns. And in a sense, I think all of us ought to be much more enthused than we are regarding the level of consumer spending. It seems to me that the saving rate in the United States is not too high and that, consequently, some rise in the saving rate-- which means a diminution in the rate of growth of consumer spending-- is exactly what the doctor would order.

Now, it seems to me that a look at forward-looking indicators really can [help one] begin to pinpoint a bit better when monetary policy has been easy and when it has been restrained. And those forward-looking indicators clearly show that monetary policy in 1988 and after maybe the first three quarters of 1989 were indicative of rather significant restraint. Whether you're looking at commodity prices, the yield curve, or the foreign exchange value of the dollar, you get a confirmation of the fact that the money growth prevailing at that time did not enable enough liquidity to be out there to support upward movements of commodity prices and it supported the exchange value of the dollar. But, frankly, it seems to me that over the last nine months we have moved--though not from a monetaristic determined way of looking at monetary policy--from monetary restraint to monetary ease. I don't think it has been an abrupt move; I think it has been a very gradual move. And we probably have not altered the real interest rates significantly, or so dramatically as to [foster] too much expansion in the period ahead. But I think it is quite apparent that the yield curve is indicating that participants in the real market are suggesting that the appropriate rates of interest are higher than we may be providing. Certainly, [that can be seen in] commodity prices. The staff did me the favor in Chart 7 of indexing these commodity prices to the first quarter of 1986, which is in some way a little embarrassing for me because I talked about keeping those commodity prices within a range of 10 percent up or 10 percent down from where they were in the first quarter. And when I look at all commodities, the index at almost 140 means that we had an 8 percent annual growth rate over a 4-1/2 year period. All commodities except crude oil show a 5 percent annual rate of gain; and that's not stability in those prices. So monetary restraint does not seem to be characteristic of this era. When you look at the bottom chart, all commodities except food and crude oil--which takes out some of the variabilities of agricultural policy--it looks like we have had a very significant trend line of rising prices over the last 11 months. So, there's nothing there that gives me any indication that monetary policy at this moment is too restrained. Indeed, if the foreign exchange value of the dollar continues to fall at the rate it has been falling--since

really over the last 10 months--it's a rather significant event, which with the recent movements in gold prices I think could be an outright devaluation. And that only occurs during periods of monetary ease, not monetary restraint. So, I'm somewhat of the view that we have already eased. And I'm of the view that that ease, if it takes hold prior to the time that we get a breakout of the rate of inflation from the rut we have been in on the down side, is going to give us one heck of a problem in the years ahead.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I'll be brief because my observations are very much in the mainstream of much of what has been said this morning. In the area of inflation, pre-Iraq I think the news was already disappointing in that we really had made very little progress. And now post-Iraq, we have an oil shock that is a virtual cinch to pick inflation up substantially. So, I believe we do have a higher inflation outlook. There is some concern that it might be substantially higher; that's a very clear and unequivocal threat. In the area of real economic activity, I think pre-Iraq we have been getting pretty much what we had asked for--maybe a little on the soft side of that, but no real nose dive that was in any way perceptible. And today, we have even more softness in prospect as a result of the oil shock. So, the recent events are certainly not a plus and they certainly add to the risk and to the uncertainty. But at least there is not yet much evidence that the economy is headed for the tank. So, we do have an exacerbated inflationary situation and I think there is a clear need that that be minimized in a way that is most sensible to the rest of the economy and its progress. Economic activity per the Greenbook may still be okay; I hope we get the Greenbook outlook and I think that probably would be okay.

One question that I ask myself is: If we did try to help the economy through easing, would it work? Would the medicine turn out to be as bad as the disease is in the first place? I'm not sure; perhaps some percentage thereof. I'm not sure what would happen to long rates in that event. I'm not sure what would happen to the dollar or the inflation rate. And I'm not even very sure whether we would get the response we would be looking for from the consumer and on the investment side if we did that.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. In general, I would like to identify myself with President Boehne's remarks. In spite of the fact that the consumer confidence figures are terribly volatile and not necessarily reliable in the long term, they are cause for a reasonable amount of alarm on my part because we have such a consumer-driven economy. I think we're very close to the edge of that cliff; if it's not a cliff, it's a steep decline. I'm concerned that if we do lapse into recession, certain weak elements in the economy could accelerate. The real estate mess could be a real collapse on a much broader front than it currently is. The further losses that a recession would imply for the banking system would further undermine the banks at a time when many of them are on skinny ground as it is. Corporate profits remain very disappointing. The debt burden of the private sector is heavy and, obviously, the burden of servicing that debt in a declining economy is going to be much greater. I have no confidence that the oil price

rise will be contained or that it will begin to decline due to offsets from Saudi Arabia, Venezuela, the United Arab Emirates, etc. I'm not sure that they really are going to come on stream as advertised and that they will be sustained. Part of it depends on the duration of the Iraq crisis and I think that's an imponderable. Short is obviously good even if it's a shooter; long is very serious whether or not it's a shooter because of the effect on the economy and the possibility of permanent or at least longer-term impairment of the flow of oil. The dilemma is that the external circumstances have threatened growth and at the same time stimulated inflation. And the challenge for us is that movement against one exacerbates the other, whichever way we go. And the whole situation is seriously complicated by the vulnerability of the dollar and the possible consequences of a free fall in the dollar to the financing of the deficit--and the deficit may be growing at the same time. So, those are comments that don't lead us anywhere, but they describe what I am thinking about at any rate.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. My views on the nature of the economy, pre-oil shock, are pretty consistent with what everyone else has described. I would consider it marginally gloomier than last time, but with no really clear evidence of a recession, and brighter than the gloom that pervaded after some of the statistics that were released a few months ago. I guess we're still pinning our hopes on exports. Looking back over six quarters, if you ignore the first quarter of 1989 drought distortions, we have had roughly six quarters of maybe 1.4 percent GNP growth. That should be the equivalent of a couple of quarters of negative 1 percent recession with the rest of them in the mid 2 percent range and you would think that it should have produced slack. We don't see a lot of evidence of slack in the economy but we do see some. Capacity utilization has edged down some and it's only high in a couple or three industries, such as mining and primary metals. Unemployment has increased and employment has fallen. The real mystery is what happened to the 600 thousand to 1 million people who left the work force. Clearly, if they were in the work force and if the latter had grown at the rates we saw in the 1980s, unemployment would be above 6 percent. I think they are legitimately out of the work force because we don't see the pressure on wages. And we see other evidence in the labor statistics, such as aggregate hours worked, that suggests there is not a lot of slack.

So, overall, I think we've seen very little progress on inflation. It is true that the June CPI number, which upset so many people, had the owner's equivalent rent in it suggesting that home costs were going up pretty rapidly at a time when other things suggested they were going down. That was true in July as well, but it was not the only factor in July; there were other concerns in July. You can't help but believe that nearer term the recent months of slow growth in money and credit should start to have an impact. But I would say at this stage that I see no hard evidence of progress. From these levels of GNP growth I'm also not that confident that if we saw a downturn we could do much to catch it in time, which is why I think we need to look ahead and think carefully about the future. My initial view of the oil shock was that it was not such a massive event. In terms of the increase in the price of oil it is perhaps 50 percent. In the early 1970s, oil prices increased by four times and

in the late 1970s by two or three times. This seemed a lot smaller, although the news media tends to equate it with those two [earlier] events. And I think the 1970s conditions were far different. Certainly, we're going to see higher CPI numbers. As Governor Angell mentioned, these will be the highest we've seen essentially in the [last decade] and in fact the highest we've seen since the last time an oil shock happened. One of the reasons we didn't see higher numbers in the 1980s was because we didn't have oil shocks in the 1980s. It's still not a very pleasant prospect; and it comes on top of not very much progress before this in the CPI. The staff estimates a moderate impact on inflation, perhaps 1-1/2 percentage point higher CPI numbers, and a transitory impact. I guess that's consistent with the notion that there is some slack in the economy. The economy is pretty weak and money and credit growth have been slow. It's not too likely that this would feed into some generalized inflation.

Yet the bond markets reacted quite negatively to this--and around the world, I might add. The reaction was pretty similar in bond and stock markets in the major industrialized countries. U.S. long bond yields went up 50 to 60 basis points, and it's hard to reconcile a transitory impact on the CPI with 30-year investors in some crude sense saying 30-year inflation is one half point higher. They are responding not so much perhaps to the projected median inflation rate as to the small probability that the high consequence outcome is letting inflation get out of hand. I also believe some important part of the higher yields is a real risk premium associated with the uncertainty and the disruption in real economies. Investing in 30-year bonds is simply riskier in a world when small countries can disrupt large economies at will. That disruption risk had been there in the 1970s. We went through the entire 1980s without one of these events; indeed, we went through the entire Iran-Iraq war without one of these events. The cold war ended and now all of a sudden we have real instability, which I think people will offset with a real risk premium. There are some arcane measures which document the volatility. The implied volatility on bond options has gone through the roof. There are technical factors in the bond market. When you have this sort of uncertainty the hedges come undone; it's more expensive to be a 30-year investor. Peter mentioned the problems with the auction. And it's not clear to me that some of the other markets that didn't have the auction problems went up quite as much. One way I try to conceptualize the oil shock impact is to assume that it hadn't happened but that instead we had a budget deal which involved a \$10 a barrel tax on oil with half of the proceeds given as foreign aid to oil-producing countries. It seems to me that the inflationary impact of that sort of budget deal in some crude sense should be roughly the same as what we've seen. But I suspect the markets would have responded far differently. And it seems to me that difference in response has a lot to do with the uncertainty and the potential for future disruptions of this type. So, I wouldn't read--

CHAIRMAN GREENSPAN. But the difference is who imposes the tax.

MR. MULLINS. I think the yield curve is going to be more steeply sloped for some time to come because of an uncertainty premium in it. What bothers me most is the impact on the real economy. This is a contractionary event. People are poorer; they have less money to spend; their wealth is reduced. Because the magnitude of the impact

is not that great in terms of the percentage increase in prices, the impact in the Greenbook is relatively small--less than 1 percent reduction in GNP. And we don't have a lot of GNP to give up now; we come out projecting .5 for the fourth quarter, which is a pretty small margin of error. I've already alluded to my major concern in this area, which is the fragility of consumer confidence. I'm a little concerned that we may see the increase in the saving rate that Governor Angell talked about if we start a shooting war over there. I'm also concerned that we haven't thought a lot about how this is likely to end. We discussed it a little here. The outcomes aren't that encouraging from the point of view of consumer confidence. We could be lucky enough to have an efficient coup. But when you think about the scenarios, it leads to a pretty sour mood. This on top of an already fairly weak economy suggests to me that there's certainly a possibility that the contractionary consequences could be greater than projected in the Greenbook.

I'm still a little concerned about the slow growth in money and credit. We have had very low growth in the past four or five months, including last month, despite the absence of RTC activity. I guess growth is picking up in the first couple of weeks of August, as we apparently have scared people back into money. Money market mutual funds have gone up and we're apparently exporting currency again at a rapid pace. Obviously, some of it could be demand; but there also is some fragmentary evidence on the supply side. The lending officers survey continues to show tightness; and finance company lending went up pretty dramatically recently, which is consistent with the notion of some borrowers having to search for alternatives to bank credit. I'd be particularly concerned about where the low investment grade borrowers are going. The junk bond market is gone; the banks are not forthcoming. You don't see the substitution effect in the commercial paper market; high-grade credit has gone down as well. The other concern I would have is the fragility of the banking system. If we have a sharp downturn, we could have some real problems there and the FDIC could have some real problems as well. So, I see a fairly weak picture to begin with--with this shock making it weaker--and with the certain prospect of higher numbers on the CPI as inflation works itself through, the specter of a real possibility that the consumer could pull in his or her horns. This presents us with a difficult dilemma for setting policy; people have extended their pity on our tough dilemma. What concerns me is that I think it's likely to get more difficult before it gets easier. As the numbers actually start to go into the CPI and as the impact on the consumer becomes clearer, the policy options down the road may be at least as difficult as the ones we face now.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. Every time I come to one of these meetings I am reminded of how difficult it is either to analyze the economy currently or to forecast it. This time we've just come through a period of having received these major revisions in the GNP numbers which, at least as I read them, show that we had weaker growth last year than most of us thought we had had. Also, the numbers for the first two quarters of this year look rather weak. In doing our forecast, I think the uncertainties are really tremendous. I mentioned a couple of them in my questions for the gentlemen at the end of the table: primarily, the impact of the Middle East situation,

the budget summit or what might come out of the summit, or how Gramm-Rudman will work and whether or not we'll have a sequester. All of those are key unknowns in our forecast. I certainly don't pretend to have any answers that are any better than anyone else's. It is interesting for someone who has been rather concerned about the signs of weakness in the economy, as I have, to be able to add some more indicators to my list this summer. A number of them have been mentioned, so I won't repeat them. Also, I think it's interesting that the U.S. Chamber of Commerce has now come up with, and made public, a recession forecast for this year. Solomon Brothers economists also are now forecasting a recession.

As I compare my own views with the Greenbook presentation, there are a couple of things I would mention. One is the area of consumer spending. I'm somewhat more negative about that than our official forecast, primarily because of the debt situation. Consumers are really loaded up to their eyeballs, I would argue. And I think this Middle East mess and what that's doing to consumer confidence is going to result in a chance that their debt problems may even worsen with defaults and delinquencies and those sorts of things. Also, I never hear anyone mention the impact of these declining real estate [values] on consumer spending. John LaWare and I have talked about it in the past as an influence on the health of the banking system and S&Ls, etc. But for the average person, at least the average person I know, the equity in their home is the biggest single item on their personal balance sheet. And when the bombs dropped on the values of those homes--they actually are facing declines in real estate values in many parts of the country, except maybe where Bob Parry lives--it made them feel more poor. I think that is a bigger impact on the consumer sector than the October 1987 stock market decline. The latter impacted people who owned equities, but a lot of other people didn't even know there was anything going on on Wall Street. I think the decline in real estate values is far more serious to the consumer and will be a future influence on consumers' willingness and ability to spend.

Also, I'm somewhat more concerned about housing and other kinds of construction because I don't think the financing problems that are out there in the real world have been fully reflected in our statistics, particularly the needs of contractors to locate funds to do their construction work. I know we've discussed the credit crunch primarily in the context of banks, but it also relates to S&Ls and to the closing of S&Ls and to the limits on loans to a single borrower. That is coming in through the back door and impacting on the construction of single-family homes, multifamilies, etc. I'm also more concerned about what's going on in state and local governments and their budgetary problems. I think we're likely to see either cuts in their expenditures or still more hikes in their taxes. We've already seen numerous instances of that but it wouldn't surprise me to see still more. And that, of course, impacts those folks who have to pay the tax bills.

In terms of why I would just as soon not let us go into a recession, the fragility of the financial system is certainly the big part of that. I'm sure that the problems that already exist would be made much, much, much more difficult. And a recession would make the U.S. budget far more difficult to deal with and would make the budget deficit much, much bigger. As for inflation, if you could guarantee

me that a trip through the wringer would cut our inflation rate in half, I might sign on for the ride. But I haven't heard anyone try to make that argument. Consequently, I am unwilling to take the risk of a recession to get what may be a very modest cut in the inflation rate. So many of the sources of inflation that I see are just out of our reach, period--whether it's an action by government or whether it's something that has to do with OPEC or Mother Nature, etc. I think we have some impact but we certainly don't have complete control. So, I hope that we can come up with a good decision today--one that will help to keep us out of a recession if we're not already in one, though be responsible on the inflation-fighting side.

CHAIRMAN GREENSPAN. I think we all need some coffee.

MR. BOEHNE. Good idea.

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

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

CHAIRMAN GREENSPAN. Questions for Mr. Kohn?

MR. PARRY. I'd like to ask a question about what you referred to as the "felicitous" outcome involving an unchanged [nominal] income path after the shock which, of course, leads to an [un]changed interest rate path and M2 path. To me that has critical implications for the policy decision we make here. What bothers me a little is that it seems to me a bit counter-intuitive; also, I know a couple of models at least where there are different results. It would seem more likely, with an oil shock of the magnitude we're talking about, that in the first year we probably are going to see more of the impact on higher prices than on the real side. That would suggest that in order to get the same path for nominal income growth we would need higher interest rates and somewhat slower growth of M2. And if indeed the same nominal income path is what we want now, this is a very critical difference. I don't know how much effort was spent in trying to verify this or to look at it in different ways, but assuming an unchanged nominal path is what we want, it's critical which interest rate path is consistent.

MR. KOHN. Well, let me make one or two comments and then Dave or Ted may want to comment as well. One is--and this follows the conversation we had before--that I think it's important to distinguish between GNP prices and the CPI.

MR. PARRY. Yes.

MR. KOHN. You get a lot more [effect] on the CPI, given that it has imports in it and given that it has a higher weight on energy, than you would on GNP prices. Secondly, it's sort of a function of the model; it falls out of the model's parameters, which are based on past experience. I think you could argue that past experience was distorted; we had controls in certain cases and things like that. So, I think it is particularly difficult to get a reading on what's going to happen now.

CHAIRMAN GREENSPAN. There's also an interesting change in the translation from crude oil to product prices this time relative to the last time. We used to have a long lag; now it's instantaneous.

MR. PARRY. Well, we had price controls.

MR. KOHN. Yes, everything was distorted by the controls, certainly in the first period. So, my thought is that past experience may not be that good a guide. And that simply reinforced my own feeling that one can start with the staff forecast as a first approximation, but this is probably a period in which the odds on that coming through are less than I would usually say is true for the staff forecast and, therefore, that one needs to be somewhat more adroit and alert in changing policy if in fact the incoming information is not so suggestive--

MR. STOCKTON. It isn't the case that our forecast is constrained by this particular feature of the model--that somehow the energy price run-up would naturally lead to offsetting price and output effects with unchanged nominal income. As Don pointed out in his briefing, it is a function of the parameters of this specific model and not a theoretical feature of the economy or something that is anything other than a summary of past historical experience.

MR. PARRY. It seems to me that we made one major judgment that interest rates should be the same or lower, but I have a feeling that we shouldn't take too much confidence in that result. It seems to me quite likely that if we make that judgment then we're probably, in effect, going to see higher nominal income and it's probably going to be primarily as a result of greater inflation. I think the risk is there and it's a significant risk.

MR. PRELL. I think the sense in which this nominal GNP concept is attractive is as sort of an automatic stabilizer.

MR. PARRY. Right.

MR. PRELL. But you don't necessarily have to constrain yourself to that automatic response. So, there's nothing magical about this. If you were concerned about any acceleration in inflation in the short run, you might want to have a lower nominal GNP path or even--

MR. PARRY. Oh, that's true.

MR. PRELL. So it doesn't do the work for you here in terms of the policy decision.

MR. PARRY. But it may cast it in a somewhat more [unintelligible] way if indeed the underlying relationships are different than as portrayed by that model. But you're right: It depends on what you want to set as your objective.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Don, what do you project for M2 growth in the fourth quarter given something like the baseline assumption?

MR. KOHN. We have 4 percent quarterly average growth in the fourth quarter. But I believe the monthly numbers, which I don't have right in front of me, are lower than that. We come out of the third quarter higher, so I think we're looking at rates more like 3-1/2 percent on a monthly basis in the fourth quarter. And partly because we have the RTC activity picking up at the end of September, once again that starts depressing M2 growth early in the fourth quarter. And then we have opportunity costs perhaps even widening a little as banks and thrifts reduce their offering rates in lagged response to other rates. So, we don't have any big push in M2 for the fourth quarter. We did raise the projection for the year to 4 percent based largely on incoming data, revisions to past data, and how we saw the third quarter. We didn't really strengthen our outlook beyond the third quarter very much.

CHAIRMAN GREENSPAN. Anybody else? If not, why don't I get started and try to cut through some of this. I must say that this is about as difficult a policy discussion as I have ever been confronted with, and I've been around these policy woods so to speak for 40 years. Let's start with where we are. I think there are several things we can stipulate with some degree of certainty: namely, that those who argue that we are already in a recession I think are reasonably certain to be wrong in the sense that we do have weekly data that suggest, as others have mentioned, that up until perhaps a week or so ago there was no evidence of deterioration in what was a very sluggish pattern. The insured unemployment data are as broad as any set of numbers that we have for the economy as a whole. They don't get revised. Sometimes they are a little unstable, but in general they do give an unfailing measure of where we have been. And I think where we have been in the first half of the third quarter is clearly some small plus. The whole thing may fall on its face next week, but I think at the moment it hasn't.

On the inflation side, those who argue that the goods inflation is suppressing the problem on the services side are clearly looking at the numbers [but] I find the numbers a little difficult to read. I think the crucial issue here is not the services inflation numbers but the wage rates which--however one looks at this inflation trade-off--clearly have not been coming down and show a slight upward tilt. Although there is still the possibility that that could turn around in the third quarter, I wouldn't want to count on it given the type of environment we're in. The services inflation problem has a lot of tricky things to it, which is what I think David Mullins was raising--especially when you try to substitute existing house prices for the cost of house operations for the owner or renter. So, it's a mixed bag.

What I am saying, essentially, is that there's a degree of apparent certainty out there in forecasts and judgments, which I think is suspect. The crucial issue confronting us right at the moment is that the odds of an actual war in the Middle East are 50/50. If you look at the form of the buildup that we're engaged in there, it's fairly apparent that this is not a military establishment that is going to sit there for a very long period of time. We are bringing in fairly significant tactical offensive weapons. The chances of this all positioning itself and doing nothing and Saddam backing down easily has to be on the low side of the probability [spectrum]. And the crucial issue here is that if a war does come, we have a very

serious question--as I think Jerry mentioned--with respect to the state of the Saudis' oil facilities, a very substantial part of which are concentrated directly under Kuwait off Ras Tanura and to the north of Bahrain. And that is not all that far away from a couple of kamikaze raids, which some Iraqi pilots have already volunteered for. Frankly, I don't think it's an issue in the next week or so. We are still building our military forces and it's extremely unlikely that anything will be triggered until we are positioned. We are nowhere near there because of the lead times it takes to move our equipment and troops. And while we have a formidable force--enough for inhibiting any adventuresome activities--I don't think we're yet anywhere near the level that the reported flow of materials suggests we are.

As a result of that, in an odd way where the economy has been is a very interesting statistic, but I'm not altogether certain it's as crucial as we probably would like it to be. We obviously have a major budget problem, not so much in the additional costs but I think in the reduced probabilities of getting an agreement, which I think clearly have declined significantly. In Gary Stern's terms, we are in a sense in economic/political policy turmoil.

In that type of an environment, it is crucial that there be some stable anchor in the economic system. It's clearly not going to be on the budget side; it has to be the central bank. It's got to be we! I think we very clearly have to preserve--which is our fundamental role, mainly--the value of the currency both internally and externally and, in a sense I suspect, be more involved in damage control than in trying to implement a policy that is apt to do something of very significant dimensions. I personally would feel very uncomfortable if we exhibited any evidence that we were going to accommodate the increase in nominal GNP that we would like to come out [unintelligible] with the price rise. As Lee Hoskins mentioned, the experience of the 1970s is something that very clearly has to be avoided. When we get uncertainties at the level that we currently have, I think we have no choice but to go to where our fundamental policy issues lie, mainly in trying to maintain as closely as we can a stable credit and monetary environment.

I must say, I disagree with Wayne Angell's pessimism on M2. I would be more inclined to explain the fact that we have had a very low rate of M2 growth in the last three or so odd years--in the context that inflation was not coming down more--in terms of the P* model that we set up. That would show in 1986 that adjusting the money supply relative to the price level indicated that the price level was down here and the long-term parallel real money supply was up here. What we have been seeing essentially is a gradual narrowing, with the price level coming up and essentially burning off the excess money supply. And it's only very recently that the lines have crossed. I certainly would say that if the inflation rates were to continue [moving] up as money supply stayed stable, then the pessimism that you're exuding has some reason to be focused on. But at the moment I think it's premature; I think we have evidence that this system fundamentally still works. And I think that we have to be focused on essentially where the credit aggregates and the money supply growth are. While at our last meeting we were getting clear indications that the markets were tightening more than we had anticipated, I had hoped that the money supply numbers we were looking

at in recent weeks were suggesting that that basically is simmering down. As I recall, Bob Forrestal mentioned that he was hearing less about a credit crunch and that may in fact be what is happening; it may well be that what these money supply numbers of recent weeks are showing us is that the cumulative pressure coming in the credit markets in an endeavor essentially to preserve capital has reached the point where that continuing tightening has at least flattened out.

In today's environment we have to recognize that there is a rather limited chance of affecting the economy in a significant way. I would suspect at this point that the Pentagon has more policymaking clout than we do, because it's fairly obvious looking around the world that if oil [prices] go up and oil [production] comes down, that will have profound effects on the system. And if Saddam is perceived to be increasing his power and his clout and his control over the West, he is going to be able to name OPEC's level of output--including his own, which will be up there and everybody else's, which will be down. And his control would be more than just strictly the Gulf states because he has terrorist groups out there and he can control Indonesia and every far flung oil producer in the world. Consequently, our ability to divert this guy probably has far more implications with respect to crude oil output, prices, interest rates, the world economy, and specifically the United States economy, than anything we can do sitting around this table for weeks. So, I would suggest at this particular stage that we ought to have a more modest view of what it is we're going to be able to accomplish. I don't think it is in our power to either create a boom or prevent a recession or vice-versa. At this particular moment and for the period immediately ahead our tools are limited. Therefore, I would suggest that perhaps the greatest positive force that we could add to this particular state of turmoil is not to be acting but to be perceived as providing a degree of stability. And I would hope that to the extent our foreign central bank associates will feel the same way, we might be able temporarily to put some degree of stability at least somewhere in the system.

Having said that, if one looks through to our next scheduled meeting on October 2, I think it's more likely that events will materialize in a manner whereby we eventually will feel more comfortable easing than we will tightening. So, I would still like to stay where we have been which is "B," asymmetric toward ease. But this is such an uncertain period that I think we're going to have to be auditing it quite considerably. And under any conditions, I would recommend that we not go more than two weeks before we meet again on the telephone because I do think that within the next two-week period something is very likely to emerge that will require a general review. I don't know anything specific about whether or not [our military] has built up to an offensive technical capability or not. Frankly, if I had to guess, I would believe that the President has not made that judgment yet. To know that we have the capability, one only needs to watch the television tube for any protracted period of time and know something about what types of armaments are used for what types of purposes. Now, if this is strictly a limited police action, there are just too many policemen. So, let me stop there with that proposal and see where everyone would like to go.

MR. HOSKINS. Just a point of clarification.

CHAIRMAN GREENSPAN. Sure.

MR. HOSKINS. In the context of what you said on asymmetric language and the conference call, are you suggesting that you are suspending what I guess has developed into a tradition recently of asymmetric meaning you have two calls of your own of 25 basis points, or would you confer?

CHAIRMAN GREENSPAN. No, this particular period I would view somewhat as a special case. I don't know how I'm going to answer that frankly at this stage. I haven't given it thought. The authority of the Chairman under this proposed directive I think has to be evaluated very carefully. Certainly, this is not the same view that I held last July when I put it the other way around. I think we need something very significant to move from where we are. President Syron.

MR. SYRON. I guess the first law of medicine is do no harm. It seems to me that you're suggesting that that might be the first law of central bankers in these circumstances. I have a lot of sympathy with that. I think of the whole situation in a sort of "BS," before Saddam, and "AS," after Saddam way. I must confess that before Saddam I was somewhat inclined to think on the basis of the data we had coming in--the GNP revisions, other developments, and the financial situation--that some moderate easing along the lines of 25 basis points might be appropriate. But in the wake of what has happened in the Middle East, with the further steepening of the yield curve and the intermingling of the concern of inflation expectations for a variety of reasons and also what has happened in the foreign exchange market, it's a somewhat hazardous course to make any change at this point in time until we have somewhat more certain information about what's going to happen with the dominant event. As you point out, the dominant event will be something not determined in this room. I must confess to being somewhat dismayed by your odds. I'm not disagreeing with them because I'm sure you know more than we do, but still it's fairly discouraging. I agree with the "B" asymmetric; and because it is a long time in this environment until October 2nd, I think we may need some consultation before then.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, in light of the uncertainties and concerns that you mentioned, I certainly would be supportive of Bluebook alternative B. In terms of my own viewpoint, though, my concerns about higher inflation are equal to my concerns about recession. Consequently, if I had my druthers, I'd prefer symmetric language as well.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. I'm encouraged by your confidence in M2 and, Mr. Chairman, I want to believe you're right. I think [your proposal] is in a somewhat acceptable range and I certainly do agree that we need to have more information to move. Although somewhat satisfied with the range that you stated, my preference would actually be "B" with a tilt toward restraint. But I don't know that that restraint would need to take place by an increase in interest rates. I just believe that there's some confusion in the marketplace in regard to what it is that we are about. And if there were some way of communicating your call for stability, and that includes price level stability, then I believe that we would have a much better chance to get long-term

interest rates down. My guess is that if we were to move the fed funds rate up 25 basis points that that would be quite a surprise and that it would be taken as an indication of our not accommodating this oil price phenomenon. And frankly, I would expect long bond rates to come down as much as short-term rates go up. Now, I realize it's a lot easier to suggest that when you're not Chairman than it is when you are, but that's my guess. In periods of low growth in which the housing industry is under such a serious restraint that it does make other consumer goods areas vulnerable to the downturn, it is important to have lower long-term rates; and those lower long-term rates come with reduced inflation expectations. I believe if the world knows the Federal Reserve stands as the guardian of the value of the U.S. dollar in purchasing goods and services in our market, which also includes a stable value of the dollar abroad, then we would do wonders for interest rates and actually increase the chances for the higher real growth that I think some of you would like to see.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, I absolutely agree with the solution that you describe in what is at best a very difficult situation. Therefore, I would support alternative "B" with asymmetric language toward ease. I have one minor operative difference, and it relates to the question that Lee Hoskins raised. Looking ahead, I do think the chances are that we will be easing policy sooner than we will be tightening it. And it seems to me that these kinds of situations happen very, very quickly and that there are brief windows in which we would have an opportunity to make a change. Therefore, I would not be uncomfortable--if you were to become aware of something and you felt we did not necessarily have time to bring the Committee together--if you were to go ahead and make a change without a phone call.

CHAIRMAN GREENSPAN. Lee was raising a question of two [changes], is that correct?

MR. HOSKINS. Yes, that was what I understood it [meant] around the table when the language was asymmetric. But my question also relates to--

CHAIRMAN GREENSPAN. I recall we always really interpreted it as one.

MR. ANGELL. One.

MR. KEEHN. Yes, that's how I interpreted it.

MR. HOSKINS. Well, I always interpreted it as that you had [as Chairman the authority to make] a 25 basis point move either way if the directive was symmetric. That was my understanding. If it was asymmetric--

CHAIRMAN GREENSPAN. I don't think that has ever actually been formulated by this Committee, at least--

SPEAKERS(?). [Secretary's note: Unintelligible because several people were talking at once.]

MR. BOEHNE. I think we shouldn't do it today.

CHAIRMAN GREENSPAN. I don't think it's the appropriate day.

MR. BOEHNE. I think we have to have some confidence in our Chairman to use his discretion, particularly in periods like we're in now.

MR. KEEHN. That's my point.

SPEAKER(?). That's the point.

CHAIRMAN GREENSPAN. I appreciate that. President Forrestal.

MR. FORRESTAL. Mr. Chairman, in the pre-Iraq invasion environment I was beginning to feel that we were at the point where we should consider some easing of policy, and I must say that the events in the Middle East have tended to confirm my feeling that that is probably the appropriate stance for policy. I'm not at all convinced that the price of oil is going to be maintained at the \$25 level that the staff is forecasting, in the context of your remarks--which I tend to agree with--that there's a 50/50 chance that we're going to get into a real shoot-out here. All of that I think is going to reduce aggregate demand in the economy and it's going to have a greater effect on the real economy and on output than on prices. My view is that we should do what we can to avoid a recession for reasons that we're all familiar with and that Governor LaWare articulated very well a few minutes ago. I think one can argue that we can attain greater stability by moving at this point and giving greater confidence to the people at large that we are not going to be moving into a recession. And I say that with full recognition of the effects on inflation and the exchange rate. But having said all of that, your argument is quite persuasive. As you said, it's a very, very difficult call--probably one of the most difficult we have faced in a long time. So, I can support your prescription with some reservation. My preference would be to move slightly to give a psychological boost, if not a real boost, to the economy. But if I were a voting member I would not dissent from your prescription.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, I'm fully supportive of your position.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I support your position as well. I think it's the right prescription for these circumstances. There might be something to be said for a symmetric directive, in part because that's my usual preference and in part because of all the uncertainties and risks. But I don't feel very strongly about that at the moment.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Mr. Chairman, I also would support your proposal. I think the most important thing that you may have indicated is the need for stability. If we were to move, it seems to me that the markets would read it as sort of a double whammy. On the

one hand, I would assume a move toward ease would indicate to some that we are more concerned about a recession and, therefore, people will accumulate the thoughts [and tend to react in ways] that will make it come true. On the other hand, another part of the market would read the easing as being inflationary over time and that will build inflationary expectations. I think nothing good could come out of a move right now. And as a result, stability is where we should be and where we should stay unless some very dramatic changes take place in the near future.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Well, doing nothing so as to do no harm is one side of the coin. The other side of that coin is paralysis. I think it might freeze us into avoiding opportunities to make some positive contribution. And I think we need to be aware of that paralysis risk as we go through the next several months. I agree that at this point we cannot change policy, if for no other reason than what's going on in the financial markets, both the bond and foreign exchange markets. But I feel that the real economy is going to need some help; it's going to need some help from us in the coming weeks and months and I think we ought not to shy away from providing that help. So, I prefer an asymmetrical directive in the direction of ease but I think I would be more active with that asymmetrical directive than I sense you would be. I would look for opportunities to ease in the intermeeting period when financial markets would be more favorably disposed to accept such an action. I view this as a tactical maneuver rather than an abandonment of our basic strategy of restraint to bring down inflation. My expectation is that whatever easing moves we make in the coming months will likely have to be reversed once the economy begins to strengthen.

We hark back to the lessons that we learned in the 1970s, but I think we learned lessons on both sides. In the first episode in 1974 we underestimated the amount of weakness in the economy that was in the background when we had that first oil shock, and we ended up with a very, very deep recession. On the other hand, in the later one in 1979, we wanted to avoid the first mistake so we tended to err on the side of ease and we ended up with one big inflation that led to recession. So, there are lessons on both sides. And while I agree with you that this is not the time to move, let's not get an inferiority complex in this big world and get paralyzed into doing nothing when opportunity knocks at the door.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I would agree with what you recommended here. I'd make three points. First, in this kind of environment, while I don't think we can rely exclusively on it, I really do think as Don Kohn suggested that we need to watch what money is doing because I don't think we can assume that an unchanged funds rate is an unchanged policy. Secondly--I've said this before as well and I think Don suggested this too in his remarks--I don't think that we can pretend to lead markets in this kind of environment; we really have to follow. Now, we don't always have to buy what markets are doing in a volatile period, but I'm suggesting that unless there were expectations of ease evidenced in financial markets, it would be very difficult for us to ease and get away with it given the concern about inflation that's out

there. And the final point I would make is that if a recession is imminent--if we're going to go into recession in the fourth quarter--I don't think we can do much about it right now. Even in the face of weak incoming data, if we feel that we're on a monetary policy course that is consistent in the long run with sustainable growth and progress toward price stability, that's about all we should do. I worry about overreacting--not on your part but just in general--to incoming weak data on the thought that somehow we could pull this economy out of recession in the short run. I don't think we can.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Well, instinct and intuition both tilt me toward ease and sooner rather than later. But the cautionary comments that you made persuade me that, as long as we monitor the situation carefully and closely and are prepared to move quickly, your recommendation is appropriate. So I join in supporting it.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I fully support your recommendation for "B" asymmetric toward ease, but I'm not as sure in my own mind that we really are locked into an eventual ease. I think we may be surprised with the strength of the economy. I also think that if we do contemplate ease, we're going to have to assess that very carefully to make sure that it is efficacious if we do ease.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I also would support your formulation. It's probably fair to say in my case that prior to the Iraqi developments, I would have leaned to easing in any event. As things stand right now, I probably would come fairly close to associating myself with Mr. Boehne's definition of the situation. But I also think it's so uncertain that it could easily go the other way. I could easily envision unpleasant circumstances where we might have to tighten monetary policy. I say that not because I favor that, but only because it captures the range of emotions that I think is really on the table. As I say, your formulation is fine with me as things sit right now. I would lean toward Mr. Boehne's prescription, but depending upon what happens I might be a lot more cautious about seeking out an opportunity to ease.

CHAIRMAN GREENSPAN. Mr. Monhollon.

MR. MONHOLLON. I think there's a serious risk that if we were to ease now, we might be misread by the public and by the markets. It might decrease our credibility and might produce sharp negative reactions in both domestic bond markets and foreign exchange markets. It might make our longer-run objectives more difficult and more costly to achieve. So, I have a strong preference for "B," Mr. Chairman for those reasons in addition to the ones you've outlined. I don't have a strong feeling about the symmetry question, but I have a slight preference for symmetry.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Mr. Chairman, I agree with your analysis this time almost wholeheartedly with respect to what monetary policy can and can't do. As I said before, we face the fact that there is an oil price shock, that output is going to be less than it otherwise would have been, and that inflation is going to be higher than it otherwise would have been. There's not a lot we can do about that. The one thing we can affect, however, is how people in the marketplace view the future for inflation--that is, inflation expectations. My view would be that we should look at that more carefully or at least give it more weight than perhaps we have in the past. This is a policy mess, but there is a silver lining in it. It does offer us a chance to regain some of our credibility or to increase it. That would argue for a position very close to Wayne Angell's. One could make a case on those grounds, I think, for a token tightening. But since the market already expected an easing by us, that would argue in my mind for staying where we are for stability reasons. But I do think we are at risk with respect to our credibility in terms of pursuing price stability. My preference would be that we have symmetric language in "B" and that hopefully we would have a Committee discussion before a move is made.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. I would support the proposal, although I'm leaning more in the camp with Vice Chairman Corrigan and President Boehne. Without this [Middle East situation] I think a case could be made for some easing, especially if money and credit growth had not picked up a little in August. It still bothers me when we go through a period of months with low growth in money and credit because history suggests difficulty a bit down the road. I would agree that in the current setting stability is important. I do think, though, that there are some risks in waiting and that it's not likely to be a lot easier down the road. What concerns me most is that we might find ourselves in a position where we're trying to play catch-up, requiring larger moves, which would make me uncomfortable because of the risk to stability. I believe there's great merit in gradualism. Also, looking down the road, I would suggest that at some stage it wouldn't be too bad an idea to get the market used to somewhat more movement in the fed funds rate instead of the assumption that it's chiseled in marble. That's something we should think about as well. But in the current climate I would support "B" asymmetric toward ease.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I know these are very tough times and it's difficult to come up with accurate forecasts and it's difficult to make good policy. And I appreciate your point about the need for stability and the need for some sort of anchor in Washington or something that is viewed as an anchor. But having lived on a river for 13 years, I remember that even boats that are anchored move a little; otherwise the line snaps. So I think we could move a bit and not be viewed as either irresponsible or reckless and also that it wouldn't turn the financial markets on their ear. In fact, it seems to me that a modest move--to me 25 basis points is modest--would offset some of the availability problems that I see in the credit markets. And at the same time it would make it easier to do further modest moves in the future as we see the need. So my preference would be for some sort of a move that would resemble "A."

CHAIRMAN GREENSPAN. I don't think I have asked specifically for support in a large number of meetings, going back a number of years. I'm not saying that people should violate what they think are their principles. I merely indicate that at this particular meeting it's important for us to have as large a consensus as we can get. Obviously, I'm not asking anyone to go against his or her particular view of where you would like policy to be, but if you can find your way clear, this is the type of meeting in which it would be helpful if we had a very substantial consensus. Having said that, I'd like to request the Secretary to put to a vote "B" with the language asymmetric toward ease.

MR. BERNARD. I have a question. On the asymmetry toward ease, we [now] have "slightly greater reserve restraint might or somewhat lesser reserve restraint would...." Stay with the "would"?

CHAIRMAN GREENSPAN. Yes, I'd stay with exactly what we had.

MR. BERNARD. "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 progress toward price stability, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, slightly greater reserve restraint might or somewhat lesser reserve restraint would 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 June through September at annual rates of about 4 and 2-1/2 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 6 to 10 percent."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Boehne	Yes
President Boykin	Yes
President Hoskins	Yes
Governor Kelley	Yes
Governor LaWare	Yes
Governor Mullins	Yes
Governor Seger	Yes, with careful writing of the minutes.
President Stern	Yes

CHAIRMAN GREENSPAN. Thank you. Our next meeting is October 2nd. Let's break for lunch.

END OF MEETING