

Meeting of the Federal Open Market Committee
May 18, 1993

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 18, 1993, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Boehne
Mr. Keehn
Mr. Kelley
Mr. LaWare
Mr. Lindsey
Mr. McTeer
Mr. Mullins
Ms. Phillips
Mr. Stern

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

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

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

Messrs. R. Davis, Lang, Lindsey, Promisel,
Rolnick, Rosenblum, Scheld, Siegman,
and Slifman, Associate Economists

Mr. McDonough, Manager of the System Open
Market Account

Ms. Greene, Deputy Manager for Foreign
Operations

Ms. Lovett, Deputy Manager for Domestic
Operations

Mr. Ettin, Deputy Director, Division of Research
and Statistics, Board of Governors
Mr. Madigan, Associate Director, Division of Monetary
Affairs, 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
Mr. Small, Section Chief, Division of Monetary
Affairs, Board of Governors
Ms. Low, Open Market Secretariat Assistant,
Division of Monetary Affairs, Board of Governors

Messrs. T. Davis, Dewald, and Goodfriend, Senior Vice
Presidents, Federal Reserve Banks of Kansas City,
St. Louis, and Richmond, respectively

Ms. Browne, Mr. Judd, and Meses. Rosenbaum and White,
Vice Presidents, Federal Reserve Banks of Boston,
San Francisco, Atlanta, and New York, respectively

Mr. Eberts, Assistant Vice President, Federal Reserve
Bank of Cleveland

1. Attended portion of meeting relating to a report on a study
entitled "Operating Procedures and the Conduct of Monetary Policy:
Conference Proceedings," edited by Marvin Goodfriend and David
Small. This two-volume study has been designated Working Studies 1,
Parts 1 and 2, of the Federal Reserve Board's Finance and Economic
Discussion Series.

Transcript of Federal Open Market Committee Meeting of
May 18, 1993

CHAIRMAN GREENSPAN. Good morning, everyone. There are going to be thunderstorms this morning, but I trust that we can integrate them in an appropriate [unintelligible] that is in sync. The impression I get is that the authorities up above, knowing that this is Jerry Corrigan's last meeting, have decided to let us know they are aware of that. If anyone can read the drumbeat as to whether it's pro or con Jerry, please let us know. We, of course, are going to be having a farewell lunch in Jerry's honor in Dining Room E after the meeting.

Let me say before we start: You may recall that a number of meetings ago I raised some questions about the security of this operation which--to use a kind word--was "dubious" for a while. I think our record in recent months, indeed pretty much back to the end of last year, really has been extraordinarily good. I cannot honestly say that I have seen a comment that I would unambiguously read as coming out of an FOMC meeting. I think you are all aware that what will be going on here today has very considerable interest outside. So, all I would suggest is: Let's not lower our guard. Let's be cautious, and I think we can fend off the clever endeavors on the part of a lot of our media friends on the outside who will try to infer how this meeting came out. I don't request anything new; I think what you've been doing is fine. Let's just have an awareness not to let our guard down inadvertently.

I will raise some questions [later] in the proceedings when we get into our discussions about exchange rates, concerning which I have a memo from our colleague, Ted Truman. I'd like to read it to you so you will be up-to-date on what the issues are. It relates somewhat to this confidentiality issue but it's not directly in that context, so I'll leave it for later. Shall we start off? I ask for a motion to approve the minutes for the meeting of March 23.

SPEAKER(?). So moved.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Al Broaddus, I assume, is available at the moment to give us a rundown on the very interesting work with which his group has been involved.

MR. BROADDUS. Thank you, Mr. Chairman. I'll be brief and just give a quick background. Members of the Committee will remember that about two years ago at the July 1991 meeting it seemed pretty clear that the economy was beginning to recover. And I think most members of the Committee recognized that somewhere down the road the Committee was going to be faced with the prospect of rising inflation pressures and the possible need to change the direction of policy toward restraint. In the environment as I remember it, Governor Angell asked a very reasonable and straightforward question, and that was: If and when that time arrived, would such a move be facilitated by a change in our operating procedures away from the current procedure of conducting policy by controlling the funds rate very

tightly? Would we change perhaps in the direction of a more automatic adjustment of the funds rate in response to emerging inflation developments or other economic developments or perhaps along the lines of the nonborrowed reserve procedure we used between late 1979 and late 1982? In any case, we got a group of System economists together and we produced two volumes as your answer, Governor Angell. It's a lengthy response but I think an interesting one.

CHAIRMAN GREENSPAN. Is he going to have to take an exam on what's in those volumes?

MR. BROADDUS. I think I may have to take an exam on it at some point! Actually, a shorter answer was delivered at the next meeting of the Committee in August of 1991 when Don Kohn summarized a memorandum that Dave Lindsey had prepared. That memo reviewed several alternative procedures that might assist in the next change in the direction of policy. Just very quickly: One set of those alternatives would have deliberately caused somewhat greater movement in the funds rate in the short run in an effort perhaps to camouflage or disguise when an increase in the rate might be taken; this might soften or at least stretch out the market and public reaction to the move. The second set of alternatives would have involved tying the funds rate, or perhaps a borrowed reserve instrument, in some way to deviations of M2 from its target. The memo also noted that in an automatic procedure we might want to substitute total reserves or perhaps the monetary base for the funds rate as the operating instrument. In any case, at that August 1991 meeting the Committee discussed all of these alternatives. And, of course, the memorandum pointed out that there were disadvantages as well as advantages according to the tradeoffs involved. The Committee I think also recognized that the current unpredictable behavior of M2 might cause some difficulties with some of these alternative procedures that would not have existed so much in the past.

In any case, all of this was brought out and in this situation the Committee mandated a more broadly scoped study, similar to studies that had been done along these lines in the past. We had one in the early 1980s and another in the early 1970s. This broader project was carried out in the second half of 1991 and the first half of last year. It culminated in a very interesting two-day conference at the St. Louis Fed in which 16 papers on this topic, along with formal discussions, were presented. Economists from the Board staff and all of the Reserve Banks participated in this conference. We also invited two prominent outside monetary economists, Ben McCallum from Carnegie Mellon and John Taylor from Stanford, to participate in the conference--actually to comment on particular papers and in both cases to give an overview. Both wrote papers giving their overview comments on the research and its implications. All the papers prepared for the conference, including the discussion papers and the Taylor and McCallum papers reviewing the overall conference, are included in this two-volume study. You should have received these volumes last week as well as a summary of those proceedings, which I hope you will have an opportunity to read if you haven't done so already.

As the summary indicates, the study did not attempt to arrive at specific recommendations as to alternative procedures that the Committee should adopt. I think we recognized rather quickly when we got into this that it would be unrealistic to try to do that in this

study. What we tried to do was to lay a solid analytical foundation on which such a discussion and decisions could be based. Frankly, we concluded that we have produced a very solid foundation for that kind of consideration if the Committee wants to take that next step; I think we've covered the subject comprehensively. Many of the papers used state of the art research techniques in reaching their conclusions. In any case, the summary document that you should have describes several of the more formal papers in some detail and it presents five broad conclusions. I'm not going to go through those in any detail but let me just paraphrase them.

First, we studied the operating procedures in a number of other major industrial countries. We found that most of them employ procedures that are similar to those that this Committee uses but we also found that some differences of detail exist. And if we take the next step, we might want to consider whether there are any significant advantages to adopting some of these procedures. For example, I have in mind something like the Lombard facility that the Bundesbank has available.

Second, in view of the current problems with the monetary aggregates as indicators of policy, in this study we looked at a large number of alternative indicators of the thrust of policy and future economic developments to see whether we might improve the execution of policy by, in some more systematic way, taking account of some of these variables in conducting policy. I have in mind here variables like bond rates, yield curves, commodity prices, and a number of others. Not surprisingly, no single indicator jumps out and says "I'm the one on which you should focus all of your attention." But we did learn that certain indicators do seem to do a better job over particular time horizons than others. So, we did a bit of filtering that I think is useful there.

The third and perhaps the most important conclusion we reached is that a case can be made that the Committee's current procedure of adjusting the funds rate in response to a variety of indicators can be used successfully over time to achieve the principal objectives of monetary policy. I think a lot of people, like Dave Lindsey, suspected that before the study was done. But the study provides very important and very solid analytical confirmation in support of that conclusion. However, and I can't emphasize this enough, the effectiveness of our current policy regime depends critically on the maintenance of the credibility of the System's longer-term policy objectives.

Fourth, some model simulations that were done for the study indicated that a feedback mechanism to guide policy might be of some assistance in improving our results without creating a lot of undue short-term instability. Several papers in particular looked at feedback mechanisms where either a funds rate instrument or a monetary base instrument would be [varied] in some systematic way in response to deviations of nominal income from a target--for example, the Humphrey-Hawkins projections that we put forth twice a year--that might be set.

Fifth and finally, research done for the project indicated that greater transitory deviations in the funds rate permit targeting that would characterize some of these alternative procedures but not

necessarily be transmitted to greater variability in longer-term interest rates. So, that possibility should not prevent us from looking at some of these alternative procedures if we wished to. In any case, Mr. Chairman, those are the principal conclusions. Again, I think this study positions the Committee to take the next step, and it would be a fairly straightforward step of looking at particular changes we might make. Let me take this opportunity to thank everybody who was involved in the project but express particularly my appreciation to Marvin Goodfriend and to Dave Small of the Board's staff who did a tremendous amount of work in editing these papers.

CHAIRMAN GREENSPAN. Thank you.

MR. BROADDUS. I'd be happy to try to answer any questions anybody has and I'm sure Marvin and Dave could help me with some of the more technical ones.

CHAIRMAN GREENSPAN. I must say I didn't have a chance to read the fat books but I did read the summary, and it really is useful in segregating the various types of problems that confront us. I'm not saying that I feel overly encouraged about different means that we could employ other than what we are doing. I guess we all hope that somewhere down the line we're going to be able to deviate from "funds only," if I may put it that way, as a policy. But I think the type of data systems that you set up for an evaluation will enable us to continue until we can fundamentally come to grips with a view that presumably for us [fed funds] continue as our optimum operating policy procedure.

Questions for President Broaddus? [Hearing none,] I guess everybody has read the two books and all the questions have been answered!

MR. BROADDUS. Thank you very much, Mr. Chairman, for the opportunity to summarize the study.

CHAIRMAN GREENSPAN. And thank you very much, indeed. We'll now move on to Gretchen Greene and operations of the Foreign Desk.

MS. GREENE. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Thank you very much. Let me just add something about that intervention episode. It resulted from fairly close coordination between the Fed and the Treasury. When we began over here to see the spillover effects on the exchange rate, on the bond market, and on the stock market, the notion of a deterioration in confidence became, I think, somewhat more evident than it had been previously. We had been arguing here that we had a necessary condition to get a response in the market from intervention because the market did not expect intervention, meaning it was net short. And in our discussions with the Treasury we suggested that a two-pronged approach be initiated that day. One was to intervene moderately in the market but visibly. This clearly came as a surprise to the market; just watching the screens one could immediately see a variety of the shorts begin to cover. Concurrently, we knew that there were opportunities for both Messrs. Bentsen and Summers to make remarks that day, considering the fact that in the period immediately preceding, the President--and obviously even earlier Secretary Bentsen

and Secretary Brown--had made comments which suggested, as Gretchen pointed out, that there was perhaps some concerted American policy to strengthen the yen. The truth of the matter is that no such policy existed. These were in the nature of ad hoc comments by commentators who were not discussing American policy, but really were observers of the scene who concluded that history tells us that if the exchange rate of the yen rises, the Japanese surplus will fall. In fact, we are not certain what would happen. Indeed, my suspicion is that if we actually tried to create changes in exchange rates by consistent intervention, the secondary consequences in the markets, mainly in the expectations area, would very likely make the correlations which are fairly robust between real exchange rates and current account deficits break down. So, what we were trying to do was to indicate that these comments were nothing more than academic discussions about relationships. I think we were about 20 percent successful, which is about 10 percent more than I would have thought. But it came out pretty well. In fact, I told [my colleagues] that I thought the [outcome] that day was about as good as it gets in this endeavor to intervene in the markets and not to expect that there is an easy process here by which one can readily manipulate exchange rates. To his credit Larry Summers, who is very knowledgeable about all of this, has been very cooperative with us; he has made certain to keep us fully informed about any issues and discussions that they have been involved in, and we have tried to reciprocate. Hopefully, that process will continue. Any questions for Gretchen? Tom.

MR. MELZER. Gretchen, in the [written] report there was a comment about the [market's] vulnerability to the dismantling of these longer-term investment positions--and you just mentioned it in your remarks--in Europe in particular. Do we have any sense of the magnitude of that, what dynamics might drive a liquidation, what the impact of that could be, and so forth?

MS. GREENE. Are you talking about intra-European investment positions?

MR. MELZER. I'm talking about investment positions in U.S. dollars.

MS. GREENE. Well, in reading the Greenbook last night I noted that there have been some persistent foreign purchases of U.S. government securities in the first quarter of the year at the same time that there has been a continued very high level of U.S. outward investment. So, in effect, one could see this as financing our capital outflow. The liquidation that I spoke of--the Japanese investments--will probably at least in the first instance not be U.S. dollars. Nevertheless, it had an effect on the dollar exchange rate because they liquidated, let's say, Canadian dollar securities, received Canadian dollars, and converted that to U.S. dollars; the dollar was a means of exchange for getting back into yen. We thought they were relatively easily shaken out of the Canadian dollar market; there was also some Australian dollar intervention by the Japanese. The market has been talking about the Japanese more as a vulnerability than an actuality as far as U.S. bond markets are concerned. My feeling is that, with the somewhat better climate that exists now in the middle of May than existed at the beginning of April, they are more secure now. But that's just a personal impression. Bill may want to say something [on this issue].

MR. MCDONOUGH. Let me just add a footnote. [In the period] before the intervention that Gretchen described and the Chairman commented on there's no question that the Japanese were not resisting rumors in the market reminding the United States that Japanese life insurance companies held a lot of rather long Treasuries and that if they dumped them, the price to the United States would be rather high. As soon as the intervention took place, all of that talk disappeared.

MR. LINDSEY. Mr. Chairman, to what extent is it your judgment that the success that day was due to the fact that it was largely not trade or even capital fundamentals but senior administration official statements that were driving the market?

CHAIRMAN GREENSPAN. Do you mean before or after?

MR. LINDSEY. Well, before having driven the dollar down and that, therefore, we were successful with our intervention.

CHAIRMAN GREENSPAN. Well, remember, the statements came after the intervention. The intervention was a perceived success, if one puts it in those terms, before the statements were made. But I think the statements reinforced it; that in large part turned around the concerns that existed. It was probably not that it moved the dollar higher, but that it may have forestalled an erosion of some of the gains that had occurred earlier in the day as a consequence of the intervention.

MS. PHILLIPS. I agree.

CHAIRMAN GREENSPAN. Any other comments? Let me just take a minute to fill you in on some comments that I heard at the Basle G-10 meeting the weekend before last and early last week. There was quite an extraordinary number of subdued people in Europe; there is an underlying fear that that system is continuously eroding. They are continually revising down their estimates; they are talking as though the upturn is somewhere off in the future, whereas earlier in the year they were talking--in sort of government-speak--about the turn being at hand and the official forecasts were [being revised] up. The mood was really quite a good deal more subdued last week. They're particularly concerned about the shortfalls in revenues impacting on their budget deficits. The French were, I think, particularly traumatized by that. The mood is really very soft--if anything, the worst I've seen this year. The British obviously are feeling somewhat better, but even among the Brits a slightly hollow cheerfulness is evolving.

In any event, let me turn for a minute to an adjunct on this exchange rate discussion and read to you three points that Ted Truman is recommending relative to our discussions about exchange rates. It comes basically out of the experience that we've observed first with Secretary Bentsen, then the President, and then Secretary Brown. Item one: Exchange rates are like interest rates, and if a central banker discusses one, the central banker will be understood to be discussing the other. The best comment for the Federal Reserve is "no comment."

[Item two:] We are going through a delicate period in terms of exchange rates and, any talk, no matter how analytical, is likely to take on exaggerated importance. Even a "no comment" from someone who has previously commented is a comment. My answer is that the best

way to handle that is to ask the reporter "May I go on deep background?" Then, when they shake their heads, I say "no comment."

Item three: The new Administration, or at least those parts of it with which the Federal Reserve deals regularly, is sensitive to the fact that talk about exchange rates, loose or any other kind, tends to be unconstructive. While it would be foolish to think that the Treasury Department would be able to shut down entirely all other sources of Administration comment on exchange rates, it is somewhat embarrassing if the Federal Reserve becomes part of the problem. Of course, the Treasury from time to time may feel it is necessary to make an official comment on exchange rates, but we hope that those comments are deliberate and well considered. The recent record shows that the Treasury is prepared to work with the Federal Reserve on such occasions. That's the end of Ted's comments and I must say I fully subscribe to them.

Let's move on. We have to ratify the actions taken by the Desk with respect to intervention against the yen. I would ask somebody to move it.

VICE CHAIRMAN CORRIGAN. I move it.

CHAIRMAN GREENSPAN. Is there a second?

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. Let's move to Bill McDonough and the operations of the Domestic Desk.

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

CHAIRMAN GREENSPAN. Questions?

MR. BOEHNE. In the context of what the market views as good news and bad news and how it might move the market, how would the market react to a tightening of Fed policy in the near term?

MR. MCDONOUGH. Assuming it would happen soon enough so that we have the present market conditions--the short end is priced on the 3 percent funds rate--the likelihood is that interest rates out to two or three years would probably go up. I think [a tightening] would probably bring the yield on the 10-year bond down a little because it would be interpreted as the Fed being both active in fighting inflation and very concerned about the economy. I think you would get those two reactions. What it would do to the 30-year bond is really hard to call. If investors became convinced--making that distinction I made earlier--that economic growth is likely to be low and that the Fed is very concerned about inflation, my guess is that the long bond would probably go up in price and down in yield. But at the present time it's really being played essentially by hedge funds and various other speculators, and in their hands it could go either way. It would depend an awful lot in the longer end of the market on whether the investors were back in. If they were, then I think we would get a flattening of the yield curve--short end up and longer end down.

MR. SYRON. Bill, what is in market expectations now in terms of the deficit? There has obviously been some change in that, but I'm

trying to get some view of any likely disappointment or, conversely, a pleasant surprise.

MR. MCDONOUGH. It has improved a little in the very recent past by Mr. Rostenkowski getting the bill through the House Ways and Means Committee in the shape that it did. And I think the market assumption now is that the House will pass the Ways and Means bill. Then it shifts over to the Senate, and the market is somewhat confused about that. There's no doubt that a fair piece of the rally through March [reflected the view] that gridlock was not likely, that there was a serious effort to reduce the deficit, and that the new Administration had the kind of political skills that they showed in winning the election. What has happened is that that view has flipped a lot. The market went from thinking that the Administration could do nothing wrong politically to a view that, well, maybe it can't do anything too well either. So, I think one would [unintelligible]. But the pricing in the market--the fact that we're in the same trading range--in my view would say that the market view is still that the deficit reduction will happen.

MR. PARRY. You indicated that the market reaction to the shortening of the maturity of the debt was muted. Was there much discussion as to the motives for shortening? Has it been received well by the market? I know there wasn't much of a move in rates.

MR. MCDONOUGH. The general reaction has been that it was motivated by the desire to reduce the deficit.

MR. PARRY. Short term.

MR. MCDONOUGH. Short term. And since most market experts, or at least so-claimed experts, advised against the move, they talked to their [unintelligible] and said it was a bad idea. It did not go over well.

CHAIRMAN GREENSPAN. Any other questions for Bill? If not, would somebody like to move to ratify the actions of the Desk?

VICE CHAIRMAN CORRIGAN. So moved.

CHAIRMAN GREENSPAN. Do I hear a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. We now move to Mike Prell. Mike.

MR. PRELL. [Statement--see Appendix.] Thank you, Mr. Chairman. I apologize for the unusual length.

CHAIRMAN GREENSPAN. Well, this is a very crucial period for us. And even though Mike Prell went on at some length, I'd like to weigh in and add to his comments. Let me just say in looking at these data that I come out with the same concerns you do, Mike. The problem that we're confronting is one in which we have to be able to understand what is causing the price movements we are seeing here that have deviated from our most likely expectations. I think we can rule out that the usual money and credit phenomenon is pushing inflation.

We can barely find the figures even though they've come up a bit; we have a very faint pulse but not much more than that. You raised interesting questions about the labor market slack issue and I do agree that there's something there, especially the size of the defense adjustment that's going on. But there, too, it is rather tough in my view, with the excess capacity especially abroad and the labor market questions that we have here, to argue readily that there is something of significance working. There are some elements that I think do clarify the issue. One is that profit margins very clearly have been rising, and rising quite significantly. In the context of coming off rather weak demand, and a cumulative weak demand, it's pretty apparent that there has been a considerable endeavor to restore margins from subnormal levels and that this process is [being reflected in] very formidable profit figures that continue to emerge not only for the industrial sector but pretty much across the board. We probably haven't run through that process as yet but it's obvious that the higher profit margins get, the less they can be expected to continue to move higher. And correct me if I'm wrong, Mike, but in the Board's model, as margins rise, the pressures on prices fall. The high margins imply that we will begin to get softer prices as the momentum from the rising margins ceases to be able to be carried through. I don't know if we're there yet, but there is something very specifically there.

An issue you didn't discuss that I do think is of some importance, but frankly I don't know the order of magnitude, is the protectionism that has been emerging very subtly but in a pronounced manner. There is no way to describe the steel price increases of late other than [as a reflection of] protectionism. This is not an issue of there being available supplies from abroad that are pushing our prices down; but squeezing the amount of imports enables the domestic mills to move their prices significantly higher. Needless to say, they have done so with alacrity. And while [the importance of] steel isn't what it used to be, it's nonetheless enough to have an impact in the durable goods pricing structure that is visible. Remember that almost by definition durable goods means "made with steel." And that really tends to spread [the effects] out in a particularly long line.

I don't now what the regulatory costs are but as we were discussing in a Board meeting the other day, I'm sure that the Disabilities Act has had some impact on costs. We view that and the Clean Air Act largely in terms of capital costs and equipment. But remember that on a consolidated basis capital costs become labor costs. And in a consolidated sense it doesn't matter whether the pressure on the cost structure is from capital or direct labor because we consolidate out materials; it doesn't matter one way or the other. If in fact this is the type of inflation we are dealing with, it is a stagflation type of inflation except for, of course, the profit margins, which are very difficult to deal with. My [suspicion] is that it's part of all this. I do think the issue that was raised with respect to inflationary expectations may be the most relevant consideration here if what we are dealing with is a continued increase in the general price level. That's because in all of our analyses of inflation we endeavor to find the transmission mechanism by which the actions of workers in the wage bargaining process and of managers in price markups take place. The conventional wisdom in our models is that [the transmission] is largely induced through changes in psychology. That is, labor force and economic slack are supposed to

change people's attitudes. But it's only when those attitudes change and indeed we get low [settlements in] wage contracts that the anti-inflation process occurs. If we get the slack but nothing happens, all we're saying is that something broke down in the process. That essentially means that people--despite the fact that they're losing their jobs and despite the fact that unemployment is rising--still view the outlook as inflationary and they want wage increases. Or, alternatively, it means that the business community--despite what we would all view as a very weak economy--perceives that in fact the economy is really strengthening and that they can get price increases. And if their customers believe it, the price increases stick. But we have to look at the actions that people are taking. Clearly, when we get a PPI or a CPI we are looking at the end result of actions taken by people. And the question is: What is driving them? At the end of the day it doesn't matter what is driving them if in fact they are behaving in a manner that is bringing the price level up. This is something that I think we will get into when we get to our policy discussion. I hope it is where our discussion will take place because if anybody seriously believes that we can move interest rates at all in this particular context and [unintelligible] choke off [unintelligible] inflation, I would say that history tells us the chances of doing that are zero short of a 200 or 300 or 400 basis point rise in interest rates.

So, the question really gets down to how we view this other structure. Unless we are willing to abandon fully all of our notions of what has historically created inflation--meaning forget the credit aggregates, forget the slack market issues, forget all of the cost pressures that occur as a consequence of regulations--we cannot readily explain what is happening. Unless we're willing to forget all of those elements involved in our ability to forecast--I don't see how we can unless we abandon all intellectual rigor--as far as I can see we cannot explain what is happening other than by this inflationary psychology [process]. And that, in my judgment, may in part reflect political questions as to whether there is stability in the system and what the longer-term outlook is--whether in fact there are really serious problems in the long term.

I do think the issue that Mike raised about accelerating demand may be quite relevant. That is, we were going through the second half of last year on an accelerating path and that could very well have altered the basic expectations of everybody. And the actions we are looking at, remember, are historical. The price changes that occurred in April, which are our latest price data, probably were made weeks before as far as planning is concerned. And the only evidence that we have since then is that wage rates in April have softened considerably. That is a somewhat useful cost development. As you may have observed in the Greenbook, the Board's staff is reducing [its projection of] the ECI, the employment cost index, for the second quarter; it is down dramatically from the first quarter. Therefore, the fundamental issue, as I read the Greenbook, is that the essential thrust of this last acceleration is where the inflation expectations are coming from rather than the politics or anything else. If that explanation is true, we should find that out within a reasonably short period of time. But I will tell you that at this stage we are pretty much testing the limits of our theoretical knowledge as to what the actual inflationary process is really doing.

There is also the obvious question as to whether the price data themselves are creating problems for us. For example, a not insignificant part of the April CPI is a big increase in owner equivalent rent, which popped up. If one looks at owner equivalent rent as a ratio to the quality adjusted price of homes--a sort of rate of return estimate--that has been rising fairly significantly of late. And that's not what one would expect in the rate of return; one would expect it actually to be going in the other direction. Now, I don't put much weight on either the numerator or the denominator of that because, as you all know, the sample that is taken on owner equivalent rent, which accounts for something just short of 20 percent of the total index, is dubious and highly unstable. So, it is conceivable that the implicit price forecast in the Greenbook is right; and that would mean that all of a sudden the rate of price increase will slow fairly dramatically. But I will say this: The fact that Mike shows a significant amount of humility [is] something that I think is relevant to this type of analysis. All I can suggest is that anyone who in their comments around the table can add anything to what we know about this price process will contribute a great deal to our colleagues' base of information, which as I see it is pretty slender indeed at this particular stage. Who would like to start off?

MR. PARRY. Mike, when I look at the forecast of quarterly growth rates for gross domestic product and inflation and compare it to the previous forecast, I see a couple tenths weaker growth rate throughout the entire period and a couple tenths higher inflation. It almost seems that a supply shock of some sort would produce this because typically a model is constructed so that if the economy runs into a slow period [the model] will pull it back--in effect make up for that [slowing] within a relatively short period. But when there is a supply shock, that's not necessarily the case. What, in effect, did you have in mind that caused it?

MR. PRELL. Well, as I noted, we're trying to understand why things have been going the way they have. Certainly, supply conditions [are] a possible explanation. That was something that was at least in our minds as we were doing this. But basically the bigger driver in this was simply a recognition that the trends had not been developing as we had anticipated and were carrying through higher levels of inflation throughout and moderating somewhat further the tradeoff; in a sense, we were getting less bang for the unemployment [buck] from here on. But it's very much a level adjustment that is involved here.

MR. PARRY. I can see that [you have made an adjustment], but do you have any particular feeling as to why that tradeoff may have changed?

MR. PRELL. Nothing more than what I suggested. It's not going to [unintelligible] a separate matter from the tradeoff if you feel that in effect the NAIRU has been raised. It is simply that the gap is small--

MR. PARRY. Right.

MR. PRELL. The tradeoff could be affected if the expectations formation process is different than the backward-looking version that's inherent in a simple Phillips curve model. But again,

it's hard to say whether that's a level adjustment we're making or a tradeoff adjustment. We simply tried to recognize the tendencies we've seen and to be a shade less optimistic, going forward, about the tradeoff between unemployment and disinflation. These are rather small adjustments in a sense.

MR. LINDSEY. Thinking of a supply shock more broadly, one would include in that an upward revision to inflationary expectations; in a sense that would worsen the possible combination of output and inflation.

MR. MCTEER. One thing that would account for both higher inflation and a weaker real sector would be weather, and we know we have had some bad weather. To what extent have you analyzed that and figured out how many points could be attributed to that?

MR. PRELL. Well, we think it's probable that weather chipped a bit off of the first-quarter growth. We could see some disruption, some temporary loss at least, of output in industrial production. But I don't see a correlation between those output losses and the price pressures. I see it certainly in vegetable prices. Clearly, agricultural commodities have been affected by the weather and we see it in their prices. But I don't think the steel price increases that were referred to earlier and the medical services price increases recently had any significant weather element. So, while it's a nice simple conceptual analysis to say "Well, we reduced the supply and the prices went up," I really don't think that was what has accounted for the uptick in the inflation trend.

MR. MCTEER. I was under the impression that the food component was a pretty good chunk of it, though.

MR. PRELL. Well, in the overall CPI it was an element recently. But we're really focusing on the core CPI, recognizing that within a few months we should move back to normal supplies of fruits and vegetables and then the price level of food should return to the basic trend. So, this is not a significant element in our analysis.

MR. PARRY. We would really have to have a convoluted impact on inflationary expectations to get the kind of effects that you have with the weather.

MR. PRELL. Indeed. Overall inflation undoubtedly is important as well as the core in determining peoples' expectations about the future, or what they perceive to be acceptable increases in wages, and so on. But I don't think weather is the story here.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I admit I don't understand the inflation numbers very well but, in thinking about the discussion on profit margins, maybe there is something there telling us about the degree of slack. After all, those price increases seem to have stuck for whatever reason. And maybe part of that has to do with the international situation. Maybe foreign competition isn't as vigorous as it was earlier; certainly something of that [nature] must be what is going on in autos I would think.

MR. PRELL. But clearly we have had an exchange rate movement and slack in the Japanese economy. Both of those things have tended to boost the prices of Japanese automobiles and have provided an umbrella for domestic manufacturers. They started off the year with relatively generous incentives that held down the seasonally adjusted prices. They've been able to take those off; they raised a few list prices. And I think this is certainly influenced by the developments in the foreign exchange market. As the Chairman noted, in steel there has been a marked reduction in imports and there has been considerable pressure on supply in some parts of the steel market. There is some uncertainty about whether that's going to persist in the coming months. Of course, this will depend in part on decisions that are made about protectionist measures. Basically, the improvement in profits has largely conformed to the typical pattern of profits moving up with an acceleration in activity and a related jump in productivity. I assume we've had a rather typical cyclical pattern in that respect.

CHAIRMAN GREENSPAN. What, incidentally, is the accounting addition of import prices on the CPI? In other words, to what extent are import prices affecting the CPI and in what direction?

MR. PRELL. Well, on net, there probably has not been a very great influence to date. The Japanese automobiles are one story, but exchange rates against other currencies haven't been adverse. So, overall import prices have not been rising very rapidly at all. In fact, for the first quarter, non-oil import prices are estimated to have declined. So I don't think to date that we've seen, overall, a major unfavorable impact from import prices. In particular areas it has been a factor.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. In reading the Greenbook for this meeting and listening to your comments and then thinking back over the analysis in the Greenbooks over the last 8 or 9 months and the swings in sentiment and developments as reported in various statistical [measures], it's tempting to have a sense of security that we're in a sort of fail-safe zone: That in the longer term nothing much can really go wrong even though we get surprised in the short run. We entered the fourth quarter with an expectation of a quite weak quarter in nominal GDP and real GDP with a 3 percent funds rate. And the surprise was that it was a much, much stronger quarter than expected. During that quarter as we were looking ahead to '93, the first quarter in particular, there was an expectation of fairly strong nominal GDP growth and real output growth; the surprise was that real output growth [in the first quarter] was much weaker than expected. And by some measures prices have been much higher than expected, yet we still have a 3 percent funds rate. When I look at your forecast through '94 in terms of nominal growth, real growth, and inflation it assumes a continuation of the 3 percent funds rate. It is still the right number in spite of all of these developments. It seems to me--and this is where I'd like you to comment on the way your model works--that when we have a development like the first quarter and real output comes in weak and inflation is reported to be much higher, it's not something to be concerned about because it means that the real interest rate has fallen or the natural rate or something because of the higher inflation and that will take care of the weakness in real growth. But

out in the future because of the slack, the gap, the NAIRU or something, inflation will decelerate; that will raise the real interest rate so that no matter what happens it's going to turn out that the 3 percent funds rate is the right rate. I'd be curious as to what it would take to persuade you that it's either too high or too low! [Laughter]

MR. PRELL. I think we all recognize the dangers of pegging nominal interest rates. It is not an automatic stabilizer. And if the pattern has been relatively stable, it has been because of various offsetting factors. I would say that coming into the first quarter we initially expected growth in the high 2 percent area for the quarter with a lower inflation path. As things have turned out, we may yet approach that real forecast but the price numbers clearly have been unfavorable. Going forward, you are correct that--as we noted in a footnote in the Greenbook--in essence the higher inflation trend and what we would take probably to be somewhat higher short-run inflation expectations than we had been expecting earlier do imply a somewhat lower real short-term interest rate. The question is whether at that level we are providing sufficient stimulus to offset the fiscal drag and other drags in the system now. Or perhaps, on the other side, is this excessive monetary stimulus? As has been noted, we don't see it in terms of rapid money growth on average. We don't see it yet in terms of rapid nominal GDP growth. But in due course it's conceivable that we would see that this [policy] was excessively stimulative. Our sense has certainly been that as we move along there would likely be some tendency for the real short-term interest rate to rise. But we do have to recognize that at least out through 1994, if this fiscal program is adopted, there is going to be a very large tax increase and a very substantial amount of fiscal drag. So the point at which this becomes an unsustainable real short-term rate may not be imminent; it may be some time down the road. At least that's the implication of our analysis.

MR. JORDAN. Can I follow-up, though, because you mentioned the fiscal drag. Isn't the argument that if the fiscal program is adopted, we would get a lower inflation premium and more stimulus coming from private investment and the household sector, even housing, because of lower nominal interest rates than otherwise would be the case? And thus the net effect of the fiscal action could be presumed to be not restrictive at all.

MR. PRELL. The simple analysis might lead you to expect lower real interest rates. But if you believe that inflation expectations are based on either some primitive notion of how deficits cause inflation or a more sophisticated one about the risks of future [monetization] then, yes, we could get also some narrowing of the inflation premium. In either case we would have had some offset from the beneficial anticipatory effects of the fiscal action. We think those are probably already behind us, but I'm not sure. Back to the question that Bill addressed earlier, what could happen here would be an important, pleasant surprise that would be a big boost for the bond market. At this point, I think people recognize that there's a budget resolution out there with which they have to contend. Most likely [Congress] will do something that at least nominally meets those requirements. No one, I think, is anticipating a vastly larger or vastly smaller deficit reduction than is currently being discussed.

MR. LINDSEY. Mike, this morning's Wall Street Journal said that the health care package would involve a 9 percent payroll tax for extending benefits--7 percent on employers and 2 percent on employees. Assuming this were enacted, how would we think that 7 percent tax would be reflected in terms of prices versus lower nominal wages?

MR. PRELL. Well, as I should remind everyone, our presumption has been that even if this were legislated by sometime in 1994 the phase-in would be long and the effects within our projection period would be almost solely those based on expectations. Our presumption would be that an increase in mandated costs relating to payrolls would be passed on only gradually to the workers in the form of lower wages and that the hit would be primarily on the price side in the short run.

MR. LINDSEY. Why wouldn't that be perceived as a positive demand shock then? Because it's either higher real compensation if you lump workers and beneficiaries together and what you're saying is that profits would eat it for a while. Why wouldn't that be a positive boost for consumption?

MR. PRELL. Well, that depends on whether monetary policy accommodates that kind of supply-side shock. Clearly, the monetary policy response to that, as it would be to any other jump in exogenous forces, is critical. But if this provided opportunities for much larger consumption of medical services to people, there presumably would be some offset on the demand side.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Mike, I have two questions about inflation. Being as puzzled as everyone else, I'm just wondering if there is any information in the cross-sectoral look at where margins have widened most. I'm just wondering whether that's more suggestive of this regulatory, protectionist argument as compared to an ability to widen margins because of demand. The other question is whether there is any information on the expectations side--looking at the relative deterioration of longer-term as compared to shorter-term inflation expectations.

MR. PRELL. I don't think I can give you any useful sectoral breakdown. On your question of the long-term versus short-term expectations, could you repeat that one for me?

MR. SYRON. When you look at the surveys that show a deterioration in expectations and try to get a handle on what is driving the deterioration--and I'm not that familiar with the data--I'm just asking whether the deterioration has [been much greater] in the longer run than in the short run and whether that would be consistent with the general notion of some kind of political deterioration, if I can call it that.

VICE CHAIRMAN CORRIGAN. You're talking about expectations in general?

MR. SYRON. Yes.

MR. PRELL. Our indicators of long-run expectations are rather volatile from month to month and my sense is that in general they haven't moved much recently. They came down some earlier in the recovery, but recently I don't think there is a particularly discernible trend. The Michigan Survey has bounced around in the 5 percent neighborhood. A survey that is a successor to the Hoey Survey shows a similar pattern, except that it's more in the 4 percent neighborhood, but I don't discern a big change there. On the short-term side, what is notable is that we have not had any consistent further lowering and there's perhaps a little firming if one wants to read it very finely. But basically it has been a rather stable picture even as we got into the 3 percent CPI increase area for two years. That's the impression I have.

Let me go back to Governor Lindsey's question. I suppose in general if people felt that they were more secure because this program offered them particular long-term care and some other safeguards against their wealth being depleted, then we could have in a sense a wealth effect that could be positive for consumption in the short term apart from the fact that the cost of medical services for some part of the population might have been lowered.

CHAIRMAN GREENSPAN. Any further questions for Mike? If not, would somebody like to start the roundtable?

MR. HOENIG. Mr. Chairman, I'll start with our District, which continues to show a very moderate pace of growth. In agriculture, winter wheat is in good condition and our cattle feedlot operations have rebounded from some winter problems. Construction has bounced back from the winter-related slowdown; it now has strengthened in all areas. In gas and oil, prices of natural gas have improved from year-ago levels and drilling has leveled off. I would point out that drilling has not picked up and is not expected to accelerate until there is more confidence in the price gains and that those prices will be stable. Absent that, they are very reluctant to push forward on any exploration or drilling. Manufacturing in our area remains sluggish and it is consistently operating below capacity as we hear from area business leaders. Banking has been extremely profitable in our region. Bank earnings are at record levels in the first quarter. In fact, in Oklahoma banks have reported returns on assets of higher than 2 percent.

Looking ahead for the District, we think moderate growth is continuing. Despite some expectations that cattle prices will come down and wheat prices may also, we still think income in '93 will be at a level close to that in '92. In construction, there is now a whole pipeline of activity that bodes well for the summer in our region. In energy, although prices have risen we don't expect a lot of activity unless those prices remain stable [or] rise. In manufacturing, the possibility of a turnaround, as I've said before, has been set back by some continued restructuring. As an example, Boeing is laying off about 7,000 people in Wichita.

At the national level, we continue to expect moderate growth and moderate inflation as we move through '93. We expect GDP growth of about 2-1/2 percent and inflation of just over 3 percent fourth quarter-over-fourth quarter. I might add that an important reason we scaled back our growth projection is because in talking with business

leaders around the District we heard a lot of anecdotal evidence [pointing in that direction]. They are thinking about or have put [plans] on hold because of expectations about taxes--particularly Federal, but even the states are talking about very dramatic increases in taxes. So businesses are focusing now more than ever on cost containment and trying to get their profits up. I think this is one reason businesses are raising prices; they want to see if the higher prices can take hold. This has been complicated in the health care industry because in some sectors, like medical devices, activity has virtually stopped because of the anticipated health care program. Also impeding renewed spending is this continued effort by businesses that we've spoken about for some time to pay down debt and to consolidate their positions in an environment of increasing uncertainty. If I heard it once I heard it a hundred times in the last three weeks: Business people are very, very concerned about the environment of uncertainty, so they are trimming back or are holding back a little more than they would otherwise. Having said all this, there is still a willingness to go forward where opportunities show through in a strong way, as we're seeing in the western part of our District. So we pared back our projections--not quite as much as the Board staff--to the 2-1/2 percent level for growth. Those are my comments, Mr. Chairman.

CHAIRMAN GREENSPAN. President Broadus.

MR. BROADDUS. The first-quarter data were quite disappointing and we have gotten mixed reports for the month of April so far in our District. But, in some contrast to Tom Hoenig's report, I haven't really noticed any major change in attitudes about the economic outlook either among our directors or most of our other business contacts. By and large, I think they still expect continued moderate growth both regionally and nationally through the forecast horizon.

I personally subscribe to that view. I was a little surprised by the size of the downward revision to the real GDP forecast in the Greenbook this time. I'm inclined to put a little less weight on current fiscal developments in assessing economic prospects than the Greenbook. It seems to me that the loss of the \$12 billion stimulus in the President's package is not a really big deal in a \$6 trillion economy. And while uncertainty about fiscal policy certainly puts a drag on the economy, it seems to me that this effect is very difficult to quantify. I don't have a sense that the uncertainty about fiscal policy is exerting any greater drag now than it was at the time of the March FOMC meeting. So, all in all, I still think that growth of real GDP in 1993 will be somewhere around 3 percent, as forecast in the March Greenbook, rather than the 2.2 percent that is currently projected in this month's Greenbook. And I believe I'm right in saying that most private forecasters are still somewhere around that number, although they may have revised their forecasts down a bit in some cases.

For me, clearly the most relevant and most disturbing recent development is the uptick in the reported inflation rate. The core CPI rate, as I calculate it, now has risen at a 4-1/2 percent annual rate over the first months of the year and that really bothers me. I recognize, as everyone else does, that temporary factors may account for part of this; nonetheless, at a minimum the data strongly suggest

that inflation is no longer coming down. So we're no longer clearly making progress toward our longer-term goal of restoring price stability and we may have regressed a bit. And as Dave Lindsey and others have pointed out, I think it's fair to say that inflation expectations have probably been revised upward at least a little since the beginning of the year. That's an interesting point because it implies that real short-term interest rates are lower than they were. So, in a sense we've had a de facto easing of policy as a result of this development in recent months, and I would hope that we would take some account of that in our policy discussion later in the meeting.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, economic conditions continue to vary in the Twelfth District. In California some evidence has accumulated that the economy actually may have hit bottom in recent months. We have seen, for example, that payroll employment is a little higher than it was in December; and taxable sales also appear to have bottomed out with increases experienced in the fourth quarter of 1992 and the first quarter of 1993. Nevertheless, we are faced with significant further defense cuts, state and local fiscal problems, and lingering weakness in commercial real estate that make it unlikely that the California economy is going to grow at any time in the next year. The Seattle area, which until recently was expanding briskly, has stagnated in recent months. I must admit that recent new orders for Boeing aircraft are encouraging. The economies of most other areas of the District continue to flourish. Utah, Nevada, Alaska, and Oregon are ranked in the top ten states in terms of employment growth between December 1992 and March 1993. And even the eastern Washington economy continues to be strong. Throughout the West, and this is similar to what Tom Hoenig picked up, many business leaders have noted to us that uncertainty about federal fiscal policy, particularly tax policy, is delaying investments and other major business decisions.

On the issue of inflation, in general report little price pressure, but there was one anecdote that I thought was rather interesting.

and he reported that they periodically conduct a price survey of packaged and canned goods. Now, this doesn't get into the problem with fresh fruits and vegetables. At the wholesale level, the latest survey revealed more widespread increases in the prices they pay for these goods than they had ever experienced before. The interesting thing is that he went on to say that he doubts that they will be able to pass those price increases along. It remains to be seen whether they will or not.

Turning to the national scene, it appears at least to me that the changes in the Greenbook forecast since the last FOMC meeting are large and, I'd have to say, quite disturbing. Real GDP seems to be on a decidedly lower path and inflation on a discouragingly faster track. Our own forecast is also more pessimistic in the short run, but by 1994 we have stronger growth than we had before and an unchanged rate of inflation. The change to our forecast reflects the defeat of the Clinton stimulus package, general concern about the extent of higher taxes, and slower-than-expected growth in the first quarter as well as the unexpected buildup of inventories. The change to the Greenbook forecast would appear to result from more permanent influences in

addition to the factors that I noted. It would seem, if the Greenbook forecast proves to be correct--and that certainly is a possibility--that the policy tradeoffs are likely to be far less attractive than I'd earlier thought.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, economic conditions in the Chicago District have been somewhat uneven since the last meeting, but on balance I think there has been an increase in the level of activity. In a modest context the outlook is reasonably positive. Starting with the automotive sector: Based on a pretty good April, the industry's confidence in their forecast for sales in the second quarter and the full year is somewhat stronger than it has been. Despite press reports to the contrary, the inventory levels in their view are currently just about right and, therefore, second-quarter production schedules have been set about 10 percent over last year. And they are pretty confident about those production schedules. I must say the mood in Detroit is much more positive than it has been and that is radiating pretty much throughout the dealer organization. The truck business also continues to improve. Orders for the Class 8 units, the large units, were strong in the first quarter and that has continued into the second quarter. For the full year the industry is forecasting an increase in sales of the big trucks of from 17 to 18 percent. Also, and something of a change, there has been a recent increase in the medium truck category, the Class 5 to 7 units, and for the full year they are now forecasting an increase in sales of some 13 percent for those. Medium truck sales are viewed as something of a lagging indicator and, therefore, this turn, which generally occurs about 6 months after the change in the heavy truck category, is viewed as a good sign. But despite the strength in the underlying auto sales rate, I must say that truck prices really have not been increased.

The steel business continues to do well and is benefiting particularly from the improved level [of activity] in the auto industry. The current order rate for one major company, which they expect [to continue] for the full second quarter, is coming in at about 110 percent of capacity. This is down from the first quarter but still pretty strong. Some of the order rate they [feel] is due to the current labor negotiations; nonetheless, the underlying demand is pretty good. And based on this they are now forecasting shipments this year of some 87 million tons, which comparatively is an awfully good year. We've talked about the steel price increases at previous meetings and again earlier today. There is, as you know, another increase scheduled for July. They would expect that to stick. But I do think it's important to remember that these increases do not apply to the major purchasers who are buying the steel on contract. Those prices are still very, very tight, and it's particularly true of the auto industry. But for others who are not buying on contract, when we're all done here this increase is going to amount to about 12 percent.

In the agricultural equipment business, sales of tractors and combines have been higher most recently and production schedules, therefore, have been increased. The large manufacturer that I talked to expects their production for the full year to be about 9 percent higher than last year. Also, there has been a recent increase in construction equipment; it has been slow to get off the mark but some

of those orders are beginning to pick up. One very major manufacturer is now selling a number of its product lines on back order.

Retail sales are uneven and this, I think, is heavily driven by the terrible weather that we had in March and April. As for car [sales], retailers tell me that their sales this year are up about 5 to 6 percent from last year. In the ag sector, as you know, we had a very wet spring and planting, therefore, has been terribly slow. But conditions looked pretty good last week and they got a lot done; that is true I will say with the exception of Iowa, which is still very wet. But they're still well behind and for the major states planting is at about 40 percent of the normal level. Nonetheless, there's enough time left and most people expect that there is a good opportunity to get a good crop. Perhaps one of the most significant changes, at least to me, has been a decided change in the attitude about lending by banks. People tell me, both borrowers and banks alike, that banks have become more aggressive. They are now actively seeking loans and are pretty much out looking for business; they have begun to shave rates, but I am assured that they have not begun to ease their credit standards.

In a national context, while the improved level of activity may relieve some of the concerns I've had about the sustainability of this expansion, I still think the big imponderable is on the employment side. Major companies--and I must say everyone I have talked to in the manufacturing sector--say they will continue to reduce their employment and will produce more products with fewer people. At some point it does seem to me that the lines between overtime and an increase in demand will cross, but so far they just are not yielding. And almost surprisingly, some of the unions don't want the companies to hire more people either. But despite this improved tone both in the District as well as in the national economy, it does seem to me that at best we are talking about a pretty modest recovery. If you look at the staff forecast, which is largely in line with ours, the outlook continues to be positive but in a very, very modest context.

On the price front, in talking to people I just don't sense the upward pressures that the recent numbers might suggest. Yes, there are some exceptions, such as steel, and for the reasons that we talked about; but there are some offsets. Raw aluminum prices, for example, are at the lowest real level in history. Labor contracts continue to be settled on favorable terms that are, I think, very much noninflationary. For example, the steel contract is a long way from settlement, but so far the thrust of the discussions has been entirely in the work rule area and productivity. Companies want to improve work rules to achieve more productivity and they are willing to give a little in terms of employment security. On the economic side the discussions really are focused on pensions, not on wages. Therefore, the steel industry hopes that they will come out of this [negotiation] without an inflationary settlement. So, although the recent numbers are a little unnerving, I do think it's far too soon to conclude that we are experiencing a basic shift in the outlook for prices. Thank you.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. In case some of you missed it, I'm pleased to report some good news from south of the border. The government of Mexico has submitted a constitutional amendment to give independence to the central bank, the Bank of Mexico, and to make price stability its overriding objective. The way they worded it was that the main mandate of the Bank of Mexico over any other objective will be to preserve the purchasing power of the national currency.

In the Eleventh District we've seen some modest weakening in the numbers and some deterioration in the tone of the anecdotal information. It's somewhat more negative, primarily surrounding uncertainty over the future. Projects are being put on hold because people are waiting to see what the tax situation is going to be and [what happens regarding] certain government spending situations and also health care reform. And probably somewhat unique to our area, we also have some slowdown related to the diminished prospects for the passage of NAFTA.

On the national economy, I really don't have any helpful insights to offer. I don't understand this recent split in the economy with the real sector seeming to turn down and inflation seeming to pick up at the same time. It's a mystery to me. On the nontraditional source of the inflation, however, and not being able to find the pulse of money and credit growth, it's probably because we're still trying to find that pulse on the balance sheet of banks. When we talk about the money numbers and what's going on, I think it's fairly clear that there is liquidity out there and there is money out there; it's just not where we used to measure it. I think we haven't quite made the adjustment when we're talking about inflation to realize that it's probably there in that context as well. That's all.

CHAIRMAN GREENSPAN. President Forrestal.

FORRESTAL. Mr. Chairman, things are looking fairly good in the Sixth Federal Reserve District. Economic activity in the area has continued to expand in the early months of this year. And perhaps more significantly, the expansion is now fairly broad-based since it has spread to several industries that previously had been lagging, namely financial services, communications, and manufacturing. As the expansion has become more widespread, a number of long-standing fiscal problems of the states in terms of their financing have begun to ease, and I think that will have implications as the federal fiscal policy emerges. The manufacturing industry has benefited from fairly good activity in single-family housing and the continued surge in activity due to hurricane rebuilding in south Florida. The auto assembly plants in the District, especially the Saturn and the Nissan plants in Tennessee, are operating at very high capacity. And this jump in manufacturing activity in the first quarter has led to considerable job growth in the District. In fact, the Southeast accounted for over half of net manufacturing jobs added to payrolls for the nation in the first quarter. Even the depressed extraction industry in Louisiana has turned around and, as natural gas prices have increased, activity off the Louisiana shore has risen to levels we haven't seen since 1985. The generally good performance around the District is dominated by Georgia and Florida, where sales tax receipts have been very strong; but other states have seen improvements as well. As I've indicated, even Louisiana is beginning to emerge from the doldrums. So, [the improvement] is not only broad-based in terms of economic

sectors but geographically as well. Now, this better performance than the nation may not continue very long because the activity due to the hurricane rebuilding will begin to slow.

The one serious negative note that I've picked up--and it has been referred to before--is the uncertainty about the fiscal and political situation. Tom Hoenig heard it 100 times; I think I heard it 110 times in the last three or four weeks. It's ambivalent in the sense that the business people in the Southeast, as reflected in my report, are fairly optimistic about their own businesses and what might be emerging in the economy. Or to put it another way, they're not unduly upset about the first-quarter numbers. But this uncertainty about the fiscal situation may very well begin to be reflected in business investment and employment plans for the rest of the year. Business people are telling me constantly that they're not able to begin to do their business planning because of the fiscal situation and the health care problem.

In spite of the good economic activity and in spite of the inflation numbers that have been reported, I don't hear anybody talking about price increases at all. They're not seeing them at the wholesale level and to the extent that any of them have tried to pass any price increases through--the minimal increases that have occurred--they are not able to make them stick. At the same time there are no wage pressures at all that I can tell.

The credit situation seems to be improving. Banks are reporting higher loan demand, particularly in the consumer sector, but they also are seeing better demand in the commercial area.

Looking at the national situation, our forecast shows a continuation of the moderate rate of expansion that we've had over the last year. Like many others we've revised our forecast down, based on the first quarter primarily, and we're looking at growth in real GDP of about 2-3/4 percent for this year, which is about 1/2 percentage point lower than our previous forecast. Overall, it seems to me that the outlook, despite that reduction, is pretty much the same--with the continued working off of imbalances and the slow employment growth that we've referred to before. We see the economy as somewhat stronger than the Greenbook and this divergence continues after the second half of the year. The difference for the most part is in the area of consumption expenditures, where we see more strength; and we see more inflation notwithstanding slow employment growth. I wouldn't want to over-emphasize these differences, however. I think our general path is fairly consistent with that of the Greenbook. I certainly don't have any insights into the inflation numbers. I'm perplexed, as I guess most other people are. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. The economy of the District continues to improve. There are some signs of life now in nonresidential construction. A lot of it is public construction, but it looks like that sector is poised for a pretty good year in many parts of the District. Consumer spending appears to be continuing to grow and business out at the Mega Mall has held up very well. In agriculture, the livestock business is very healthy and very strong. With regard to crops, there is the concern about moisture but, of course, it's always either too dry or

too wet. This year apparently it's too wet but I have a hunch they'll still [be able to plant] most or all of their crop. There are also some renewed signs of life in the energy business. Exploration and leasing activity in western North Dakota and eastern Montana are starting to show some signs of life, and iron mining activity in northern Minnesota is expected to pick up as a consequence of the improvement we're seeing in the domestic steel industry.

The one thing I might comment a little further on is what's happening to employment. It's something that, of course, shows up in the data, so I think we're aware of it. But I've heard a couple of comments lately that have put this very directly. Employment is up in the District. And yet if we talk to business people, they say they're clearly trying to do more--or at least the same--with less when it comes to employment. Part of that has to do with fringe benefit costs, such as workers comp and insurance and health care. Part of it, I think, is expectations in that businesses that used to think they were going to make at least some of their higher incomes over time through expansion are revising down their expansion plans. That has to do in part with environmental restrictions and other regulations. I think they're concluding that the way to improve profitability is through very tight cost containment, and they seem to be succeeding. And that has affected employment, certainly in the District, and perhaps nationwide as well.

With regard to the outlook for the national economy, my principal concern, as many have commented, is the inflation situation. I am not as sanguine as the Greenbook that inflation is going to decelerate from here. I certainly agree that a lot of the fundamentals we typically look at--slack in the economy, money and credit growth, and so on and so forth--don't seem to suggest an environment where inflation ought to be accelerating. In fact, they suggest an environment where further deceleration is likely. Yet I remember from the 1970s that we're always pretty good at explaining away inflation but those [situations] don't seem to have happy endings. So, I'm very uncomfortable with what we're seeing and I'm not convinced that what is going on now is simply temporary and will self-correct.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Most of the business people I talk to feel deprived in terms of price increases. They feel they are owed price hikes if only they could make them stick. If you look at it from an individual business person's point of view, their sales growth for the most part has been slow, competition has been tough, they have cut costs and lowered their break-even point, and they still feel very squeezed. So it's not surprising that they would jump at whatever opportunity they can to raise prices, whether it's a streak of good orders or a weaker dollar and foreign competition that isn't quite as tough or an attempt to get ahead of the regulatory or tax changes. It's not surprising that that is happening and that that's the way they feel. The question is whether it is broadly sustainable or cumulative, and I don't think any of us really knows. But my hunch is that it's not, given the generally sluggish economy, the underlying competitive situation, plus what is going on in money and credit.

Looking at the District economy, growth is very modest, very modest indeed. Retail sales are going up negligibly. Industrial production, while still advancing, seems to be advancing at a decreasing rate. We have sluggish loan demand, or flat loan demand really, and slow job growth. And, as has been mentioned almost by everybody, there is slipping confidence and building anxiety in national leadership and all the uncertainty about taxes. Every day in the paper some other tax that might [be enacted] is mentioned, and that has really pulled the rug out from any kind of increases in spending. There is just a strong desire to hold tight and steady and to put on hold everything that one can.

My sense on the national economy is that, yes, we are going to get somewhat more inflation than we thought earlier this year. And I think we're going to get somewhat less growth. But my basic conclusion is that at this point it's more a matter of degree rather than a fundamental shift.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Thank you, Mr. Chairman. As far as the District goes, the situation remains mixed. I'd say it's soft, but not collapsing, and to some extent the overall tone is almost improved. In the job market, employment isn't increasing but it's stabilizing; hours are up. Hiring of temporary help is up a good bit, along with all you've heard. We are still having major layoffs, though, in some areas and an overall softness in the employment market. In retailing, like everywhere else, the weather impact was particularly severe. Some bounceback from that occurred but there was some renewed softening more recently in retail sales. The same weather pattern holds for autos, but auto sales have been making up their losses and remain quite strong. Housing activity, particularly at the lower end of the market, is quite strong, with prices actually rising at that lower end for houses selling for less than \$150,000. The rest of the market is still fairly soft. The commercial real estate market is flattening with vacancies stabilizing but values are still quite soft.

If you want another worry to add to all of this, you can talk to people in the financial services industry, particularly the mutual funds. They continue to have very, very strong inflows into bond funds, junk bond funds, and other [investments]. Everyone takes the money, but at the same time they express continued concern about the sophistication of the investors, particularly that in a lot of cases people are not really aware that they can lose some capital in those bond funds. Also, a lot of concern is being expressed about how clear people are when they buy these funds in banks that the value of these instruments is variable, not just the yield.

As far as manufacturing goes, the situation is mixed. Anything tied to autos is doing all right; the same is true of environmental [firms]. But in defense we see more and more of a slide; it's continuously softer. Like everyone else, we hear continuous complaints about uncertainty and what is going to happen. I had some people in the other morning and one fellow said his company was not going to do anything they don't have to do and that every CEO he knows is absolutely frozen until he can see where things are going.

Unfortunately, as far as the national economy goes, I'm pretty much in agreement with the tone of the Greenbook that--excuse the colloquialism--it's just a plain lousy situation that we have here. Like everyone else, I'm very disappointed about the price situation. If it was just one month it would be one thing, but it has been longer than that now. I really can't understand what is going on; I find it hard to believe that the fundamentals don't have something to do with this in the longer run. And, if anything, the economy right now seems softer than six weeks ago at the time of the last FOMC meeting, [based on] retail sales control, [initial] claims, and industrial production. But having said all that, I don't have a whole lot of conviction. There is an enormous amount of uncertainty; and to some extent it seems with these concerns about taxes and other things that [people] are almost trying to jawbone the economy down, not in a purposeful sense but in the "if" effect it is having. And in that environment, it's hard to have very strong convictions about the intermediate-term [outlook for] either output or prices.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, I have one disagreement with the Greenbook. The Greenbook implicitly has a reduction in inflation from a 4.6 percent rate over the first four months to 2.6 percent in the next eight months in order to get to the new higher inflation forecast. Again, I respect the talents of the people involved, but that seems like an awfully steep deceleration of inflation in order to get to the new [forecast of] 3.3 percent for the year. I think the reason that we've had the higher inflation was well argued by you, Mr. Chairman. It is expectations-based. You ran through a better list than I could: mandated benefits, strike replacement, calls for a higher minimum wage, re-hiring of workers; that's for labor. For management, there's protectionism, protectionism, and protectionism along with loan guarantees for our failing industries such as airlines. So, no matter whose side you're on, labor or management, there is Uncle Sam to stand behind you.

You asked for another reason why inflation might be there. I'm going to give it to you. I don't mean to say that this is a dominant reason. It's not one that people in this room are familiar with. It goes back to the redistribution of income literature. I doubt many people in this room are readers of "Nation" or "American Prospect." I would hope not anyway. I read this literature some years ago as part of my research for my doctoral dissertation. You can also look up Ira Magaziner's writings on this. The most unspoken part of the health care plan is its redistribution elements. Right now, effectively, health care is a lump sum tax. It's \$4,000 per worker on the payroll, paid over to the health insurance company. What is going to change, and the only question is to what degree, is that it is now going to become what is effectively a proportional tax; it's payroll based. Those are very different because income is distributed [unevenly]. Now, when we are talking about a shift of 14 percent of GDP in the income among various quintiles, that will dwarf whatever Reagan has accomplished by a big factor, and in reverse.

There is a good reason to believe--in fact I can argue four reasons--that at least in the intermediate term such a redistribution is likely to be inflationary. The first comes from the higher tax on the wealthy. Now, in the short run at least, we would expect some of

that higher tax to come out of savings. That might not be true in the longer run; but certainly in the short run the part from the higher taxed people will come out of savings. On the other hand, for the lower taxed people it's more likely to augment consumption. So on the demand side the redistribution effect of the burden of health care costs is liable to increase demand via increased consumption. On the supply side there are also two reasons to suspect inflation. The first is the "classic" supply side argument that when you move from a lump sum tax to a proportional tax what you're going to get is less output. And if you think about both the substitution effects and the income effects, they're both going in the same direction. I'd assume that with, God forbid, another 9 percent payroll tax, the typical worker will be pushing 50 percent as a marginal rate. And people in this room will probably be at around the 65 percent area for the marginal rate. That is a whopping substitution effect. On the income effect side, if you no longer have to work to service a \$4,000 bill, you will get less work on the other end as well. The other supply side reason why an intentional redistribution is liable to be inflationary has to do with the Keynesian argument about nominal wages being sticky. Effectively, a low cost worker for whom [a firm is] now paying \$4,000 in health care is entitled to a raise. And the unions representing that individual certainly will make that point. So, I think nominal wages will rise at the lower end. Indeed, it will reverse probably two decades of declines in real wages at the lower end. On the other hand, for those who are taxed more--who will cost management more to hire--[firms] actually would have to force a decline in the nominal wage of those people. That would involve, say, middle management on up. In a 7 or 8 percent inflation environment that would be easy. You'd simply hold nominal wage increases down. In a 3 percent inflation environment, you're not going to have nominal wage cuts. So, what you're going to have is a bit of a wage/price spiral, with rising wages for workers and insufficiently falling real wages for management. So, for all four of those reasons--again, one can go back in the literature even from the '20s about redistribution and its effect on inflation--it all adds up. Now, I'm not saying that's what is causing it. But we all know the health care story is on our minds and it might be one reason at least to explain why, [given] the supply shock, the higher [inflation] expectations might actually turn out to be rational.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. First of all in terms of the District, the unemployment numbers I'm going to report are really the best numbers I've seen in a good while. We had payroll employment growth in the most recent three-month period, which would be through March, up 3.8 percent in the District. Another notable change [is that] we've been getting marginal growth in employment. And certainly the St. Louis District in general has done better than the nation through the recession. Another shift has been that we're getting more of the growth through manufacturing. That was actually up 4.8 percent, with particular strength in electrical equipment and transportation equipment; it was up somewhat less in nonmanufacturing, 3-1/2 percent. And there is considerable strength in construction. It's somewhat stronger in residential in terms of contracts and significantly stronger in nonresidential for that most recent three-month period. Notwithstanding that, as I talk to people around the District, I don't get the sense--in terms of the tone of comments--that people think

we're in any kind of a boom. And I'm hearing the same concerns others have expressed regarding uncertainty about fiscal policy and other government policies.

With respect to the national picture, in thinking back to the second half of last year when real growth came in at around 4 percent, I'm struck by the fact--just thinking about where we are now and where we thought we were then--that the economy is fundamentally in a lot better shape now than it was then. We are getting some job growth now which we weren't getting then. There were considerable uncertainties at that time and, indeed, there are uncertainties now. But in some ways they were even greater at that time. The whole financial restructuring process has proceeded further. I think one has to assume that we're in better shape in that sense. And the anecdotal reports we've heard around the table today in general are better. As Mike Prell acknowledges in the Greenbook, there is a possibility of the first-quarter GDP being revised up. But I think it's a little dangerous to put too much stock in one quarter's GDP numbers. We could actually be surprised in retrospect in terms of how well things are going now.

As some others have mentioned, notably Al Broaddus and Gary Stern, my principal concern is on the inflation side. I, too, am skeptical as to whether or not we will resume the disinflationary trend we seemed to be on. And I think the experience of the first four months of this year has definitely had an impact in terms of expectations. In terms of why that could be, it seems to me there is an explanation relating to money and credit, though not one we in this room generally put a lot of stock in. We had M1 growth over the last two years through the first quarter at double-digit rates. I guess I'm not prepared to try to translate that into what it may mean exactly in terms of real growth and prices, but I view that as a very substantial monetary impetus. As that growth slowed very dramatically in the first quarter it gave me some comfort that perhaps the general thrust of policy had shifted somewhat. But what I'm seeing as far as M1 projections looking forward [concerns me]. Again, this is only a month or two, but for May we're talking about a possible 25 percent annual growth rate in M1. It may be that what I perceived as a significant sea change in the thrust of the growth in that aggregate in the first quarter of this year was really only a temporary pause and that we're still on a very strong upward trend in terms of monetary thrust. We're probably not compelled to act now, but if these inflation expectations become embedded and the first-quarter [inflation rate] turns out stronger than people perhaps think it is now and if real growth is stronger, it's just going to be harder to catch up later. So, my principal concern relates to developments we've seen in the wage and price climate.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mr. Chairman, I find the recent indicators of a possible intensification or rekindling of inflation very disturbing in the context of our stated objective of price stability, which I believe is the proper objective for this institution. The question, it seems to me, is whether this is the time to take the punch bowl away before everyone but the host gets drunk and the party gets rowdy. The timing of any tightening of policy is critical. It must be early enough to stop inflation before it gains momentum but it must also be

late enough to be based on reality and not just intuition. In the current situation it is hard to make a substantive case, in my opinion, that a real inflationary trend is under way rather than the effect of simultaneous aberrant one-time influences. By contrast, I believe that a case can be made that the apparent slowdown in growth is a result of collapsing confidence on the part of both consumers and businesses in the extremely uncertain environment created by record high proposed tax increases, large proposed [defense] cutbacks, and fundamental change in a health care system that was basically established in our culture more than 30 years ago. Consumers and businesses continue to be more interested in debt reduction than in re-leveraging with long-term commitments. It can't have escaped any reasonably intelligent observer that the economic proposals that are before the Congress right now are essentially contractive. A premature move to tighten policy against that background could be disastrous to economic growth and could run the risk of reigniting enthusiasm for fiscal stimulus rather than deficit reduction and budget discipline. In that scenario the inflation fat would really be in the fire again. It seems to me that this is the time to hold to our present course at least long enough to have a better idea of what Congress will do with the President's proposals and what the effect will be on economic growth.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, with the emergence of the most recent data, it seems to me that we now have before us about the widest spectrum of fundamentally conflicting possibilities that I can remember. I have attempted to make a bit of an inventory of what those possibilities are and what some of their implications might be, just to help my own thinking along. If we were to make a straight-line projection [based on] the most recent data, we'd wind up with stagflation, which obviously would be a very serious situation. But there are a number of other possibilities and each carries a different set of implications. In the area of real economic activity, I think there may be two basically credible paths we could find ourselves on. The first is that the first-quarter data are signalling an emerging decline--that things are indeed beginning to go back downhill and that we might even be looking at the possibility of a new recession down the way. That's possible but it seems to me highly unlikely. We have a good bit of momentum going; jobs are being formed net of all the restructuring that's going on; new claims are flat; the credit crunch is easing; the consumer is returning; our competitiveness is improving through productivity, which is the good way, and through a somewhat softer dollar in some cases, which may not be so good a way. Nevertheless, competitiveness is [improving]. So, I would doubt that what we're looking at is a fundamentally weaker economy that is going downhill. But if that is what emerges, then we're going to have to reverse a lot of the thinking we've been doing.

What seems to me much more likely is that we've been looking at some type of a blip in the rather moderate upturn that we've had for eight quarters now. I noticed that of the eight quarters we've had in succession that have been basically positive, four have been lower than the previous quarter, which is rather interesting. So, it seems likely that we're looking at a blip. And the question is what's going to happen after that blip.

The first question, obviously, is: When is the blip going to be over? It may last a little longer; it may still be going on. But is the Greenbook basically correct? Are we looking at an extended period of slow or sluggish growth? Is it going to be somewhat stronger than that, maybe a good deal stronger than that? Each of these [scenarios], it seems to me, takes us in a different direction. But regardless of which one begins to emerge, there doesn't seem to be any compelling impetus in real economic activity that we can see [as cause] for concern right this minute. I think there will be time to have this very murky situation begin to [clarify].

In the area of inflation there may be three possible scenarios working here. The first one--which I think all of us hope is the case and which has a fair probability in my mind--would be that the things we've been seeing the last several months are indeed aberrations and that the disinflationary process that we've had is still more or less in place. I hope that's the case. It seems unlikely to me that we're in an incipient rising new [inflation] trend, that the game is over and [inflation is] on the way back up. Now, we've been talking about that all morning. And a number of possible explanations that would lead one in that direction are out there. That may turn out to be what is happening, but it's very difficult for me to see how that can be, given the fundamentals of the slack in the economy. In my mind the highest probability would be that we're looking at some rough bottoming out process in here, and that may be the toughest of all to deal with. If we are looking at a rough bottoming out process with the kind of economy that we have now, it would really be disappointing to still have 3-1/2 percent or so on the CPI. And what should be done about it? When we think about what should be done about that, if that's the case, we have to have a context or a view of what is happening in the real economy. If we're going to have an economy that will start to accelerate soon and strongly, then it's fairly clear what we'll need to do as soon as that becomes apparent. If the first quarter is the start of a new decline, then we have some very fundamental economic problems that I'm not sure I understand, and maybe nobody understands. What in the world would be going on that would lead us to this kind of configuration? If we have the Greenbook's economy, continuing sluggish growth, that gives us a nice philosophical policy question to answer. Do we try to restrain this kind of economy in order to push inflation lower? If we did, would it work? Or as you suggest, Mr. Chairman, are we perhaps looking at some other kinds of problems that appropriately would require some other answers. It seems to me that this is the type of question that we're going to need to address in the next part of the meeting.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. As things started to thaw out in my part of the country after our last meeting, it seemed like a good time to do a great deal of traveling throughout the District in large and small communities to hear what people had to say. I found it an increasingly depressing experience as the weeks wore on. Had I just stayed at home I could have given you a much better report because the numbers really are not bad. But the mood is totally sour.

Our agricultural sector is in good shape. Planting got off to a slow start, but it did dry out and by the beginning of May

[farmers] were closing the gap on getting the planting accomplished. As of last week they said they were very close to finishing their seasonal planting. Farm equipment sales--implements of all types--are the strongest in years but that doesn't seem to be driven as much by confidence as by fear [that induces people] to go ahead and get it done. Land prices are up sharply, 10 to 20 percent for agriculture. There is talk of prices up to \$1900 an acre, which cannot be sustained by current [crop] prices.

Manufacturing is in good shape if one looks at the numbers; new orders and backlogs are quite good. The metals are strong; auto parts suppliers are in good shape and are taking market share away from imports, especially by selling to the transplant firms but also to the domestic producers. Capital goods also are strong both on domestic sales and [exports]; they feel they are able to take market share back from where they dropped before. A telecommunications equipment firm also reports very good sales, with good export sales to Latin America in particular. Coal production is down 13 percent in the first quarter but [our contacts] don't know whether that was weather-related or not. I spent some time touring these coal-producing areas and mostly they're in a shrinking mode; their strategy is a gradual longer-term exit, with a decline in capacity that is planned.

Employment wasn't too bad in the District, but there is no sentiment to increase employment. The areas where we had been getting some increases, especially health care, are totally frozen. Staff levels are "replacement only" in major communities for health care. One large hospital group said that it had cancelled all openings for doctors and has no plans to fill the openings it previously had listed.

Nothing is going on in commercial construction in the District, but in industrial construction there is replacement of capacity. No expansion is planned, but [firms] will build where they need a facility to replace something that is obsolete. The residential sector is pretty strong, both in sales and in construction.

When I starting hearing about business loan demand picking up at banks, that seemed to be an element of encouragement. But I was quickly dissuaded from that by bankers who said: "No, it's people coming in whom we haven't seen in a long time saying that times are going to get tough so they had better get friendly with their banker and [arrange] lines of credit because they are going to need them somewhere along the line."

On prices, the two types of firms that are able to get price increases are those related to capital goods or motor vehicle companies that are experiencing demand. But the others are those that are shrinking [production]; they feel they're "right sizing" their operations. So, it's really a shift of supply and a shrinking of their overall capacity. Some of that is defense or aerospace-related and some is in electronics.

When I think about the national situation, I still cannot persuade myself that we've entered a period of accelerating inflation [and that] the erosion of the purchasing power of the dollar is

worsening. [But] I don't know a single person outside this room who agrees with [me on] that. I've heard over and over again talk about inflation, whether people relate it to the deficit or overall fiscal policy or health care concerns. To me health care can raise costs and redistribute [income], but I try to persuade people that it doesn't mean a sustained erosion in purchasing power and money. And people tend to snicker at me; I have zero credibility. My own daughter was telling me why she was buying a town house at a fixed-rate mortgage in southern California and I was trying to explain some things about southern California's economy. She said I was being totally naive. I explained that I'm a central banker and it's important that I talk about price stability and controlling inflation. She said it was time I had a reality check! [Laughter] She said: "Why do you think inflation is not going up? You're just wrong." And I found this same sentiment among bankers and people in small and large businesses. They have persuaded themselves that inflation is going up and there's not anything anybody can do about it. So, even though I felt relieved by the March numbers coming in much better than those for January and February and I thought we were okay--and I still have some reservations about how reliable the April numbers are--I don't think that's the issue. The issue is not whether we really have inflation; I think we have inflation psychology. We have people acting on the belief that future inflation will be higher. That's what we have to address no matter what the statistics show.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Jerry, your comments are very much along the lines of my thinking. I learned to fly an airplane very early in my life; I had a father who was my flight instructor who taught himself back in 1931. He spent his life teaching me that the best way to be a general aviation pilot is to find out what mistakes people make. And even though I don't fly very much, I do read very regularly about airplane accidents to find out what mistakes pilots make. And it's interesting to me that the major mistake that amateur pilots make is that they get in bad weather and they don't feel the gauges are right. Somehow or other they think the gauges are wrong. It feels as if the airplane is doing this and the gauges tell them the airplane is doing something else. We're at the place, in the murky weather, where the old monetary aggregates don't give us much help. In this environment, we have to look at the gauges; we have to look at the instruments. And the instruments tell us that inflation is rising. Clearly, inflation is not going to go down to the 2-1/2 to 2 percent level that I thought was doable as recently as one year ago. I think the Chairman is correct when he says that it's not a question of money or credit that explains this phenomenon. Clearly, as others have said, it is an attitude question. Now, in December I made some comments about a 200 basis point increase in the fed funds rate and, Mr. Chairman, you [went further] when you said that 300 or 400 basis points really wouldn't work to change the attitudes. Well, I guess I don't quite agree with that.

CHAIRMAN GREENSPAN. I didn't say it wouldn't change the attitudes; I said it wouldn't change the--

MR. ANGELL. The result.

CHAIRMAN GREENSPAN. --the result.

MR. ANGELL. Here's what I think would happen. I don't think we should increase interest rates by 300 basis points but, if we did, I'm quite certain the price of gold would immediately begin a [sharp], quick [drop]. It would happen so fast you'd just have to go and watch it on the screen. If we made a 100 basis point increase in the fed funds rate, the price of gold surely would turn back down unless the situation is worse than I anticipate. If we made a 50 basis point increase in the fed funds rate, I don't know what would happen to the price of gold but I'd sure like to find out! [Laughter] Now, I want to remind you that monetary policy cannot do anything about growth except harm it. Monetary policy can't fix growth; monetary policy can only harm growth; monetary policy can only cause growth to be worse. I agree that there are some attitude problems out there and some significantly held belief by the American people and foreigners that the U.S. government budget deficit is out of control. And they believe that because it's out of control the Federal Reserve will not be able to stand firm. They believe that we'll have to give in and that we will have to inflate our way out of this problem. Now, I don't believe that. But the American people do believe that, including, I think, your daughter, Jerry. Maybe she doesn't even understand that; she just knows that inflation is going up.

We cannot make growth better in the period immediately ahead. We just can't do that. Now, when I look at the first-quarter numbers in the Greenbook, nominal GDP was 5.2 percent. Mike tells us that if the trade numbers come in [as projected], if real GDP goes up, then nominal GDP may go up also. Now, we only had two quarters of the eight in the current expansion when that 5.2 percent was exceeded; one was 6.2 percent and one was 7.1 percent. Of the eight quarters, the 5.2 percent is [the third highest] and everybody is sitting around wringing their hands about what kind of growth we're [experiencing]. Pardon me, but every time I look at GDP quarterly data I see variations quarter to quarter. I don't know what is going to happen right now, but monetary policy can't fix it. Monetary policy can harm it. Monetary policy is about credibility; inflation is about credibility. Now, if the American people believe that we are not going to act, then this phenomenon of inflation attitudes we have will get worse; if attitudes get worse, that means the tradeoff gets worse. We can fix the attitudes about the Federal Reserve very quickly. And if we fix those attitudes, we will gain stature for our institution and our political system. Our democracy respects proper decisionmaking. If we do what we need to do, [inflation] attitudes will improve.

At the last meeting I was very concerned about what commodity prices were doing. And as you know, they got lucky again and told us that the rate of inflation was higher than we thought it was. Now, I know there's nothing to it but they did get lucky. I've had plenty of econometric studies tell me how lucky commodity prices can get. I told you at the time that the reason I had not been upset before the March FOMC meeting was that the price of gold was well behaved. But I said that the price of gold was moving. The price of gold at that time had moved up from 328 to 344, and I don't know what I was so excited about! I guess it was that I thought the price of gold was going on up. Now, if the price of gold goes up, long bond rates will not be involved. People can talk about gold's price being due to what the Chinese are buying; that's the silliest nonsense that ever was. The price of gold is largely determined by what people who do not have

trust in fiat money system want to use for an escape out of any currency, and they want to gain security through owning gold. Now, if annual gold production and consumption amount to 2 percent of the world's stock, a change of 10 percent in the amount produced or consumed is not going to change the price very much. But attitudes about inflation will change it.

The longer we go with this situation, the more we'll have to increase rates and the higher long-term rates will go. The sooner we move, then the sooner we [will remove] the uncertainty in intermediate and long rates that comes with an increase in short rates. I hope Bill McDonough is correct that a rise in short-term rates will mean that the 10-year rate will fall. Whether that's the case or not to me is a little uncertain, as I think it was to you. That is, I don't know whether people will say: "Oh my goodness, the Fed is worried about inflation." If the market's reaction to the first move is that the Fed is worried about inflation, then in that environment I would expect long bond prices to improve. But every 25 basis points we give away on long bond yields--and we've already given 25 away by not acting when we should have acted--is lost. When we act, when we let the American people and the capital markets around the world know that we care about price level stability--that's our mission--then we will be well ahead and we will return to falling intermediate- and long-term interest rates, which will help get growth higher. A monetary policy step at this time is a win/win. I don't know what is going to happen for sure. I hope Mike is correct that the rate of inflation will move back down to 2.6 percent for the remaining 8 months of this calendar year. If we make a move and Mike is correct, we could take credit for having accomplished this and the price of gold will soon be down to the 328 level and we can lower the fed funds rate at that point in time and declare victory. But if what some of us suspect is true--that the Greenbook is a little optimistic on inflation--then it seems to me essential that we take a [firming] step. I don't feel very strongly about it! [Laughter]

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you. Clearly, I haven't mastered the timing of when to get my name on the list, having to follow such an impassioned statement. As I listen to the discussion around the table, I'm always struck, but even more so this time, by the vast regional differences and perceptions. These people are trying to bring some anecdotal evidence that gives us some clues on where we're going as opposed to complete reliance on the statistics. So I'm particularly struck this time by the differences regionally.

My own read on the national situation is that I think we're more than likely returning to a slower, but I do believe sustainable, growth path. And I don't think that this is necessarily bad. Certainly, there are some areas of strength, and Mike pointed out a number of them. But it does represent a continuation of this operating restructuring that we're going through--the defense restructuring and the balance sheet adjustments. I don't think it's very clear how long this process is going to take. Six months ago or eight months ago we were trying to make projections as to how far along it was. [Now] I think it's pretty clear that we probably can't make those kinds of assessments. People and businesses are trying to adjust to a new order of technology and more complete world

integration. In fact, I think the whole inflationary/stable price argument is clearly becoming a central part of day-to-day business decisions. There is the uncertainty that's associated with the Clinton economic program. If you think about it, this Administration has been in office only four months but we've been on an amazing roller coaster with different thrusts. Some of [the ideas] clearly were trial balloons, but some of them were certainly put forward with great fervor as proposed bills. We are still not sure where all of this is going to end up. Nevertheless, all of these arguments do appear to be leading us to more inflationary pressures. So, no matter how it comes out--even though we didn't get the stimulus bill and I think some folks might question whether it was really a stimulus proposal--it is still leading to increased inflationary pressures.

I know I have talked about this in the past but I continue to think--and I'll echo some of Si's comments--that the labor markets remain a key to the economic environment. The economy is growing enough to produce some jobs but hardly enough, really, to accommodate even the population growth. I think the unemployment rate does mask some of the adjustments and the turmoil that is occurring in the labor markets on account of the downsizing, the de-layering, and the changes in employment needs on account of new technology. The huge fixed costs that are associated with taking on new permanent employees are clearly deterring many businesses from staffing up. I come back to this whole labor market question continually because I think it's the flip side of what is going to happen with spending and whether or not consumers are going to be able to participate in the stimulation of the economy. So, whether or not this is a setback or a blip, and whether or not this is a long blip or a plateau, I think it's not that unexplainable if we go back to this entire question of restructuring that is occurring.

Let me turn to inflation. Like everybody else I'm having a hard time reconciling the recent numbers with the economy. One observation I would make is that we shouldn't necessarily assume or expect a smooth route of progress on inflation any more than we should necessarily expect a smooth route on a recovery. Some bumps and plateaus are likely. We should expect some experimentation in prices as folks attempt to see if they can get price increases to stick. We've seen lumber prices shoot way up but we've also seen them come back down again. In looking at cattle prices, for example, we've seen very strong prices, and they've finally been reflected in some of the meat numbers in the CPI. Tobacco is another example: We saw strong [price] increases--that was what was driving the CPI--but now we hear that we're going to have some cuts. I agree with Jerry's argument on inflation psychology. I think we had inflation for so long that people in demanding wage increases confuse growth with inflation. It used to be that a 6 percent salary increase was nothing. But now that would be fairly large. So, I think it's going to take a long time to work through this entire process. I don't think we should lose sight of some of the countervailing pressures on prices: international competition; weak economies, certainly domestically but also internationally; quality improvements; improved productivity; and weak credit conditions. All of these things may well start to be reflected in prices, so we will see this movement that's a bit up and down. Having said all of that, the most recent CPI and PPI numbers and some of the commodity price increases are clearly disturbing. But we have to recognize that we have considerable difficulty interpreting these

numbers, even the ones that are historical, much less trying to address some of the future ones. So, I certainly agree with the Chairman that this is an area that we have to address our attention to. It makes the policy questions that we're going to be facing in the next round even more challenging.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. With respect to the real economy, my sense continues to be that we're on a path of moderate growth. I don't really see a change in outlook with the mean between 2-1/2 and 3-1/2 percent, but with individual quarters ranging from perhaps a bit below 2 to a bit above 4 percent. The first quarter is pretty well explained, it seems to me, by the weather and the pullback from the surge in consumption. We had a similar phenomenon last year. As for the employment situation, I know there is a lot of negativism around it; but unemployment has come down from the peak last summer of 7.7 percent to 7 percent. And even California's unemployment rate this last time came down to 8.6 percent; it had been up around 10 percent. When I look at the monthly payroll numbers, I find it difficult to get too depressed. The monthly average payroll growth in the third quarter [of last year] was 25,000; it was 85,000 in the fourth quarter, 147,000 in the first quarter of '93, and it eased off to 119,000 in April. The overtime is at record levels and the employment gains are running at more than double what they were in the second half of last year. So, I think this bodes well for durability and sustainability. Auto sales seem to be holding up; the housing starts numbers were good this morning; there may be an inventory adjustment. Confidence certainly has fallen back from the euphoria of late last year but it has stabilized at levels well above where it was, say, in October. So, I guess people are buying housing and cars. It's hard to become too convinced that we're headed for another serious swoon. On the inflation watch, to paraphrase an old Ronald Reagan TV ad, last time the question was: Is there a bear in the woods? As far as I'm concerned the inflation bear has been sighted--not by our staff I might add! [Laughter] I think they should not be allowed near the woods; I fear for their health.

Well, it's a curious phenomenon we've been going through the past [several months]. Perhaps it's a blip; it's a very long blip if it is a blip. Now, I suppose there are many hypotheses. I won't bore you with my own personal list. It's not especially useful to have arguments saying this [upturn in inflation] can't happen with this set of economic fundamentals because that's pretty articulately rebutted by the fact that it has happened and has persisted for a number of months. I feel pretty much the same way about the notion that basically the economy has to slow down for inflation to slow down. It has been slow and we've had rising inflation. I suspect inflation is driven mostly by expectations. That's one of the reasons there's not so much talk about it; it's roughly what people expect.

I do think we can affect inflationary expectations, at least in the market. Since I think we have 4 percent inflation, I now see a couple of issues. The first is whether a 3 percent federal funds rate is appropriate in this environment. And, secondly, are we satisfied with 4 percent inflation? To focus on the first question, the more immediate question, I think no one is proposing instituting a restrictive policy to actually try to get on top of inflation in the

sense of positive real rates. The only question that I can see is whether one might partially adjust the nominal rate to reflect the reality of higher inflation, leaving real short rates still lower than those prevailing last year. But at some stage we're going to have to think about whether 4 percent inflation is something we want.

I thought in the latter part of last year that there was some chance that if inflation continued to decelerate we could hold a 3 percent federal funds rate--that that would be sustainable. The perception was that inflation was 3 percent and falling. Now I have very serious doubts as to whether a 3 percent federal funds rate is sustainable. It seems out of line; it seems to violate some basic tenets of common sense. The last time we had a 3 percent federal funds rate was in 1963. This is not a 1963 inflation environment. When one looks around the world today, the only other 3 percent short rates observed in captivity are found in Japan. And their economic environment in terms of fundamentals is clearly as sluggish as ours, if not more so. But we are not in a Japanese inflation environment. Their inflation is on the order of 2 percentage points below ours. Obviously, we had a lot of opportunity to choose a federal funds rate 1 percent below the inflation rate last year and chose not to do it. I would suggest that the result of the negative real short rates in the 1970s was not pleasant. So, I rather doubt that anyone parachuting into this economic environment would choose a 3 percent federal funds rate. Now, perhaps real short rates don't matter, at least in a weak economy. We certainly instruct the weak economies of eastern Europe and the former Soviet Union that the one thing they have to do is to get that nominal rate at about, or a little above, the inflation rate. We certainly felt that significantly positive real rates made a lot of sense in late 1990 and early 1991 [even] with negative real GDP growth because of concerns about price stability. However, without the aggregates to guide us, I think it's also a pretty visible and simple measure which people may focus on. I wish we had the aggregates to guide us; we don't know what is happening to the hypothetical, shadow M2. I suspect it may be growing pretty rapidly, given the volume of funds going into the stock market. It is true, clearly true, that we don't understand the transmission mechanism well. But I don't believe the lack of thorough understanding should lead us to ignore what seems apparent to me: namely, that 3 percent short rates seem quite a bit out of line. So, I don't have a lot of doubt that we're going to feel that the 3 percent needs changing. The question is one of timing, and my argument is for sooner rather than later.

The concern is that as people start to look at the recent inflation performance, it stands in direct contradiction to our publicly stated objectives. It also stands in visible contrast to the FOMC's inflation forecast of 2-1/2 to 3 percent issued only a few short months ago in February. If we stand by while measured inflation shreds our publicly stated convictions and forecasts, the concern I have is that the long rate will continue to rise. As Governor Angell mentioned, we've already lost 25 basis points. As inflation concerns fester, I think long rates will move on up. And in my view perhaps the market needs a signal that we're not going to allow this to get out of hand, that we actually do care about inflation and that this caring goes a bit beyond just the rhetoric. We lagged the market on the way down and I thought that conserved credibility. But in the opposite direction if we wait until we're dragged up by the market, I

think that will extinguish credibility. A measured response could limit the damage on the long end of the market. To me this is important not just for long-term concerns but for near-term growth as well. The only component of the current environment that is stimulative or conducive to growth is the capital market environment and in particular the long bond rate. My concern is that, with rising inflation unchallenged by the Fed, the long end could deteriorate quite rapidly. Ultimately, it's not up to us whether we tighten or not. The markets are going to tighten on the long end as people focus on the inflation and start thinking about it. And that's going to have whatever impact on the economy higher long rates will produce. We can't do anything about that. What we can do, and about the only thing we can do, is to try to limit the deterioration in the long end by indicating that we're on the job. I think the long rate would likely move up a bit if we made a measured move. But if credibility matters at all, somehow at the end of the day when all the dust settles the capital market environment and growth prospects should be better compared to a situation with Fed inaction.

So, I think a lot is at stake: not only the credibility [of] long-term success but the capital market environment [of] near-term success. The risk of waiting too long is that market participants will start to focus more and more closely on inflation. They will look back not just to the beginning of the year but to the fourth quarter as well. They will look at our forecasts and our statements, and the market will start to price in concerns and hypotheses about Fed inaction. And I believe this could do serious damage not only to credibility but to long rates, [including] mortgage rates, and to the near-term outlook.

To summarize, I do see a changed environment. There is no compelling evidence of any change in the outlook for growth; I think we're still sort of in the middle there. We have a very different inflation environment than the one we thought we were in, one in which inflation has been running much higher. And the question is: Does the same federal funds rate of 3 percent make sense with no material change in the outlook for growth, which is the way I see it, and an environment of much higher inflation? It seems to me that if it made sense in the old environment, it doesn't make sense in the new one. And my preference would be to face up to this sooner rather than wait until the market takes it out of our hands.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I'll try to do this in three sentences. First, my instincts about the real economy have not changed much; Governor Mullins was on the mark there. But as I've said at several meetings running, I still do not have any great conviction about the future in terms of the real economy. I still think it could be stronger, but it could be weaker; I just don't have that conviction. I want to second very strongly the comment you made at the outset of the meeting, Mr. Chairman, about the situation in Europe. I was not, as you know, at that last Basle meeting, but the string of visitors who passed through after the Interim Committee meeting, both on the official side and the private side, were gloomy across the board. I mean really gloomy. The third point is that I don't understand this inflation situation any better than anybody else does. I think we cannot dismiss it as simply broccoli prices and

other wholly transitory things. On the other hand, I do still think that economic fundamentals matter. And while I probably am not as hopeful as Mike Prell, I don't think I'm quite as gloomy as some others appear to be in terms of where we are going. But I agree that it is a changed situation.

CHAIRMAN GREENSPAN. I don't know whether the coffee is cold or not, but it's out there.

[Coffee break]

CHAIRMAN GREENSPAN. David.

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

CHAIRMAN GREENSPAN. Thank you, David. Questions?

MR. MULLINS. What's been happening to M2 plus flows to funds?

MR. D. LINDSEY. We have attempted to construct an M2 plus mutual funds. We've tried to define the bond and stock mutual fund component of that aggregate as consistent with M2 by pulling out the IRA/Keogh components of bond and stock funds and also institutional holdings, which unfortunately are reported to us only once a year. We, therefore, have had to interpolate. The most recent data we have for this measure are through March. They show that whereas M2 has fallen since December, M2 plus mutual funds was about flat in January and February before jumping up to a 6.7 percent rate of growth in March. As you may remember, M2 growth for all of last year was 1.8 percent and growth of this broader measure was about 4-1/2 percent or so.

MR. MULLINS. Thank you.

MR. PARRY. In alternative C you state that you think the impact of higher rates would cause the prime rate to go up by 1/2 percentage point. How strong are your convictions in light of this historically large spread between the cost of funds and the prime and also the very weak demand for bank credit?

MR. D. LINDSEY. Well, they are not absolute but our guess was that banks would tend more or less as a knee-jerk reaction to maintain the spread, given the opportunity. Presumably, at some point those spreads would come down but I'm not sure it would be tomorrow if the FOMC decides to move up the funds rate.

CHAIRMAN GREENSPAN. Any other questions? If not, let me start off. Frankly, I found this a really interesting meeting in the sense that there is a new view about what is going on out there which I found quite intriguing. In fact, I think it explains part of what the big problem is. It's interesting to go around the table, especially hearing the presidents, and to get the sense of this political pessimism which seems to have emerged. It's a relatively recent phenomenon. It's the type of thing that we, of course, have been exposed to inside the Beltway to some considerable extent. The Washington Post has been publishing all this to a large extent. There

is some evidence in the political polls, which show a deterioration in the view about where the country is going, etc. What is new is that I haven't heard this in the business community at the level that I've been hearing it around here. What this suggests to me is a possible explanation of what, indeed, is going on in the inflation area.

As I indicated earlier, I don't think one can look toward the fundamentals for an explanation. One of those fundamentals is protectionism; but even though it is a key factor, it cannot be contributing a large-size impact on inflation at this stage. I think the effects of regulatory changes are real, but again we're talking a minimal effect of .1 or .2 percent. It strikes me that what we are dealing with here are very strong and in a certain sense accelerating psychological expectations--pessimism or concern about whether this country has the capability of politically solving the problems which the markets have been terribly concerned about. The deficit has been hanging out there for a long while and it is only very recently that [unintelligible] the current services deficit starts to turn up in the long run. In effect we've seen in recent years an extraordinary tilt in the yield curve, which is very suggestive of that. The long-term view is one which is scarcely positive.

Now, if you superimpose a deep-seated pessimism on the outlook and if you argue that the transmission mechanisms that we're all used to are fundamentally psychological, then the reason why slack labor markets affect wages is essentially that people react in a certain way; they [assess] their prospects and they bid in the markets accordingly, and those markets work. And it's true, as I indicated before, in the price area as well. So, the major issue in examining inflation is not to start where we usually do in trying to look at slack markets and money and credit and to watch the transmission affect the price level. It's really important for us to recognize in looking at prices--assuming that prices are correctly calibrated, and there are problems, so obviously that is a question--that the price levels and the wage levels tell us what people are doing. And then it's up to us to figure out why they're doing it. That they are doing it is without question. The question that we've really got to confront is: What is the mechanism? I must say, having looked at all of the data and having done all the contemplating that I could, I cannot believe that anything other than inflation expectations is embodied in here. Clearly, actual inflation can run up wholly independently of the real world for a while; ultimately, the real world will cave in. The problem, however, is that before the real world works, the very fact of the price movements themselves has real world effects. So, we're dealing here with a very interesting problem in which the underlying inflationary expectations can have real world effects. We cannot view this type of outlook by stipulating that there are fundamentals and then there is the psychology, because that's not what happens. What happens is that when interactions begin, they basically change the fundamentals.

Now, I don't know whether or not this [increase in] inflation is a bubble or a blip as some of you said. I don't know whether it's deep-seated and irreversible. It may well be that the President will get his budget passed very quickly and this whole [issue] will dissipate. That's the expectation on the Hill. I frankly don't know whether it's true or false. I do know that great certainty at this particular stage about what any of these variables is doing is

probably ill advised. What we have to deal with here is something that I would suspect we have to watch very closely. I think Governor Mullins is right that a 3 percent funds rate is too low. I think we've known that for quite a long while; the issue has never been that. The issue is: When do we move? I would suggest that while there is a remote possibility that we may not want to move at some point in the future, it has to be pretty remote.

My inclination for today--and I'm frankly most curious to get other people's views--would be to go to a tilt toward tightness and to watch the psychology as best we can. By the latter I mean to watch what is happening to the bond market, the exchange markets, and the price of gold, and try to sense whether inflation is accelerating or dissipating. It is perfectly credible, having lived through these types of things many times in the past, that this [upturn in inflation] can suddenly begin to deflate. It has happened innumerable times in the past. I know that both Governors Angell and Mullins have argued that there is a 25 basis point ratchet in the long bond. I respectfully submit that you know, more than anybody, that if you really seriously believe that that is a ratchet, it can go either way. I must say I agree fundamentally with the philosophy that both of you are raising and the only point I would raise is the ratchet issue.

MR. MULLINS. It has gone up 25 basis but not entirely due to this, necessarily.

CHAIRMAN GREENSPAN. That's the point I'm trying to get at. In any event, my initial inclination--and frankly this is a very tough issue and one that has all of us sort of swimming around--would be to have a tilted directive and to keep a very close eye on the situation and see day by day what is happening. If this [inflationary expectations sentiment] simmers down in the marketplace, then I think the next sign post is what actually happens to the price indexes because that clearly will have a significant psychological effect. I also think this is one of the rare times when we ought to have more frequent telephone conferences as events evolve. And rather than take any action today, which I don't think would be desirable for a number of reasons, I would very much like as a starting point to go to an asymmetrical directive and then just watch developments and perhaps have one or more telephone conferences until we get a better feel on this. We are in an unstable environment and I think it can go either way. That would be my recommendation.

I have one other issue I'd like to throw on the table. I hesitate to do it, but let me tell you some of the issues that are involved here. If we are dealing with psychology, then the thermometers one uses to measure it have an effect. I was raising the question on the side with Governor Mullins of what would happen if the Treasury sold a little gold in this market. There's an interesting question here because if the gold price broke in that context, the thermometer would not be just a measuring tool. It would basically affect the underlying psychology. Now, we don't have the legal right to sell gold but I'm just frankly curious about what people's views are on situations of this nature because something unusual is involved in policy here. We're not just going through the standard policy where the money supply is expanding, the economy is expanding, and the Fed tightens. This is a wholly different thing. Anyway, I'm most

curious to get your views in these various respects, so please don't be afraid to throw things out on the table.

MR. LINDSEY. Just a question.

CHAIRMAN GREENSPAN. Yes.

MR. LINDSEY. Mr. Chairman, last time you argued very eloquently against an asymmetric directive because of the costs involved. I was wondering what has [changed].

CHAIRMAN GREENSPAN. Costs?

MR. LINDSEY. Well, I can't say it as well as you did last time, but the case against an asymmetric directive last time was that there are fixed costs in our putting out [such a] directive. And in fact you persuaded me actually to dissent. So it's relevant.

CHAIRMAN GREENSPAN. I'm not sure I referred to "fixed" costs.

MR. MULLINS. The argument was that it's better to move from a symmetric directive, that there's nothing to be gained from--

CHAIRMAN GREENSPAN. No, what I was arguing then--remember the two-month moving average on inflation then was higher than it is today and either it was going to come down dramatically or not--was that it wasn't going to matter whether we moved from a symmetric directive or from an asymmetric directive. My impression now is that we are truly asymmetric and that we are looking at a process which is different from the one that existed previously. I did not have a view that what we were looking at was essentially a risk driven by inflation expectations. In fact, I don't think I raised that issue; my recollection eludes me. This is different. I think this relates to a large extent to the political-psychological issues. I thought Jerry Jordan [said] it best: When he looks just at the data everything looks fine; when he goes out into the boondocks he sees awful attitudes. I don't know how many of you said it; I didn't write it down, but there were five or six of you who said that. And it's certainly very startling.

MR. ANGELL. I'd like to ask you a question also. When you mentioned where we are, if the dollar were to weaken somewhat on foreign exchange markets do you think it would be appropriate in that circumstance to surprise everyone and not sterilize the intervention?

CHAIRMAN GREENSPAN. Well, that's another way of saying just raise rates.

MR. ANGELL. I know, but it seems to me that the timing would be--

CHAIRMAN GREENSPAN. I think we would confuse the market. I don't know how they would read that. It would take them a long while to figure out what was going on. Supposing we intervened for \$200 million and didn't sterilize; I don't know what it would do to the funds rate.

MR. MCDONOUGH. I think people would be so busy trying to figure out what we'd done that I doubt the funds rate would move. I think it would just enormously confuse people.

CHAIRMAN GREENSPAN. Yes, that's frankly my impression.

MR. ANGELL. You think a \$200 million change in reserves would cause the fed funds rate to move definitely?

MR. MCDONOUGH. Our intervention today was a two-day System repo of \$3-1/2 billion.

MR. ANGELL. Yes.

MR. MCDONOUGH. The law of supply and demand doesn't get changed at all by \$200 million. So it would be only the signalling effect, and the signalling effect would be to confuse.

MR. MULLINS. We have to tell them what the fed funds rate is!

MR. D. LINDSEY. The problem is that there are a lot of other things going on. If you held everything else equal and affected borrowing by \$200 million, that would have a big effect.

MR. ANGELL. But what I meant was that if we change a path by \$200 million, that's quite a few basis points, right?

MR. D. LINDSEY. Oh, my goodness! [Laughter] You're approaching zero or near double-digits, I think, with that kind of change. Maybe that's slightly exaggerated.

MR. ANGELL. What other meaning can you give to non-sterilized intervention than a change in the target?

MR. D. LINDSEY. Well, around current levels, [we estimate that a change of] \$25 million in the borrowing level will have a 50 basis point effect. So, you're talking almost 10 times that much.

MR. ANGELL. You could demonstrate the \$25 million of foreign exchange intervention--

CHAIRMAN GREENSPAN. I think it's an interesting idea but it's too complex. Why create uncertainty when what we're trying to do is to eliminate it?

MR. JORDAN. May I ask a question that relates to that uncertainty and trying to reduce it? If an action that results in a higher funds rate, which would be the first increase in I don't know how many years--

CHAIRMAN GREENSPAN. This is the longest period we've gone since when without changing the funds rate?

MR. JORDAN. Well, we haven't changed it since September 4th [of last year].

MR. ANGELL. We haven't raised it since February of '89.

MR. JORDAN. So, if it's the result of an action by the Committee after a full set of deliberations, I don't know that it would raise many questions in the minds of people as to what happened. [It would be clear] that this Committee looked at a whole lot of things and in its collective wisdom decided to raise the funds rate. But if it's done as a result of an asymmetric directive, which involves discretion, then what it was that triggered the increase is going to be very important.

CHAIRMAN GREENSPAN. Let me put it this way. I would have no intention of acting on that directive without full consultation of this Committee because it's a very important move.

MR. SYRON. So, would you have a vote?

CHAIRMAN GREENSPAN. That depends. The evidence may be sufficiently startling that a vote may not be required. The answer to the question is that I don't like to take votes on the telephone; I don't think we've had many and I would prefer not to. But this is a very unusual situation, and I'm not sure how I would [do it]. We could have a vote in that event.

MR. ANGELL. It seems to me important that the Chairman's powers not be diminished to require a vote. I just don't think we want to do that at all.

MR. BOEHNE. The purpose of an asymmetric directive is to give the sense of the Committee to move in that direction. And if we're going to meet frequently, then the notion of tilting it one way or the other seems to me to lose some of its merit.

CHAIRMAN GREENSPAN. I think that's right.

MR. BOEHNE. If it's too important a decision to move without making sure you have the Committee's agreement, then you can decide it then. We don't need to bias it.

CHAIRMAN GREENSPAN. That is a very legitimate issue, and I would be fully willing to agree to that because it does raise an interesting question as to what the meaning of asymmetry is if we're effectively going to go back into a meeting. The Desk can move from symmetry as well as asymmetry. But it does raise the interesting question as to what would be the appropriate vehicle. I do not feel strongly on this question and I would yield to whatever the Committee would be interested in doing.

MR. KEEHN. Just to add to Ed's point: If we think the inflation issue is expectations as opposed to real, it seems to me that an asymmetric directive, which no one will be aware of for another six to eight weeks, isn't going to do anything for us. An asymmetric directive that won't be known for eight weeks isn't going to do anything with regard to the expectations issue. If in fact the inflation increases are sustained, then it seems to me we ought to move in a way that will deal with those issues, and that ought to follow a phone call. Therefore, I think the asymmetry confuses the issue and doesn't deal with it. My thought is to leave the directive as is but be very specific that we will have a phone call.

CHAIRMAN GREENSPAN. That is a very thoughtful note. That's the other side of this argument, and I think it's important to put that on the table.

MR. FORRESTAL. Mr. Chairman, what would be the trigger point for the consultation? Are you going to be waiting for the next PPI and CPI?

CHAIRMAN GREENSPAN. No, not necessarily. It would be a judgment that something is deteriorating and the Committee must address it. If this simmers down, and I think there's a reasonably good chance it may do exactly that, then we can remain tranquil until, say, the next PPI/CPI comes out. If that is tranquil, then we can afford to stay where we are, as far as I'm concerned.

MR. ANGELL. I think the Committee should remember that the reason for having [an asymmetric] directive is that sometimes the deliberation/decisionmaking process is facilitated by having the Chairman be free to make the moves that need to be made based upon what the Committee has said. I guess I thought that's what you were after.

CHAIRMAN GREENSPAN. Let me put it to you this way. My preference is to have an asymmetric directive on the grounds that, as I listen to the Committee, that's my inference as to what the [consensus] is. However, it's my inclination on a very serious issue of this nature to consult with the Committee--because it's a very important move if we move--and I think the Committee should be satisfied that everyone has had his or her say in this regard. In that context, I don't think it's going to look that bad whether there is a symmetrical directive or not. The question basically is the choice of the Committee as far as I'm concerned. Vice Chairman Corrigan, you've been around here for a long time. What's your view?

VICE CHAIRMAN CORRIGAN. Let me make a factual observation and then a comment--not that we should let facts get in the way of these things. On this inflation issue, the question, aside from the diagnostics of what is causing it, is really: Where are we? It's clear that achieving the further progress toward price stability that everyone is hoping for in 1993 looks a bit remote at this point. But the other side of the question is that while we may not be doing as well as we hoped, are we doing as badly as we think? Of that I'm not so sure, so I think a little perspective here might be useful. Look at the core CPI in the first and second quarters of the years 1990, 1991, 1992, and 1993. In '90 it was 5.3 and 5.5 percent; in '91 it was 6.5 and 3.8 percent; in '92 it was 4.2 and 3.3 percent; in '93 it is 4.1 percent and--if you take the Greenbook [projection for the second quarter], which I'm quite prepared to do--3.3 percent. Now, that's not what we had hoped for. Again, Wayne or David made the point that the number reported in the Humphrey-Hawkins testimony as the central tendency of the Committee was 2-1/2 to 3 percent or something like that. So, in that sense things aren't working out as well as we had hoped. But at least to date I'm not yet quite persuaded that the genie is out of the bottle. If you look at the experience at least so far, while there's no question it's not what we want it to be, I'm not so sure that I'm personally ready to concede the point that all is lost. I don't think it is.

Now, on the question of procedure: First of all, under any circumstance I have always believed that no matter what we do we've always got to leave the Chairman with maneuvering room. I don't care whether the directive is asymmetric or symmetric; to me that's irrelevant. There always has to be that powerful, powerful prejudice that leaves the Chairman with flexibility when he needs it. Having said that, and putting aside my own views about policy which will come later, in my mind's eye one argument for an asymmetric directive that I don't think has yet been mentioned--it has nothing to do with process--is that if it turns out that things do start to look a little better, we're going to look a lot better by virtue of having that asymmetric directive on the record.

CHAIRMAN GREENSPAN. When you say "look a little better," look a little better in what sense?

VICE CHAIRMAN CORRIGAN. If overall performance starts to look better in terms of the economy, inflation, or both, and that asymmetric directive is on the record, I think institutionally that makes us look better. In other words the signal is still there that we weren't insensitive to what was going on.

MR. MULLINS. Yes, we noticed.

VICE CHAIRMAN CORRIGAN. Yes, we saw the bear in the woods; he went back to hibernate but we saw the SOB. This seems to me to be a win/win [situation] because if on the other hand it turns out that things aren't so good--that the bear is out in the corn field or the back yard--and we have an asymmetric directive that we've utilized, we're better off as well. So, putting aside all of these complicated questions of process, I think those arguments should be part of the picture. As a matter of fact, I think the substantive arguments are more important in this setting than are the process arguments.

CHAIRMAN GREENSPAN. I think the substantive issue here is a crucial one, and how we want to handle it relates to the secondary picture of the question. President Broaddus.

MR. BROADDUS. I had a question but it was answered earlier. Thank you.

MR. MULLINS. I was going to make the point that President Corrigan made. I think an asymmetric directive captures at the minimum where we should be. And I see no down side from it; we can only look good. If things get better, it says at least that we were concerned about [inflation] and were focused on it. It also says the same thing, as Jerry mentioned, if things get worse. If we don't have [an asymmetric directive], then I think it says that somehow we were not attuned to or did not recognize the situation.

CHAIRMAN GREENSPAN. You're raising an interesting point. There's a timing question here. Let me just say for the sake of argument that we move from a symmetrical directive three weeks from now because of certain events that are occurring. If we do that, it gives the impression that we are moving because 24 hours before something happened whereas if we--

MR. MULLINS. It's event driven.

CHAIRMAN GREENSPAN. It means that there is a process--

MR. MULLINS. And I think it's worse if inflation gets better because then, looking back, people will wonder: Shouldn't they at least have been on watch? Again, I just see no down side. Last time perhaps there was a down side in the sense of alerting people. I don't think it affects process at all but instead will communicate, though not for quite a while. But it will communicate the right things.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Actually, my view on this just changed 180 degrees based on what you said. My original view was that there was a cost to going asymmetric and if the economy were to weaken and prices were also behaving favorably, given the timing of Humphrey-Hawkins--. But I'm persuaded by the point you just raised that if we have to act, it's much better that it be seen that there was an extensive discussion of this and not that a number came in out of the sky and that we were acting just on that number. So, I changed my mind 180 degrees based on that.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I guess I'm persuaded by the arguments for asymmetry. It seems to me that if what we want to do is to deal with inflationary expectations, then the most effective way to do it--in terms of when we change the rate--is to do it by vote to show the full Committee's participation in that decision. I'd say it would be even better at a meeting, either this one or the next one, but certainly by telephone if not that.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I have to agree with what President Parry just said. If what we have is psychology, we want to deal psychology a death blow. I think that is [best] done at a meeting and I would suggest now.

I think we have another problem. Governor Angell and I may have more of a problem than anybody else; on Friday our dissents [at the March FOMC meeting] will come out. And it will be obvious that the Committee considered a move and rejected it again at this meeting. So, I would again say that the best thing to do, if in fact what we have is psychology at work, is to [vote for] an increase at this meeting.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. May I just ask a technical question in reference to Jerry's point? I haven't had the feeling that the difference between symmetry and asymmetry necessarily constrains your ability to make a move. It seems to me that as the Chairman you ought to have the ability to make a move under [changing] circumstances as you see fit. Asymmetry means to me that we would go into the intermeeting period [ahead] with a very strong bias toward making a change to tighten, and I don't think the lack of asymmetry necessarily ought to

inhibit your ability to tighten if in fact the numbers [develop] in a way that makes that seem the appropriate thing to do.

CHAIRMAN GREENSPAN. Well, let me just say that I'm not sure that whatever happens in the real world over the next period of time is going to be significantly influencing our decision relative to whether we were symmetrical or asymmetrical. Normally when we talk in those terms we are talking about real economic variables and we are looking at whether or not the economy is [weakening] or strengthening. It happens in a gradual way. Remember that when we were asymmetric toward ease for a long period of time it was because what we were seeing was a gradually sagging economy. And we could anticipate how we'd react. This is really quite different. This is almost a bubble. It is either going to go burst and disappear or it's going to build up. I don't visualize looking at that sort of process in the same manner. I think how we stipulate our directive is probably irrelevant to how we will want to behave. So, as I said before, I don't consider it a big deal one way or the other. And I don't think it will significantly affect what this Committee does or how we do it. I think it's strictly a perception question of how we wish to be recorded in this particular meeting and under what conditions. And there are arguments on both sides of that.

VICE CHAIRMAN CORRIGAN. Si, just to emphasize in case I wasn't clear, I agree with you: There's no question that with or without asymmetry the Chairman always has a margin of flexibility. I was trying to suggest that on the issue of whether to prefer symmetric or asymmetric--not that they are the only possibilities but just focusing on those two--the substantive [reason] for having an asymmetric directive is that no matter what happens, if things get worse or if things get better, the Committee is at that point on the record as having been vigilant and alert.

MR. BOEHNE. The cost of an asymmetric directive, I think, is not insignificant. If, for example, this turns out to be an inflation bubble--if it turns out not to be a problem and goes away--but the real sector because of all the uncertainty about tax policy and so forth turns out to be a good bit weaker than we [anticipate], we're going to look pretty trigger happy. So I think there is a cost involved. I don't know if it's going to come out that way but we have a very uncertain environment. The situation can go either way both on the inflation front and on the real growth front. I think we need to watch it very closely and we need to show that we have an open mind as to which direction policy is going to go. If circumstances warrant a tighter policy, then let's tighten. I think deeds, not words, speak to expectations. I just don't see that asymmetry buys us very much. There can be a plus to it, but there can be a negative to it. And I don't think we need to take the chance. We're going to meet frequently.

CHAIRMAN GREENSPAN. Let me state that we have another tool, which we're not discussing, that can be used here--not as far as policy is concerned because I think we've all concluded that policy will be what it is--because we're talking now about the question of perceptions. We haven't discussed the fact that we do have a policy record--I beg your pardon, minutes. And we have the capability in those minutes, depending on how they are stipulated, to characterize what we are doing. And that should readily capture the particular

problems that we are all addressing here. So, in viewing this I think we ought to try first to find a means by which to separate what policy is and then to discuss the issue of how we wish to be perceived. If we can make that distinction--and from what I can judge I think most of us would be willing to do that--they should be handled separately. President Jordan.

MR. JORDAN. I had started off this year hoping that inflation would be less than last year; but much more importantly I believed that inflation this year was going to be less than last year. It has already been mentioned that it would take [an inflation rate of] 2.6 percent or something like that for the rest of the year [to achieve the staff forecast for inflation]. But I had been thinking more that 2-1/2 percent nominally should be a goal that was doable this year for the whole year, which would have been an average of .2 for every month of the year. Now, if it averages .2 for the remaining eight months, that still is going to hold inflation only at last year's level, and I find that unacceptable. So, I think there is already enough information, that nothing else needs to be learned, and that an immediate action is warranted.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, we're obviously operating in a very difficult environment and within parameters that may be quite different. I think I could make an argument for easing on the basis of a decelerating economy just as I could for tightening in the light of the recent inflation numbers. Given the amount of pessimism that is out there, given the employment situation and the high level of unemployment--even though it has come down, 7 percent is not a desirable number--a tightening action could well abort the expansion or certainly cause greater deceleration in the economy. And I think we have to be as attentive to that as to the inflation numbers. Now, it may be that we will have to make a move to counter inflation but before we do that I think we have to be very sure that inflation is really on an upward trend. Inflationary expectations may be out there, but I certainly haven't heard anybody in our area of the country telling me that they're concerned about inflation. Maybe they should be, but there isn't any concern about it. I agree entirely with Governor Angell that monetary policy can harm the economy. If we were to make a premature move, we could harm the economy; and I think we ought not to be doing that. Again, these inflation numbers may be temporary. They may not be but they could be, and I think we have to be very careful before we overreact to the inflation numbers. So, I would not be in favor of any move at this time and I agree with your prescription in that regard.

On symmetric versus asymmetric, in light of my views on the economy, I think we ought to have a symmetric directive. The down side of having an asymmetric one is exactly as Ed Boehne described: We could be viewed as overreacting to the inflation numbers if in fact they get better. So, I hope if we have to take action that we do it very, very deliberately in light of real information about a trend in the inflationary situation.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, my inclination is to say that although there is some pessimism, it is fiscal-related. My own bias is that these inflation numbers are bothersome and that tightening would be the better path if I were convinced that they were permanent. At this point I am willing to wait and see a little longer. So, I would leave [policy] the same. When we do act, though, I think it should be by vote, so I would also say symmetric for now.

CHAIRMAN GREENSPAN. President Broadus.

MR. BROADDUS. Mr. Chairman, I'd like to support action today. As far as I'm concerned, the issue is credibility. I think Governors Mullins and Angell made that point very eloquently. In matters of credibility there is no substitute for action, so I think a good move today would be to raise the funds rate 1/4 point. Yes, there are risks, but it's possible to exaggerate those risks. The funds rate now in real terms is negative. I think it's easy to overstate the risk to the economy of a small increase [in the funds rate]. The other point I would make is that if we wait until we're absolutely certain and convinced that the inflation trend is upward--we've been down that road before--we may well have waited too long. That would reduce our credibility and it might be quite costly to regain it. So, I would favor action today.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Maybe I'm haunted too much by late 1986 and early 1987. At that time a lot of regions of our economy really were pretty sick. You could put a football over the map of the United States and put one end on Phoenix, Arizona and the other end on Pittsburgh, Pennsylvania and lay that football out and the economy would really [unintelligible]. Talk about pessimism and talk about depression and talk about the fall in land values from \$1700 an acre to \$900 an acre and in Iowa from \$3100 down to \$1400! That pessimism was strong. It was hard to see then, but we knew what was there if we looked at commodity prices and gold. And yet when we got ready to act, we were so incapable of acting because events got in our way. This speech is about events that may get in our road. One event was the Louvre Agreement. When the Louvre Agreement [existed], it didn't seem appropriate for us to make a move because in some sense that was a part of what some of us thought was a deal. And then we got into May of '87 and the dollar got strong; and I remember Paul Volcker saying: "Well, is this the day we want to increase rates?" And I felt that the dollar was strong on that day, [so] maybe we didn't want to do it then. We didn't do it; events got in the road and all of a sudden we found ourselves with the wrong fed funds rate in the fall when you came on Board, Mr. Chairman. So, of course, I want to act today. I want to raise the rate today. I'd be satisfied with 25 basis points. That's crazy when I want 50, but I'm a compromising person. [Laughter] I would recommend to you--in a sense I've taken myself out of the decision--that you stay with the Chairman's recommendation on an asymmetric directive. I think it's very important that you do that.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. My preference would be for no change today but with an asymmetric directive toward tightening. I think having that

on the record in the future is more likely to be in our favor than against us for reasons that Jerry Corrigan and Governor Mullins mentioned. For psychology, I think we ought to get Governor Phillips to dump her bracelet on the gold market at some point!

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I'm marginally persuaded to go with asymmetric toward tightening. But I must say that I'm rather astonished that Bob Forrestal is the only one around this table who has even discussed the possibility that tightening might have a very, very serious effect on economic growth. That is what worries me. And the political reaction to a dumped economic growth rate could have much more serious inflationary implications and also serious implications for the future of deficit reduction. So, I think we ought to be very, very careful not to move until we're really persuaded that there are overwhelming reasons to do so.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, my earlier comments were really observations and questions. Just to be clear as to where I come out on policy at this point: It seems to me, as we went around the table and talked about the economy, that the general thrust was that the economy is okay but there was a theme that some moderation has taken place in terms of growth since the last meeting. I didn't hear anybody talk about a growth rate that to me would be high enough to sustain this inflationary trend that we're worried about. It does seem to me that Ed Boehne makes a very compelling point on this. In light of all that, I'd be for alternative B with symmetric language. But I would be prompt to take an action by telephone if something in the future would warrant that.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Mr. Chairman, just on the issue of policy itself, it seems to me that credibility is a two-way street. It's important to maintain credibility but I fully agree, as I think everyone does, that we are--using your words--in an unstable environment. I would argue that psychology is poor not just on the price front; we heard a lot of that. I think we're in a situation where a lot of our institutions look very weak. And the Federal Reserve is one institution that hasn't looked weak so far. So, I'd be pretty cautious about running off and doing anything that looks too much like overreacting in one direction or another. And for that reason I would strongly feel that now is not a time to do something. Also, on the psychology front, [unintelligible] even on prices unfortunately the markets would react with it. I'm not sure Jerry Jordan's daughter would react right away [in terms of] what she wants to pay for the house if we raise the funds rate 25 basis points. For a lot of people we would have to wait until it affects their pocketbooks and they see some impact from that.

On the question of symmetry, I think that's not an enormous issue. It depends an awful lot on whether we end up being wrong, which is at least a 50/50 chance. How would we want to present ourselves in that case? Where is the lesser cost of being wrong? I think it probably is to be asymmetric.

CHAIRMAN GREENSPAN. Yes, having heard the conversation here, I think that's the real question. It's not what happens if we're right, but how we want to appear if we're wrong. Since we are the central bank, if we're going to be wrong, we should be wrong on the side of preserving the currency. That's where I guess our bias should be, provided we don't allow that to affect how we are going to--

MR. SYRON. One small last point: On the issue of implementing policy--and several colleagues have said this--this is an important enough point that I hope we would have a telephone conversation. Everything else being the same, I would hope that people could be recorded if this is seen as a critical problem.

CHAIRMAN GREENSPAN. Well, I take that as a serious question and I think it's going to depend to a very substantial extent on what happens out there. I hate to go out of a meeting with the degree of uncertainty that we have. But the uncertainty is real; and we're not going to change the level of uncertainty by making believe that it is unreal. Let's face that. We happen to be meeting at this particular date because that is what was on our calendar. If we were meeting on a different date, we'd probably have a greater degree of certainty about what is going on. Governor Kelley.

MR. KELLEY. Mr. Chairman, we've been around this bush a number of times now. I would support no change with an asymmetric directive. The reason I like the asymmetric directive is that I think it reflects the fact that this Committee is on top of the situation and is concerned. That is the case and I think we should have an asymmetric directive for that reason. That does not mean that I necessarily think we're going to use it. If we move to tighten now, it seems to me the reason would be because we have the perception that inflation has indeed already set in on us and has to be countered now, or maybe it should have been countered sooner. The way to counter it is to tighten money; and the reason we tighten money is to restrain something. Well, if we had a strongly accelerating economy, it would be clear that it needs to be restrained. We have something less than that--the Greenbook economy or worse. What is it we want to restrain? There are not any excesses that I can clearly find. It seems to me that if we want to tighten, we've got to be very clear why. To simply say "to counter inflation" really isn't enough. If there's something we want to restrain, let's decide we want to restrain it. If it is a matter of restraining expectations, let's be very express about that and be very careful that we take a good look at whatever secondary effects--in the way of hard effects--we might set off in an attempt to counter a psychological or soft effect in the area of expectations. Now, that's not to say that we might not need to tighten at some point; but I think we ought to be quite careful about tightening in the face of a perception of an expectation-driven inflation without some other harder evidence to go along with it.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. In these circumstances I think we need at a minimum an asymmetric directive toward tightening. A lot of the reasons for that have been covered and I won't belabor them. But I would note that we have been shooting for further disinflation and indeed, ultimately, for price stability. That is the long-run target that we have committed to, appropriately, and we seem to be drifting

away from it. I don't think it's fatal if the drift goes on a little longer; and I admit that I don't know what the short run--the next month or two of data--may bring. But it seems to me that we have to be very careful at this point because we're not getting the result we anticipated nor are we moving in the direction of our long-run objective. So, at a minimum I think we need the asymmetric directive toward tightening.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. I agree with what Gary Stern said. I guess I'm less concerned than Ed Boehne is about the notion that we might be viewed as trigger happy. We haven't been close to a trigger in months. This may be temporary, but seven months is a pretty long temporary time as far as I'm concerned. It is true that we wouldn't be restraining anything or countering anything if we moved because I doubt that we would get ahead of inflation since it has already moved. But at least we might be catching up in the sense of reflecting the higher inflation in nominal rates. When we talk about moving a small amount, we ought to be realistic about what sort of potential impact it could have on the economy. I don't think there's anything sacred about 3 percent rates. The yield curve has been upward sloping for quite a long time now, since people have been expecting higher rates. And the real short rate would still be negative and lower than it was last year. So, I wouldn't be opposed to moving now. At least we should be asymmetric. We ought to be clear on the risk of waiting too long here, and that risk is that we will have to make precipitous moves down the road. And if you want to think about the consequences for the economy and the flak we're going to receive if we wait a bit long, I think it's useful both for signalling and also for execution that we be asymmetric now.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I would prefer symmetric. I still have concerns about the weakness of the economy, so I think one can make arguments in either direction. I will say that, having listened to this discussion, I am persuaded that perhaps the perceptions of our being [watchful]--or maybe getting out the signal that we really are addressing inflation--might be helpful. So, I could live with asymmetric toward tightening.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I didn't put my hand up, but I have to speak anyway! I was very much influenced by this meeting. I came in sitting on the fence, frankly. And based on hearing the discussion my preference would be--if I had to do one or the other--probably to move rates up a little right now. But it's clear to me that there's not a consensus to do that. This is a very important move and I think there has to be a stronger consensus than exists right now. Therefore, I could accept deferring action. I think there's a risk in deferral and David put his finger on it. There's a risk that we might have to do more later if things break the wrong way. In a sense, even if they break the right way and we follow [developments] in this intermeeting period, we may decide we really don't have to act. We can discuss it again at the next meeting and maybe decide that we don't have to act then either, but it won't remove the fact that the funds rate probably

is not pegged at a sustainable level. The question is: What is that [delay] building in, in terms of lagged effects that ultimately are going to come home to roost later? And then there's the credibility question that Al Broadus raised in terms of where we all expected inflation to come in this year and where it is likely to come in and what that means if we take that sitting down. It's a tough issue, but that's where I come out.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I'm quite comfortable with "B" asymmetric. I might say, if I could just add a word on process which I know you want to deal with separately, that if it turns out that the Committee does come to a consensus that a tightening move is needed in the foreseeable future, of course, I won't be a part of that decision. But leaving that aside, if a tightening move is needed any time between now and the next meeting, that will be one of the relative handful of watershed policy decisions that come along. This is not a "gimme putt." Indeed, it's probably [a watershed decision] not just because it would be a turning point but because of the environment in which it is going to happen, if it happens. So, I think there's a great deal of wisdom in the suggestion that several people have made that if you do that, you better do it right with a meeting of the Committee by telephone or otherwise and by a vote.

CHAIRMAN GREENSPAN. I'm inclined to agree strongly with that in the sense that we haven't moved interest rates up since 1989. We haven't moved at all in over six months. This Committee is going to be highly visible. And no matter what it is we do over the next 3 to 6 or 9 to 12 months, it's going to be quite important for us to be as close as we can to each other. In other words, it's important since there's no doubt from our various conversations that the underlying philosophy of every member of this Committee falls within a relatively narrow range in terms of what should be the economic and monetary policy of this country. I think it would be very tragic if a group of this extraordinary capability--as Bob Black used to say, this is the best Committee he has seen in all the years he had been on the FOMC--were perceived to be in disarray. It's very important that we act as a Committee and try to avoid, where we can, any evidences that this Committee is in disarray or something of that sort. If it ever gets to the point where this Committee is either in disarray or perceived to be in disarray, there is no other institution in this government that can substitute for us. And if my [assessment of] what in fact is causing the problems we are confronting is correct--that it's a deep-seated psychological deterioration that continues--it is crucially important that we stand tall as a group and try to find the means by which we can merge our differences in a way in which the vast majority of the Committee can support. There have been occasions in the past when I've raised the issue of "Let's try to vote together because it's a crucial issue" but they were very few. I think I raised it a couple of years ago; I may have raised it two or three times in the last several years. I don't think it's something that ought to be raised often because one of the great strengths of this Committee is the capability, which I think we exhibited today: namely, that we have interaction where a lot of minds are changed. I know my views changed several times as this meeting evolved because of the evidence and the strength of the arguments that came up. That's an extraordinarily valuable facet of this Committee. If we at any time endeavored to

sort of force ourselves into a mold, we would lose that. So, there are two sides to this question. All I want to say is that Jerry Corrigan won't forgive us if we don't get this right!

In any event, as I read this Committee as to where we stand at this point, there is a significant majority who are willing to support an asymmetric directive, using alternative B. I think we are in a position where before any action is taken--or indeed if any evidence emerges that would even raise the question of whether we should or should not act--we would want a telephone conference. My best hope is that this whole psychological thing will dissipate, which it could conceivably, that the next set of price data we end up with are benevolent, and that we won't speak to each other for the next six weeks! The chances of that are less than 50/50. But leaving that aside, are there any other issues that people would like to surface at this time before I call for a vote?

MR. KEEHN. I think I hear that any change would be preceded by a phone call.

CHAIRMAN GREENSPAN. Correct.

MR. ANGELL. But that would be more restriction on you than you normally have when we have [an asymmetric directive].

CHAIRMAN GREENSPAN. No, I don't consider that a restriction on me. This is something that I want to do. I think it is important that I get the views of this Committee before making this particular decision. Frankly, I don't consider it a diminution of the Chairman's power; I want to emphasize that.

VICE CHAIRMAN CORRIGAN. I also assume that if something really ugly happens that has nothing to do with the things we're talking about here, you will always have--

CHAIRMAN GREENSPAN. Well, let me put it this way. I've been around this Committee for a number of years and I think I can say that I pretty much know how every single member of this Committee would come out under [any given hypothetical] event. In other words, I could take the vote myself if I had to and I bet I'd get it on the nose three times out of four! The reason for that is that I know where you're all coming from. We get updated periodically on what our basic views are. So, I don't consider that a major concern. Obviously, I'm not arguing that we are setting any precedents; this is not a precedent. This is something quite extraordinary. I hope that we don't have to talk again shortly; but if we do, we shall. And with that I would like to get a vote on an asymmetric directive and have the Secretary read it.

MR. BERNARD. "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, slightly greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected

to be consistent with appreciable growth in the broader monetary aggregates over the second quarter."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	No
President Boehne	No
President Keehn	Yes
Governor Kelley	Yes
Governor LaWare	Yes
Governor Lindsey	Yes
President McTeer	Yes
Governor Mullins	Yes
Governor Phillips	Yes
President Stern	Yes

CHAIRMAN GREENSPAN. Officially our next meeting is when?

MR. BERNARD. July 6-7.

CHAIRMAN GREENSPAN. July 6-7. I assume that all of you are joining us for lunch to give our best wishes to Jerry.

END OF MEETING