

Meeting of the Federal Open Market Committee

May 14, 1991

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 14, 1991, at 2:00 p.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Black
Mr. Forrestal
Mr. Keehn
Mr. Kelley
Mr. LaWare
Mr. Mullins
Mr. Parry

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

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

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

Messrs. Broaddus, R. Davis, Lindsey, Scheld, Siegman, Simpson, Slifman, and Ms. Tschinkel, Associate Economists

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

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

Mr. Stockton, 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

Messrs. Balbach, J. Davis, T. Davis, Ms. Greene, Mr. Lang,
Ms. Munnell, Messrs. Rolnick, and Rosenblum,
Senior Vice Presidents, Federal Reserve Banks of
St. Louis, Cleveland, Kansas City, New York,
Philadelphia, Boston, Minneapolis, and Dallas,
respectively

Mr. Judd, Vice President, Federal Reserve Bank of
San Francisco

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

Transcript of Federal Open Market Committee Meeting of
May 14, 1991

[Secretary's note: The Committee approved the minutes of the March 26th meeting at the start of this meeting.]

CHAIRMAN GREENSPAN. Are there any comments raised by the report on the examination of the System Open Market Account--agenda item 2? If not, would somebody like to move that?

SPEAKER(?). So move.

CHAIRMAN GREENSPAN. Without objection. We have a memorandum from Mr. Mattingly on amendments to the Rules Regarding Availability of Information. Virgil, do you have anything to add at this particular stage?

MR. MATTLINGLY. No, I think these are technical. The major reason is that the Committee is required by law to have a fee schedule for processing requests under the Freedom of Information Act, so we came forth with these recommendations. Because we had to do so, we suggested certain other changes to the rules to update them. They are all technical; they don't result in any substantive change in any of the disclosure policies of the Committee.

CHAIRMAN GREENSPAN. Are there any questions at all on this issue? If not, would somebody like to move acceptance?

SPEAKER(?). Move it.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Gretchen Greene, would you now report on foreign currency operations?

MS. GREENE. Thank you, Mr. Chairman. I hope you can hear me; I'm suffering from the same throat ailment as some others here. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Ms. Greene? If not, would somebody like to move to ratify the transactions?

MR. KOHN. There is nothing to ratify.

MS. GREENE. There were no transactions.

CHAIRMAN GREENSPAN. No transactions. That's easy. Thank you. In that event, let's move on to the report of the Domestic Desk. Peter Sternlight.

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

CHAIRMAN GREENSPAN. Thank you. Questions for Mr. Sternlight?

MR. FORRESTAL Peter, what was the foreign participation, particularly Japanese, in the Treasury refinancing?

MR. STERNLIGHT. It was quite strong in the 3-year, rather modest in the 10-year, and about average in the [30-year] bond. The bond had really light coverage. I think the major deficiency there was domestic demand; customer demand was really on the light side.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. On the 30-year bond auction I noticed a messy tail and light coverage. How much of that had to do with this botched bid problem?

MR. STERNLIGHT. There was, as you note, a botched bid; but it still would have been quite light coverage.

MR. MULLINS. But the tail wouldn't have been there?

MR. STERNLIGHT. The tail wouldn't have been as big, but--

MR. MULLINS. We don't have an automated auction system!

MR. STERNLIGHT. We're working on it, Governor; we don't have it yet but I would say that even an automated system is not going to remove totally the possibility of botches from time to time.

MR. MULLINS. How about the noncompetitive bids?

MR. STERNLIGHT. I don't remember specifically; I don't remember their being out of the [ordinary].

MR. KOHN. On the 3-year note, they were very close to the previous one; but I'm not sure about the 10- and the 30-year issues.

MR. MULLINS. Okay, I thought there was some sense that they had ticked up a bit.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Are you surprised by the narrowing of quality spreads at the long-term end of the market? What do you think explains most of that narrowing, particularly that involving less than investment grade securities?

MR. STERNLIGHT. I'm a little surprised at the extent of it. I think the big widening of spreads occurred, and particularly got exacerbated, during that somewhat scary year-end period when some genuine systemic concerns were beginning to emerge. As it was clear that we were getting through that period and that the economy was, though in a downturn, not in utter collapse, I think there was reason to expect there would be some narrowing. So, the fact of some narrowing shouldn't be any surprise; but the extent of it has been a little more than I would have predicted.

MR. KOHN. On the index I'm looking at, which is the Merrill Lynch index, although the spreads have narrowed by 4 percentage points from their highs around the end of the year, as Peter said, they are

back to where they were in the first half of 1990. And that's 4 percentage points over where they were in '86, '87, and '88.

MR. KEEHN. Peter, the 30-year Treasury rate, which seems to be going in the wrong direction, is hard to judge. What is the market's view on this? Is this a supply issue--just a very heavy volume of financing coming to market for [unintelligible]--or is this inflationary expectations?

MR. STERNLIGHT. It's very hard to sort out. I think both of those factors are there, President Keehn. Recently the most potent concern has been just the sheer supply. But lurking in the background there is concern not so much about a lot of inflation expected but of recovery expected and concern that there will be more competing demands for long-term financing.

CHAIRMAN GREENSPAN. Any other questions for Peter?

MR. HOSKINS. I just have a short one for Peter. The Bluebook indicates that the [funds] rate traded low because of market expectations. And I was wondering if you were having trouble signaling to the market.

MR. STERNLIGHT. There was that one occasion when the funds rate was sagging in mid-April and there was even some speculation beginning to build up that we were deliberately being tolerant of lower rates, and we thought it was good just to clear up those misperceptions by going in early one day. And I think the market got that message quite clearly on that occasion. Through virtually all the rest of the period the market seemed pretty clear in its perception of what they thought we basically were aiming for.

CHAIRMAN GREENSPAN. Would somebody like to move to ratify the actions of the Desk?

VICE CHAIRMAN CORRIGAN. Move it.

CHAIRMAN GREENSPAN. Is there a second?

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. Let's now move on to Mike Prell.

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

CHAIRMAN GREENSPAN. Questions for Mr. Prell?

MR. SYRON. Mike, on inventories: What do you make, if anything, of these stories that we have a smaller number of retail outlets for any given volume of sales and that there is a secular downtrend in this? Is that something worth paying attention to?

MR. PRELL. Well, I've made the argument for a long time now as I've looked at the trend of inventory-sales ratios in retailing. I've looked at the enormous growth in floor space in retailing and the many shopping malls that have opened up. We have developed an awful

lot of stores. Each one of them has some inventory. They have clearly moved beyond the point of adequate returns and we're seeing an industry shakeout. And in the course of that shakeout we probably will have some consolidation over time and some movement down in inventory-sales ratios. That's a very macro sort of view of the process. But clearly retailers have moved to try to capitalize on computerization and some of these other [techniques] such as "just-in-time" deliveries. They should be doing better on inventories than they seem to have done, and maybe this is part of the story.

MR. SYRON. What makes it a little hard to tell exactly is the lack of some abstract notion that targets what the inventory-sales ratio is and how far we are--

MR. PRELL. We still don't hear a lot of complaints that inventories are uncomfortably heavy. On the other hand, the profits aren't there. Something is out of kilter. I think this excess capacity in the industry is reflecting part of the excess stock of consumer goods on the shelves.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. One of the reasons for weakness in the second quarter is the pickup in nonfarm inventory liquidation. If you look at what we know in terms of sales and industrial production, which is admittedly very sketchy, do you think it's possible or would you say more likely now that we could actually see the pattern that seemed to be developing in the first quarter continuing in the second? That is, could actual inventory liquidation turn out to be less in the second quarter than in the first?

MR. PRELL. Well, I think you put your finger on the problem in saying anything with any great conviction at this point: We don't have much data. We've looked at orders to try to see beyond the data for recent months that we have on industrial production. We don't know a great deal about the flow coming in from abroad or going out from current production; that's an unknown. We basically reached this conclusion as one that was consistent with what we thought plausible as a final demand picture and what we sensed was going on in terms of production. Also, I think there is certainly in some sectors a desire to achieve lower inventory levels. And, as I've noted, this is the third successive quarter of substantial inventory liquidation. For a recession that we entered with supposedly pretty lean positions, we're ending up in total absolute dimensions with an inventory liquidation that's pretty much in the ballpark of previous cycles--not relative to GNP but simply in '82 dollar terms. So, maybe there is some upside risk, but I don't think there's a great desire to accumulate inventories at this time.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Is there something unusual in what we're seeing in personal income?

MR. PRELL. I don't think this is greatly atypical.

MR. SLIFMAN. Relative to what is happening to GNP, this is not atypical. In other words--

MR. PARRY. But GNP has been strong.

MR. SLIFMAN. The falloff in GNP, assuming our forecast is right, would be about half the typical peak-to-trough decline in GNP. But if you look at the ratio, say, of personal income to GNP, that ratio has its own cyclical pattern.

MR. PRELL. And we may not be getting, overall, the kind of cushion we did in some cycles in terms of the government sector. But I don't think there's a gross disparity here. We were disappointed, as I noted, in the first quarter; much of the surprise was in data revisions. Some of it seems quite plausible to us. Previously, the interest income figure seemed to be holding up more than appeared reasonable in light of what was happening to interest rates. So now we've had a significant reduction in interest income in the figures for the early part of this year. It's reasonably sensible.

CHAIRMAN GREENSPAN. They calculate that interest income in a very simplistic manner.

MR. PRELL. Well, of course, they use the very best data that are available: our flow-of-funds accounts!

CHAIRMAN GREENSPAN. Any further questions for Mike? If not, can we have our "tour de table"? Who wants to start off? Si.

MR. PRELL. Let me correct something. We did have some numbers and I blanked out on this. We're getting more DPI decline in this recession than on average in prior recessions. That's what I had in the back of my mind, but then I was thinking no other data I had seen looked different from that.

MR. PARRY. Again, is that relative to the GNP decline?

MR. PRELL. Yes, especially since this is a lesser GNP decline.

CHAIRMAN GREENSPAN. Who would like to start?

MR. KEEHN. Mr. Chairman, conditions in the District remain unchanged from the last meeting. You will remember that having come through the early phases somewhat better than other areas of the country, the data have now caught up with us, and the current level of activity in the Midwest, I think, is very much reflective of national conditions or already perhaps even a little weaker. There may be some tentative signs of improvement, but nothing specific to suggest that we have reached a turning point.

I think you can tell from Mike's comments, and it's certainly true in the District, that the critical area of focus is the auto industry. Our District will not show a real-side improvement until we see a sustained pickup in the level of retail auto sales. With the first and second quarters essentially complete now, the 1991 model year really has been a big disappointment. The forecast of total sales for the full year was being pulled down to 12-1/2 to 13 million units and even that reduced level is quite dependent upon having a good improvement in sales in the third and fourth quarters. And though car inventories at the retail level are really quite low at

this point, the dealers are still reducing their orders substantially. At the time of the last meeting I reported that orders by retail dealers were in excess of or within the sales level. That has turned around. The dealers have turned quite negative and are ordering cars at about 80 percent of the current sales level, and that's, of course, very unusual for this time of the year. In part, the dealer attitudes are based on the fact that many of them are losing money; at this point something like 50 percent of the dealers are in loss positions. Despite this, given the seasonal factors of course, production in the second quarter is going to be up quite a bit from the very depressed levels in the first quarter. Still, that higher level of production will be substantially under the production levels of the second quarter of last year. But because of this shift between the first and second quarters, in a production sense the industry is going to be less of a drag on GNP than it was in the first quarter; indeed, it might have something of a positive effect. As a final comment on the auto industry, I certainly would say that the enormous first-quarter losses that the Big Three experienced have cast a big pall on the Detroit area.

Many of the other sectors of the District are impacted by the auto situation. In the steel business, for example, one of the CEOs was telling me that his business was, in his term, "rotten." They currently are operating at about 70 percent of capacity. The forecast of shipments for the year has been reduced from 85 million tons last year to 76-77 million tons this year. And of that reduced level, about 20 percent is going into the export markets; of course, those sales have very little margin, so there's not very much profit there. Other suppliers of the auto industry are equally hard pressed. Some of the other parts of the District also are having a fairly weak time of it. Construction activity, for example, continues to fade. Construction contract awards are off very substantially from last year; through March the awards level is something like 26 percent under last year's level. And people in the concrete business say that they are experiencing something of a free fall.

More positively [for prices], though, the news in the agricultural sector is really quite good, mainly because of a reduced level of exports. Corn and wheat prices are under [downward] pressure; that's going to hold down farm income. Nonetheless, I think in an inflationary sense that ought to be good. Due to heavy rains-- we have had a lot of rain in the Midwest--planting is about 10 days late. But this is really a good problem, not a bad problem. People I talk to say that the planting conditions really are excellent. And while it's certainly far too early to judge the outlook for crop production, at least at this point it looks pretty good.

Also positively on the inflation front, based on my talking to people, I think the price outlook is continuing to improve. Competitive conditions in the marketplace are awfully tough. Price increases are just very, very difficult to sustain. And people who keep track of their raw material purchases say that they are experiencing very little price increases on raw material purchases. The CEOs, looking ahead, still don't have any expectations that they're going to experience a very big price escalation.

Net, while in a national context we may well be reaching a turning point, certainly we don't yet see it in the District. From

our perspective within the District an improvement is going to be very dependent on the auto sector--an improved level of sales following the end of the model year production--and also an increase in exports. Certainly at this point both of these objectives seem agonizingly elusive.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I think the staff's downward revision in their projection of real GNP for the second quarter makes sense in light of the incoming information. More generally, the overall profile that they've predicted for the next three or four quarters strikes us as eminently reasonable given the staff's policy assumptions, the behavior of most of the leading indicators, and the pattern of recent anecdotal information. It's interesting to me how close the projections of the staff are to those of the private economy. Mike suggested theirs were a bit stronger, but it seems to me they are remarkably close, which is something that many people might view with alarm given the record of forecasters in the past. I might be one of those except that I believe they're about right on this. And I believe that the risk of error is about equal on the up side and on the down side. I guess the most important question we ought to ask ourselves is: How great is the risk that we will have a big error on the down side? In other words, how likely is it that we will get a significantly greater decline in the current quarter than the staff expects and that this will be followed perhaps by a greater decline in the third quarter? Obviously, we can't rule that out entirely; but in the absence of some totally unlikely, unexpected negative supply shocks such as we had last August, the probability of that kind of decline seems to me to be pretty low. We've already taken out a lot of insurance to prevent such a thing happening, with the cumulative policy actions over the last six months or so. And beyond that, we're now seeing new signs of life in residential construction, strength in the stock market and some of the other leading indicators, and a recent upturn in the National Association of Purchasing Managers' index, which was higher in April than it was in the lowest quarter trough of any previous full economic upturn.

So, those all suggest to me that we are probably now very near the bottom of a recession. Whether it's going to be longer or whether it's a near trough, I don't know. But it seems to me that a significant further weakening is decidedly unlikely. I was particularly glad to see that the staff has reduced its inflation forecast because I have felt for some time that we had followed a very wise policy [course of] action and that it would pay off in terms of inflation numbers. The staff has cut a couple of notches off the inflation projections for both this year and next year and they're now predicting a core rate of inflation of about 3 percent at the end of 1992. And I think we ought to have at least that degree of progress against inflation. But it is important that we keep in mind what the staff has assumed when it made these projections, and that is that we'll come very close to achieving the midpoint of our target range for M2. I think it's critically important that we take whatever steps are required to keep M2 somewhat in that range in case the recovery and consequently the money demand turns out to be somewhat stronger than it now appears to us that it might be.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, activity in the Atlanta District is generally the same as in the rest of the country as a whole, although I must say that the business people I've spoken to recently are somewhat less pessimistic than they were six weeks ago. In the immediate Atlanta metropolitan area, the sentiment has gotten a big boost by the announcements from UPS and Holiday Inn that they are moving corporate headquarters there as well as the awarding of the fighter aircraft contract to Lockheed. The most positive event that has happened is that there have been significant increases in sales of single-family homes in the last several weeks. On the retail side, consistent with the report we had this morning, retailers in the District are reporting a pickup in sales in March but activity in April fell off and was below their expectations. Tourism, too, has picked up as well as convention bookings in the District, and that is interesting to note, too. Foreign visitors are beginning to come into the area again after the Persian Gulf situation; that's particularly true in Florida.

In the manufacturing area, orders are still fairly weak, employment levels continue to be reduced, and capital expenditures are still being postponed by most business people that we talk to. Exports from the District have also been weak; some are attributing that to weaker growth abroad. But I think another factor to be taken into account is that military shipments from the District ports displaced regular shipments; that probably accounts for some decrease in that export activity. The agricultural area is quite mixed. Crop production probably will be lower this year but fruit, vegetable, and livestock should be higher. Si mentioned the rains; we've also had heavy rains almost throughout the entire District and that has delayed planting in practically every state. All of the states in the District have been hit, as have many others of course, by revenue shortfalls. Up until now in our District the legislatures have resisted any major tax increases. But if we don't get a turnaround in the economy fairly soon, I think most of the states in our District are going to have to look at major tax increases next year.

The credit crunch seems to be about the same as it was at the time of our last meeting; that is to say there really doesn't seem to be much change in the standards that the banks are applying. The problem, according to most bankers, is on the demand side. There just isn't a great deal of demand for loans. Price increases, as someone else mentioned, are minimal if not nonexistent; and that seems to be what is expected over the next several months.

Looking at the national economy, we've lowered our forecast since the last meeting. We're somewhat weaker in both '91 and '92 compared to the Greenbook, but not appreciably. We have both consumption and exports weaker and as a result our unemployment is a bit higher. But we also show a little better success on the inflation side; our inflation number is a bit lower. I think the risks in the forecast are more symmetric now than they were several weeks ago-- certainly more symmetric than they were earlier. I have been saying right along that I thought the risks were on the down side; I'm not so sure that they're completely on the down side now. But, and I think Bob Black was alluding to this, the costs of missing are really not symmetric at all. That is to say, it seems to me that the costs involved in overshooting the forecast are not very high, given the present levels of capacity and unemployment. But if the economy turns

out to be weaker than the forecast, then I think the costs would be very, very high indeed. Obviously, we need to take that into account as we set our policy recommendations.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the Twelfth District employment statistics have become a bit weaker since our last meeting, although the District as a whole continues to outperform the rest of the nation. In March only the state of Arizona reported a month-to-month gain in employment in our District. However, the declines in the District's other states follow several months of relatively robust employment growth. Employment levels still are between 1.6 and 4.8 percent higher than they were a year ago in District states other than California. And that would compare, I think, to a fall of about 1.2 percent in the rest of the nation. California's economy has slowed with the nation. Since last July employment has fallen nearly every month; in April the state posted its first year-over-year decline in the level of employment which was down 0.4 of a percent. Durable goods employment continues to fall, led by declines in aerospace and electronics. I think some of our losses were gains in the Atlanta District. Construction employment has fallen to a level about 8 percent less than it was a year ago but, interestingly, real estate sales and prices have picked up. As a matter of fact, the median price of residential real estate in California is now above its previous peak.

The effects of California's economic slowdown, combined with growing structural problems in the state's budget, have resulted in a projected \$12.6 billion deficit by the end of the next fiscal year. Tax receipts have been low for rather obvious reasons: weak sales, weak consumer spending, and also unexpectedly low corporate and bank profits. At the same time, case loads in the health area, welfare, and especially at prisons have risen sharply, and mandatory cost-of-living adjustments have further increased required expenditures. At the same time Governor Wilson has proposed [reducing] the deficit through a 1.5 cent sales tax increase--the tax right now is 6 percent or higher based upon some local initiatives--elimination of all COLAs on programs, and shifting some state services to the counties, although no one can figure out where the counties are going to get the money to finance this. Where this will all end up is difficult to say because the governor is adamant about not changing income taxes.

As far as the national outlook is concerned, our view is not very different from that of the Greenbook. We have slightly slower economic growth and a bit less inflation. We expect the economy to be roughly flat in the current quarter and then we think real growth probably will average somewhere in the 3 to 3-1/2 percent range in the second half, which is a little weaker actually than the Greenbook. Next year, we look for growth to slow a bit to 2-1/2 to 3 percent. It's clear that the main sources of expansion should be the easing of monetary policy, which President Black referred to, a gradual improvement in consumer and business confidence, and a pickup in inventory investment. It also seems quite obvious that the recent rise in the dollar and slower economic growth abroad are going to limit the contribution to growth that will be coming from the foreign sector. In view of the slack in the economy and also the lower oil

prices and the higher dollar, we would expect inflation as measured by the CPI to decline next year to about the 3 to 3-1/2 percent range.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. With regard to the national economy, we have no quarrel with the Greenbook forecast.

For the Eleventh District, we have been right at the top of the Districts in terms of maintenance of employment levels. As a matter of fact, we were probably number one until a couple of months ago; I believe about a month ago the Kansas City District overtook us. But now we're beginning to experience a decline in employment and a rise in unemployment rates. Many of our local unemployment rates are now at or above the national average. The strongest data in our District are in Texas, particularly the Houston and the Gulf Coast areas. Petrochemicals and energy seem to be helping them a little. The impression we get from our directors is that growth is positive but barely so.

Borrowers in our District believe that the credit crunch is very real; they always have and still do. Generally, bankers have been telling us that there is just not good credit demand. The Texas Bankers Association did a poll the other day and the majority of them said there was a credit crunch and that it was all the regulators' fault that it existed. State finances are tight, too, and Texas is beginning to talk about an income tax.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Thank you, Mr. Chairman. The economy in New England is very poor, with few spots showing improvement; [there are some exceptions], primarily housing. Perhaps most disturbing is that I think this may have to do with just getting further into a recession; an enveloping feeling of gloom has affected everything. And I see that it spreads further down in the Northeast, actually.

As other people have noted, we too have continued problems with state and local governments. If anything, the estimates of the deficits on a state-by-state basis are increasing and increasing in a fairly significant way, which will absolutely necessitate significant tax increases. The retail situation, however, is a little mixed. Durables are not good; autos in particular are very soft, although nondurables have picked up somewhat. Some mail order houses particularly have noted a pickup in demand; a lot of that is probably [goods] sold out of the District. Interestingly, consistent with improving their margins, some [chains]--and we still have to see how this will work out--actually are charging for postage on catalogues.

Commercial real estate continues to decline. As I mentioned, housing has picked up a bit for first-time [buyer] units, which in our District at this stage of the game are homes whose prices total less than about \$200,000. Manufacturers seem to have become quite pessimistic even in the computer area where things have picked up a little nationally. Suppliers to the auto industry and to the aerospace industry are quite pessimistic. Interestingly, we have several defense contractors some of whom--for example,

--also have a significant part of their business in the commercial sector, and they have said that on balance any improvement they got on the defense side was washed away by the regular civilian side. They still see this long-term reduction in restructuring on the defense side. Prices, consistent with all this, continue to be pretty well behaved.

Our lenders are quite cautious. Even a couple of our largest banks will say, essentially, that they are not lending unless it's extremely good credit. Others that are in a little better shape will tell you that they just are concerned about the loan quality coming in. But universally they are seeing very, very little in loan demand. As a consequence, they just don't want money. I think this is related to what is going on in the monetary aggregates. Some institutions that have had potential customers come to them are really lowering their offering rates quite a lot. Those are people coming from institutions that are closing or have capital [problems] and from others that don't feel they need any money. I'm not quite sure how one factors this into evaluating the situation, but at least in New England--and I suspect more so nationally as well--this issue of restructuring that we've talked a lot about both in financial services and manufacturing, and what is happening in inventories and in state and local governments, does make a situation in which one has to look at the employment numbers at least somewhat skeptically as we go forward. Once managers get into this process of feeling that they can have the same level of output and maintain their margins by reducing costs if not increasing sales, they discover all kinds of opportunities that I think they're going to exploit for some time to come. I was struck by talking to several people who were saying that there's still more to do here and that they are discovering new opportunities.

One interesting story that fits with what is going on in inventories--showing that this is again a two-sided sword--is that we talked to an off-price discounter who indicated that business was horrible but the reason business was horrible wasn't so much that the demand in the stores was horrible; it was because manufacturers had maintained their inventories more carefully and he wasn't able to pick up the volume of distress sale goods that he could before.

Nationally, I find the Greenbook forecast very plausible on a center-weighted basis. One would really have to nitpick to find fault with it. It is more useful to ask what the risks are. I would think that in a very, very marginal sense the risks might be slightly on the down side; I see the third quarter falling into the same pattern as the second quarter conceivably, typically because of concerns about exports. But I do think--and this goes back to what Bob Forrestal said--that one needs to look at the risks of the outcome, if you will, not just the risk of something happening. If we were to get much further deterioration than we expect, that could be fairly difficult to deal with given the problems that we have in some sectors. On the other hand, one has to be very encouraged by at least the forecasted improvement in prices that we see. It really would be tragic to throw that away. So, I think it's very hard to be sure of the outlook at this point, which makes it extremely important to follow the data that continue to come in very, very closely.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Mr. Chairman, I would continue to characterize conditions in the District as mixed, but overall not bad. Agriculture is looking pretty good. The key word there, as usual, is moisture, and in much of the District it now appears to be adequate this year. The livestock sector is really doing very well, as it has over the past several years as well. In the paper industry and the forest products industry, again, conditions are mixed. There is a lot of excess capacity at the moment in paper and even more coming on [stream], but the profits aren't there. But that's a business where they tend to run at capacity almost no matter what, and they're still running at capacity, at least in our District. The wood products business has come back a bit, and that's probably a consequence of an inventory cycle and maybe some optimism about the outlook for homebuilding. Clearly, housing sales have picked up substantially, certainly in the Twin Cities. It's my understanding that not only are houses selling but they are selling at pretty close to asking prices without any fancy financing so far as I can tell. On retail sales, once again I haven't heard any horror stories. Some people say business is tough and some say it's satisfactory, and that seems to be about the way that has been holding. Only one state in the District has a significant budget problem with which they have not yet come to grips. I don't know at this juncture what the pieces of that resolution might turn out to be.

With regard to the national outlook, I'm pretty comfortable with the Greenbook forecast. I also think, as several people have commented, that it pays to reflect on the risks a bit at this juncture. The risks are probably symmetric in the sense that while a recovery by midyear is likely, I do think we're going to need to see a good deal more consumer spending. In that regard, I have been under the impression, and Mike confirmed it, that perhaps disposable income has been somewhat weaker than I would have expected throughout this contraction, and that is certainly a source of concern in my mind. On the other hand, as to the risks on the inflation side, I find the recent data encouraging and most of the anecdotal reports I'm getting encouraging as well. But I must say I'm not persuaded yet that we have nailed down a significant reduction in the core rate of inflation. I'm a little puzzled as to why the bond market has not responded at this juncture, not just to the inflation news but to the overall picture of what is happening domestically and abroad. And I wonder if we don't have to be a little sensitive to that.

CHAIRMAN GREENSPAN. You mean [the volume of debt financing] doesn't explain it?

MR. STERN. No, I don't find that an adequate explanation.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. In the District, the signals are mixed but on balance I think the overall District economy is still down like that for the nation. As in the nation, commercial real estate and retail sales are generally negative. There are some indications that manufacturing is beginning to bottom out. The only clear area of upturn is in home sales. Loan demand is still weak. Bankers say that there isn't demand; the business people--or some of them, anyway--say that the bankers won't lend. With regard to state and local

governments. Philadelphia is about to go broke; the states have deficits. So, I think that situation is fairly general.

I would say the attitudes vary from cautious optimism, with more emphasis on "cautious" than "optimism," to a lot of concern on the part of business people about when a recovery will occur and what kind will occur. I find more people who are just about writing off 1991 as a bad year and they are beginning to look to 1992. I sense, and I don't think it's particularly unusual at this stage of the business cycle, a dichotomy now between those who analyze the economy and those who manage it. I think most of those who analyze the economy see signs that the economy is beginning to pick up, whereas those people who have annual meetings to chair--whether they want to downsize the company another notch or they are going to meet the financial analysts--want to be reassured that there really is a recovery out there; they don't really yet feel it in their bones. We're at a fairly critical period in that, if we don't begin to see some tangible evidence on a broader base that we are indeed going to get a recovery, we could see confidence really drop off and we might have a double-dip in terms of the downturn. I do subscribe to the notion that the economy is going to pick up, but I think we're playing with some tender attitudes out there. I would say that the risks are probably even to maybe marginally on the down side. But I [agree with] those who are concerned about the outcome. If we don't get a recovery or if it's postponed, I think there will be some real costs and it will be quite difficult to try to get the economy turned around.

On the inflation side, my sense is that financial markets may be somewhat behind in appreciating what is going on in most of the economy. We're making better progress on inflation than I would have expected a few months ago and that's positive. I think the long bond market has some catching up to do there. As for the Greenbook forecast, I think it's reasonable. I would probably have more of a saucer shape kind of recovery--perhaps a little weaker--but it's hard to quarrel with the basic analysis there.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. In the District itself we continue to see some modest pickup in economic activity. In manufacturing, for example, the auto plants are not back full out, but the Ford plants are running two shifts and a large General Motors plant in Kansas City itself is beginning to put people back on [the payroll]. It also has raised a problem in that they simply have begun to use overtime rather than put a second shift back on. And the unions have become very upset because auto manufacturers haven't put the second shift people back to work. As a result, I think they're trying to manage [unintelligible]. It does seem quite clear to me that although the auto makers' projections are not strong, there will be some positive impact on our output in the period ahead simply because they are starting from a very low base and they are at work and are producing. In the aviation area, general business aviation--the small jets, for example--is still very good. They had very good bookings and sales in the first quarter and that is projected to continue. Construction remains sluggish, particularly in the commercial area, but in the residential and other nonresidential areas some pickup is evident.

The agricultural area has already been discussed. The winter wheat crop looks to be fairly good and is spotty only in the sense that we've had some fairly severe weather come through the Midwest and that could be devastating to wheat at this stage in its development simply because of the hail and strong winds. But by and large there is a fairly optimistic view of that crop. The problem, obviously, is the weak commodity price for wheat. Nonetheless, it's better to produce than not to produce. Cattle producers, as I've indicated before, are doing very well, and that's projected to continue.

In the energy area, drilling has slacked off I think simply because the stability of the imported oil prices at \$20 a barrel or thereabouts does not encourage very much exploratory drilling. There has been some development drilling. That is, after a field is discovered, it has to be developed, and there is some modest activity going on in that area. The other area of optimism in the energy field is the oil field suppliers who take some encouragement from the Gulf contacts that they established as a result of the Persian Gulf oil catastrophe.

With regard to the national picture, I have no great quarrel with the Greenbook forecast. As a matter of fact, I think it's a good deal better than it has been in the past. We believe that the staff is a little over-optimistic on the timing in that their second-quarter forecast is considerably stronger than we have, although the second half of the year really comes out about the same. So, it's simply [a difference in] timing. When we scaled back the second quarter we scaled back a bit from where we were before. But, on balance, it's as good a forecast as I think one can make, and it's a believable forecast.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. Well, Mr. Chairman, on the forecast first: We have a profile at least that is similar to Mike's, although not quite as strong--especially in the second half of the year. But certainly [we expect] a respectable recovery over this six-quarter period. Mike did mention several areas of uncertainty. One of the reasons why our recovery is less robust than the staff's is net exports; the staff essentially has net exports plateauing and we have a \$20 billion deterioration built in over the entire forecast period. I don't have a lot of confidence in that forecast and I think Mike made the point earlier that it could go the other way. But it is in marginal terms an area of great uncertainty in this forecast period. And the difference between 0 and +20 or 0 and -20 in terms of the kind of growth rates we're talking about here is not inconsequential. Another point I'd just mention about the forecast--several people have mentioned it--is the state and local sector in a context in which the underlying thrust of fiscal policy is probably on the restrictive side as well. The state and local [data] have all kinds of smoke and mirrors in them and it's hard to know what the real picture is. But it's hard to dismiss the possibility that there could be a greater measure of difficulty there, especially because these problems are so pervasive. There are darn few states and certainly few major cities that don't seem to have pretty hefty fiscal problems. Again, the smoke and mirrors makes it a lot harder to judge how difficult that may be. But, as I said, I would associate myself with those who feel

the risks in the forecast probably are more symmetric than they were, in part because of the changes in policy that have been made.

On the anecdotal side, we clearly hear report after report to the effect that the residential construction market is looking much better. In your old neck of the woods of [northern] New Jersey, Tommy, one of the thrift people was telling me the other day that in the first three months of the year the stock of existing unsold houses in Summit was cut in half. That's one little community, but that community is not a trivial piece of the puzzle up there in northern New Jersey. The commercial side is lousy. And in the industrial sector, the comments that I get from big manufacturing companies continue to be sour across the board. Of course, a lot of these guys are sour all the time so you don't try to make [much] of that. But one comment you do get from these guys who are sour all the time is that there is a higher sense of anxiety about the outlook for their exports over the next four to five quarters.

It's also important at this point to note--and several people have touched on various facets of this--that we can now see several areas in which some good things are happening that are not entirely unrelated to the kind of policy that we've been following. For example, balance sheet rebuilding even in the face of the decline in the saving rate in the household sector is making some real progress. And what we're beginning to see in the corporate sector is also noteworthy. Indeed, if you look at some of the things that were going on in the second half of the '80s, particularly for the companies that aren't already bankrupt, this reverse of the old phenomenon is not entirely inconsequential. Taking a longer view, I think this balance sheet rebuilding, while it may temper the recovery, could turn out to be a very healthy development for the intermediate term even though it may dampen things a bit in the near term. Somebody mentioned--Dick Syron, I guess--that restructuring is taking many forms and includes state and local governments. I think that is now more than straws in the wind and that's beginning to pay off. I'm trying to remember, Mike, when the last time was that we had a 2.8 percent decline in GNP and a 1 percent rise in productivity; I'm sure it has happened, but not very often. And that in itself may be symptomatic of some of those things.

A number of people have mentioned the inflation situation, and I have to say that in this area there has been a change in my thinking. For the first time since the so-called core inflation rate plateaued at around 4 to 4-1/2 percent in 1984, I think we have a pop at penetrating that 4 to 4-1/2 percent core inflation rate. I've never felt that in this entire period. Now, like Gary Stern, I'm not ready to bet the ranch on it, but I do think that the inflation outlook is distinctly better. I still have to wait a little to see if we can get through that threshold. My hunch is if we can get through it, we might have a reasonable chance of staying through it.

So, I think the outlook is still murky; there are plenty of uncertainties. But on the other side of the coin, I can see in a number of areas things that might bode well for the intermediate term.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I haven't heard much change in the kind of anecdotal information we've been hearing for the last couple of

months, though there is a somewhat more positive tone to it, with strength in the obvious places but no evidence in those comments of new areas of strength and no new areas of concern. One other comment on the anecdotal side I would make is that Jerry mentioned the sour comments from manufacturers and I wonder--and it's too early to tell now because I suspect their orders are still pretty lousy--whether they're going to be expecting too much out of this recovery. They may be thinking of more traditional recoveries. My guess is that it's still going to be a very difficult environment in which to do business. On this point I was amused that when Alan was in St. Louis a month ago we heard one manufacturer who heads up a very well-managed company fussing about the margin pressures. He said he hadn't seen anything this bad since '74-'75. But subsequently, having seen their first-quarter earnings, there was another increase--maybe a record. So, there are some people who like to tell us how tough it is.

As for the numbers themselves, as was noted before, the positive information we're receiving is mostly anecdotal and it isn't there in the numbers. In our District it's starting to show up in the numbers through the first quarter. We actually had nonagricultural employment growth at about--not quite--a 1.5 percent annual rate. Manufacturing is still weak; that's primarily in transportation, autos and aircraft. And in nonmanufacturing and services, there was strength across the board with most of the contribution being from wholesale and retail trade and services. We also had growth in the construction sector. The previous four quarters all had declines, so this was the first positive quarter in nonresidential construction contracts in over a year.

On a broader basis, one comment I want to make is on this inflation question. I'm somewhat troubled the more I hear comments about and see in the press good reported inflation numbers. When I say in the press, I mean comments from market observers--I don't associate this with what Jerry was saying before about better reported price numbers in the short run--that somehow that gives policy room to move. I have two reactions to that. One is that I think the numbers we're seeing now are the result of actions taken many months ago, if not years ago. And in that sense I don't think they justify any action on our part in the short run if policy is in the proper position. The second aspect of that, and the more important, is that these are declines from unacceptably high levels to somewhat lower but I think in a longer-term context still unacceptably high levels. What I'm saying is that if the policies we've put in place over a long period of time are working, we're going to go through a fairly long period where we're going to see better price numbers, but that in and of itself shouldn't be a justification for easing. There is this rather simple-minded concept sometimes in the financial markets that somehow that gives the Fed room to ease and I just don't buy it.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. There are indeed mixed signs out there. But I think we should note that the three major forces that took us into a downturn are no longer there. We no longer have any energy/oil price escalation that is eating up purchasing power; most of that price increase is now out of the system, as we've seen. The housing price situation, whether it's deflation of disinflation, has changed; whatever it is has slowed down. We're in an environment in which we

have improved affordability of housing, and I think that going from a minus to a plus is a rather significant factor. And we're already seeing what is happening in regard to the autos--at least the inventory adjustments that already are there. That leaves us, then, with [a question of] what it might be that would take the economy another leg down. And I frankly do not believe that the risks of that happening are symmetrical. I suppose it certainly is true that if net exports were to falter, having been as strong as they've been, that would be an offset to some of these other areas of improvement. But it seems to me rather unlikely that we'd get that much movement in net exports with the time lags that generally exist in the net export sector. Now, I think we should note that bond supply always tends to increase during a periods of downturn, which impacts government revenues. But what happens to the financial markets is that loan demand generally falls off as much; so during most recessions we get a typical downward movement of long-term interest rates that exceeds what we've had this time. We can do all the talking we want about why it is that the financial markets do not see the improvement that we see; and yet there are people who are making bets with real money and I don't think they have any reason to want to be biased. As long as we maintain money growth above the [bottom of the ranges] that we have adopted--and certainly we've maintained it around the midpoint--it would be conducive, it seems to me, to an increase in nominal GNP, if not quite as robust as you have it, Mike. Nevertheless, I would expect nominal GNP to increase rapidly enough that this improvement in inflation that everyone is anticipating thereby provides that kind of growth. It may very well be time for us to be patient with regard to being willing for that phenomenon to take place. What is wrong with nominal GNP growing 1 percent less than we have projected if that means that we're going to make that much more progress on price stability? When the bond market really sees that [progress], then I think we'll get the additional stimulus that will come from a normal cyclical decline of long-term interest rates. That has not happened in this cycle.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Not a lot has changed around the District since the last meeting. There has been no drastic drop-off in anybody's order book that I can find and no drastic increase either. Really, very little has changed. We're running at an unemployment rate somewhat higher than the nation. And the same comments that others had about pessimism apply to the District.

In terms of the national outlook, I have some discomfort perhaps even with the way we structure the meeting. We talk in these meetings about the forecast as if it's something that we can control; we can control the forecast but not the outcome very well. There are a number of real events that we simply are unable to anticipate that will change the actual outcome from the forecast. So, we almost set it up in some sense to lead us toward more of a fine-tuning approach than I think is warranted by the knowledge that we have as policymakers or as economists. That leads me back to Tom Melzer's and Wayne Angell's comments in terms of what we ought to be thinking about in the future, and that is not to be making tradeoffs for inflation and employment. It seems to me that that's nothing but a potential problem for us. Because the inflation rate is low by the standards of recent history that is no reason not to continue to press forward with

what I think is the right thing for a central bank to do, which is to eliminate inflation. We can look at long-term interest rates all we want but there's not much we can do about them unless we get rid of the uncertainty about inflation. And the way to do that is to have a credible and predictable policy. I think at this point the Federal Reserve's credibility will be tested and it's very important for us not to err in that test. I'll save the rest of my comments for the [policy discussion].

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mr. Chairman, I have been very disappointed in the fact that a rather aggressive pattern of moves toward ease over the past several months has not really resulted in much more stimulus to the economy than the refinancing of existing debt. That leads me to the conclusion that perhaps we have a somewhat different kind of phenomenon here, namely that we have a real crisis of confidence that doesn't necessarily get cured by repeated signals of monetary ease. I guess I'm convinced that the number of things that are acting against renewal of confidence in the economy is very significant. First of all, we have genuine concerns about the health and the future of the banking system, which I think are very widespread. We have corporate profits that are very disappointing. We have a very heavy debt burden remaining for consumers, for businesses, and for governments--to the extent that the fiscal problems of state and municipal governments really have taken away their ability to have any stimulating effect on the economy. In fact, there's an overhang of apprehension on the part of both businesses and consumers that these problems of state and local governments can only result in higher taxes or reduced services or a combination of both. We have press reports of layoffs and restructurings and bankruptcies; we have lackluster performance in new orders that certainly has damped business enthusiasm for expansion. And the stubborn resistance of long rates to respond to lower rates on the short end is a reflection, I think, of inflationary expectations on the part of the public. I believe that, until confidence picks up in some fashion, the economy is likely to remain sluggish. Therefore, that leads me to conclude that the risks in the forecast really continue to be on the down side. But for the life of me I don't have a good solution as to how to stimulate that recovery in confidence.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. I'm hopeful that the economy is pretty much on track for bottoming out this summer or in the third quarter. The evidence does suggest that it is contracting at a slower pace. We see that in the industrial production numbers, employment data, the purchasing managers' report, and maybe even in the retail sales numbers. There continue to be things that bother me. Paralleling what Mike did, I have a list of moderating influences on the strength of the upturn; it started out with only the debt overhang and commercial real estate as the two factors. I've added financial fragility--although maybe I can retire that one--higher unemployment, state and local government problems, the higher dollar, weaker foreign economies, and now some inventory concerns in some sectors. So, the weight of these moderating influences is becoming a bit heavier.

It also seems to me that the Greenbook story this time in May versus March is a little less satisfying; it may be more accurate.

But it is unlike the old story, which had a starring role for the consumer to lead us out of the recession--propelled by increases in real income as oil prices dropped, a wealth effect out of the increase in stock prices, and a rebound in consumer confidence. It has been four months since the market rebounded, four months since oil prices collapsed to pre-war levels, and two-and-a-half months since consumer confidence rebounded. And now in the May Greenbook we're projecting consumer spending to grow not nearly so fast as we were projecting it in the March Greenbook. Obviously, consumer spending grew a bit faster in the first quarter. The saving rate remained low but personal income didn't grow. Governor Angell asked what will take the economy a leg down; I guess I'm wondering what will take it a leg up. I wonder if there's enough impetus in this new story to get us moving. In the new recovery script, the consumer takes a less prominent role and we project these three factors to lead to the recovery: homebuilding, inventory accumulation, and capital spending. It seems to me that each one is promising and each one has some question marks.

There's every reason to be optimistic that the housing rebound is real. The issue remains that of translating housing sales into housing construction. I think there's reason to be optimistic when one sees the volume of debt and equity issues by commercial banks bolstering their capital positions. It is clear that banks are going to apply higher standards in lending to homebuilders, but maybe with improved capital conditions they will not extinguish the housing upturn. I'd say there are still some questions, though, on the translation of the home sales into homebuilding.

On inventory accumulation, I wonder how much we're going to get out of this. Companies either have moved or are in the process of moving to a fundamentally different philosophy of inventory management; they now have improved information technology to implement a philosophy involving very tight management of inventories. I think businesses will seek to maintain very lean inventories when the economy turns up. There has to be some contribution from inventory accumulation when they stop cutting inventories, but even when there's a little wind in the sails from some other source, I wonder how much contribution we're going to see out of inventories.

I feel about the same with respect to capital spending. I see little in the orders data to suggest optimism or little from talking to the sour executives that Vice Chairman Corrigan talks with. I think we're more likely to see capital spending in response to a recovery lag the recovery rather than lead it or be coincident with it. It is encouraging to see the volume of stock and long-term debt issues by corporations. Most of that, though, is going into shoring up balance sheets, which is a good thing; not much of it is getting through to capital spending. Still, the availability of ample long-term funds on good terms should encourage some capital spending for the competitiveness reasons that Mike alluded to, or at least limit the decline in capital spending. I tend to think we'll have to see a pickup in demand first before we see much [impetus from] capital spending.

So, it does seem to me that the story is a little less convincing than last time. I have a little less confidence in the upturn since we have no reliable lead actor to replace the consumer. Again, it may be more accurate, but it's not quite as simple a story.

And I think waiting around while the consumer flunked his screen test for this recovery may be one of the reasons why there is some increased gloominess, at least in the business community. It may be just the executives of large companies that Governor Seger mentioned at lunch on whom the international situation--the higher dollar and weaker foreign economies--is having an impact. I think there continues to be the worry that as we wait around for this [upturn] there will be some atrophy in consumer confidence as it retreats toward the real numbers rather than spending rising to meet confidence. The discount rate move a couple of weeks ago was useful in injecting a little optimism into the picture and in demonstrating that the Federal Reserve is still in the game. And I think precipitating the prime rate reduction was a help. Still, when I look at the markets, I'm pretty reassured. The markets still seem in pretty good shape, although they may be down a bit. And they represent not only a forecast of recovery but a contributor to it--not only with the elusive wealth effect but also, as Jerry mentioned, we see them freeing up debt capacity, including short-term debt capacity. That means companies will be in good shape to respond to increased demand, should that demand ever arise.

We've also absorbed a fair amount of bad news in the market: another round of bank insurance fund bad news and some insurance company bad news among those companies that specialize in high-yield bonds. There continues to be some skittishness in the long-term bond market. It made some progress and then drifted back some, although it is still off a bit, obviously, from the peak of over 9 percent in the fall. I tend to think that if you invest in 30-year bonds, you need some real convincing on the inflation side. The people who bought 30-year bonds in 1965 at 4 percent own them today or were fired and the new portfolio manager owns them. So, it's not surprising that after seven years of core inflation at 4-1/2 percent it will take some time.

I agree with the sentiments expressed that we have the potential for substantial progress in reducing core inflation and that we should be careful on that front. There has been some deceleration in the monetary aggregates, which Don was talking about. Some of that was warranted to bring them more in the middle of the ranges. When I look at the interest-sensitive components of M2--money market deposit accounts and savings accounts--they are still growing at a very rapid clip and, if anything, at a too rapid clip. Of course, time deposits have been dead in the water ever since I've been here. The deceleration in M1 is accounted for by currency and demand deposits and there are plausible explanations--special factors associated with April. I don't see at this stage a serious risk of M2 growth decelerating to an unacceptably slow rate, but in this environment we ought to keep that in mind just as we should the other side as well. We still have a good bit of stimulus in the pipeline. We see its effects in the buoyancy of markets and the rebound of residential housing. And as the prime rate has been reduced, I think we may see it more broadly.

Overall, I guess I'm a little more concerned than last time about the path of the real economy; I swallowed the March Greenbook whole and this one is a little less digestible. However, the markets look pretty good and I think the policy looks pretty good, despite my queasiness. This is probably a time for patience, but it's also a time for vigilance as well. I think we should stand prepared to keep

things moving in the right direction if necessary. The lengthening list of moderating influences--the reduced forecast of consumer spending, somewhat slower M2 growth--suggest to me less risk of an overshoot in the current environment. And the current environment reminds me of a sailing analogy: When you're sailing and you try to tack, which means to turn in a very light wind, what you do is push the tiller over to the other side of the boat and you shout as confidently as you can "hard-a-lee," which means "we are turning." Then you wait and wait and hope a little puff of wind comes along and grabs the sails and moves you off in the right direction. I think we have pushed the tiller and we are in the waiting phase. The only reason I hesitate to use the sailing analogy is that I'm a notoriously poor sailor and, when I try to tack in light wind, about half the time I end up dead in the water drifting backward. But we have a much more experienced crew on this ship, I'm sure!

VICE CHAIRMAN CORRIGAN. Want to make a bet?

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLY. Well, Normand, will you please make a note for the next meeting that whenever Governor Mullins signals he wants to speak, put me down immediately ahead of him!

There's isn't much left to say, Mr. Chairman. As I read the statistics that are available to us, and more particularly as I listen to the reports from the Districts, it may well be that the bottom and the recovery are at hand, but they sure aren't in hand. I'm confident that they will be and that we are reaching the bottom. I'm not that confident about the outlook thereafter. I'm not sure what kind of strength we're going to get out of a recovery or how sustainable it's going to be. I don't think those are sure things. I continue to have considerable concern about the drag that's going to be present with us for a while from balance sheets. I'm sure Jerry is correct that balance sheets are beginning to recover both at the household and the corporate level. But I also wonder if that doesn't have a long way to run yet. And I wonder, as that process does run its course, what the implications are more broadly. I don't see where our real strength is going to arise from. There are some good straws in the wind but none of them look to me as if they're of the nature that they have the strength to push or that we can be very confident as to their sustainability. The exception to that is probably the inflation outlook, which I think ought to help in a lot of ways that are both visible and invisible. And, of course, there is a natural buoyancy to this economy that, as Mike and others have pointed out, usually leads to better results than one can see at any given point in time. But I continue to think that perhaps the risks are not yet symmetric. For the short term at least, they do seem to me to continue to be on the down side. Confidence is the biggest fragility I see. As John LaWare said just a moment ago and as Ed Boehne said earlier: If confidence doesn't continue to improve and begins to deteriorate, it could lead to some potential real problems down the road. But as far as our work goes, I do think that policy has provided us with a good deal of insurance against these gloomy possibilities. It seems to me from a policy standpoint that it's a time to wait and see how things develop.

CHAIRMAN GREENSPAN. Thank you very much. Let's break now for coffee.

[Coffee break]

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

CHAIRMAN GREENSPAN. Thank you. Are there questions for Don? If not, let me get started with an anecdote that I was confronted with at the meeting of the Business Council last Saturday. They had me on a panel on Saturday morning with the Chairmen of IBM, Penney, Morgan Guaranty, Chemical, and Monsanto. And a gloomier set of forecasts you will scarcely hear. It makes the most dour view of this afternoon [that of] a raving optimist. At the end of the discussion, it finally got to me. They all looked at me as if to say: "Well, what are you going to do about this?" And I turned to the audience and said "This sounds the way it always sounds right at the bottom of the business cycle." And the truth of the matter is, it did. Now, that is not the same thing as saying that if that's what it sounded like, therefore, it is the bottom of the business cycle! But it is true that when the economy is at the bottom of the business cycle that is what it sounds like.

In a sense I think the evidence is very clearly falling gradually into place in that respect. The problem that we're having in evaluating it is in part the consequence of two things that have occurred, and they have been mentioned previously. One is the structural change in inventory policy, which has limited the extent that inventory accumulation is followed by massive liquidation, with production levels substantially under consumption levels. The total system finally drains out and pops back. The second is the issue that Don was raising: namely, that as far as monetary policy and the credit aggregates are concerned, we didn't have the counterpart to the tightening as the economy since the peak [turned] into the break, the liquidation, and the reversal. What we're seeing at this stage is a far slower [than usual process of adjustment], where in effect the contraction follows the very heavy and excessive debt creation of the 1986-87 period, the subsequent gradual retrenchment of debt growth and M2 growth, and basically, deleveraging beginning to occur, arriving at a point where I gather we had record equity issuance in April. And the effects of this are very obvious. We're seeing that the quality of balance sheets, as Mr. Corrigan points out, is improved. Despite the fact that the banking sector is still fragile, there is no question that the difference between the banking sector today and the banking sector six months ago is really quite stark. The structural weaknesses that we saw back then and the yield spreads and the difficulties to borrow relative to what we have today I think indicate that we have a much sounder [banking] system now.

I think the inflation numbers at this stage are really credible. If you look at them in detail, if you look at them in an historical context and in an overall credit sense, unless inflation has ceased to become a monetary phenomenon, something fundamental is happening. And I think it is extremely unlikely to reverse. We're picking up the benefits of several years of fairly substantial improvement in all relationships of money, debt, and prices. But in that context I think monetary policy gradually defused the overheated economy and slowed it down to a point that in effect what I was hearing at the Business Council was not that their orders were deteriorating but that they were absolutely dead. Nothing was moving; everything was just absolutely frozen. The only problem with that is

that it appears, unless our data are just all wrong, to be allegedly freezing at a point in which production, fortunately, is well below consumption levels. And that has to run out. It's not a question of an inventory pickup; it's basically the end of inventory liquidation, which has been the classic element to turn around the economy in every pickup after recession that we've seen in the post World War II period and I'm sure earlier. So, when somebody says "What's the spark? What's going to move us?" the implication is that everything is in balance. The problem at this stage is that it's not in balance. Unless the data are all just wrong, we are undergoing a rate of liquidation at this particular stage, despite the fact that we have this structural change [in inventory management], that cannot persist very much longer because businesses are running out of stocks. And at that point production begins to move, real income begins to move--the classic Keynesian stuff, to whatever extent it works--and that's when it works. We get the multipliers working and the whole economy begins to move. The problem is that it's happening very slowly.

I think John LaWare raised the relevant question here. This is a confidence issue. We can sit at this level for quite a while and eventually everyone will get discouraged and pull the plug on the capital goods market. Even though the capital goods markets have come in below our forecast, it does not appear from talking to a lot of people that what we are seeing are cancellations and major contractions. What we're seeing fundamentally are stretch-outs in the capital goods markets because we can see the appropriations backlogs are holding. Everything is holding. The only thing that has changed is the fact that instead of doing it today, it's "manana;" but it's still there. The danger is that they will become so discouraged that eventually everyone will start to contract and pull in their horns; and then we will get a secondary double-dip in the recession. At this stage, even listening to all the gloom that I did on Saturday, I don't get the impression that there is a widespread initiation of cancellations of projects, as distinct from stretch-outs. So, I think we have a little time. The trouble is that everything is going in such slow motion because of the inventory and the credit [situations] that it may be too slow to get us out of this in time. But the elements are here. The basic [issue] is that we cannot sit with everything as it is now because the levels of production are too low relative to consumption, and something has got to give.

One thing that disturbs me, which disturbs a lot of you, is that we are uncomfortable about where long-term rates are. Obviously, should bond rates back up, then the mortgage market will back up and we could abort [the recovery] in the residential real estate markets, which are still healthy. But I suspect that the difference between the analysts and the managers, as Ed Boehne called them--and it was the managers that I ran into on the Business Council--is that the managers are operating as though they are serving the level of demand; the analysts are saying they're not. And we're about to find out whether or not the data really tell us anything.

All this suggests to me that we probably just ought to xerox the last directive and rerun it, because I can't see any argument that I at least find plausible to push us on one side or the other. So, I would just put out as an initial recommendation, "B" symmetric. Governor Angell.

MR. ANGELL. Mr. Chairman, I agree.

VICE CHAIRMAN CORRIGAN. So do I.

CHAIRMAN GREENSPAN. Okay. That's two.

SPEAKER(?). I do too. Three.

OTHERS. Four. Five. Six. Me too.

MR. KOHN. Norm, it will be fun writing the policy record on this one!

MR. GUFFEY. I have just one [comment]. I happen to agree with what you said with the exception that if the aggregates--in particular M2--do not come in as projected over the next couple of months, I would have some concern about the outlook.

CHAIRMAN GREENSPAN. You know, Roger, I would suggest that that is probably telling us that the capital goods markets are beginning to fade. It may be one of the early signals the Committee gets about the need to be very watchful. Who was it who said we ought to be vigilant? Was it Governor Mullins? I think the money supply may be a very weak tool, but I suspect in the current period it may be far more serviceable than it has been in a very long time.

MR. GUFFEY. I think there's some informational value over the next couple of months.

CHAIRMAN GREENSPAN. Yes. And we also need to take a look at the weekly asset side of the intermediary system, which reconciles to the money supply--disaggregate it into real estate loans, business loans, [and so forth] and in a sense try to see what the obverse of money supply elements is. Right now the data indicate a definite weakening in business loans, but I suspect that's being offset by issuances of securities in the long end of the market, so it's not a contraction. But if we get what you're concerned about, I think we're going to see it on the asset side of the intermediary balance sheet and it would be quite suggestive of the type of problems we worry about.

MR. FORRESTAL. I'm perfectly willing to xerox the last directive, Mr. Chairman. But for the record I'd like to indicate that while I believe the risks are somewhat more symmetrical than they were, I would still prefer an asymmetric directive simply because I think that if we do move between now and the next FOMC meeting, it's going to be a move toward ease. And I think we ought to have that reflected, but I don't feel that strongly about it.

CHAIRMAN GREENSPAN. That's probably factually correct, but I think the tone of the balance of risks is symmetric. In fact, I think you put it exactly right: The balance of the risks is probably symmetric even though the policy risks may be asymmetric. Si.

MR. KEEHN. I agree exactly with what Bob Forrestal has said. I have a slight preference for asymmetric language, but I don't feel strongly about it. And I do absolutely agree with both the current situation and with [policy] as you see it. It's a fairly long time

between now and the next meeting, and a question comes up in my mind. Presumably, we have now established that you have the right to move policy, and by that I mean the fed funds rate, by some amount. I don't want to get into that but what would cause you to make a change as you look at the data that may be coming up in the next few weeks?

CHAIRMAN GREENSPAN. Well, do you mean on the down side or the up side?

MR. KEEHN. The down side.

CHAIRMAN GREENSPAN. I would say on the down side that the major issue would be the money supply. If it's beginning to show a kickback from the weak April and all of a sudden it starts to dip down again, I think we had better be careful. Don did mention that.

I think the data had been [unintelligible] but in the last loan officer survey even though the rate of tightening is much less it is still tightening. And in a sense there are liquidity questions because it's very hard to figure out how in the world we would get significant interest rate reductions in the context of very subnormal money supply growth and an exchange rate that is firming not only against the European currencies but against the yen as well. In other words, there are some people, and I have a certain sympathy for this, who are saying in effect that those are indications that monetary policy may be too tight. However, if the money supply is moving adequately, I would say it's a hard argument to make. But if we end up with a situation in which the money supply is beginning to shrink and/or the dollar is beginning to firm very extraordinarily, or if we get some really weak [economic] numbers--and that I would say at this point is unlikely unless something cracks--we need something. I think the Committee has actually created enough of a bottoming here that some new force has to come on stream to knock the economy down. As I said here the last time, the danger is really the capital goods markets. If the capital goods markets hold up, I think we're out of the woods. But as I think all of us are saying--that's right, Jerry raised it and I forgot all about it--the real issue here is that if all of a sudden the stock market falls on its face and breaks business confidence, then we ought to be prepared to move pretty quickly.

VICE CHAIRMAN CORRIGAN. [Then] we've got problems.

MR. KEEHN. Well, I haven't looked at the calendar of the data that will be coming out over the next three or four weeks, but I'm simply saying that if there were some indication of basic weakness, I would hope there would be an opportunity to move.

CHAIRMAN GREENSPAN. If it is of the form that's cumulative. But if it merely reflects what anecdotally already is in the system, that probably is not new information. Look, durable goods orders for April I assume are going to be down. If they're down by huge amounts, then we've got to look at it; but if they're just moderately down, I don't see that that is telling us anything new.

VICE CHAIRMAN CORRIGAN. I think what President Keehn is hinting at, if I may, is that it might not be a bad idea to have rather firmly in mind a consultation in the first week in June or something like that.

MR. KEEHN. Thank you!

CHAIRMAN GREENSPAN. Why didn't he say that! It's inconceivable to me that we can get through the next three weeks without something happening that is not important to talk about. I would assume, even if there's nothing to say, that we ought to meet. Does anybody else want to comment?

MR. MELZER. I just want to explore the stock market issue. We talked to some investment managers a week or so ago and my sense is that some are expecting some sort of a correction.

CHAIRMAN GREENSPAN. We just got it today.

MR. MELZER. Oh, we did? How much?

CHAIRMAN GREENSPAN. Down 37.

MR. MELZER. Well, I'm not sure that's what they had in mind!
[Laughter]

MR. KELLEY. Are you talking about 2600 to 2550 on the Dow?

MR. MELZER. Maybe this is a peculiar circumstance at this time, but I think it's a little tricky to tie monetary policy into a stock market predictor. I just don't know what the linkages are.

VICE CHAIRMAN CORRIGAN. Don't misunderstand; I wasn't suggesting that kind of rigid linkage. What I was saying is that if we had a major "tanking" in the stock market, I think that would rather quickly show through to other things.

CHAIRMAN GREENSPAN. Suppose the market goes down 180 points? Isn't that what monetary investors have in mind?

MR. SYRON. In one day or over, say, a period of a week?

CHAIRMAN GREENSPAN. No, in one day.

VICE CHAIRMAN CORRIGAN. Tommy, if we had a very substantial correction in the stock market, I think it would feed right into the kinds of things that Don was talking about in terms of the confidence factor and the double-dip factor.

MR. ANGELL. I guess I'm a little uncomfortable with the conversation. The bulk of the conversation is agreement over the M2 growth and that seems to me a very good thing for us to be watching. Quite frankly, the stock market has behaved rather robustly and we didn't say that that means the recovery is going to be robust.

CHAIRMAN GREENSPAN. I would bet you that it had an effect in stabilizing this.

MR. ANGELL. Oh, I think it did, too. That's why some of us were pretty confident about it. Clearly, there would be a change in confidence in our [unintelligible] if the stock market turned up at 2450.

MR. MELZER. Well, for the record, I would be in favor of what you proposed as the policy prescription.

CHAIRMAN GREENSPAN. Anyone else before we vote? If not, there is a correction.

MR. BERNARD. Yes, to catch up with what has been happening in the foreign exchange markets, the staff is proposing a change in lines 35-36 from "increased somewhat further on balance" to "show little change on balance over the intermeeting period."

MR. BLACK. This is in the Bluebook, Norm?

MR. BERNARD. This is in the draft directive, line 36.

MR. KOHN. The one that was distributed.

CHAIRMAN GREENSPAN. The one that was distributed.

MR. BERNARD. The whole sentence reads "The trade-weighted value of the dollar in terms of the other G-10 currencies showed little change on balance over the intermeeting period."

MR. ANGELL. Fine.

CHAIRMAN GREENSPAN. I'd like to propose that we repeat the directive, but obviously it requires some changes.

MR. BERNARD. [It would read:] "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. Depending upon progress toward price stability, trends in economic activity, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, somewhat greater reserve restraint or somewhat lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with growth of M2 and M3 over the period from March through June at annual rates of about 4 and 2 percent, respectively."

CHAIRMAN GREENSPAN. Okay.

MR. BERNARD.	
Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Black	Yes
President Forrestal	Yes
President Keehn	Yes
Governor Kelley	Yes
Governor LaWare	Yes
Governor Mullins	Yes
President Parry	Yes

CHAIRMAN GREENSPAN. The next meeting is July 2 and 3, but [in the interim] we will have one or more telephone conferences.

END OF MEETING