

Federal Open Market Committee

Conference Call

September 17, 1990

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. Black, 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. Gillum, Deputy Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

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

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MR. CROSS. [Unintelligible]. Since the last FOMC meeting the dollar has slipped about 6 to 7 percent against [the yen]. The market continues to focus on the weak fundamentals of the economy and the implications of that are lower U.S. interest rates and easier monetary policy. Of course, the United States already has the lowest short-term rates, I think, of anyone in the G-10; and the market is concentrating on the fact that, if anything, rates are likely to go lower here and they may be going in the other direction in some of the other countries. During the Kuwait crisis the dollar hasn't seen as much of an upward movement from the kind of safe haven consideration that might have been expected from earlier situations. In fact, [those in the trading] rooms around town tell us that since August 2 their older traders who have been through these situations before haven't done as well as the younger traders who haven't had that experience. So, the safe haven consideration has not given as much upward momentum as the old hands would have expected. But there is still some effect. For example, last Friday, when it looked as if there was going to be real shooting with real bullets and on similar occasions when the situation has become that serious, the dollar has shown some upward movement. So far, though, I think the effect has been mainly in helping to keep the dollar from sliding more. And it does give people pause about going too short against the dollar. There has been an awful lot of attention on the yen, given that Japanese interest rates have risen significantly since our last Committee meeting, and there are expectations of, if anything, possible further increases--in contrast to the situation here. And as the dollar/yen rate has declined, we think there has been some increase in hedging by some of the Japanese investors through currency options and [unintelligible]. So far we haven't heard of a major strategic decision for massive kinds of hedging or currency shifting. But there is the danger that if the dollar continues to slip we could get a lot more of that at some point. So, Mr. Chairman, we sit here in a rather precarious position in which the dollar in trade weighted terms is at about the low point that we hit around the end of 1987. The decline thus far has not been disorderly or frightening, but it could move in that direction very suddenly. That completes my report, Mr. Chairman.

CHAIRMAN GREENSPAN. Thank you. Are there questions for Mr. Cross? I assume, Sam, that you have not been getting any indications from the Treasury to pull out the intervention club?

MR. CROSS. We have not gotten any serious indications. They have, of course, become more attentive to the situation as the dollar has continued to slip. But there has not been evidence of that desire at this point.

CHAIRMAN GREENSPAN. Okay. Peter Sternlight, could you update us please?

MR. STERNLIGHT. Thank you, Mr. Chairman. We've continued to aim for reserve conditions consistent with a fed funds rate around 8 percent. Operations have been conducted against the background of market expectations of a more or less imminent monetary policy easing move. That sense of imminence seemed to reach a high about a week ago

when the market focused very intensely on the employment report for August. Since then, the anticipation of an immediate move has faded a bit, but there are still expectations of a fairly near-term move as the economy is seen as quite soft, though not collapsing. And outside of monetary policy, there are expectations--related to the view that an agreement on a budget deficit reduction package is close to being reached--about market reaction to any such package. Since the August meeting short rates have come down somewhat--about 15 to 20 basis points for bills--while longer-term rates are about unchanged to slightly higher depending on one's precise starting point. That leaves the long bond yield right now a shade over 9 percent, about 9.03 percent when I last looked. That's my brief summary, Mr. Chairman.

CHAIRMAN GREENSPAN. Questions for Peter? If not, Mike Prell, would you update us on the more relevant economic statistics of recent weeks?

MR. PRELL. Mr. Chairman, we've begun to get some information on developments since the Iraqi evasion of Kuwait but the data really do not provide a decisive reading on even the current quarter let alone where we are headed in the remainder of the year and into early 1991. Read literally, the employment report, retail sales data, and other economic figures that have come in would appear to us to be on track with our expectation for the third quarter. At this point, based on the data, we have no reason to make a significant revision. Looking toward the fourth quarter, given the flow of data, there probably would be little reason to make any significant change. Our forecast had been for 1/2 percent GNP growth; in essence, we were saying there was little more than a 50/50 bet that we would be in positive territory. I would have to say that the anecdotal evidence coming in through the reports from banks and everything else we hear has been quite negative. My reading would be that it might even be somewhat more negative than we thought would be coming in, given the kind of economic environment we had forecast. So, I'd have to say that if we were to write down a Greenbook forecast today, we'd probably be more in the vicinity of zero. Whether we'll be in plus or minus territory in the fourth quarter, I think, at this point, is really too close to call. But, as Peter suggested, many private analysts may be thinking it's not evident that a significant cumulative collapse is in process at this point. Indeed, one factor--which I would defer to Ted Truman to discuss further--as we look out over the next few quarters, is the decline in the dollar. While it may have some additional adverse price level consequences, it certainly seems to indicate that there's a greater likelihood that the trade sector will be a source of some buoyancy in the economy. I might just turn to Ted to see whether he has anything he'd like to add.

MR. TRUMAN. You said it fine.

CHAIRMAN GREENSPAN. Questions for Mike or for Ted? If not, Don Kohn, would you like to fill us in on your area?

MR. KOHN. Mr. Chairman, the aggregates have strengthened about as projected in the Bluebook; in fact, they may be just a tick stronger than we were projecting. Given a September projection for M2

of a little over 6 percent and for M3 of around 4 percent, for June-to-September we're looking at 5 percent for M2 compared to 4 percent in the Bluebook and 3-1/4 percent for M3 compared to 2-1/2 percent in the Bluebook. Generally speaking, the strength has been in the liquid components of these aggregates including M1, which is several percentage points stronger than we'd expected, and in money market funds. Core deposit components are still fairly sluggish. We have bank credit data for August which suggest a pickup to around 10 percent, but a lot of that pickup is in reverse RPs and securities loans; business credit remains quite sluggish. Consumer credit has picked up a little but that reflects a drop-off in securitizations; otherwise, it remains sluggish as well. And real estate credit appears to have dropped from the 8 to 12 percent area it has been in for several quarters now to around five percent in August.

CHAIRMAN GREENSPAN. Questions for Don? If not, I'd like to ask among the Board members and the Presidents whether they have a sense of change in their views since our last telephone meeting.

MR. BOEHNE. This is Ed Boehne, Mr. Chairman. I have observed a clear and significant change toward the weak side in this District in the last several weeks. And I think that economic activity across the board has slowed both in August and in the first part of September. Our manufacturers report a continuing decline in business; in fact, we have not seen as sharp a decline since the recession of the early '80s. Retailers generally indicate that sales have fallen from the prior month, and that is continuing into September. Bankers report an overall decline in lending activity. I would say that a recession mentality has taken hold, and I think it's not limited just to this District. Business sentiment is in the process of thinking pretty much on a wide basis that we're headed toward a recession and I think that is also the consumer mentality.

As I look at the national economy, my sense is that economic growth is essentially at a standstill based on the employment, production, and sales data, and that negative growth is the likely outcome for the fourth quarter. And I think if we wait to ease until a recession is upon us, we have waited too long. I think it's important to be somewhat anticipatory if we're going to stay ahead of the recessionary curve.

CHAIRMAN GREENSPAN. Ed, is it your impression that if we were to ease we'd bring long-term rates down?

MR. BOEHNE. If we did ease, I think it would be very important for us to be up front and quite clear that we are easing because we are trying to offset some [slack] in the economy rather than to try to find some other reasons for doing it. If we did that, I think we would have a reasonable chance of at least keeping long-term rates from falling or falling very much. That's a risk, but I think we minimize the risk by saying that we are easing because of the softening in the economy. The recessionary mentality is moving rapidly in business thinking and an easing on our part would seem to be a very reasonable expectation.

MR. SYRON. Ed, Dick Syron. May I ask a question?

MR. BOEHNE. Yes.

MR. SYRON. I agree with your analysis about where the economy is. Certainly, in the First District our sentiment is comparable to that in the 1973 recession in terms of people's expectations. I agree with your view of what's going to happen in the fourth quarter, and I think a move in the easing direction [is appropriate.] But I am wondering about the timing. If we were to take the course that you mentioned, which is to explain that we're easing--even before a budget accord has been reached and with the uncertainties in the Middle East--because the economy is so soft, how much weight would you give to the chance that people would expect further easing because they would be saying: "Gee, the Fed has gone ahead and eased, when they clearly didn't want to, preferring to wait for a budget accord. They must think things are awfully bad."

MR. BOEHNE. Well, I don't think it makes a lot of difference whether we ease today or tomorrow or the next day. Personally, I'm growing increasingly uncomfortable with the continuation of a no-change policy. If we think that there's going to be a significant budget announcement in the next couple of days and we could [wait], I don't have a problem with that. But I think we can get ourselves paralyzed waiting for the next development to occur to provide a more favorable environment to ease. And then we could find out we're staring a recession right in the face and we would have to ease fairly dramatically. I think it looks as though we're more in control of the situation if we ease the same way we tightened: that is, to take a series of steps when the timing seems right, being somewhat anticipatory about it.

MR. PARRY. Mr. Chairman, this is Bob Parry. One question I have--perhaps this should be directed to Don--is: If we were to ease very modestly, what would be the expectation of the effects on nominal growth in '91 if we wanted it focused on [unintelligible]. What might happen to nominal growth if we kept the interest rate constant? That probably would result in nominal growth being higher as a result of the oil shock, and the Board staff's expectation was that nominal growth would remain unchanged. If interest rates go down, it seems to me we are probably talking about higher nominal growth, which is going to result primarily in higher inflation. I wonder what Don's view is on this.

MR. KOHN. I think I'll defer to Mike who makes the GNP projections.

MR. PRELL. Well, I think the direction should be reasonably predictable: that if we take a more expansive approach by pushing rates lower at this point than they otherwise would have been, we would have somewhat higher nominal GNP growth next year. Our reading of history suggests that in the short run that probably is going to have more effect on the real side than on the price side. But I should underscore that a movement of a fraction of a percentage point isn't likely to have a dramatic effect in any event in 1991.

MR. BLACK. Mr. Chairman, Bob Black. To get the other side on the floor, let me just say that in looking at the national figures the sense of our directors is that the economy is going to continue at a pretty slow pace but we don't really [expect it to] turn down now [unintelligible]. And I think this may be a very crucial point in policy where we have to take a little less in the short run in the

interest of our long-run objective of bringing inflation down. So, I would urge that we not move just yet. It may be that we'll need to move soon, but I don't see the evidence quite yet that suggests we ought to move. My answer to the question you asked Ed a while ago is that an easing move would raise long-term interest rates. And I think that could be very counterproductive for the economy.

MR. GUFFEY. Mr. Chairman, Roger Guffey.

CHAIRMAN GREENSPAN. Yes, Roger.

MR. GUFFEY. [Unintelligible] the District economy will show relatively [unintelligible], albeit slow. Agriculture is the bright part, though it is still uncertain because of conditions in the Middle East. On the question that you asked Ed Boehne, I line up about right in the center of that. It's quite clear to me, given the weakness in the dollar and the uncertainty about the Middle East and the budget accord, that one simply would push long-term interest rates higher--and perhaps even much higher--and the dollar lower. I don't think this is the time to take that kind of action.

MR. HOSKINS. This is Lee Hoskins, I am here now.

VICE CHAIRMAN CORRIGAN. Mr. Chairman, Jerry Corrigan up in New York. Let me make several comments. First of all, this dollar question is becoming a matter of increasing concern to me. I think the dollar question itself has been joined with a lot of the banking issues and questions, especially abroad. I mentioned to you, Alan, on Friday, that last Tuesday I had an occasion to visit with banks in London. And one of the major themes of our conversation--which gets back to something Sam mentioned earlier--was that we have this rather unusual phenomenon of the dollar being on the weak side in the midst of an international crisis. One of the things he said in very unmistakable terms was that large flows of funds into U.S. institutions and U.S. dollars, which they themselves would ordinarily expect, were not there. Funds were finding their way into British and other institutions and into non-dollar instruments, not only because of the uncertain macroeconomic situation in the United States but also because of the elevated concerns and perceptions in Europe about the banking situation in the United States. And I think that reinforces macroeconomic considerations. In those circumstances, it seems to me that the dollar presents another risk beyond the one just [mentioned] on price level effects and that is, though we still have this big financing need, any significant further weakness of the dollar itself runs the risk of cutting the wrong way in terms of how it plays out in long-term interest rates here in the United States. I should also say that impressionistically and otherwise, I think that this credit contraction process has yet to run its course. For example, I know that some of the major banking institutions are going to be in an asset contraction [mode] for the foreseeable future, in part because of supervisory policies and initiatives but also because these institutions are distinctly on the side of being gun shy. But beyond that, I have had further anecdotal evidence that suggests that asset contraction by important regional institutions is having the effect of rationing out some who are perceived to be creditworthy borrowers--and in some cases creditworthy borrowers not associated with the real estate business. So, I think

that is still at work, though it's very, very difficult for us to quantify it in any sense.

Insofar as the economy itself is concerned, I would agree with the judgment that several have made that we don't, at this precise point in time, see evidence of a cumulating process of downward pressure. But, I must say, given the sourness of business and consumer attitudes, that I don't think it will take a heck of a lot to give us the message. Having said all of that, and having debated mightily with myself and my colleagues, my own view of policy at the moment is that we ought to try to sit tight here a bit longer in the hope that we do get something rather promptly in the budget area that is at least reasonably credible to the marketplace. In those circumstances, the dollar situation would tend to be a bit better, depending upon the [actual budget] package. As things stand right now, I think the likelihood is that we should ease at least a step further, but I'd rather sit it out here a bit longer in the hope that we can do that in the context of something of a positive nature in the budget process.

CHAIRMAN GREENSPAN. Any further comments?

MR. BOYKIN. This is Boykin, Mr. Chairman. Looking at the District, I would say that we're certainly quite [unintelligible]. To some extent the oil situation is a bit of a positive, but it's still too soon to get very much of a reading on that. In my mind, the external aspects of what policy should be tend to override the domestic concerns at the moment. As Jerry Corrigan and others have said, I think it's going to rest pretty heavily on what, if anything, comes out of this budget effort. So I would be a little hesitant to move right away.

MR. PARRY. Mr. Chairman, this is Bob Parry. We've seen some signs of weak economic activity in recent weeks; we recently had a breakfast meeting where that was communicated. But at this point I'd like to be associated with Bob Black, Roger Guffey, and others who suggest that perhaps we ought to not take this step to ease at the present time.

MR. STERN. Mr. Chairman, this is Gary Stern. In terms of the domestic measures of the economy, I'd say things are still moving along rather well in our District, all things considered. Having said that, there is no doubt that there has been some deterioration in attitudes and certainly concerns about the outlook; the level of anxiety is up appreciably. How and when that actually will affect economic activity remains to be seen. The only other thing I would add is that I'm concerned, even without the energy price issue, that we haven't been looking at very good inflation numbers for some time it seems to me. And we now also have some acceleration in money growth. So, I'm reluctant to be in a rush to ease policy in these circumstances.

MR. HOSKINS. Mr. Chairman, this is Lee Hoskins. I'd like to associate myself with Gary Stern's comments. I think it would be premature to move at this point, particularly with the aggregates coming back roughly to trend. I think we ought to stay where we are.

MR. KEEHN. Mr. Chairman, this is Si Keehn. I can't report anything in the way of a change over the last couple of weeks, since our last phone call. But I do think that the attitudes are becoming increasingly cautious out there--really even pessimistic. My hunch is that the numbers on growth in the Midwest are still a bit stronger than the national numbers. Clearly, we are at what I think is a very moderate [pace] and [the risks] are very much on the down side. It's getting awfully close here. While I was disappointed by what the 30-year rates did, I think there's enough anticipation in the market that we will ease that I'd be in Ed Boehne's camp--that we're moving close enough [to recession] that we ought to use a near-term outlook for policy.

MR. FORRESTAL. Mr. Chairman, as you heard on Friday, the economy in the Sixth District would be characterized as quite weak. There is definitely recession mentality among business people and consumers. However, I do not think that we have seen any deterioration; the report that you heard on Friday from our directors suggested, if anything, a slightly more positive attitude and slightly better numbers than I had heard two weeks before. In general, I continue to think that we need to ease policy and I had been in favor of making the move two weeks ago. However, in light of what has been happening on the budget side, perhaps it might be better to wait just a bit to see what happens on that score. And, of course, we do have the problem with the dollar to consider as well.

MR. MELZER. This is Tom Melzer. I guess I better speak so you know I'm here! In our board meeting last Thursday, I picked up a tone similar to that cited by Gary: People would comment that they felt very negative and yet the information that they were looking at hadn't really changed that much. Right now, the facts perhaps don't confirm the kind of pessimism that is out there and that is whipped up to some extent by the press. I don't think this is the time to move; so, that's where I stand.

CHAIRMAN GREENSPAN. Mr. Mullins.

MR. MULLINS. This is David Mullins. As the numbers come in on the national economy, my sense is that the economy continues to sink slowly and is not [about to] fall off the table. In the employment reports there was a down-tick in aggregate hours worked. My view was that retail sales were pretty weak, even though they were down only .6 in August; without gas station sales, they were down 1.1 percent. Industrial production continued to ease; capital utilization ticked down another notch. On the other hand, the PPI numbers even without the food and energy components were not especially encouraging, even though there were some encouraging labor cost numbers in the employment reports. In terms of the aggregates, it is true that money market funds and currency have picked up, but as Don mentioned, the [core] components continue to be weak and credit growth also continues to be sluggish. Another point, which some people mentioned at the last meeting, is that our financial institutions appear not to be in very good shape. I do think there's some danger in pinning our hopes to a budget accord. I'm not very optimistic that we'll get a very impressive deal and I'd hate to be put in a position of trying to validate a weak deal, at least in the eyes of the market.

I would agree that there's a significant chance that if we did ease marginally, long-term rates would react adversely and move up somewhat. That's almost inescapable in the current environment and I don't know if it will be any better later on. My feeling is that with the economy this weak and the [core] components of the aggregates and credit growth also weak, there is not a real substantive danger in being perceived as giving up on inflation. But there will be doubters. I guess my view is that it wouldn't be such a bad idea to get the market used to somewhat more movement in the fed funds rate and try to avoid the need for much larger changes later on. I would agree with President Corrigan and others that the dollar puts us in a more difficult situation now, and I would not oppose sitting tight. However, I continue to fear that as we move from a third quarter which I tend to think will be pretty weak into a fourth quarter which will be even weaker and as the inflation in the energy numbers starts working its way through the CPI--and if a weak budget accord comes out--we may find ourselves in a more difficult situation later on.

MR. ANGELL. It seems to me that this slowdown is not primarily a typical end-of-period monetary induced event. That is, it's a rather unusual event, given that we are 15 months into a period of the Federal Reserve bringing short-term rates down. Now, I think that means that we probably don't have as much monetary ability to maneuver since it's not a monetary-induced event. And given what Jerry Corrigan said about the exchange value of the dollar and what others have said about long-term interest rates, a move that shows a lack of Fed credibility on the price level objective simply will cause the rate of interest that the money market will insist on to be higher over the period ahead than we wish it to be. So, ironically, in order to have rates be lower we must not make the move until we get a climate for the dollar and a climate for inflation that is better than what we see at the present time.

MR. KELLEY. This is Mike Kelley. As I try to think through the risks and [unintelligible] characteristics of an easing here, I imagine that we probably could buy some insurance for the first and second quarters of 1991. How much of that would play through to real GNP and how much to inflation, I'm not sure. On the other hand, on the cost side it seems to me quite likely that we would have a further substantial drop in the dollar, which could be a problem for a long time to come. And possibly we run the risk of a surge in the core inflation rate here that we probably don't have presently. I emphasize core rate of inflation. It also seems to me likely that we would get a rise in long rates, which might well offset much of the benefit that we would hope to achieve from an easing of short rates. On balance, the reward that we might get from an easing seems rather ephemeral whereas the costs seem quite substantial and long-running. So, I would favor hanging tight for now.

MR. LAWARE. This is John LaWare. I'd like to identify very closely with Jerry Corrigan's remarks. As you well know from repeated speeches, I am more concerned about the risks of a recessionary environment and believe that the effects could be very serious and deep and long-lasting. On the other hand, if I thought that ease at this point would put the dollar into a free-fall from its present level, I would be very concerned that we might be abdicating real control over the situation in the future because the financing of a lot of our deficit would be forced back into our domestic market and

we'd have no choice perhaps but to flood the market with money in order to keep interest rates down. I am persuaded, however, that much of the tendency toward lower rates already has been discounted in the dollar. I really don't see it going into a free-fall, and I believe that there is a significant danger in waiting too long to move toward ease. So, I guess at this point for the first time I really would be on the side of making a modest move.

MS. SEGER. I'll bring up the rear and vote with John LaWare and Ed Boehne, probably because in the last week I met with some of Ed Boehne's bankers from Pennsylvania along with a lot of other people. I feel that the negativism is getting to be a very big problem in and of itself; the [negative] talk is just tremendous out there. In New York I talked with some brokers, and they are seeing many of their customers pulling funds out of equities in the stock market and going into money market funds. So, this is not money that's going to be supporting some big spending spree; it's money that people are scared about--they are escaping to something that's perhaps safer. So the money market funds are a parking lot; therefore, I don't view this increase in the monetary aggregates as a sign of strengthening but rather just the opposite. Also, there is tremendous concern about the overall health of the financial system, not just S&Ls but banks as well. I had two days of meetings with small business people in Chicago and heard again the very negative feelings. Many of the business people feel that they are in a recession at the moment: it's not a forecast, it's a fact for them individually. And frankly, I think they need some encouragement. Also, there's more and more talk about the spreading credit crunch. And it is no longer just from bankers who are complaining about being roughed up by the regulators and particularly by the examiners. I think that the credit crunch actually is getting worse and that, as Jerry Corrigan said, we probably have not seen the end of it.

Finally, in connection with the budget negotiations, I think we're really inviting trouble to tie our policy moves to what Congress does or does not do, because by delaying we will either produce a recession or, if we're heading into one anyway as some people argue, we'll just make it worse. Whichever way it is, we're going to sabotage the efforts of those budget negotiations because a recession itself is going to make those numbers worse regardless of what kind of deal they strike. I personally don't feel comfortable arguing that the existence of the negotiations is a reason to delay a decision. So, as I said, I would support John LaWare's position that we don't have a lot to gain by delaying and that we should be easing. I think much of a modest easing is already discounted in the foreign exchange markets and that that's one of the reasons we have seen the dollar decline in the last month or so. That would be my position.

CHAIRMAN GREENSPAN. Okay. This has been very useful. Does anybody have any closing comments before we adjourn? If not, this session is adjourned.

END OF SESSION