

TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

September 23, 1993

Prefatory Note

This transcript has been produced from the original raw transcript in the FOMC Secretariat's files. The Secretariat has lightly edited the original to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcript was not fully edited for accuracy at the time it was produced because it was intended only as an aid to the Secretariat in preparing the record of the Committee's policy actions. The edited transcript has not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Staff Statements Appended to the Transcript

Mr. Fisher, Manager for Foreign Operations
Ms. White, Vice President, Federal Reserve Bank of New York
Mr. Prell, Economist
Mr. Truman, Economist
Mr. Kohn, Secretary and Economist

Meeting of the Federal Open Market Committee
September 21, 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, September 21, 1993, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, 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. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Patrikis, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist
Messrs. R. Davis, Lang, Lindsey, Promisel,
Rolnick, Rosenblum, Scheld, Siegman,
Simpson, and Slifman, Associate
Economists

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

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

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

Messrs. Judd, King, and Ms. White, Vice Presidents,
Federal Reserve Banks of San Francisco,
Atlanta, and New York, respectively

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

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

Transcript of Federal Open Market Committee Meeting
of September 21, 1993

CHAIRMAN GREENSPAN. Good morning, everyone. We welcome our two new colleagues [at the end of the table] from the Federal Reserve Bank of New York. I'll ask as a starter: Would somebody like to move the minutes of the August 17th meeting?

SPEAKER(?). So move.

CHAIRMAN GREENSPAN. Without objection. I call upon our Vice Chairman for nominations for slots now open for Manager for Foreign Operations and Manager for Domestic Operations.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. As is evident by the fact that we have two nominations, our recommendation is that we revert to the method which has served the Committee very well during most of its life, and that is to have separate managers for the domestic and foreign operations. You'll recall that we have had two managers except for a very brief period in the 1970s and then for an even briefer period when I had the joint responsibility. A bit of background: We are doing some recasting of our research area at the Federal Reserve Bank of New York, and we needed a very capable senior economist with a strong international background to move in under Dick Davis and take care of [international] economic studies. And the perfect candidate for that was Gretchen Greene. So, Mr. Chairman, I would like to recommend and nominate Joan Lovett as Manager for Domestic Operations. Joan is a graduate of Albertus Magnus College and the New School for Social Research from which she has an MA. After two years at the U.S. Treasury she has been with the Federal Reserve Bank of New York since 1968; she has spent most of that time in the Open Market function although she did also have experience in the foreign exchange area as well, which I think is attractive. She has been the Deputy Manager for Domestic Operations. Further, I would like to recommend and nominate Peter Fisher as Manager for Foreign Operations. Peter is a graduate of Harvard College and Harvard Law School. He's made his entire career at the New York Fed, originally in the Legal Division where he spent five years. He spent two years in Basle, Switzerland and was the principal scribe of the Lamfalussy Report. Then he returned to join the Foreign Exchange Department and has been responsible for day-to-day operations for about the last 20 months.

CHAIRMAN GREENSPAN. I just want to note that Joan Lovett was not able to join us today because her mother died late last week and we have Betsy White here as her temporary replacement. Nominations have been made. Are there any further nominations for either of those posts? If not, I will ask for a motion. May I have one from you?

VICE CHAIRMAN MCDONOUGH. So move, Mr. Chairman.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. All in favor say "Aye."

SEVERAL. "Aye."

CHAIRMAN GREENSPAN. Opposed? The "ayes" have it unanimously. We congratulate you, Peter; and I trust that similar congratulations will be extended to Joan at the appropriate time. Why don't we start off with Peter with his inaugural analysis of the foreign currency operations.

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

CHAIRMAN GREENSPAN. Thank you. Questions for Peter? If not--

MR. FISHER. We need to approve the System's \$82.5 million participation in the intervention operation of August 19th.

SPEAKER(?). So moved.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Now, I call on Betsy White. Although she has been at several FOMC meetings, she too is making her inaugural presentation.

MS. WHITE. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Thank you. Questions? If not, would somebody like to move to ratify the actions of the Desk since the [last] meeting?

SPEAKER(?). So move.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Let's now move on to the staff report on the economic situation. I call on Messrs. Prell and Truman.

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

MR. TRUMAN. [Statement--see Appendix.] That concludes our presentations.

CHAIRMAN GREENSPAN. I'd just like to raise a question with Mike or Ted. We discussed very briefly last night this interesting path of long-term rates relative to the simplistic model. There's an interesting question that's implicit in this; namely, that if, in fact, this is a primitive model, one could postulate that we could drive the funds rate down to zero, hold it there for a very long period of time--which we have the physical capacity to do--and therefore look forward to a significant further decline in long-term rates. Now, obviously, I don't think anybody here believes that that process would happen. That raises an interesting question as to whether the relationships that are being picked up in the model are

basically the result of the fact that short-term rates are generally perceived not to be significantly out of line with productivity and that the events that surround the short-term market will eventually begin to affect the long-term market. And so long as the Federal Reserve does not endeavor to force the short-term rate away from where it otherwise should be, that model is merely reflecting the fact that the same forces affecting the short-term rate will ultimately affect the long-term rate. But I seriously question whether we can infer from that sort of relationship any significant policy issue because I have this suspicion that were we to try to drive that relationship by monetary policy, we would automatically find out as of that day that it doesn't work any more. I was just curious to get your response to that [issue which I raised in] our conversation last night.

MR. PRELL. Well, I think you hypothesized a situation in which the consequences are obviously explosive. If you held short-term rates too low for too long, initially through this term structure mechanism lowering the cost of capital below the equilibrium rate in the intermediate- and long-term end, you would generate excess demand and inflationary pressures. Those inflationary pressures would mount over time. Something would have to give; presumably at some point monetary policy would have to adjust in the proper direction. But one of the reasons I have reservations about the model is that in a sense it doesn't include a place for people to recognize where things are headed and to have a more forward-looking response. The latter could introduce an inflation premium earlier on and tend to override what this model's formulation would suggest. And perhaps because we didn't move into those patterns of behavior the model didn't have those kinds of experiences from which to estimate. So, I grant that this likely has limitations. If I didn't feel that, we presumably would have a significantly different kind of forecast. But the one thing that gives me pause, as I suggested, is that this model has worked remarkably well in the past, even the past decade. I noted that it was fitted over 1958 to 1983, and even during the 1980s when there has been an acute sensitivity to inflation risks and what had happened in the past, the model has tracked quite well. Other versions of the model, with the same sort of formulation, [have also tracked quite well]. So it has gone through some difficult times and I think it does capture one element of human behavior, its adaptive expectations formation as people become accustomed to given rate levels. But I would agree with you that in the extreme it's likely to break down.

CHAIRMAN GREENSPAN. Any further questions for either gentleman? President Jordan.

MR. JORDAN. The funds rate has been unchanged for a little over a year now. So, it seems to me useful to look back over the period to see what else has been unchanged or what has changed and in which direction and to try to make some sense out of it. In reviewing the successive Greenbooks in the period since a year ago, one of the things that struck me was how little your forecast of nominal GDP for the second half of 1994 has changed. A year ago at this time you [extended the forecast] another year, so I am curious as to what your 1995 projections will look like once we get those, but that's not my main question now. The funds rate has stayed at 3 percent and [your forecast for] nominal GDP growth still is on the order of 4-1/2 percent or a little more for the second half of 1994; that hasn't changed much even though a lot of other things have changed in the

meantime in successive Greenbooks. Then, I see that your estimates of potential real output have been revised up, partly because of the new benchmark numbers. Actual output has been somewhat below where we anticipated and it continues to be projected on the low side in '94, so you've got a bigger gap. There are two essential elements to your framework. One is that the gap says something about future inflation and that nominal and/or real interest rates say something about real output growth. Bond yields are lower than you had anticipated earlier; I don't know about real rates, but at least nominal rates are lower. Short rates are the same and inflation [is higher], suggesting lower real rates. So, ex ante, one would look at this set of things and say: Well, your forecast should have implied that the split of nominal GDP would be less inflation and more output. Instead, we get the opposite. We have a bigger gap yet we have lower output growth by almost a percentage point in 1994, and with that bigger gap we have higher inflation. I'd be curious [to learn] what other things must have changed, because other things equal we would have gotten the opposite. We would have expected more output, less inflation. So, what were the things that changed in your framework to produce this combination of higher inflation and lower output for the same GDP?

MR. PRELL. Well, President Jordan, that's the kind of very complicated question that I'd have to have in writing a week in advance, I think, to be able to do justice in answering it. I don't think I've absorbed all of the threads. We do have, obviously, in our forecast for 1993 a substantially less favorable mix of output increase and inflation. We've gotten much lower growth than we anticipated and inflation has been running somewhat higher. Now, curiously, the unemployment rate has not been higher than we anticipated; it has been lower, and that needs to be taken into account as well. Furthermore, looking at the revised national income account data and at both the actual growth and our estimate of the potential growth, the output gap we've estimated tentatively at this point is somewhat smaller than we thought, not larger. The actual growth has been revised up more than our estimate of potential growth. So, in a sense the gap here that is exerting disinflationary pressure isn't larger than you thought; it's probably smaller. Furthermore, we had earlier in the year what we view to have been some response to the surge in activity. We think that is unwinding now, but on net thus far this year I don't think it has been helpful.

I would really have to review a lot of detail here to be able to give a better answer to your question, but I don't think our basic model, in the sense of how this works, has changed. We've had a few surprises. What I've suggested in regard to the current forecast is that we see some underlying confirmation here of the scheme that we've been applying in our forecasting. And that has led us to be a little more confident that we can extend the disinflationary trend going forward. And we think that if growth for '95 remained moderate and unemployment remained close to where we have it, there would be an ongoing disinflation. But we have not seen quite the favorable tradeoff that we anticipated, and the slack has been a shade less on average thus far.

MR. JORDAN. Can I follow up? I expected you to put a little more stress on the fiscal package.

MR. PRELL. Well, we don't think that has affected the tradeoffs here but, as you know, at the beginning of the year we didn't introduce a fiscal package because of the uncertainties. Then we introduced one that included fiscal stimulus because we wanted to follow the President's lead on this. Ultimately, there was no near-term fiscal stimulus in the package; in fact, it probably moved the restraint forward in time beyond what anyone would have anticipated earlier. And we now have a substantial amount of fiscal restraint in the forecast damping aggregate demand but not affecting the unemployment/inflation tradeoff. Well, there are some elements here, [such as] gasoline taxes; an excise tax impact in a sense gives you a short-run deterioration in the tradeoff. And there are other things that have been going on and that could still happen that will tend to raise the price level in the short run relative to what everyone--

MR. JORDAN. It raises some interesting implications for the Committee's policy because on the second page of the Greenbook summary you say "Achievement of this middling expansion path may require maintenance of relatively low real short-term rates--to counter the contractionary effects of fiscal restraint, uncertainty about government policies, and, at least in the near term, slow growth of foreign industrial economies." That's a stronger statement--I would call it advocacy--of monetary policy than we typically see in the Greenbook. The Greenbook is typically a little more neutral in terms of an assumption of monetary policy. And if it's the case that the real output projection is being influenced by fiscal actions, and if it's the position of the Committee generally that monetary policy cannot be used to correct mistakes of other parts of the government sector, and if you advocate a monetary policy in the future that is different than it would have been in absence of the fiscal package, then that is saying that monetary policy is being adjusted because of the fiscal regime.

MR. PRELL. Well, there are two things one could say. One is that monetary policy can't be adjusted to offset shocks such as a change in fiscal policy. I don't think there's an economic basis for that statement. There may be difficulty in doing that because we can't anticipate with precision what will be occurring without a shift in monetary policy and there are uncertainties also about what the effects of a monetary policy change will be. So, all those uncertainties may lead you to think it might not be desirable to attempt to engage in fine-tuning. Certainly the Committee over the recent decade or so has in one way or another repeatedly made the statement that it realizes it would be impossible to be fully effective in fine-tuning and that there would be some risks in attempting to do that.

In terms of advocacy, I would view that statement more as a positive statement than a normative statement. It simply says that if you wanted to achieve this growth path, it might require low real short-term interest rates for a longer span. We didn't advocate that particular outcome. That's clearly the Committee's decision to make. [It's up to the Committee] to weigh the risks that might attend the policy movement or no policy movement here in terms of whether you might end up with less output or more inflation or whatever than you desire. We're attempting to be as neutral as possible here by taking as our essential assumption that the nominal funds rate remains fixed. We aren't advocating that necessarily; we were just taking that as a

baseline and giving you something you can adjust from based on whether you feel the risks are different or that the fundamentals are going to push things in the stronger or easier direction.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mike, your projection for real personal consumption expenditures for the third quarter, given the high July level, implies a decline on average in August and September, if I calculated it right. Is that right?

MR. PRELL. We have a very marginal increase in September for PCE. We see a pretty healthy gain in the third quarter because of the data already in hand. Real consumer goods expenditures other than motor vehicles seem to be well above the level of the third quarter, and service expenditures were running very strong early in the summer. So, we think we have the likelihood of a strong advance there. We see a flattening out, and arithmetically that works in the direction of a more moderate increase in the fourth quarter. But we are basing that on income trends and attitudes and all the other factors that one might look to in explaining the prospects for consumption expenditures.

GOVERNOR GREENSPAN. Governor Angell.

MR. ANGELL. Ted, did you have a NAFTA [assumption]?

MR. TRUMAN. We have continued with the same NAFTA assumption we've had in the past, which has been that the legislation will pass. We noted in the Greenbook that in light of recent noise, if I may put it that way, that may be somewhat less of a "gimme" putt than we regarded it earlier. And we thought a bit about what the implications of that might be, which largely--at least in the short term--revolve around the impact on Mexico, not the secondary impact on the United States. We have seen this year that Mexican growth has slowed substantially. That appears to us to be a combination of tighter policies in Mexico in the face of what had been a rising current account deficit and some uncertainties associated with NAFTA and the level of capital inflows. Therefore, for next year, on the assumption that NAFTA would pass, we had moved up Mexican growth somewhat by about a percentage point. In the absence of [NAFTA], we regard that increase in growth as problematic--I think that's the way we put it in the Greenbook. Moreover, we think there would be some downward pressure on the peso and, therefore, there would be some drag on exports for the United States as a result of the failure of NAFTA. That's about as far as we've gone.

MR. ANGELL. I have two questions for Mike. Mike, when I look at those interest rate forecasts that you have in place and then look at the ECI numbers on page I-14 of the Greenbook, I'm wondering what happens to the pension contributions. For any period in which interest rates behave as you have them forecast, assuming that before the end of 1994 there might be some upward pressure on short-term rates, would that make much difference in regard to the impact on the ECI if pension plan fundings come under pressure--that is, given some of the assumptions on rates of return that are built in?

MR. PRELL. Well, we've alluded to this problem in the last couple of Greenbooks and there has been a great deal more discussion about this in recent weeks in the press, some of it by investment banking firms such as Salomon Brothers who have been calling attention to this issue. It appears that a large number of corporations are in serious risk of having major underfunding in their defined benefit pension plans with these kinds of investment returns. They've been very optimistic in maintaining high expected returns, [i.e.] in the assumptions they've used for determining their contributions. They're going to be under significant pressure to make those more realistic. And we would expect that there will be upward pressure on that component of employment costs. That is not likely to be a gigantic effect. We don't really have a good enough handle on it to size this, but we feel there's probably something there that is of significance in buoying increases in benefit costs. While other items may be coming down, the overall deceleration seems likely to be limited by this factor.

MR. ANGELL. At the same time, for persons who are retired or approaching retirement and are counting on short-term funded investments, is there likely to be current and continued downward pressure on consumer spending from this segment due to the fact that there is a perceived reduction in investment income?

MR. PRELL. I think it's possible. It's also possible--I don't think we have much evidence, though I've asked a few businessmen whether they can perceive this--that people may not opt for early retirement to the degree that they have in recent years because they may have lowered their expectations about what their assets will earn in the way of income over their retirement years. I don't think we can see anything yet in labor force participation data to support this notion, but things may work in that direction. We may see some tendencies toward a little less of that 55 to 64 year old male retirement that we've seen recent years.

MR. ANGELL. The last question has to do with your statement in regard to substantial fiscal restraint. Substantial wasn't exactly the word you used but you had some--

MR. PRELL. I might have.

MR. ANGELL. --adjective regarding fiscal restraint. Yet when one looks at the Congressional Budget Office forecast and I think even our own, the budget deficit doesn't change very much over this forecast period. I recognize that a deficit staying around \$250 billion would [constitute] a declining percentage of GDP, but I'd like to have you explain why you call it "substantial" fiscal restraint.

MR. PRELL. Well, the numbers in terms of the unified budget are distorted by the year-to-year movements in deposit insurance, so that the drop, for example, from fiscal '93 to fiscal '94 excluding deposit insurance programs is on the order of \$40 billion. If we look at the NIPA budget deficit numbers, we're going to get something like an \$80 to \$90 billion reduction in that deficit over a two-year span with roughly constant levels of resource utilization. If we look at the structural budget deficits, while the CBO numbers and the OMB numbers show a flattening out as we go out several years, in the near term there are a couple of years of fairly substantial reductions in

the structural deficit. Our own measure of fiscal impetus, looking at discretionary components, indicates a significant movement in the direction of restraint. I think the direction is pretty clear, but gauging the economic significance is always problematic. We interpret things as suggesting that in this period going out through '94 and maybe well into '95 the direction of fiscal policy is one of significant restraint.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Could I ask you to refer back to the interest rate model that you discussed in your presentation as to whether there is a policy implication regarding relatively small changes in the fed funds rate? If one were to say there would be some merit in easing, it would appear that the model would say that there is still considerable bang to the 3 percent fed funds rate buck and that this will be transmitted over time, as the model suggests, to lower medium- and long-term interest rates. On the other hand, if we were to increase the fed funds rate by, say, 25 basis points, does the model suggest that the change in expectations could have a rather significant effect on the real economy by restraining investment because of the effect on medium- and longer-term rates?

MR. PRELL. No. As I said, this is a very simple model; and a small upward movement is just going to begin a process of altering the moving average, which in our model reaches back several years. So, it's not going to have a major effect. I think you have to ask whether this model is something you want to rely on in reaching a judgment, though. The other questions are how low the rates have to go in order to get the outcome you want and how fast do you want to get there? Do you want to be patient? If you believe that rates might [move] as the model is suggesting, is that quick enough for you? Would you rather accelerate the process by cutting rates further, knowing that ultimately you probably are going to have to reverse course more dramatically down the road in order to move real rate levels to something that is more appropriate in terms of the longer-run equilibrium? But a small adjustment, in terms of this model, is going to be essentially meaningless.

VICE CHAIRMAN MCDONOUGH. Thank you.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. There is a rather slow decline in the unemployment rate in the Greenbook forecast and there's no decline from where we are now.

MR. PRELL. Right.

MR. PARRY. And you had included an upward revision of the growth in trend productivity and higher potential output as well. If one looks at the growth rates, the real growth rates appear to be roughly equal to or in some cases below the growth rate of potential. Why is there such small progress made in the inflation area? I think you mentioned health care, gasoline taxes, etc., but it seems to me as though it's surprisingly small progress.

MR. PRELL. Okay, let me address a couple of things very briefly. One is that, as we are gauging it now, we believe that a reasonable estimate of potential output growth at this time is perhaps a shade below 2-1/2 percent. So, it's very close to the growth rate of output that we are projecting. If that is so, then all other things equal, one would expect the unemployment rate to be reasonably stable. There are short-run uncertainties about labor force participation. If it remained on the weak side, then one might anticipate a lower unemployment rate. If it rejuvenated suddenly, the unemployment rate could easily go higher. I'd say, looking at various models, that there is a very slight upside risk on unemployment.

As for the inflation forecast, basically we've had about 3-1/4 percent over the past year for the core CPI. We see it edging down to just under 3 percent over the next year or so. This is not out of line with various models we look at. Some of them would give more deceleration and some less. It is a bit less favorable than we had been hoping a year ago, say, or at least at the beginning of this year. We remain concerned that there is a certain momentum here that is supplied by expectations, which still have not adjusted downward among households, that appear to be in the 3 percent area. We think part of the disinflation process will be a gradual adaptation of expectations to that kind of inflation; but in the near term it tends to keep wage increases a little higher than they would otherwise be. We think we're in a reasonable middle ground, given the uncertainties that we feel. Based on the experience of the past year or so, we think it would be a little aggressive at this point to lower that forecast further.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. We've probably talked enough about the model, but I thought I'd kick it a few times as well. What bothers me is not just that it's sort of transparently nonsensical and violates enormous evidence which has been accumulated on the way markets work, [including] market efficiency. I don't think one needs too extreme circumstances to realize that the model may capture what is happening over some period. But it can't be what is happening [now]. I take it that if we continue to run this model, with the backward-looking nature of the model, as you say, the long rate pierces 5 percent. And I've noticed Michigan mean inflation expectations have often been around 5 percent, so basically it is a real possibility in this model that it will drive long real rates negative.

MR. PRELL. I would anticipate that if the inflation outcome is also similar to what we're forecasting, those inflation expectations would come down. But you are correct--

MR. MULLINS. But the expectations in the market are a little different than ours.

MR. PRELL. What I'm saying is that as inflation has remained low expectations have been adjusting and they will continue to do so.

MR. MULLINS. What I was going ask is this: Short rates roughly track inflation, so suppose you included with the model some

measure of inflation and the formation of inflation expectations. Would that take all the predictive power away from the model? Essentially what we've gone through is a period of gradually falling inflation expectations, with a little turn up, but associated with an upward movement in short-term rates and then a reduction and again a gradual [unintelligible]. If you had some model of inflation expectations to see whether this interest rate model has anything other than that driving it, what would you get?

MR. PRELL. Well, I can't speak to all of the experimentations done over the years on this. In the current model, there is only a minimal role for inflation expectations in the term structure determination. And it's in [the model in] an arcane fashion. It is possible that such a model as you hypothesize might be serviceable, but I suspect that we have experimented enough that this formulation has proven more robust. I think saying that this model is nonsensical and totally at odds with reality runs up against the point that it does contain some very basic notions that people have talked about theoretically for a long time, and it has worked. But I don't want to push that too far.

MR. MULLINS. The reason I say it's nonsensical is because it doesn't make logical sense. You know you can take the short rate to zero and it's not going to work. You get ridiculous answers out of the model.

MR. PRELL. Indeed.

MR. MULLINS. Plus there appears to be a lack of evidence on the way markets incorporate the data that are available, which makes one think that what it is picking up is some other process. When one hears what people talk about when they set long rates, they talk a lot about inflation over long periods of time. So perhaps it is somehow capturing that process. It may be a good model which implicitly is capturing this inflation expectations process. It seems to me a little questionable when we start to reach these levels; when you project that going forward for a couple more years, you run the danger of getting pretty interesting [results].

MR. PRELL. Let me say a couple of things. One is that a 5 percent long-term rate, with inflation moving below 3 percent and a short-term rate around 3 percent, still looks like a high long-term rate if you go back to the early 1960s. Now, if that's what people were thinking, perhaps about 3 to 4 percent inflation for the next X years--they were probably thinking 1 or 2 percent [in real terms] which is not inconceivable--

MR. MULLINS. Of course, it's not inconceivable if we get inflation down to the level that we had in the early '60s, which was 1 percent on the measured CPI.

MR. PRELL. But in that case you'd be looking maybe for a 4 percent long rate.

MR. MULLINS. Yes, then you can move that rate on down. I would just say that it's not clear that is what is driving--

MR. PRELL. Well, to take minor issue with that, I think that perhaps is embodied even in some of your recent comments about what has been happening with the way investors have been moving into the stock and bond funds. I think it's very much compatible.

MR. MULLINS. Well, why is it that all the survey data show the opposite?

MR. PRELL. Those people are not necessarily thinking in any precise way about what inflation will be doing over the next 10 years. They're saying "I just can't stay with these 3 percent rates forever." They are saying here that maybe [rates] aren't going to go back up, and they shift out [of CDs and the like]. The model doesn't precisely specify the psychology, but it's compatible.

MR. MULLINS. But that's another theory that I don't know if we want to get into as well.

CHAIRMAN GREENSPAN. We don't.

MR. MULLINS. I knew you were going to say that! The only other thing I would say is that if you look at the '70s, a period in which perhaps short rates weren't appropriately set to track inflation, you might separate what was going on to see whether it was a formation of inflation expectations or this backward-looking model.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Short data question: Coming back to what Bob Parry asked about inflation, these mandated programs come and go and are going to affect inflation--or inflict inflation, however one wants to say it. Do you have a meaningful number, if I can put it that way, in your forecast for that stuff now? Or is it just below the [unintelligible] in terms of being--

MR. PRELL. Well, cumulatively, it's conceivable that it's non-negligible. A number of things have happened over recent years where we've had various mandates that have added to the cost of production in one way or another or circumscribed supply. But whether those things have been increasing in size on a trajectory that means faster inflation in recent years is very hard to say.

MR. SYRON. I meant prospectively.

MR. PRELL. Prospectively the same thing would hold. The big issue hanging out there clearly is health insurance. And we have not made an assumption on that in this forecast, in part because we've not yet ventured beyond 1994. I grant that we need to before very long because of the necessities of monetary policy strategizing. But I don't expect that a program will be in place before the end of 1994. And it is likely to be phased in over several years in terms of the various costs. So, whether it will show up as a sudden large boost to costs isn't clear. I'm reminded of another thing we had in our earlier forecast, based on some trial balloons or whatever, and we've taken it out, which is a minimum wage increase. The kind of minimum wage increase that is being discussed is only going to have a very small effect if implemented in 1994, maybe one-tenth of a percent.

MR. SYRON. And the environmental stuff is all [measureable]?

MR. PRELL. It's partly that [such costs] aren't readily measurable in terms of their aggregate price effects. A bunch of little things have come along, all of which may tend to increase costs and in some cases are perhaps affecting the willingness of employers to take on full-time workers and so on. So, there are broad effects. And one of the reasons we have this rather subdued view of aggregate demand going forward is the thought that there will be a continuing burden of worry in the business community and among households about what government mandates may do to them over the years.

CHAIRMAN GREENSPAN. Any further questions for either gentleman? If not, who would like to start the Committee discussion? President Forrestal.

MR. FORRESTAL. Thank you, Mr. Chairman. Well, for the last several meetings I have been reporting that economic activity in the Sixth District has been outperforming the rest of the country. That is no longer the case because we are now seeing some deceleration in economic activity, and there now is a convergence of the District and national economies. As I've said earlier, our performance during this expansion has been based mainly on housing-related activity; and as the housing cycle matures, the stimulus is tapering off. Retail sales have also been quite disappointing in the District, and that's across the board, even though we've had a continuation of rebuilding from the hurricane and that's still positive. But retailers now are reporting poor sales at the end of the summer, and they're very cautious in their orders for the holiday season. On the other hand, auto sales have been quite good; the only constraint really to auto sales has been the lack of supply. Inventories have been low due to the fact that the 1994 models have been late in arriving and most of the dealers are sold out of 1993 cars. So, auto sales would have been better if the supply had been greater.

Tourism and business travel in the District remain quite strong, and Atlanta is doing especially well. Our hotel bookings and air travel are at their highest level in three or four years. Florida, obviously, is very concerned about the tourism industry due to the tragic events that have occurred not only during the past couple of weeks with respect to foreign tourists but throughout the year. And since this is a \$60 billion industry in the state, I think that concern is quite well placed. It goes beyond tourism actually, because there is concern in light of the adverse press reports that this will affect relocations both of businesses and retirees.

Factory activity was mixed as the summer drew to a close. There has been some seasonal increase but nondurables and consumer paper products are quite soft. And manufacturers indicate that consumer demand has been quite sluggish. Real estate activity also is mixed. The residential side has been quite healthy. In the single-family sector we're seeing more building of spec houses than we had earlier. The multifamily sector remains in the doldrums and commercial construction is still soft, although we do notice in many of the cities of the Southeast, particularly Atlanta, that there is some absorption of space. But at the same time the lease rates are pretty low and that's not encouraging any speculative building. The employers that we talk to around the District report no upward

pressure on wages, although there is concern about benefits and, of course, about the health care program. Prices of raw materials and finished products are steady, although lumber prices have started to rise again. In the energy sector, we've had some increase in the rig count, which is good for the economy of Louisiana. On the agricultural side, the drought has been quite severe in the Southeast although not quite as bad in our District, I think, as in the Fifth District. There has been an estimated loss of about \$230 million; that's basically affecting the corn, tobacco, and peanut crops.

We had a meeting of our Small Business and Agriculture Advisory Council last week and the small business people continue to complain, rather bitterly I might say, about the lack of credit availability. They now say they are not even talking to their banks anymore but are trying to use nonbank sources of funds, including their own internal fund development. The farmers, on the other hand, say the banks are quite aggressive in trying to get agricultural loans, so they're not having any trouble at all in finding credit.

Finally, with respect to the District, I've been quite interested and surprised that NAFTA seems to be a greater source of conversation among people that I've talked to than the health program. And, unfortunately, while there seems to be support in many quarters, the sentiment at the moment is that NAFTA is not going to pass, for what that's worth.

Turning to the national economy, our forecast in the near term is very close to that of the Greenbook. We do see greater growth in the middle to the latter part of 1994 and our inflation forecast is a little higher. That increased growth in our forecast is predicated almost entirely on our assumption that hours worked and overtime can't continue at this level and that at some point employers are going to have to take on additional workers. While that's in the forecast, I think employers are still at this point very reluctant to take on additional people; and where they are adding workers at all, they are temporary workers for the most part. If we get the Greenbook forecast, which is a bit lower than ours in 1994, I think that would not be a bad result. I think at this point we're in the fortunate position of perhaps being able to sit back and wait to see what data come in a little later. Thank you.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, turning to the District, the level of economic activity seems very much unchanged since the last meeting. Still, the underlying tone of the reports seems a bit stronger, at least in terms of volumes. The automotive business continues at a surprisingly good pace. The fourth-quarter production schedules have been set some 11 percent over last year. In a comparative sense, the fourth quarter of last year was really quite a strong one so this year's fourth quarter bodes to be a pretty good one. And with retail inventories still at good levels, as long as the sales hold up the industry thinks the downside risk on production is reasonably limited. The automotive industry, therefore, expects that their activity will be a plus in terms of fourth-quarter GDP. The steel business continues at a strong pace given the good first half that they had; it was the best first half since 1981. As [for] the current level of operations, they're at running about 87 percent of capacity. They

expect shipments this year to come in at 87 to 88 million tons. So, in terms of production it's a good year. They just aren't making any money. The October price increase that was announced earlier is not going to stick; but despite that they're really pumping out a lot of metal.

Despite the floods and other adversities in the agricultural sector--and as an aside I would say that the weather over the next few weeks is certainly going to be critical to that sector--the farm equipment business continues to be very strong. The company I talked to has a scheduled fourth-quarter production level some 30 percent over last year, but last year was really a very, very poor comparative quarter. In the truck business, the 1994 outlook for medium trucks is good. They're expecting a 10 percent increase next year. Heavy trucks will be down a bit, 5 to 6 percent, but this is a result of a regulatory issue; there's a change taking place at the beginning of next year and, therefore, there was some advance buying this year to get the trucks in before that change. I continue to be impressed, really even surprised, by the intensive competitive conditions of the marketplace and the very restraining effect that is having on pricing. Many companies are achieving outright reductions in the cost of their outside purchases. And for those companies experiencing increases, the increases tend to be pretty small and in the production process they are able to overcome those through productivity improvements. So, it really is a very, very intense pricing environment. But I do find the employment aspects of the environment increasingly worrying. Companies are continuing to contract their work forces, and CEOs are taking a very, very hard line on this and are exerting an awful lot of employment discipline on their organizations. As an example, in one company in Chicago, which 15 years ago had sales of about \$1 billion and 53,000 employees, their sales level currently is up to \$4 billion and their employment level is down to 25,000. And despite the increased production levels, which in some cases really are quite significant, I think it's a fair statement to say that no one I have talked to plans to add permanent employees to their payroll.

One change in the outlook that I find a little interesting and almost surprising is in the commercial real estate business. I talk to a company from time to time that is in the upper end of the commercial business, and over the last three years they have had nothing to report other than just absolutely dismal conditions. This time, though, there was a slight change in the tone. They think conditions are beginning to improve. As yields on alternative investments have come down, people are looking at real estate as a possible investment for a higher yield. This is probably an improvement for the wrong reason; nonetheless, it appears to be beginning to result in something of a stronger tone in rental conditions, terms, and other things like that. They expect, if this continues and there is an improvement, that as we get into the second half of the 1990s the underlying fundamentals can begin to show some improvement.

With regard to the national economy, I think the 2-1/2 percent or so growth rate that we've been talking about continues to be very realistic, very achievable, and that at this point the risks are about evenly balanced. Thank you.

CHAIRMAN GREENSPAN. Thank you. President Parry.

MR. PARRY. Mr. Chairman, economic activity in the Twelfth District is still weak, and it's not a surprise to indicate that that is due largely to poor conditions in California. We saw employment down in August; since the peak of employment in July of 1990 there have been 588,000 jobs lost in the state. It's also interesting to note that if one were to back the state out of the national figures we'd probably have an unemployment rate of about 6.3 or 6.4 percent as opposed to the 6.7 percent. Residential construction activity shows no signs of picking up in the state and this, of course, is despite the low interest rates and also reduced home prices. The number of housing permits is down 13 percent from a year ago and stands at about a third of the level that was reached in 1989. On the commercial side, the only thing I could say that would be of a positive nature is that property values have fallen so low that we seem to see some serious buyers in the markets. Actually, there are some transactions taking place. If you looked at the situation a year ago there was virtually no activity. Reflecting California's economic troubles, net migration to other states rose to 150,000 in fiscal 1993. In contrast, the number of legal foreign immigrants to California rose 23 percent in 1992 to a record 237,500. Now, the official estimate is that illegal immigrants are 100,000; I think that's really low. So, in spite of the moves to other states, the state's population is growing very rapidly.

Conditions are much better in other parts of the [District]. In fact, we have two states that are among the top five in the nation in terms of growth rates, Utah and Nevada. Homebuilding activity is very strong. The number of housing permits during the three-month period that ended in July was up 22 percent in Idaho and 35 percent in Utah. Home prices are rising dramatically. From 1990 they're up 27 percent in Boise, up 18 percent in Salt Lake City, up 16 percent in Las Vegas, and up 13 percent in Reno. Manufacturing growth is also strong and outpacing the national average in many of these states. We've seen 4.3 percent growth in manufacturing in Idaho, 3.4 percent in Nevada, and 1.7 percent in Utah.

If I can turn for a moment to the national economy: While I agree with the Greenbook pattern of modestly accelerating growth and decelerating inflation, I'd have to say I'm a bit more optimistic about the magnitudes in 1994. We're expecting that real growth will be up a bit more--not quite half a percent--with somewhat less inflation. On the price side, while some factors--certainly one-time factors--are going to have the effect of tending to raise the CPI a bit in 1994, our estimates are that we're going to see some greater improvement in the CPI than is indicated in the Greenbook.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Thank you, Mr. Chairman. Well, there hasn't been much change in our District over the period since the last meeting. The information we're receiving from our business contacts, directors, and others indicates that the District's economy is growing at a moderate pace. But, as Bob Forrestal said, we've been hit hard in agriculture by the drought; we're coming out of that now but outside of agriculture things are pretty much unchanged. As elsewhere, people are frustrated by the slow pace of overall recovery; they are especially frustrated by the sluggishness in job growth. But I don't think very many people in our region think the economy is

about to turn back down. One sector where we do seem to be seeing pretty consistent signs of somewhat greater strength is housing. Home sales, construction, and both new and existing home prices seem to be rising in most local areas in our region.

As far as the national economy is concerned, the Greenbook's projection is certainly reasonable and plausible; and objectively speaking the risk of error is probably pretty evenly balanced on both the up side and the down side, given what we know now. I've been more optimistic about the outlook in recent months than most people and I guess most people have been more optimistic than the actual outcome. But I think I have been more optimistic than most people coming into this meeting, so I need to be a little humble in making any conjecture about future growth at this point. Nevertheless, I would humbly submit that we may get somewhat stronger growth going forward than the staff expects. I would make three points in this regard. First, both the Greenbook and the Beigebook seem to suggest that the greater strength in housing, which as I said a minute ago we see in our District, is pretty general across the country. As the Greenbook points out, the latest reports of builders, lenders, home buyers, and others in the market all seem to indicate that the housing outlook generally is better than some of the latest data seem to suggest. That might to some extent be substantiated by the increase in housing in August that you announced a minute ago, Mike. In light of these reports, and given the substantial further decline in mortgage rates, the pickup in housing that seems to be going on currently may turn out to be more robust and sharper than many people think. Second, I think consumer spending is looking increasingly solid. We had a good rate of increase in real personal consumption expenditures in the second quarter and, given a high level in July--if I calculated this correctly--the third-quarter rate conceivably could be close to 4 percent even if there are relatively small increases in the months of August and September. And finally, as many people have pointed out, job market conditions are generally stronger than the weak August payroll figure would seem to suggest. The lengthening workweek, the strength in the household survey data, the continued fairly healthy rise in help wanted advertising, all suggest to me that the labor market is at least holding steady and perhaps even improving a bit.

So all in all, it seems to me that at least one can say that private domestic final demand is firming up noticeably. Well, "noticeably" is too strong; I guess one has to exert a little effort to notice it, but I think it's there. Activity undoubtedly will continue to be restrained going forward by the forthcoming tax increases, employer concern about the cost implications of health care reform, and the economic weakness in many of our major export markets. But I still think on balance that there's a better than even chance that we will get a little more growth than the 2.3 percent rate projected by the Greenbook for the second half of the year.

One final point, if I may: In my view the most significant development by far since the last meeting is the further decline in long-term rates. One of our major objectives in policy in recent years, as you all know, has been to help bring long-term interest rates down further by raising the credibility of our efforts to achieve price stability over time. I think the much greater than expected declines in long rates recently are evidence that that strategy is working over time. That may be evidence of other things

as well, but there's no doubt that our actions recently have aided the further decline in long rates. And I hope we will do whatever we need to do going forward to maintain and extend that progress. Thank you.

CHAIRMAN GREENSPAN. Thank you. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. Our District continues to grow modestly, as I've said time and time again. Construction remains reasonably good in our area mostly due to housing, primarily in the western portion of our region in Denver. Energy has posted gains and that's tied to the natural gas industry, which is still fairly active in our area. Banks' earnings are doing extremely well; in the second quarter, as for the nation, they were very strong. In fact, in Oklahoma, which I think was once the worst in the nation, banks earned in the second quarter something on the order of 1-1/2 percent on their assets. I was in Oklahoma last week and there were a couple of banks actually talking about making loans! That's the first time they've said that in almost a decade. They said they wanted to wait two more quarters, though. [Laughter] I'm only half kidding! The service industry is generally solid, although not as good as the nation. Where tourism is very important, it's a little disappointing. Manufacturing is really weak; durable goods employment actually has declined over the last year in our region, about 2-1/2 percent we estimate, and that has to do in part with the aircraft industry. Prospectively in our region, we expect more of the same in terms of slow growth. Low mortgage rates should keep housing starts strong in our region, especially in the mountain area where there is a bit of in-migration from California going on. Agriculture will report solid income, we think, due importantly to livestock prices; and crop losses will not be sufficient to offset that, including [those associated with] the effects of the flood and of the drought, and also some freeze that we had in portions of our region. In manufacturing, though, we see nothing that would show any strong improvement in our region, so we think it will continue to be rather slow as we go forward.

For the nation, we expect moderate growth, as everyone else does, although we are somewhat stronger than the Greenbook. We also expect modest inflation, about the same as the Greenbook. Some of that comes from a little stronger growth in business fixed investment and a little more accumulation of inventories, but basically we see very modest growth going forward. Because of our stronger growth projections, we see employment being a little better than what the Greenbook shows but, again, not enough to change how we view the economy into 1994.

CHAIRMAN GREENSPAN. Thank you. President Boehne.

MR. BOEHNE. The Philadelphia region has improved a little but it continues to grow modestly and still, I think, lags the nation. Employment growth is sluggish and attitudes remain cautious, neither optimistic nor pessimistic. Where there has been some improvement is in the manufacturing sector, which has been a major drag on the economy. It's not that it's going up so much; it's that it has tended to stabilize after several months of decline. Also, New Jersey, which has been one of the hardest hit states in the country, appears to be improving. The weakest sector there was construction, and both residential and nonresidential are showing some signs of growth

although from very low levels. Also, New Jersey had a good tourism summer and that has been a positive. More generally, I'm picking up the same kinds of vibrations that Si is in the commercial real estate market: That investment in real estate is beginning to look relatively attractive because other alternatives aren't so good. It has been a long time since I've heard the term REIT in our board room but I'm now hearing it again, which isn't all good news. We went through the REIT problems of 20 years or so ago. But this noise we hear about some improvement in commercial real estate is not for this year or next year so much as later in the decade.

District bankers report weak commercial loan demand. However, when we pursue that a little more, they are beginning to wonder how they will finance a pickup in loan demand when it comes. And that's a new kind of attitude. They're worried about the runoff they've seen in deposits and whether they can get enough deposits back to fund what they think someday will be an upturn in loan demand.

On the national economy, I think the fundamentals are about the same and will likely continue to be the same: moderate growth, subdued inflationary pressures, employment growth insufficient to cause a significant drop in unemployment, and cautious attitudes. I don't believe there's very much that monetary policy can do to alter that outlook even if we wanted to. But I think the respite from criticism that we've had in recent months is likely to come to an end. Impatience is going to be our greatest foe in the next few months. And I suspect that we will increasingly have to defend a no change policy as the restlessness over this rather disappointing employment growth continues to build.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Even though it has been a fairly short period since the last meeting of the Committee, I would not characterize the situation in the District as better than the nation anymore. The mood coming back after Labor Day for large and small businesses was less positive for the District than I thought it was before. Objectively, the numbers look still pretty good. Unemployment has been declining in our District, even if it hasn't nationally. The auto sector is doing quite well, mainly because of a larger domestic share, the transplants and all of that. One of the things that I hadn't considered before about the transplant companies raises an interesting problem for them. This came up with the recent Honda actions. They cannot effectively sell essentially the same car that's produced in Ohio and produced in Japan at different prices. So, the exchange rate is forcing them to make choices between pricing that's appropriate for an import or pricing that's appropriate for a domestic car, with considerably different implications for volumes depending on which way they go. It's quite different for a company like Honda that has a very substantial domestic production relative to their total versus some of the other foreign manufacturers.

Retailing was disappointing. The major retail companies headquartered in the District that operate nationally said that the back-to-school selling season was less than they had hoped, but they remain hopeful about the holiday selling season. In a joint board meeting last week, large and small businesses made reference to the idea of expecting leaner times--that '94 would be weaker than '93.

And they talked about the general pattern of what they call "making small downward adjustments" in spending habits and expectations in order for it to get soft in the region. One director in doing a roundup for me of minority businesses in the major metropolitan areas said that there's a general sense that minority owned businesses are being more negatively influenced by government actions than non-minority businesses because of the way the tax laws and the health care proposals affect them.

Turning to the nation and the Greenbook, a number of comments are being raised on some issues that concern me. First, this discussion about long-term rates and the backward-looking model and the forecast part of that seemed to me like a debate a long, long time ago, involving the views of Ptolemy and Copernicus. The Ptolemaic model did work well apparently, but that didn't make it valid. What we do know is that in the very long run there is a relationship between the quantity equation and the Fisher equation. [That's] because the real return on productive assets and the real return on financial assets are going to approximate over time the real growth the economy is able to produce, and one would expect that inflationary expectations in a sustained steady state world are going to approximate inflation. In the 1953 to 1963 period nominal GDP growth averaged about 5 percent, what the Greenbook projects out toward the end of '94. And, of course, in that period long-term rates were substantially lower than they are today. But at that time I think we had a regime where people believed that increased inflation and interest rates were temporary and bound to go back down, whereas today we still have the opposite. And what we're trying to do is change that regime. It's not an inflation objective in terms of numbers, but rather a mind set about what the natural order of things is.

And that brings me to some [points] about fiscal policy and the way it was raised both in the projection and discussed in the Greenbook. Mike said in his response to me that it's not advocacy to say "achievement of this middling expansion path...." But that to me implies that real output is an objective of monetary policy, assuming we know how to measure the thrust of monetary policy actions on nominal or real magnitudes. I'd say a couple of things. This month is the 25th anniversary of a study completed on various ways of measuring fiscal policy at the St. Louis Fed; that's a long time ago and I don't think we've learned a heck of lot since then about how to gauge these things. The notion of characterizing current fiscal policy as restraint is about like the Lyndon Johnson surtax of 1968. I would worry about that being allowed to influence monetary actions as it did at that time. If we maintain that the objective of monetary policy is price stability, somehow measured or viewed, and if we accept the Greenbook projection that inflation is now higher than we previously thought it was going to be with the current stance of policy and if that policy is [deemed] acceptable, then that says that we have either changed our objective or the time horizon for achieving that objective or that we think the Greenbook is wrong on its inflation forecast or our policies are wrong and they need to be adjusted.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Most indicators in the Eleventh Federal Reserve District remain positive. Our District economy seems to be

accelerating a bit from a level that was already above the national average. NAFTA dominates the conversation in Texas when we talk to directors, Beigebook respondents, members of the Small Business Advisory Council, which met last week, and banking groups, although the small business people are very afraid of mandated health benefits coming out of the health reform effort. Commercial real estate still hasn't done much but home and apartment construction are beginning to be very strong in a lot of our markets, particularly Austin and San Antonio, and even in Dallas to some extent; within a five mile radius of where I live there are, I believe, 8,000 to 10,000 apartments under construction. Austin has more under construction than Los Angeles, Chicago, or New York, and Dallas is third behind Chicago and Atlanta. New construction appears to be putting downward pressure on existing home prices. I refinanced about three weeks ago. And while I got some rate relief, my appraisal came in considerably below what I paid for the house, which is somewhat discouraging because I thought I moved to Texas at the bottom of the real estate cycle and it turns out I didn't. We don't hear a lot about upward pressure on prices in the District but we do hear about it in building materials. Retail sales in the District seem to be holding up rather well, but

who has interests in real estate, specialty real estate stores across the nation, and showed us a chart indicating that in the three weeks following the passage of the new tax law, retail sales in those stores just collapsed after having been growing rather nicely.

CHAIRMAN GREENSPAN. Is this a high-price type operation?

MR. MCTEER. Not necessarily, it involves things like high-volume office supplies, [unintelligible], that kind of thing. Some of them are specialty and higher priced. I guess that's all I want to say.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Thank you, Mr. Chairman. In New England the economy is mixed but there are signs of growth. To put this in context, in a sense one really has to look at this period, given the enormous overheating we had in the '70s and '80s in New England, as a long-term healing period. I think that's pretty important, and some [healing] is still going on. We see some wage rate adjustment [and other] things happening. And there are improvements in some areas. We've seen very substantial improvement in the banking sector. Now, the returns are still not numbers that are comparable to national figures; return on assets is about 1 percent currently. There is an improvement in bank willingness to lend, and I think an appropriate degree of caution with it, but there is more lending now even in small commercial real estate ventures. On the small business side, I think there is a willingness to lend, and I think we actually have a new equilibrium being approached with small business loans being made on terms that may be [reasonable] over the very long run. Small business just hasn't adjusted to that, and those who can't just have to get a deal someplace else and change long-term relationships. But I don't think there's an awful lot more to be hoped for in that change in willingness to lend.

Like everyone else, we're seeing an improvement on the residential side. And even in manufacturing all of this restructuring

that has been going on--we had a lot of transitional problems--is still going on, but we can see the end of the tunnel, hopefully. Going back to this issue of price pressures, it's interesting that in the health care industry, among the producers of health care equipment--U.S. Surgical and these kinds of [companies]--we really do see a change in the way people are approaching things. They think this is a permanent shift in their business in a lot of ways with very, very substantial price pressures, and they are adjusting prices downward in some areas. One fellow from a quite large health care equipment company said: "If the country does the right thing, my business is going to be lousy for five years and there's just no way to avoid that." We've mentioned that in the mutual fund business we still see very strong flows [and] increasingly nervous fund managers. The comfort I take out of this is in their nervousness; it's the non-nervous fund managers who worry me. But I think we are making some progress there in terms of people being more and more aware of where we are in this situation. I'd just mention that tourism in New England runs inversely to air fares. We had a great year, probably the best year since the mid-1980s in tourism.

As far as the United States goes, I'm very much in agreement with the overall contour of the Greenbook forecast. I'm a little more optimistic on prices but I have to admit that's based on a usual kind of capacity and to some extent labor market view of things, and I'm a little more concerned on the export side. I would think that the risks are probably center-weighted. One thing I can't quite figure out is these consumption numbers, [given] what we're seeing in the income numbers. [The inconsistency] has been going on long enough now that I'm starting to wonder whether some of the other figures are right. Particularly in New England, of course, there has been a revision in some of the data captured in the national revisions. As bad as things got, the mood never really got as bad as the data were. And I think that's consistent with what we're seeing now, so it makes me wonder about them.

Over the long term, I think we just have no choice but to slide through this period; I have some sympathy for what Ed Boehne said about what monetary policy can and can't do. I do think, though, that we can't avoid, not immediately anyway, the fact that there are tradeoffs in all of these things. And I personally think that at least in the intermediate term monetary policy affects real magnitudes. Over the long term it may be a different matter. And I always thought the reason we want price stability--and I think it's absolutely important we get it--is to maximize real output. So I think that is what we're all about; and unfortunately in some intermediate periods that can involve some tradeoffs.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. In terms of economic conditions in the District, the trends and patterns remain generally positive as they have for quite some time. There are some concerns with regard to agriculture because of the weather, of course. There's the concern that all the shoes haven't dropped yet with regard to military bases and possible closures. And there are some strikes under way in some of the taconite mines in northern Minnesota and the upper peninsula in Michigan. But with those caveats, conditions really are pretty good. Employment is up in all District states and we are getting renewed

reports of pretty tight labor market conditions in some of the major markets in the District. That does not seem yet to have translated into demonstrable wage pressures, but we are hearing reports of difficulty in hiring--and these are above-minimum-wage type positions --and retaining workers.

With regard to the national economy, I don't see much that's going to break us out of this pattern of moderate growth and moderate inflation that we've been in for quite some time. I've been surprised--Ed Boehne raised this point--that there has been as much patience, or maybe less impatience than I would have expected, with regard to the performance of the economy over the past couple of years. Maybe that's about to change, but so far it seems to me that there certainly has been less impatience than I expected. And I guess the Committee at least implicitly seems to be patient or satisfied with both the pattern of growth and inflation that we've been getting.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. In our District the situation is pretty much like the one Al described. I don't detect any major changes in activity. We're still seeing modest growth. I would say that retail sales are reasonably strong. That's not getting fully reflected in employment, though, where we've been pretty sluggish. We're relatively stronger than the rest of the country in manufacturing and quite weak in services right now. Some of that may be flood-related because of the impact on construction in particular, which has been a weak sector employment-wise. We do hear reports from our directors and others about modest expansion in manufacturing areas--firms adding several hundred jobs here and there. So, generally, I'd say that's picking up. Housing has been quite strong over the last year. What we heard earlier was that the wet weather in the spring was going to push activity later into the summer and I think we're seeing that now in terms of a pickup in activity. With respect to the flood and its effects in general, there wasn't that much disruption of employment activity and many of those who were disrupted are back to work now. Cleanup efforts are under way. There will probably be some positive impact on construction activity in due course, although I don't think it will be that noticeable on a national basis. Barge traffic is moving on the river and so forth, so in many senses the crisis of the flood is behind us.

In terms of banking, it was interesting to note an increase in loan activity across the board in the second quarter; actually loan growth was relatively healthy in Eighth District banks, up not quite 6 percent. Consumer, real estate, and business categories were all growing. My final point--maybe this is somewhat related to the flood, but [it's difficult] nationally to sort out the flood, drought, and other effects--is that the crop estimates aren't dramatically down that much. But it's interesting that in Missouri the corn crop is estimated to be down about 40 percent, which is a fairly dramatic hit, but in Illinois [the effects are] very little, maybe about 15 percent in terms of the corn crop.

Nationally, I keep asking myself why I don't feel better about the relatively sanguine outlook that we have. This ought to be ideal from a central banker's point of view. I know we're paid to worry, but real growth around potential and reasonably well behaved

prices is something I guess we ought to feel good about. But there are two things that bother me somewhat. One has to do with the fact that I just don't think we can gauge the current thrust of monetary policy very well, and I'm very uneasy about the fact that we may well be in a very stimulative posture and those chickens will come home to roost. The other thing--and I think it has been appropriate to show some flexibility on this front--ultimately would be the question in my mind of moving the inflation rate down closer to what would be some representation of price stability. Others have commented on this at other meetings. I think to some extent we've taken comfort in the fact that prices haven't been moving up. But at some point we may have to think about trying to move inflation a little lower.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, given what I've done in the last month, I think my contribution would be to talk about a district we don't have represented here. It's what Congressman Clay called America's internal third world nation. Having been to hearings all around the country, I thought I'd just report on economic conditions that I've heard about. There seems to be a growing gap between expectations, which are rising, and realities, which are falling. The rising expectations stem largely from political changes and promises of change and reform. I'd point out that there are extremely high expectations about what potential changes in the Community Reinvestment Act could do. I doubt very much that anything we do could fulfill those expectations. So I think it's going to lead to disappointment.

With regard to realities, in the 1980s real black family income rose about 70 percent faster than real white family income. Black small business creation as well as Hispanic small business creation was quite quick. Both of those trends have stopped, which seems rather puzzling until one thinks about the usual process that's going on. The usual pattern for all ethnic groups moving up has first of all been the civil service. And limits on civil service employment at the state and local level and now in federal civil service are impacting minority communities particularly. Even more dramatic, particularly for young people, are cutbacks in military hiring which has long been a way out. We've seen an historic and continuing trend of decline in pay in manual jobs; that's no surprise. But during the '80s there was robust growth in office jobs, which led to rapid gains in female incomes relative to male incomes. In minority communities female incomes are a more important component than they are in the white community, so that was a net plus. That has stopped and it is one of the problems being faced. And finally on the horizon is the fact that the health care industry, which has also been a major employer of blacks and Hispanics, now appears to be facing cuts. As a result there does not seem to be the job growth going on and, therefore, the realities are somewhat grimmer.

There is good news. Minority test scores, SATs and what have you, continue to rise; they've been rising now for 12 years. It's interesting that white test scores are unchanged, but for all other groups test scores have been continually rising. The reason they're static for the country as a whole is that the composition of the population is changing. But, still, progress is being made. Graduation rates are up and, according to survey data, drug use is

down. In fact, it was lower in the last survey for the minority community than for the white community. The other big piece of good news is the [increased] affordability of housing--and that's largely due to lower interest rates--which is a real plus.

But I'll tell you, I heard quite a bit about the effects of regulation. Jerry Jordan mentioned that with regard to small business and minority small business in particular. There are three that I think we should take a close look at. The first is the appraisal mess, which is without any question devastating for the minority community. Appraisers, even licensed and certified ones, have no idea how to do appraisals in the inner city and as a result are literally destroying what equity might exist there. Second is the tightening of down payment restrictions; the monthly payments are more affordable but it's a lot harder to come up with 20 percent down than with 10 percent or 5 percent down. And tightening of bank regulation has adversely affected the minority community in that way. Finally, and I heard this everywhere I went, is something we don't think about; it's a classic unintended consequence. For historically underserved communities, cash is not only a medium of exchange, it's a store of wealth. If you don't have a bank account you keep your money literally in cash. Well, in the name of anti money-laundering laws, we have made the use of that cash and its entry into the banking system virtually impossible. I had a lady in Denver confront me. She was trying to buy a house and had \$5,000 in cash; obviously she was not allowed to use it by the bank, as you might imagine, under our laws. And she said: "You're treating everyone in the community as if they were a drug dealer." And I had no answer for her. I thought it was a very good observation.

CHAIRMAN GREENSPAN. Very interesting.

MR. LINDSEY. It's something we should definitely think about. I don't think the Congressmen who are leading the fight on the Hill are aware of exactly what that's doing. So, I saw a tremendous amount of bitterness. I had never seen anything like what I saw at the hearings in Los Angeles. I think the country would see a great cloud lift if we could somehow cut southern California off from the rest of the country! The bitterness there was not only directed against the establishment but against other minority groups to an extent that I just found unbelievable in a public hearing setting.

CHAIRMAN GREENSPAN. The Koreans and--

MR. LINDSEY. Yes, and backwards in time. We had testimony from the Chinese banking community, which was a good lesson in history. As late as 1946, it was illegal for Chinese to own land in California. 1946! So, needless to say, this community felt that it has been historically disadvantaged and yet has solved its own problems. We had a witness testify who said, in effect: We solved our own problems; don't expect us to solve anyone else's problems. And the witness said it that bluntly. Also, I think the amount of tension that exists in Los Angeles between the Mexican American community and the black community is something one never sees on the news, but it came through loud and clear in the hearings. So, that was a matter of some concern.

CHAIRMAN GREENSPAN. Is that going in both directions?

MR. KELLEY. You bet.

MR. LINDSEY. Yes.

MR. BOEHNE. It certainly does in Philadelphia.

MR. LINDSEY. Yes. It's competition for everything. It's competition for civil service jobs; it's competition for contracts; it's competition for housing. I don't know what implication it has for the Greenbook, but it is a matter of great concern that we have a situation of rising expectations and falling realities. And in the long run we've got to reverse those two curves.

CHAIRMAN GREENSPAN. Right, I would agree with you. I think the CRA issue has created a political [fallout] that has gotten out of hand with respect to expectations, and it will be very tough to fulfill a lot of what people are hoping to see.

MR. BOEHNE. Larry, I think those observations are especially insightful. I wonder if you wouldn't mind just dictating some of those and passing them out.

MR. LINDSEY. Thank you. I see the recorder is on.

MR. BOEHNE. Well, maybe it could come from that. Also, some of that ought to be in your public remarks at the appropriate time. I think those are things that need to be said.

CHAIRMAN GREENSPAN. Well, I think it could be appropriately embodied in the minutes of this meeting.

MR. SYRON. Good idea.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. The Second District economy remains extraordinarily flat. The level of employment in the state of New York is almost exactly what it was 12 months ago. And the level of employment in our portion of the state of New Jersey is actually down. So, throughout the area--I've been travelling around upstate New York and parts of New Jersey--the level of optimism is very low. It's not quite into pessimism but feelings are sort of flat [and people are] very concerned about what's going on.

In the national economy, Dick Davis tells me that there has never been such identity of forecasts between that of the New York Reserve Bank and the Greenbook, which probably means the chances of the forecast being wrong are geometrically increased! But we do feel that [outlook] is by far the best bet. However, probably because of our proximity to Wall Street I do have stomach rumblings that I think I should share with the Committee. There is growing concern in the financial markets about the level of the DOW and of the equity markets in general--and some concern about the debt markets but considerably less--as to the sustainability of these levels of equity prices. The question is the effect that anything other than a very modest correction could have on the holders of mutual funds who signed the prospectus that said they understood that what goes up can go down and that the [value of the] investment could turn out to be less than what

they invested. But I don't think there are very many who actually understood what that prospectus said. And there is very serious cause for concern on our part and growing concern within the financial community--I suspect in Boston as well, from what Dick Syron said--about what the effect of a sharp correction would be and what the reaction of the smaller investors will be who by and large were not there in the '87 crash. Do they think they can get quick cash and that the cash they will get is at least approximately what they invested? Some of the more astute mutual fund managers are keeping higher levels of cash than they normally would, so that they would be able to handle a greater than usual level of redemption requests. But it does not appear that those levels of cash are anywhere near high enough to handle a really sharp correction in the market if there should be a psychological reaction on the part of the small investor who says: "I want to get out."

With the tremendous interconnection of financial markets, perhaps that concern from our neighbors in Wall Street makes me even more concerned about certain things that one sees internationally. We are absolutely in agreement with Ted Truman's forecast on what will happen in the major economies in Japan, Europe, and Latin America. And yet I think one has to worry

For our economy I think it's not just the question of what effect those developments in Europe and Japan could have on net exports, it's the effect that they could have on the financial markets as well, which could exacerbate any of these concerns that we might have about what would happen in the case of a correction in the DOW and the effect on mutual fund holders. Domestically, we think, assuming that there is no contamination from abroad, that the economic forecast is quite sound. One would think, with the level of consumer confidence not being very high and the level of business confidence not being very high, that one would have to be more concerned about

the forecast being accurate. But it seems to me that the projections on consumer spending are quite defensible and likely to be accurate.

In the business investment area, we've been doing some interesting work in New York on where we are in the restructuring of the corporate sector. And it would appear that it is really a bit further along than we had thought, pretty close to the point where most businesses could say that the restructuring in the balance sheet is about where one would wish it to be. However, it would not appear that they're very likely to increase production with consumer spending not being more robust. Then, I think one has to ask the question: Is the forecast of rather strong business investment spending likely to be right? We think it is because so much of it is in the investment in increased power of the magic machine; however, that is not geared toward increased production but rather increased productivity and would appear even within the bounds of the economic forecast to be something that one could expect to be very likely to take place.

Another rumbling that we get around Wall Street is that the attitude toward official Washington has improved considerably over the last couple of months. It went, if you will recall, from euphoria in December/January--a kind of view that if Richard Nixon could go to then-Peking, that a Democratic president could do certain things that no Republican could do. Then, [attitudes] went into an enormous funk in the spring months and are now--I think largely because of the budget reconciliation bill--somewhat more sensible, I'd say, in the view that it's going to be very tough to get NAFTA through and it's going to be very tough to get a sound health bill through. But there does seem to be a view that Washington is working, if not perfectly, at least better. So, I don't think that weight on the financial markets, which I believe was quite serious a few months ago, is quite what it was then.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Looking back over the last 18 months, the data seem almost unbelievable. In fact, no one talks about it because it's really hard to believe. The fact that we got to a 3.9 percent increase in real GDP--which no one talks about and I would admit wasn't 4 percent--and then had that cut literally in half...! In some ways it doesn't seem that way. That is, during 1992 no one really felt that good about things and in some ways during 1993 no one feels that bad about things. [But] that's really quite a significant step down to be operating at that level and then to fall back. What makes it more disconcerting is the fact that in 1992 December over December the CPI was up 3.1 percent and we've still got the CPI running at 3.1 percent. Now, we're forecasting 1994, Q4 over Q4, of 2-1/2 percent, and I don't think anyone knows how to change that number. No one seems to have any real good suggestions or real good alternate numbers that they've been advocating. To make it even worse, the revisions seem to show productivity trends higher than we thought they were. We've got productivity trends very, very high; we've got the ECI very well behaved and yet we're not getting the kind of combination of output and price level response that certainly seems desirable. I wish I could say just why it is that the economy has faltered so badly, and yet I can only guess. I think corporate rationalization certainly has been a factor. Certainly, the FASB rules in regard to post-retirement health care benefits undoubtedly gave some impetus to

downsizing employment. Certainly, the pension plan underfunding that seems to be there probably already is impacting large corporate employment plans. And I think all of us are very well aware of how disconcerting that is. Apparently, many people who have jobs in this environment are much more aware of the fact that jobs are not necessarily permanent. So you'd think maybe we'd be getting a higher savings response or somewhat more conscious spending response and yet the numbers don't show that at all. We don't see any budge upward in the saving rate. So, all in all, from the domestic scene it seems a very strange combination.

When we look abroad, certainly [we see] the impact of the economies in Europe and Japan; I guess the Federal Reserve staff and members of this Committee have all agreed that those economies are going to be weaker than they were generally thought to be by the governments and the central banks of those countries. When we look at the stock market, I guess we would think that if all this downsizing and rationalization efficiencies are going on, the profit numbers ought to sustain the kind of equity prices that we see. And yet ironically we don't seem to be having any inflow from abroad to U.S. equity markets. Indeed, in terms of diversification, mutual fund investors in the United States seem to be the only ones that are buying equities in Japan. So, all of this gets to be pretty confusing and maybe I better stop before I get in worse trouble.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. I'm pretty close to where Governor Angell was at the end [of his comments]. It seems to me that on the economy we have a rather tight consensus with a couple of important exceptions today. There was consensus around the Greenbook type of view, and that certainly includes me. Very frankly that worries me a lot! I mistrust it; my contrarian antennae are twitching. I was interested yesterday in the Wall Street Journal that Keynes reminded us that the inevitable never happens.

CHAIRMAN GREENSPAN. Except for death and taxes!

MR. KELLEY. Good point. I don't mean to be facetious when I say that the thing that concerns me the most right now is that I don't know what I should be most concerned about. Where's the balance of risks? If you look at the things that we're able to analyze and make some responsible comments on, the risks seem to be quite balanced. And it seems to me that the things we can see are unlikely to take us very far away from our consensus view. It seems to me that if the consensus were to break, it could most likely be because of some unanticipated or unexpected event. And it seems to me that the world may have more than the usual potential for that right now; it always has potential for it. But there are some things out there that I think could change things radically. It's easier to see the bad things than the good ones. The failure of NAFTA, which could impact on GATT, could cause a rather severe dislocation of international trade at least for a while. Many friends of mine in the Southwest are terrified that oil may collapse below \$10 a barrel, which could have some pretty severe impacts. There are a couple of major economies that we all know are in a very shaky state. The former Soviet Union has various civil wars going on; optimism in the Near East runs very high and it better be brought to pass or [the repercussions] could be

more severe on the down side than ever, and so forth. I think there are up side [possibilities] too. It would not be out of the bounds of the imagination to see job growth start to pick up; the potential for that has been alluded to a couple of times this morning. If that were to happen, it could have a dramatic impact in terms of a resurgence of confidence. I think Americans like to be confident, and we haven't been for a long time. We could see a pretty strong bounceback in confidence, which could cause a real surge in the economy. All in all, Mr. Chairman, in August I said that I thought we should all enjoy our vacations because we'd have work to do soon enough. But it doesn't seem to me that the time is here yet. And I honestly don't seem to be able to generate any very clear notion about what it may be when it comes, either as to timing or circumstances or extent or even direction. Thank you.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mr. Chairman, all of the Cassandra-like insights into what is going on that I had in mind have already been stated by Presidents Melzer and McDonough and Governors Angell and Kelley. So, I'll just be marked present. Thank you.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Well, I should follow right along with that. First of all let me say that I, like a lot of people, have been disappointed by the [slowdown] in 1993. I also was disappointed to see the downward revision by the staff for the third quarter; but I can't really argue with it. I do hope that the fourth-quarter bounceback that is projected in fact really happens. If that's the case, then that would make 1993 all in all reasonably respectable. I again am struck by the stark differences in outlook in various regions and also by Larry's comments about differences among groups. Sometimes when we focus on the Greenbook or the national economy, we tend to gloss over some of these drastic differences. One unifying factor in all of these comments, though, has been continued concern about the employment situation. The employment gains we've seen so far in '93 have been encouraging; we have seen jobs added. I think, though, that job quality is still a problem. Employees are still trying to learn to adjust to the restructuring via temporary part-time employment. This notion of downward mobility is still a concern. I hope that Dick Syron is right and that there is light at the end of the tunnel. I wonder whether this is more a function of learning to live with the adjustment as opposed to light at the end of the tunnel.

All of this, I think, is continuing to weigh on consumer confidence. That's likely to be exacerbated over the coming months because of the uncertainties regarding what is happening to health care reform and taxes and also the NAFTA rhetoric and the defense cuts. Some of the other risks to the economy have already been discussed. As for productivity, we've seen a marked improvement so far in the '90s, but the question remains as to whether that's going to continue or whether the downturn that we've seen for the first two quarters of this year is going to be more the shape of the future. The fiscal drag that is likely to be setting in is a bit more worrisome because there's less room for error in projections. If we're at a 1.2 percent projected growth rate for the third quarter, that doesn't leave as much room for error in potential effects of the

fiscal drag. And we have yet to see the health insurance and other spending cuts that are supposed to be put into place play out yet. State and local government shortfalls also are going to have more of a negative effect; that's going to mean either more cuts in spending or more state taxes, neither of which is very healthy for the overall economy. If the first announcement of the third-quarter GDP is really around 1 percent, I wonder what kind of effect that's going to have. It may well be that we're going to start getting more sentiment for a stimulus package. It may well be--and both Gary Stern and Ed Boehne talked about this--that the light may be focused on monetary policy a little more brightly. The other big down side that I'd mention, which has already been outlined by Bill McDonough and others, is the uncertainty in Europe, Japan, and the former Soviet Union. I agree that the risks are not just on the export side but that other kinds of effects might be engendered if there are problems in those financial markets.

Now, having said that--and a number of people have stated that they believe the risks are balanced around the Greenbook projection--I don't think we should forget some of the strengths that we do have in the economy. The broader monetary aggregates and even credit are showing some signs of strength. The banking system is stronger; the financial markets are stronger. I must admit when I look at the stock market that I do see it as more problematic than the bond market, although I'm not one who has visions of tulips when I look at the stock market. But it is at a higher level. Perhaps the last good news or better news story to mention is on the inflation front: commodity prices have retreated; the PPI has been showing a disinflationary trend. And I agree that it's going to be possible to make some continued progress on core inflation.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. Well, Larry Lindsey talked about neighborhoods and Bill McDonough talked about the world; I guess that leaves relatively little in between, although there are a lot of things in common. Bill McDonough suggested that some of the problems have to do with the _____ and I have no doubt that that's the case; but

That's probably not all of it. I think it has a lot to do with the nature of this environment in which it's just a very difficult political job, and no one has been very successful because of the adjustments we're going through and the economic sluggishness. And we've had it far better than most countries. Patience with political systems has already run out, and numerous incumbent governments have fallen. Just to extend Ed Boehne's intuition, I would be a little concerned if the patience were to start to run out with central bankers around the world. Central bankers have done a pretty good job during this period. We have had a pretty impressive turnover in leadership in the world's central banks, with a lot of the seasoned, very credible personalities moving on.

Turning to the domestic side, I see very little new information to alter the views that I've stated a number of times. The revisions in the GDP data reinforce my view that the forces of moderate expansion seem well entrenched. One can certainly see this for the last six quarters--the last year and a half--which have

averaged 3 percent real growth. The last four quarters have averaged 3 percent. It is true that 1993 is weaker; we'll wait nine months to see what it really is, just as we had to do with 1992 as Governor Angell pointed out. I think the pattern this year is in part due to the unsustainably robust fourth-quarter 1992 growth of 5.7 percent. It was natural to have a pullback in the first quarter. If you take those two quarters together, there was still 3.3 or 3.4 percent growth; they are still on this moderate path. But [the swing] created an inventory adjustment problem, which affected the second quarter and meant that was only about 2 percent; but still PCE in the second quarter and final sales grew more than 3 percent. The forces seem to be there.

And I see no shocks to knock us off this--even the fiscal package--given the offset on interest rates and given the rather modest structural reduction in deficits. The third-quarter Greenbook projection is again for meager growth, 1.2 percent. I think that is about what it was last year at this time--maybe precisely what it was --for the third quarter of 1992. In fact, in the September 1992 Greenbook the projections for both the third and fourth quarters were between 1 and 2 percent as we headed into a 4-1/2 percent half. I'm not suggesting that's going to happen. I would suggest that even in the Greenbook's forecast the underlying forces of expansion seem to me to be well in place. Consumption is projected to grow more than 3 percent; business fixed investment is continuing to grow at a reduced but still healthy pace. Housing growth is expected to pick up and I think accelerate in the future. Even with slow exports and government spending, final sales are projected to continue to grow at roughly a 3 percent pace. The low growth in the third quarter projected in the Greenbook is due solely to adjustments: inventory adjustments, crop losses, and the auto inventory adjustment. So, it's an odd picture. We could have the first three quarters of 1993 come in at 1.3 percent. Yet, when I look at it underneath--the bottom line numbers--the underlying growth in demand seems consistent with moderate growth in the future roughly of the same order of magnitude that we've had in the past.

It seems to me that sentiment as measured by the Michigan survey has plateaued at a level well above that prevailing in October of last year. In October we were just headed into a 5.7 percent quarter, you'll recall. And the current conditions are also above that entire fourth quarter of last year. It is a little troubling that the longer-term outlook continues to sour in the Michigan survey. August payroll [employment] was weak; the overall employment data still seem to reflect steady though gradual improvement. Initial claims continue to ease; the strong hours suggest pent-up labor demand. I continue to hear that payroll jobs are weak; they've grown by 1.7 million in the last 12 months and 1.2 million in the last 8 months. And the household survey, once you make the adjustment, seems to give the same sort of picture even though it uses an entirely different methodology.

So, I think this is all consistent with steady momentum. Diminishing deleveraging head winds have been replaced in part by fiscal drag but countered by substantial easing in the capital market environment, and the dollar has eased some as well. It's interesting that the long bond yield has come down 50 basis points in the last month. Real long-term rates when you use the Michigan long-term

inflation expectations or the Philadelphia one are starting to get to quite low levels. On inflation, I think Governor Phillips is right; the PPI has performed remarkably well; it's up only .7 percent over the entire 12 months. Of course, ex tobacco it's up 2 percent! So, smokers are approaching price stability! [Laughter] I think the health care plan may well take care of that. It is down a bit ex tobacco and maybe that's not quite fair. But I think it is clear that even with that adjustment we have made some progress. The higher-than-expected CPI we had recently for August did remind us that the bond markets still notice these things; they backed up a bit. Core CPI for the year to date is up at a rate of 3.3 percent, the same as for the 12-month period and the same as it was at the end of last year. It's an interesting 12-month period, though, because it consists of the most recent 6 months with core CPI at 2.5 percent and the previous 6 months at 4 percent. I think this pattern of a run-up in inflation that we saw is easier to understand with the revised GDP numbers when we realize just how explosive growth was in the latter part of 1992 and why people might have tried to return to passing through 4 percent price increases. And once it was clear that growth was going to moderate, the increases didn't stick. It's not at all clear to me where we go on inflation now. Commodity prices are again subdued only if we include oil prices. They still show a bit of an upward pattern without oil prices. Now, the Administration has inflation flattening and turning up gradually despite ample projected slack. It stabilizes once the slack has disappeared, but while there's plenty of slack in the economy inflation continues up.

CHAIRMAN GREENSPAN. They need that for revenues!

MR. MULLINS. Well, it's interesting that they appear to suggest that our current interest rate environment is unsustainable because they do show interest rates increasing to levels above the inflation rate pretty quickly next year. Next year they show a Treasury bill rate above the inflation rate and then moving on up. Again, with the slack, I don't see why we shouldn't expect the disinflation trend to be re-established. I think that should be our objective and I hope we will get there. Of course, rates are still quite low now, both short and long rates. I think the financial system has eased and that monetary policy is doing what it can do to support growth. We're still pumping out the liquidity. M1 growth is 12 percent and is projected at 11 percent for the year. M2 plus bond and stock funds has accelerated to 6 percent growth in the second quarter and 7 percent in the third quarter. Governor Phillips mentioned that nonfinancial, non-government debt has gradually increased; it's growing at a rather moderate level. So, I think we're still sort of pushing it. I see no convincing evidence that we've gone too far. By the time we see such evidence, we'll probably be a bit late. So, I feel there's very little new to add. The economy still seems to be on track and I think we still will likely face some challenges on monetary policy, and we should try to stay focused and conscious during this period.

CHAIRMAN GREENSPAN. Do we have some coffee and some doughnuts?

MR. BERNARD. Yes.

CHAIRMAN GREENSPAN. We'll adjourn for coffee and come back with Don Kohn.

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

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

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

MR. JORDAN. Don, on the chart package--I guess everybody got this yesterday--the last two pages have M1 velocity and opportunity costs and M2 velocity and opportunity costs. The Committee has had some discussions in the past about what is going on with the relation between M2 and alternative variables. I don't recall any discussion about M1, its velocity, and opportunity costs. Looking at this, it struck me first how close the relationship still appears to be visually. And I started thinking about some other things that I once was more familiar with than I am today, the empirical models of money demand on the monetary base and M1 that use intermediate- and longer-term interest rates. Over the last year we've had double-digit growth of M1 and the base, on the order of 10 to 12 percent, about twice the rate of growth of nominal GDP. And the decline that we tended to get in long rates is consistent with the elasticities in those earlier studies. I don't know what you have in your opportunity costs, but using either version of that, I can think of four possibilities for the future. It would be interesting to get you to assign probabilities to the possible outcomes. One, of course, is that the relationship simply breaks down. One would be that nominal GDP accelerates to double-digit rates. At least the Greenbook doesn't have that! That would at least establish the relationship of velocity. A third would be that M1 and monetary base growth are essentially cut in half in the next year, down to about 5 percent or so, consistent with nominal GDP growth. And the fourth is that we continue to get a plunge in opportunity costs. Since I don't know what yours are, I don't know what those implications are; but for long-term government bonds that means a yield of approximately 4-1/2 percent a year from now. Comments?

MR. KOHN. It's true that our models also have been tracking M1 pretty well, as you can see from this chart. We use short-term interest rates--the [3]-month Treasury bill rate--relative to rates on NOW accounts basically as the opportunity cost for [the NOW account component of] M1, and the short-term interest rate itself relative to the zero on the currency and demand deposits [components]. We find that our models underpredicted M1 a little over the last few years and we think that's primarily because of the currency flows overseas and maybe a little because of the mortgage repayments which are mostly in demand deposits. So, I guess we don't see a major disconnect that needs to be changed here. We have slightly slower M1 growth projected for next year based on our expectations that in fact interest rates will be flat and that there will be some further decline in NOW account rates. It continues to be [unintelligible] at the end of this year and the beginning of next year by mortgage refinancing. So, I'm not sure we see anything major that needs to be explained. M1 has always been very interest-sensitive, and I think that was the reason the Committee stopped targeting it in the early '80s. It's just that

in order to make any sense of the connection between M1 and nominal income one had to be very clear about the connection between interest rates and nominal income. When NOW accounts were invented, the swing between [small] time deposits and NOW accounts as interest rates moved became very dominant in the M1 demand [function], and it became extremely interest-sensitive. So the initial response of the Committee was a widening of the bands for M1, then they re-based it midway through the year, and finally they just threw up their hands. If you couldn't get a fix on interest rates, you couldn't really get a fix on the M1/GNP relationship. I agree with your original observation: that, unlike for M2, we don't see major unexplained misses in M1 relative to interest rates and income. It's just that the relationship [between M1 and nominal GDP] is not very tight. The velocity of M1 swings over very, very wide ranges. So, therefore, it hasn't been all that useful to the Committee in guiding policy.

CHAIRMAN GREENSPAN. Further questions for Don? If not, let me get started. But first let me raise an issue which has been disturbing me more than the economy in recent weeks, and that is the initiatives up on the Hill with respect to the structure of the Federal Reserve System. As Don Winn will be discussing, there are hearings forthcoming in the next few weeks on the Gonzalez bill, and Senator Sarbanes will be there as well. Secondly there is the issue of the consolidation of regulatory agencies under a central independent agency. When I looked at both of those initiatives, I concluded that they didn't necessarily have very much behind them. That probably is still a correct presumption, but I'm no longer sure that that is the case. We here at the Board, I hope in conjunction with those of you at Reserve Banks, will be increasingly sensitive to the fact that this issue is surfacing and we're going to have to respond to it. We are going to have to appear as a sort of partial Committee at the request of Mr. Gonzalez. I'm going to have to go up there. [Given] the people who are being asked to testify before the House Banking Committee, it clearly suggests that we are leaning up against a stacked deck. It really is a wholly unbalanced operation. But instead of shrugging it off, I'm inclined to increase quite significantly our general positioning to make certain that we don't allow something to sneak up from behind and result in some major changes in this institution purely because we were too complacent. In any event, Don Winn will be discussing with us the current initiatives at lunch.

MR. KEEHN. When you say "a stacked deck," do you mean in terms of the people who will be testifying in front of them or is there something else?

CHAIRMAN GREENSPAN. The witnesses are all there to say that the Gonzalez and the Sarbanes bills are perfect.

MR. KEEHN. The non-Fed witnesses?

MR. MULLINS. We hope so! [Laughter]

MR. KEEHN. Who other than the voting members [of the FOMC] is likely to appear there?

CHAIRMAN GREENSPAN. Well, ask that of Don Winn; it's not clear what is going to happen. In that regard let me just say that we

have been successful in keeping the issue of the minutes reasonably under cover. I think we have to be especially circumspect in the next couple of months and keep our heads down as best we can.

Let me just tell you that the last thing we need during this sensitive period is any indication that there is a loose cannon in this organization. Maybe I'm being overly sensitive about what the risk to our institution is, but I much prefer to be overly sensitive and too cautious and find out after the fact that it was all unnecessary than to be on the other side of that issue. I just want to emphasize that this seems to be bulging in a way that makes me a little more nervous than I'd like to be. We'll review that summons a little more with respect to the legislative initiative at lunch, but I didn't want to discuss a number of things at lunch other than just what the legislative agenda is. So, I just want to put that on the table.

I think the policy questions are less difficult, less a matter of concern. The more I look at the data the more I'm inclined to believe, as some of you have hinted, that there is something wrong with the numbers we are looking at. It's just not credible to me that we can have a significant rise in employment and in hours both from the payroll series and the household series--two measures that are about as independent as one can get of an economic phenomenon--and say that the GDP indicates productivity declined in the first half of this year. Now, I don't know what is going on in the statistical system, but I'm almost certain that out in the real world in an economy that is growing, the thought that we are having declining productivity just doesn't square with my understanding of the real world.

Historically we have had alternate measures of output--for example, gross domestic income. Granted, the income side of the national income accounts is a little more flaky measure--with the proprietor incomes categories and even some of the profitability numbers--than the output side, which is the reason obviously that the output side is used. But if you look at it, you get something that frankly looks a lot more credible. You get a much lower rate of increase in gross real incomes in the second half of last year, or more exactly in the growth of gross domestic income in constant dollars; that grew a lot more slowly than the GDP and it was moderately faster in the first half of this year. I haven't looked to see what happened to the productivity numbers but my suspicion is they were still going down a little. I'm inclined to believe that when we look back at this period with the better annualized data, which may be a year or two years from now, it's going to look better because we can't have the unemployment rate declining, the initial claims falling and, as Governor Mullins said, a tight labor market with average hours of work moving up, and have declining productivity. It just doesn't make sense. Something is wrong with the data system, and I suspect--or I hope--that eventually that will get resolved. If you look at the

industrial production index and its counterparts in other elements of GDP, it does look as though it was extraordinary even before the revisions; but with the revision we're still getting some evidence that the real part--the goods part--of the GDP may be running somewhat under what we're picking up in the industrial production index. It's a close issue and, frankly, I haven't had a chance to have somebody look at it in the detail that I would look at it. But the numbers just don't square. If that is in fact the case, we may be not all that far from potential here. I'd say the economy is moving [up at a rate] that has to be over 2 percent at this point, maybe 2-1/2 percent. I realize that this may seem to be making the figure look the way I think policy ought to run, but since I don't sense that anybody out there is talking in terms of any radical changes, I won't press this issue.

The one thing I heard around this table, which I did find rather encouraging, was some semblance of a pickup in transactions in commercial real estate--not in prices. But the first stage of a bottoming out of the commercial real estate operation has to be that the number of transactions has picked up, because we [previously] had a terrific decline in the bids for the properties. The offering rates came down somewhat, but there was no meeting [of supply and demand] and nobody was doing anything. And it's only when the offering rates come down to the bid prices that the thing changes. And it's about time because if you look back at when the whole thing began to change, we have experienced a very significant number of periods where leases have been renewed. In other words, we've actually had most of the leasing adjustment and the [market clearing] valuations are beginning to emerge and apparently the ice is cracking. If we have been dealing with a significant balance sheet stringency problem in both the household and especially in the business area where commercial property collateral has been a critical factor in the whole system of restraint and if this [restraint] is beginning to ease, it may be that we're seeing the first stage [of a turnaround] in commercial banking itself; it may be starting to nudge back. And this little modest quickening of M2 may be something; then again it may not be. But I don't think the outlook has deteriorated at all; I don't think it has been great on the other side. I suspect that eventually we'll come out of this, but I don't think it's going to be soon. We still have a way to go. [It's clear] looking at the various relationships in the balance sheets that those relationships are not anywhere near back to where they were in 1987. And it should be fairly obvious, having gone through what we've gone through, that if anything the desired equity/debt ratios have probably gone up, not down, since 1987. So, we probably are still working our way through that; but as we've discussed many times in the past, the economy can accelerate its growth before the so-called head winds go to zero.

As far as I can see, leaving aside the quality of the figures, the process that we're going through seems to me exactly what we perceived it to be over the last year. As I recall, we got to a 3 percent funds rate a year ago. I like to interpret that as: We finally got it right and decided to sit with it. In retrospect it may not be the wrong interpretation that we happened to hit the right level of policy. Despite the issues that Jerry Jordan is raising about a lot of things going on underneath, which is unquestionably true, we probably have not been badly fixed for the last year. And unless the data that come out a year or two years from now suggest

that the economy actually is growing far faster than we think and we should have been tightening, my expectation is that we'll look back at this period and say that for once we got it right for a longer period of time than has ever been the case in the history of this institution. In any event, listening to what I have heard around the table I don't see any inclination, at least on the part of anyone who has spoken up, to move off where we are, which at the moment is a symmetric and no change directive. And I personally don't see any particular reason why we should veer from that prior to the next meeting, which is in mid-November.

MR. LINDSEY. Well, Mr. Chairman, when we used to be asked "Are interest rates going up or down?" we always dodged the question by saying "Yes." We can't say that anymore; we have to say "Maybe." [Laughter] But I think your analysis is quite right.

MR. KEEHN. "B" symmetric, I completely agree.

MR. SYRON. "B" symmetric.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. "B" symmetric.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. "B" symmetric.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. "B" symmetric.

MR. BROADDUS. "B" symmetric.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. "B" symmetric.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. "B" symmetric.

MR. BOEHNE. "B" symmetric.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. "B" symmetric.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Far be it for me to break the pattern: "B" symmetric.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. I agree, "B" symmetric.

CHAIRMAN GREENSPAN. President Parry,

MR. PARRY. Agree.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Count me in!

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. I can go along with "B" symmetric. I would simply note that if you're looking at real output, the recognition lag may be longer than we would wish it to be. So I agree with you that we need to remain alert.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. "B" symmetric.

CHAIRMAN GREENSPAN. Anybody else? If not, we'll put that out for an official vote. Would you read--

MR. BERNARD. This language is on page 13 of the Bluebook: "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 or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with modest growth in M2 and M3 over the balance of the year."

CHAIRMAN GREENSPAN. [Call the roll].

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
Governor Angell	Yes
President Boehne	Yes
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. We will adjourn, and our next meeting is on November 16, 1993.

END OF MEETING