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.

Meeting of the Federal Open Market Committee
February 4-5, 1997

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, February 4, 1997 at 2:30 p.m. and continued on Wednesday, February 5, 1997 at 9:00 a.m.

PRESENT:
Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Meyer
Mr. Moskow
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

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

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel 1/
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Beebe, Eisenbeis, Goodfriend, Hunter, Lindsey, Mishkin, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

1/ Attended Tuesday's session only.

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

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Ms. Johnson, 2/ Assistant Director, Division of International Finance, Board of Governors

Messrs. Brayton 2/ and Rosine, 2/ Senior Economists, Division of Research and Statistics, Board of Governors

Messrs. Brady 2/ and Reifschneider, 2/ Section Chiefs, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

Ms. Garrett, Economist, Division of Monetary Affairs, Board of Governors

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

Ms. Browne, Messrs. Dewald, Hakkio, Lang, Rosenblum, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Boston, St. Louis, Kansas City, Philadelphia, Dallas, and Cleveland, respectively

Mr. Miller and Ms. Perelmuter, Vice Presidents, Federal Reserve Banks of Minneapolis and New York, respectively

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2/ Attended portion of the meeting relating to the Committee's discussion of the economic outlook and its longer-run growth ranges for the monetary and debt aggregates.

Transcript of Federal Open Market Committee Meeting of
February 4-5, 1997

February 4, 1997--Afternoon Session

CHAIRMAN GREENSPAN. I would like to welcome Craig Hakkio from the Kansas City Bank, who is attending his first meeting. He is seated here somewhere.

MS. MINEHAN. About where Tom Davis used to sit.

CHAIRMAN GREENSPAN. I turn to Governor Rivlin to initiate our proceedings.

MS. RIVLIN. It is my pleasant duty to open the meeting and to ask if there are nominations for Chair of the FOMC. Governor Kelley.

MR. KELLEY. I will be happy to nominate Chairman Greenspan for that role.

MS. RIVLIN. Is there a second?

SPEAKER(?). Second.

MS. RIVLIN. We have a second. All in favor?

SEVERAL. Aye.

MS. RIVLIN. Opposed? Mr. Chairman, you have won!

VICE CHAIRMAN MCDONOUGH. Surprise, surprise!

CHAIRMAN GREENSPAN. I thought I had voted no.

MS. RIVLIN. Shall I proceed?

CHAIRMAN GREENSPAN. Yes, would you move the other nomination?

MS. RIVLIN. Is there a nomination for Vice Chair of the Federal Open Market Committee?

MR. BROADDUS. I nominate President McDonough of the New York Fed.

MS. RIVLIN. President McDonough. Now there is an original idea! [Laughter]

CHAIRMAN GREENSPAN. I hesitatingly second the motion. [Laughter]

MS. RIVLIN. All in favor?

SEVERAL. Aye.

MS. RIVLIN. All opposed? The ayes have it. Congratulations, Mr. McDonough. Back to you, Mr. Chairman.

CHAIRMAN GREENSPAN. I congratulate the Vice Chairman. The next item is to elect the staff officers, and Norm has a list.

MR. BERNARD. Thank you, Mr. Chairman.

Secretary and Economist,	Donald Kohn
Deputy Secretary,	Normand Bernard
Assistant Secretaries:	Joseph Coyne and Gary Gillum
General Counsel,	Virgil Mattingly
Deputy General Counsel,	Thomas Baxter
Economists:	Michael Prell and Edwin Truman
Associate Economists from the Board of Governors:	David Lindsey; Larry Promisel; Charles Siegman; Lawrence Slifman; and David Stockton.
Associate Economists from the Federal Reserve Banks:	
proposed by President Parry	Jack Beebe;
proposed by President Guynn	Robert Eisenbeis;
proposed by President Broaddus	Marvin Goodfriend;
proposed by President Moskow	William Hunter;
proposed by President McDonough	Frederic Mishkin.

That is the list, Mr. Chairman.

CHAIRMAN GREENSPAN. Are there any objections to the list? If not, I will assume that it has been moved, seconded, and voted in the affirmative.

The next item of business is the selection of a Federal Reserve Bank to execute transactions for the System Open Market Account. Are there nominations? If not, I will nominate the Federal Reserve Bank of New York! [Laughter]

VICE CHAIRMAN MCDONOUGH. I second the motion. [Laughter]

CHAIRMAN GREENSPAN. I don't know whether you have standing, but I will accept your second in any event. We have an official second, thank you. Without objection.

We have a significant and controversial issue next, the selection of the Manager of the System Open Market Account. The incumbent, Peter Fisher, has been nothing short of superb, and I say that despite the fact that I pick on him at every meeting and that is my most interesting and enjoyable FOMC activity. Would somebody like to move Peter?

MS. RIVLIN. I nominate Peter.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Peter, having been duly elected to office, you now have to work. You are on.

MR. FISHER. Thank you. The next topic on your agenda is the review of the Authorization for Domestic Open Market Operations. I do not have any changes to request at this time, but I did want to use this occasion to bring you up to date on three issues.

The first is a preview of coming attractions. Following the Committee's discussion in September of the maturity structure of the SOMA portfolio, we have continued to work both on trying to articulate a set of principles that could guide the management of the SOMA portfolio and to develop some concrete alternative portfolio structures that illustrate different mechanisms for implementing what we have taken to be your consensus objective. So, we continue to work on that, and at some point in the future we will be bringing that back to the Committee.

The second topic is an elaboration that I would like to make on an answer that I made last September in response to a question from President Melzer. He asked me how different portfolio structures might affect the securities lending program that we are authorized to implement to assist the dealers. In September, I expressed some discomfort with the current program. I would like to explain that a little and explain other work we are doing at the Desk. The current securities lending program was devised in the 1960s as a response to the back office crisis. It was premised, and continues to be premised, on the assumption that we lend securities, but not to a dealer who is "short" securities. The idea was that we were providing securities to facilitate the paper clearing process, and in the event that a dealer was going to have a fail, we would be providing the securities and thereby averting that fail. Well, we have had a book entry environment for some time now, and it has never been entirely clear to me how our lending program really fits in a book entry environment where a dealer often will not know if he is short, in the sense of a cash position to settle, until after the wire is closed. In that case, it is too late for us to lend him a security. I have some sense, perhaps more than a sense, that when dealers do call and ask us to lend them securities, some seem to have forgotten the requirement that they should not borrow to cover a short position. They know they have to affirm that they are not short the issue in question, but I have some reason to doubt the veracity of statements, based on my consultations with senior management at dealer firms.

I think we ought to have a securities lending program of some kind, and I think the Treasury depends on it to a certain extent as a backstop to provide some elasticity in the supply of securities in the government securities market. However, we do not want to be the first-stop shopping source for securities lending because that would mean that we would destroy the whole securities-lending industry, given the size of the SOMA portfolio. We are in the process of a review. We are trying to start from first principles but on the assumption that we will have a program. I believe an appropriate program would be consistent with the Treasury's wishes, with our joint concerns for the efficient functioning of the government securities market, and with our market surveillance responsibilities. We are trying to be creative and open in our thinking. I am mentioning this to you now because I would like to invite suggestions from the dealers. I am going to ask them what they think. Some of them have raised the subject with me. I want to open it up a bit and let all the dealers know that we are rethinking the securities lending program and that we would be open to their ideas about how we could structure it given our objectives. I wanted you to hear about that from me before you heard about it from them. I will come back to you and let you know once we have a concrete plan. That is the second topic.

The third is to bring you up to date on our discussions with other central banks about liquidity assistance, something we have talked about here from time to time. As the Committee knows, we have put aside for the time being any work on a program that would involve the Desk in doing reverse RPs for the SOMA account with foreign central banks that are in need of temporary liquidity. As the Committee and the Board know, we received an inquiry from

about our willingness to act as agent, not for the SOMA account, for a multilateral repo facility. It relates to a rather complex policy of cooperation among

The matter is not moving forward with great speed, but we have responded. We are posturing ourselves in a helpful but not pushy way and are leaving our positive reaction on the table.

We are now considering the idea of the Desk acting as agent with the Street for individual central banks, much as we did earlier in this decade for authorities. That is, had a portfolio of government securities at the New York Bank and the Desk repoed them out to the Street, providing with liquidity. We conducted those transactions as agent for an undisclosed principal. We are considering a similar function as the pass-through agent particularly for the authority and the I suspect that the also may be interested in that approach.

Those are the three works in progress, if you will, on which I wanted to update the Committee.

CHAIRMAN GREENSPAN. Thank you. Questions for Peter? If not, would somebody like to move a renewal of the Authorization for Domestic Open Market Operations?

VICE CHAIRMAN MCDONOUGH. So move.

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. Ted Truman has circulated a memorandum to which he attached the text of the Foreign Currency instruments--the Authorization, Directive, and Procedural Instructions. He proposes that they be renewed in their current form for the coming year. He also suggests in his memorandum that the current $20 billion warehousing agreement with the Treasury revert to the $5 billion level that existed for some years prior to the increase associated with the now-terminated Mexican assistance program. In keeping with past practices, you might recall that we vote separately on the foreign currency instruments and on the warehousing agreement. Before we do so, I would like to know whether anybody has any questions they wish to raise with Ted.

MR. BROADDUS. A point of clarification, Mr. Chairman. The authority for the warehousing is in the first vote, right?

MR. TRUMAN. Yes, the authority to enter into a warehousing transaction is in the first vote.

MR. BROADDUS. Okay.

CHAIRMAN GREENSPAN. Is that satisfactory to everybody? Would somebody like to move the first vote on the warehousing transaction agreement?

MR. TRUMAN. Mr. Chairman, President Minehan has a question.

MS. MINEHAN. Just one small question: When we ratcheted up the amount of the warehousing authority in the late 1980s, what was the proximate cause for that? The Brady policy?

MR. TRUMAN. That was a period when we and the Treasury were doing quite a lot of intervention in the markets. The Treasury essentially ran out of dollars in the Exchange Stabilization Fund. We warehoused some of their foreign currencies to provide them with dollars so that they could participate with us in foreign exchange operations.

MS. MINEHAN. Thank you.

CHAIRMAN GREENSPAN. Would somebody like to move the warehousing agreement?

VICE CHAIRMAN MCDONOUGH. I move the warehousing agreement, Mr. Chairman.

CHAIRMAN GREENSPAN. Seconded?

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. The next item on the agenda is boilerplate; it is the report of examination of the System Open Market Account--

MR. BROADDUS. Mr. Chairman, I apologize for interrupting. My views on foreign exchange intervention are well known here, and I will not rehash them. I would like to vote "no" on the question of renewing the Foreign Currency Authorization and the Foreign Currency Directive. I thought we were going to have two votes.

CHAIRMAN GREENSPAN. Didn't I call for that vote, or did I miss it?

MR. TRUMAN. You went immediately to the warehousing issue.

CHAIRMAN GREENSPAN. Sorry about that; I got distracted. Let us go back and start from scratch. On the first vote, would somebody like to move the renewal of the Foreign Currency Authorization, Directive, and Procedural Instructions?

SPEAKER(?). So move.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. It has been moved and seconded. All in favor say "Aye."

SEVERAL. Aye.

CHAIRMAN GREENSPAN. All opposed say "No."

MR. BROADDUS. No.

CHAIRMAN GREENSPAN. The "ayes" have it. On the warehousing agreement--

VICE CHAIRMAN MCDONOUGH. Move approval.

CHAIRMAN GREENSPAN. Approval has been moved; is it seconded?

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. All in favor say "Aye."

SEVERAL. Aye.

CHAIRMAN GREENSPAN. "No?" The "ayes" have it unanimously.

As I said, the next item on the agenda is the report of the examination of the System Account. This report is considered each year on an irregular schedule that relates to the variable date of the New York Bank examination. Would somebody like to move acceptance?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection.

The next item is a memorandum that came out in the last few days on the Program for Security of FOMC Information. Again, this is boilerplate. Does anybody have any questions they wish to direct to Don Kohn or anyone else? If not, would somebody like to move approval?

VICE CHAIRMAN MCDONOUGH. Move approval.

CHAIRMAN GREENSPAN. Approval has been moved. Is it seconded?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection.

President McDonough has raised an issue in a letter he sent me about the schedule for releasing the minutes. I thought I might turn the issue over to him to present.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. We now follow the practice of releasing the minutes of our meetings on the Friday afternoon following the next meeting. So, the minutes for the December meeting are scheduled to be released this coming Friday. The effect of that is that the press report on the minutes disappears into a squib in The New York Times on Saturday. That is not a very widely read edition of The New York Times;

in fact, it is the least widely read of the week. By the time newspapers like The Wall Street Journal arrive on Monday, the minutes are old news. Frequently, they are not picked up at all or in a very rudimentary way. That is unfortunate because in the course of the last several years, the minutes have become a quite accurate and revealing indication of what actually happened at the meeting. They are, I think, a very important part of the increased transparency that the Committee is seeking to establish. Therefore, I think it is unfortunate that we continue to adhere to this release schedule because of past practice, though nobody can quite remember exactly why we started releasing the minutes on Friday afternoon. So long as we continue this practice, we will have a very important contribution to our transparency effort disappear into the weekend. We actually have ten releases a year--the Chairman's two Humphrey-Hawkins testimonies and the eight releases of minutes--in which the Federal Open Market Committee is telling the American people what we are trying to do. I believe that greater exposure to the minutes is desirable, and that could be achieved by moving up the time of the release. Apparently, the view held by Joe Coyne and others is that Thursday would be a day that we could use. That would get the Friday press, which is better than having less visibility than I believe is desirable.

MS. RIVLIN. That seems like an excellent idea to me.

CHAIRMAN GREENSPAN. There is one technical problem relating to the timing. I would like to turn to Don Kohn merely to raise the question.

MR. KOHN. I think Thursday resolves our problem. Sometimes, as happened when President Moskow raised a question at the last meeting, it takes a while to revise the minutes, reproduce them, and then get the copies out to the Reserve Banks so that they are available for release.

CHAIRMAN GREENSPAN. A Thursday release would get the press reports into the Friday morning papers?

VICE CHAIRMAN MCDONOUGH. That is right. My letter suggested a Wednesday release or a Thursday release after a two-day meeting. If we make it consistently Thursday, that is actually an improvement on my proposal.

MR. KOHN. Particularly since the minutes are approved at the beginning of the Tuesday-Wednesday meetings, then presumably any problems would be cleared up on Tuesday, so a Thursday release would work.

CHAIRMAN GREENSPAN. I thought it was a very useful idea. Does anybody have any further questions or comments?

MR. BOEHNE. I think it is a good idea. I am sympathetic to it. Just a couple of things occurred to me, and I would be interested in either your reaction or Joe Coyne's reaction. One is that while The Wall Street Journal and The New York Times will likely get the story reasonably straight, are not some other newspapers and television networks likely to get mixed up and indicate that the minutes refer to the meeting that was just concluded one or two days earlier rather than to the meeting held some six weeks earlier?

VICE CHAIRMAN MCDONOUGH. My feeling is that any news media that can't make that distinction will find the minutes so uninteresting that they probably will not carry a report on them. Those that do understand the difference are the ones that are interested enough to publish a report.

MR. BOEHNE. I think doing it on Thursday rather than Wednesday probably helps that, too.

VICE CHAIRMAN MCDONOUGH. Yes.

CHAIRMAN GREENSPAN. Any further questions on Vice Chairman McDonough's proposal? Are there any objections to this change in procedure? I will assume then that the Committee will accept the change in procedure, and we will proceed on your recommendation.

VICE CHAIRMAN MCDONOUGH. Thank you.

CHAIRMAN GREENSPAN. In this regard, would somebody like to move approval of the minutes of December 17?

SPEAKER(?). So move.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection.

MR. MELZER. Excuse me, Alan. When would we release those?

CHAIRMAN GREENSPAN. Thursday afternoon.

MR. MELZER. We will go ahead with the new schedule for these minutes?

SPEAKER(?). Yes.

MR. MELZER. Okay.

CHAIRMAN GREENSPAN. Do we release them at 4:00 p.m.?

MR. COYNE. 4:30 p.m.

MR. MOSKOW. A question about the timing: If you release the minutes at 4:30 in the afternoon, isn't that awfully late for the next day's newspapers. Don't you want to release them earlier in the day?

MR. COYNE. Our current practice is to release them at 4:30 p.m. on a Friday.

MR. KOHN. For the Saturday papers.

MR. MOSKOW. Right, but if we are trying to get more exposure to the minutes as a document to explain our policy, wouldn't it be better to release them earlier if we could?

VICE CHAIRMAN MCDONOUGH. If I could ask, Mr. Chairman--Joe, we could certainly move the release time to 4:00 p.m. when the stock market closes.

MR. COYNE. Yes, we could. Some options markets stay open beyond 4:00 p.m.

MR. KOHN. Maybe we could consult on the timing. The other issue, Mr. Chairman, is that domestic market participants sometimes complain when we release things at the end of the day, particularly on a day when the Japanese markets are opening for the next day's trading in Japan.

CHAIRMAN GREENSPAN. Are you suggesting that it would be better to release the minutes at 2:00 p.m. so that there is time for trading on the information in our markets? Let me ask you this: Can we leave the decision to Messrs. Kohn and Coyne to come up between them with an optimal conclusion?

MR. KOHN. Consulting with Mr. Fisher.

CHAIRMAN GREENSPAN. That will slow you down a bit! [Laughter] President Minehan.

MS. MINEHAN. I know we have decided this issue, and I do not mean to say anything to change the decision. I had some misgivings, and they have just been heightened by this conversation. I think there is a distinction to be drawn between transparency and seeking media coverage, and I am wondering whether our discussion of these timing questions may not lead to some confusion of the two. It seems to me that we are being transparent by releasing the minutes and having them available and doing them the way we do them. I am a little nervous about going the extra mile to seek the media coverage.

CHAIRMAN GREENSPAN. Let me defend the Vice Chair's position on this because I would generally agree with you on this particular issue. The purpose of moving the release forward, as I understand the Vice Chairman, is to give more emphasis to a key policy report that we prepare in a less-than-opaque manner. We do not have that many releases relating to our policy decisions because if we tried to do very many more, I think we would very significantly restrict the functioning of this Committee. The presumption of a very significant portion of the Congress is that we release nothing. As a consequence, to the extent that we make it clear that we do release things, I think it probably is a plus rather than a minus. I would restrict that comment to the official issuances of this Committee with respect to monetary policy. I would not wish to go beyond that.

VICE CHAIRMAN MCDONOUGH. Nor would I.

MS. MINEHAN. I just wanted to register a degree of nervousness.

CHAIRMAN GREENSPAN. It is a valid issue. If we were to start to try to manipulate the press, we would lose and so would the System. Let us move to the Desk operations. Mr. Fisher.

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

CHAIRMAN GREENSPAN. Questions for Peter?

MR. BOEHNE. I have a question, Mr. Chairman. The operating balances that the commercial banking system holds at the Fed have been declining. When in your judgment do we start to get into a range where those reduced balances will materially affect your operations?

MR. FISHER. I remain an optimist that it is not the level but the rate of change that is important. I am sure there is some single-digit number that would have a material effect on our behavior--whether it is as low as 1 or 0, I am not sure. But as long as we have a gradual move from the current level down toward 10, as we have had in the last couple of years, I am not sure there is any magic point in that range at which our operations will be impaired. My hypothesis that that is the case is progressively being confirmed.

MR. MELZER. Just to follow up on that question, Peter, we have not made such a decision for a while, but what would happen if we were to change the degree of reserve restraint? Given that the banking industry has demonstrated its ability to operate effectively with smaller and smaller amounts of reserves, do you have any thoughts as to whether a change in reserve conditions would have any impact in terms of what you would have to do in the reserve markets to achieve a given federal funds rate effect?

MR. FISHER. I don't have any concrete sense there would be anything different in what we would do every day. Maybe we would have to intervene a little more than we do currently. A development that could become problematic, I am hypothesizing, would occur if a critical mass of the major banks in the country were all to become unbound. That is, they would meet their required needs with just vault cash. If every one of these banks were over the other side, we might have a very interesting federal funds market. But I remain an optimist in believing that some banks are still going to be operating in the funds market, even if it is the smaller banks, and that their behavior, if all this continues to happen gradually, would adjust to the new conditions and clearing would take place. All of us around the table know that we do not need required reserves to conduct our business. We can run the banking system on a bigger deficit or just up to zero or we can be filling in with temporary operations. The tools are very flexible.

MR. KOHN. Of course, even if banks do not need any required reserve balances at the Reserve Banks at the end of the day, they need clearing balances through the day and at the end of the day. So, even if every bank in the system were unbound, I think there would be a demand for balances at the Federal Reserve, and we would be able to implement monetary policy. I suspect there might be a critical level, Peter. I think the rate of change is important. We have been pleasantly surprised that, with this gradual rate of change, the banks have adapted. My guess is that they will continue to adapt, as Peter says, as long as the rate of change is low. But there might be some level at which the clearing needs are the operative needs rather than the reserve needs. Clearing needs vary a lot from day to day. Peter will still be able to get the right average funds rate over a period of time, but there might be more volatility. We just do not know where that point is. I think it is lower than some might have suspected it was, based on past experience. It may be considerably lower than its present range in terms of inducing more volatility. But I think even if no bank is bound, there still will be a demand for balances at the Federal Reserve.

MR. MELZER. I do not doubt that.

MR. KOHN. And still something for Peter to operate on in carrying out the Committee's policies.

MR. MELZER. As balances have gone down, has anything happened with daylight overdrafts? Is there any pattern in what we are observing?

MR. KOHN. I don't think so.

MR. FISHER. I agree with Don. I generally think of the cause-effect as running the other way. We had the change in behavior in daylight overdrafts when our policy changes were implemented five or six years ago, and we are now seeing the pass-through.

CHAIRMAN GREENSPAN. Further questions? If not, would somebody like to move to ratify the operations of the Domestic Desk?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection. We also need to approve the increased intermeeting leeway for Peter. Would somebody like to move that?

VICE CHAIRMAN MCDONOUGH. Move approval of $12 billion.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Let us move on to Messrs. Prell and Truman.

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

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

CHAIRMAN GREENSPAN. That is about as good a "Chart Show" as the staff has presented to this Committee in quite a long time.

MS. MINEHAN. It was very interesting.

CHAIRMAN GREENSPAN. Very, very informative.

MR. PRELL. Ted suggests it is because we set a low standard previously. [Laughter] But I will try to take it more positively.

CHAIRMAN GREENSPAN. I am sorry you raised the hurdle; that will require more work in the future. Questions for either gentleman? Yes, President Broaddus.

MR. BROADDUS. When you started off, Mike, I think I heard you say that the actual fourth-quarter data published after the Greenbook was completed had not changed the profile of your forecast from what you had in the Greenbook. What about the risk to that forecast and specifically the upside risk to which you gave some attention in the Greenbook? What motivates my question is that, if I remember your presentation correctly, when you compared the Greenbook projections with the actual fourth-quarter numbers, you referred to the unexpected strength of net exports, which clearly may prove to be temporary. But I believe you also indicated that a number of final demand categories were stronger than your projection, including consumer spending on durable goods, business fixed investment, and I think housing as well. Does that unanticipated demand late last year give you a sense that there may be more underlying momentum in the expansion and that the upside risks may be a little higher than you had in mind before the fourth-quarter GDP data came in?

MR. PRELL. Perhaps, but not so much that I felt the need to feature that aspect of the picture. There are some sectors where historically one would look for positive serial correlation. The fact that consumption was as strong as it was according to the published numbers, though only a little stronger than we had forecast, might lead us on the basis of historical experience to anticipate ongoing strength to some degree. On the other hand, the personal saving rate was lower than we had forecast. On still another hand, the fourth-quarter outcome may be a sign that the wealth effect is beginning to show through more importantly and that one of the upside risks that we have noted for some time now is coming more into play than we sensed in the fourth quarter. Those durable goods categories may be a place where that would occur.

In the area of business fixed investment, nonresidential structures were stronger. In fact, our reading of the construction put-in-place data for December released just yesterday suggests that there might even be a slight upward revision in that number for the fourth quarter. However, I am not inclined to view that report as a sign of even greater strength going forward. In fact, the spike in such construction was so sharp that there probably will be a slight tendency for it to drop off in the near term, at least in growth rate terms.

In the residential construction area, we made a very substantial error. That was an error that we should not have made in our translation of housing starts into residential investment. We did not anticipate that the estimates of housing starts and residential investment would be brought back into line as quickly as they were. We think that, going forward, the changes in residential investment that we have been anticipating remain reasonable. The data on new home sales that we got today still look about the same as in November; they seem to confirm our notion that housing activity has perhaps stabilized at the about the level we were anticipating. So, we would not have a new view of the outlook for residential investment. The other aspect of this is that, if we have a level adjustment in GDP that does imply more output. That might call for more inputs and a somewhat lower unemployment rate than we have in our forecast. But the difference here, given our interpretation of the GDP data, is so small that it really is not material to the outlook.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mike, I had a question that is somewhat similar in terms of the implications of the fourth-quarter number for, say, 1997. At the end of the fourth quarter, the GDP gap was obviously a couple of tenths higher. Are you saying that if you were to revise the Greenbook forecast that the degree of resource utilization by the end of, say, 1997, would be roughly what it is in the current forecast or that the gap would be larger roughly by an amount equal to the difference between the fourth-quarter Greenbook forecast and the advance estimate for the fourth quarter? I am not quite sure of the answer.

MR. PRELL. You will recall that we learned nothing new about the level of resource utilization in the fourth quarter as measured by unemployment or capacity utilization. So, there is a question of alignment here. In the fourth quarter, by Okun's law equations, we found the unemployment rate to be a little higher than we might have expected, given our GDP path. This new number suggests an even greater excess. We had been anticipating that we were going to catch up, with more of a drop in the near term than suggested by the rule-of-thumb applied to the quite modest increases in output that we were forecasting for the first part of this year. We would just, I think, continue in that vein. It would be, in a sense, a bigger catchup. But any adjustment we make would perhaps be on the order of .1 percent on the unemployment rate, and it is a tough call. We would have to think about whether we would want to alter productivity slightly from the higher level. One has to consider other possibilities as well. I just do not think it is a material difference as we are interpreting the data.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you. On chart 3, in the middle section that shows inflation and price-earnings ratios, I had not seen the information presented quite like that before. I am wondering whether there are enough observations in each of these buckets to get a meaningful average. In addition, I assume that the less-than-3-1/2 percent bucket includes a lot of the earlier years in the period.

MR. PRELL. Because it is such a long period, there are a lot of quarters to put into these buckets.

MS. PHILLIPS. So this is done on a quarterly basis?

MR. PRELL. I cannot tell you how many quarters there are in each of those inflation ranges; I probably should have checked that. In terms of the broad sweep, if you look at a chart of inflation versus the P-E ratios--all the noise in the relationship makes it a little hard to see--you can perceive this correlation. There are reasons that are propounded for why this pattern might occur. There are differences of opinion, but it's not difficult to come up with reasons that might lead one to believe that there is this kind of correlation. Clearly, that is not the whole story in assessing whether P-E ratios are abnormally high, abnormally low, or right on the historical norms. One needs to think about the interest rates that are prevailing at these times; one has to think about the expected earnings growth at these times. Perhaps because of the phase of the business cycle, and apart from whatever inflation might lead one to think about the stability of the outlook, other factors could affect what kind of risk premium one wants for investing in equities as opposed to fixed income.

MS. PHILLIPS. The tabulation was impressive, and I guess I was surprised that the relationship is as consistent as is implied by this table.

MR. PRELL. To be fair, this table is just a slight variation of the one Abby Cohen has used. As you know, she has been among the most bullish and the most correct stock market forecasters. This is one of the key exhibits she presents in support of her opinion.

MS. PHILLIPS. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Mike, a couple of technical things: The principal surprise to me in the fourth-quarter data was the employment cost index, and I know you looked into that. My question is whether you are satisfied with what you found out because there were a couple of characteristics that looked a little out of line to me.

MR. PRELL. I can pick one that was widely discussed, namely the behavior of the nonproduction bonus component of benefits. It struck many people on Wall Street who were pocketing huge bonuses as out of keeping with reality. However, as best we can tell, this is probably at least in part a matter of timing. If the bonuses were not paid by mid-December, they will be picked up in the March ECI. It could be that these are errant numbers reflecting just some sampling problems. Conceivably, the firms with the big bonuses might not have been in the sample. So, there may still be grounds for residual doubt about the accuracy there. We have not found any smoking guns that tell us that we should look at these numbers with a jaundiced eye. They are reasonably credible, I think.

CHAIRMAN GREENSPAN. Is there evidence that the Wall Street bonuses at the end of 1996 were significantly greater than the year before?

VICE CHAIRMAN MCDONOUGH. Yes.

MR. PRELL. That is what I read in the newspapers.

CHAIRMAN GREENSPAN. What is the order of magnitude? What information have you got?

VICE CHAIRMAN MCDONOUGH. At some of the major firms the level was approximately 50 percent higher in 1996 than in 1995. The tax receipts of New York City and New York State reflect this boom as well.

CHAIRMAN GREENSPAN. When do they usually pay the bonuses?

VICE CHAIRMAN MCDONOUGH. The earliest is December and most of them are paid out by the end of January.

MR. PRELL. Our supposition is that a lot of this discussion just did not recognize that a good share of the bonuses will be paid out after December.

CHAIRMAN GREENSPAN. So, the seasonal adjustments do not capture this change?

MR. PRELL. I don't know whether that timing is new, though I think there has been some shifting over time. In part, it is inconvenient in terms of tax planning to get this big slug of money very late in the year. But I think there are other considerations, too.

MR. STERN. My second question: What is your estimate now for fourth-quarter productivity? Is it up 1-1/2 to 2 percent or something like that?

MR. PRELL. My recollection is it that it is up 2-1/2 percent.

MR. STERN. 2-1/2 percent?

MR. PRELL. Yes. That is based on a reasonably firm view of what the nonfarm business output was for the quarter but only a tentative view about what the total hours worked ultimately will look like. We think we have a reasonable handle on it. It will probably be in the 2-1/2 percent vicinity.

CHAIRMAN GREENSPAN. What is the comparable compensation per hour figure?

MR. STOCKTON. It's 3-1/2 percent.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mike or Ted, I have a question on your oil price comments. I don't disagree with your projection of a decline in oil prices. But I am hearing more from individuals in the energy industry that, given their current outlook for world oil demand and the limited ability of producers to accommodate that demand, they are increasingly of a mind that these prices will stay higher longer. As you judge this and from what you hear, do you have any inclination to move away from your baseline projection toward a higher price scenario?

MR. TRUMAN. I think there are two aspects to your question. One would relate to the short term, meaning the period we are looking at here, and the other would be a longer-term perspective.

With regard to our assessment of what the industry is saying about the short-term supply and demand balance and abstracting from accidents of one sort or another like cold weather in Europe, hurricanes, and so forth, we are in fact quite conservative in our use of conventional relationships in terms of what the industry itself says about new production coming on line over the next year or so. That said, I think that for a medium-term forecast going out beyond this period--and leaving aside the little run-ups that we have had--we might be more inclined to shift from an almost flat nominal price trend, which implies a real price decline, to something that might be more flat in real terms. While there is no inviolable arithmetic involved here, I think almost everybody believes that we have to get there ultimately. That's because of a sense that some of the technological improvements that have come on line and other factors will come into play to produce that result. Now, I say all that partly against the background of an assumption that Iraq will stay put. If we assume that Iraq will reenter the market with 3 million barrels a day or something like that, then we are postponing that scenario for 18 months or a couple of years before the extra supply is absorbed. The one negative on the other side is that a good deal of this new production is in parts of the world that are not the most stable; one example is Columbia. So, we might have a lower level of prices for a while, but a firmly higher level of volatility as a result of interruptions of one sort or another in the supply of oil. That's the best I can do.

MR. HOENIG. Okay. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I have a couple of questions, Mike, following up on what President Stern was talking about in terms of productivity assumptions. You have a discussion in the Greenbook about a change in your thinking about the trend rate in productivity growth. I was interested first of all because it moved down rather than upward, and second it would appear to have implications for potential output. I wondered what those implications were--they are probably part of your forecast--and what your range of uncertainty is around that trend in productivity growth because it does seem to have an impact. I don't disagree at all with the trend in your overall forecast. I just wonder how those changes came about and whether they are reflective of something different in your thinking recently.

MR. PRELL. We aren't certain and I don't see how anyone really could be in this area. We had clung with great determination to the assumption that the underlying growth trend in this decade would prove to be 1.1 percent. We have been continuing to reassess this assumption, and I guess particularly because this meeting is one of those when a longer-run perspective may be important to the Committee's deliberations, we took another hard look at it. What we perceived was that a trend line well below our 1.1 percent growth assumption clearly would fit in a more natural way what we had been experiencing up through at least the third quarter of last year. The historical pattern is that productivity tends to be above the trend in level terms until almost the end of an expansion, if not all the way to the end of the expansion, and it then dips down below trend during a recession and the early recovery phase and subsequently moves back up. What we found is that, with a 1.1 percent trend line, we were well below that trend line now and have been for a while even though the expansion has not come to an end. That just did not fit. Something like .7 percent gave a picture that looked more like the recent history. Now, there may be reasons why earlier historical patterns would not hold this time. The adjustments of labor to output in the short run may be different, and so on. But, when the divergence persists over several years, that is a troubling pattern.

We also noted that there were reasons to think that output, and thus productivity, may have been underestimated over the last few years. The question is how much. One could look at the difference between gross domestic income and gross domestic product--a difference that has become quite sizable--and conclude that production really has been much stronger than the data suggest and productivity greatly understated. But looking at the history of revisions and what little we know about what might be the flaws in the income-product data, we thought that was a rather aggressive assumption about what true output and productivity had been. So we in a sense compromised. We did assume that the trend in actual levels of productivity has been understated in recent years, but only by enough for us to try to square things by assuming about .9 percent trend growth in productivity. The fourth-quarter number actually is reasonably helpful in getting a picture that looks sensible with that kind of trend line. Now, this would naturally feed through to our potential output assumption, but there are offsetting considerations. When we looked at the trends in the average workweek and the factors that get us from nonfarm business output to GDP and so on, we were led to conclude that an estimate of about 1.9 percent for the period since 1990 still looked pretty good. So, we have not changed our potential output trend; it is still about 1.9 percent per year, chain-weighted on a 1992 base.

MS. MINEHAN. Just to follow up on that: The lower trend rate of productivity growth, then, has been consistent in your mind with where we are on an unemployment basis and where we are on a change-in-inflation basis.

MR. PRELL. That was another factor. We looked at Okun's Law. It has worked pretty well.

MS. MINEHAN. Okay.

MR. PRELL. It does not in itself suggest that output growth has been a lot more rapid than measured. That also gives one pause because, while Okun's Law is not a relationship one can depend on from quarter to quarter or even year to year, over extended periods it works pretty well. So, that gave us some pause as to whether we should maintain the seemingly optimistic view that the productivity trend was 1.1 percent. Having to adjust that trend, we also adjusted our sights on what actual productivity growth would be over 1997-1998, and that is how we formulated our forecast.

CHAIRMAN GREENSPAN. Further questions? If not, let me raise the question that President Jordan raised in his letter to all of us with respect to our individual forecasts. I always thought that the combination of the central tendency and the range was an effective way of summarizing what everyone has been trying to convey. It is not clear to me why that is not the case, and I am just curious to know, Jerry, what you think could be significantly improved and what you think you can infer from the greater detail.

MR. JORDAN. My emphasis was not so much on the distribution, although I would like to see the detailed distribution of these forecasts because I know that three on each side get tossed out to arrive at the central tendency. I am more interested in the multi-year aspect of our efforts to address our problem of distinguishing between a forecast of what is going to happen in the near term and a public statement about what our objectives are.

CHAIRMAN GREENSPAN. I think that is an issue that will be coming up later. So, you are not focusing on the question of publishing more detail than we do currently?

MR. JORDAN. No, I am not worrying about that. More detail would not add much to what we already publish, though I don't know why we don't share the detailed distribution. I don't care who makes which forecast. But I am interested in trying to evaluate specific forecasts in terms of what I think of as my version of the internal consistency of a forecast. It can tell me a little about peoples' thinking when I look at their forecasts of output, unemployment, and inflation.

CHAIRMAN GREENSPAN. I'm not terribly certain what you would learn if you looked at that. The degrees of freedom that exist in playing around with those numbers, as you know better than anybody, are quite large. Let me suggest this, rather than getting into a discussion now, which I don't think we really need to do. You all have gotten Jerry's letter. If you will communicate your views to Don Kohn, perhaps we can get a sense as to whether people think there are reasons to change what has been a long-standing practice. Is that satisfactory, Jerry?

MR. JORDAN. That would be fine.

CHAIRMAN GREENSPAN. Let us move on to the Committee's discussion. Who would like to start? President Parry.

MR. PARRY. Thank you, Mr. Chairman. Strong growth has continued in the Twelfth District in recent months and the base of the expansion is broadening. The recent trend of growth has been robust in California despite some lack of cooperation from Mother Nature. Severe flooding in northern California destroyed a large number of homes and disrupted many businesses. But the extent of the recent losses is small relative to overall state income or to the losses from some of the other natural disasters that have shaken the state in recent years. Property damages from the Loma Prieta and Northridge earthquakes were roughly three to five times the damages from this year's flooding. I might note that the damages from our recent flooding in California were about the same as those from last year's flooding.

In our other most populous states, growth has picked up a bit lately. Employment growth in Arizona and Oregon is averaging in the 4 to 5 percent range. Job growth also moved up to about 4 percent recently in Washington, reflecting hiring by Boeing to ramp up its production in an effort to work down its huge backlog of domestic and export orders. Several types of nonresidential building activity also have picked up recently in the District, consistent with the national strength that we saw in this category in the fourth-quarter GDP estimates. For example, we have seen a large recent pickup in office construction activity as the fundamentals in that market have improved considerably in some of the District's fastest growing metropolitan areas. Office vacancy rates are particularly low in Seattle and in the San Francisco Bay Area.

Turning to the national economy, the stronger-than-expected real GDP growth late last year was related to an apparently temporary jump in exports. That suggests that we should see much more moderate growth this quarter. Nonetheless, last quarter's surge still means that the economy is operating at a higher level than seemed likely last month. This puts additional upward pressure on inflation. The recent rise in the dollar and in long-term interest rates may slow the economy's growth rate later this year. However, we still would expect real GDP to rise at or slightly above its trend growth rate this year if the funds rate were to remain at its present level.

With regard to inflation, we expect the CPI to rise by a bit under 3 percent this year. For the longer term, however, I continue to see a significant risk of an increase in underlying inflation over the years ahead. While judging resource utilization is difficult, the unemployment and the capacity utilization rates taken together suggest that excess demand pressures are building in the economy. Even with a healthy dose of skepticism about estimates of resource utilization, it appears unlikely that containing inflation, let alone reducing it which I certainly would prefer, will be forthcoming without a tighter monetary policy in the future. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. There are a couple of things that I want to talk about. One is a report that the National Federation of Independent Business made two weeks ago covering the end of last year and the beginning of this year. I thought there were some interesting items in the report. The percentage of firms reporting higher prices plunged to record lows, but plans to raise prices in the next few months jumped to a 12-month high. Reports of compensation increases reached a new record high. Some 32 percent of the firms said they had raised compensation, and that is 8 percentage points higher than in any previous report. But on the other side, plans to raise compensation in 1997 fell significantly, almost to a record low. Capital spending plans remain strong. The report now says that 37 percent of the respondents are planning to increase capital outlays. A record 76 percent of the firms reported actual increases in capital expenditures last year.

Let me turn to developments in my District. First on the retail level,

who is in retail distribution nationally, and it is not always clear whether his remarks apply to regional or to national developments. He said that retail sales were very good in January in spite of some of the weather problems. They had been somewhat disappointed about December. He expects that wages in the retail sector will rise 4 percent this year versus a 3 percent increase in 1996. Whether or not that rise can be justified in terms of greater efficiency or what some might call productivity was not clear from his comments.

We are now hearing from contacts in the construction sector in the region that they are no longer expecting some falloff in 1997 from 1996; in fact, some concerns are being registered about possible overbuilding in the commercial sector. The claim being made is that what is already in the building pipeline to be completed this year, especially retail space, could result in oversupply. Labor contacts tell us that labor negotiations in the construction industry are going to be tough this spring, meaning that they plan to catch up. The view in the unions is that the cost of benefits has been coming down in the last few years and that the contractors are adding to their incomes as a result. The workers feel that they now deserve larger wage increases in the next contract than they received in the last contract because of what they see as very substantial increases in productivity and efficiency in the construction trade. They believe they are not benefiting from that improvement and that now is catch-up time.

In the steel sector, we are hearing that wages are expected to be up about 3-1/2 percent this year, and our contacts say that such an increase is in line with gains in productivity. However, they think prices are going to end the year lower than where they are currently and that 1997 prices will average below those in 1996. So, earnings at best will be flat and are more likely to be down. Steel industry executives also continue to be concerned about imports, especially because of the appreciation of the dollar. In our area we are being told, mainly by suppliers of automotive parts, that auto sales will be down this year from 1996.

I thought one report on labor was of particular interest. There are 70,000 manufacturing workers in northeast Ohio, and their average age is in excess of 50 years. One of the large firms, a steel company, put out a notice that it wanted to hire 100 entry-level production workers. They stopped taking applications after two days when they had received 1,500 applications for jobs with starting wages of $38,000. However, they could not find 100 qualified workers out of these 1,500 applicants. So, there is concern about the quality of the work force.

One note on the housing market: I don't know how general this phenomenon is yet, but we are hearing reports that prices of houses on the high end of the scale are softer and that these houses are staying on the market longer.

Quite a few of us took a tour of facilities so that we could report to Don Kohn on what is going on in The discussion focused on the productivity and efficiency challenges is facing. They claim to be in the midst of major leaps in productivity due to new equipment technologies. The latter are leading to the introduction of new products that are substituting for products previously made out of other materials. All this raises some interesting issues. The time for designing and testing a new product a couple of years ago was measured in months. It is now measured in days, because of the use of computer assisted design equipment and new testing procedures. Computerization also has enabled to achieve extraordinary gains in efficiency by using production equipment that is fairly similar, or looks similar, to existing equipment. As recently as 1995, it took them 8 hours on average to change a mold. This year they are planning to do it in 45 minutes. They anticipate machine downtime in 1997 to be 1/4 of what it was in 1995 and their scrap rate to be less than 1/2 of what it was in 1995. They operate on a rolling 3-year plan, and they say that they currently expect a 3 percent per year increase in their labor costs, but their output prices will fall 1 to 2 percent per year. Their earnings are good and they expect them to continue to be good. For 1997, they indicate that their labor costs will average about 5 percent of the wholesale price of a product. We looked at one product in particular--the --which sells for about $10.00 at Wal-Mart. Last year, they were making 2 cans in 35 seconds on one machine, and the new equipment they are installing now will make 4 cans in 35 seconds. The wholesale price will be $6.00, and there will be 30 cents of labor cost in the $6.00.

I asked them about the effects of NAFTA on their operations in Mexico. They said that NAFTA was largely irrelevant to their production there. They noted that they have virtually no turnover of labor in their operations. All new hires start on the night shift. It takes approximately 30 years of seniority for a worker to get moved to the day shift. [Laughter] In Mexico, on the other hand, they are experiencing 25 percent turnover. So, recruiting and training in Mexico are huge costs to them. They say that in the end the difference in labor costs is about $2.00 an hour, but when the labor cost is only 30 cents per $6.00 trash can, it is irrelevant. They say that labor could be free in Guangdong province and they still could not make such products there and import them at a profit. So they have crossed over a threshold in which the value added coming from labor is so small because of efficiencies in production that they cannot afford to produce at a remote location and move the product around. They have to have their manufacturing facilities close to their points of distribution. They said their biggest challenge is being able to respond when they know every single day which of their products were sold and need to be ordered in each and every store of a Wal-Mart or some of the other chains.

One more note on District manufacturing companies: When they respond to our questions about inflation, they say they are experiencing no inflationary pressures even though their wages are increasing 3 percent or so and their earnings are very good. Their earnings were good last year and are expected to remain so in 1997. So, their story provides at least indirect evidence that productivity gains are quite high and are expected to be quite high in an environment of very, very low labor turnover. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. Overall, 1996 was a very good year for the Seventh District. For most of our key manufacturing industries, shipments exceeded their early 1996 expectations and housing activity for the year as a whole was much stronger than anticipated. As we move into 1997, expectations are that these sectors will continue to operate at very high levels, but perhaps not quite as high as last year. Specifically, discussions with major producers in our District indicate that most of them are expecting 1997 sales to post small declines from 1996 levels. These producers include autos, construction equipment, machine tools, appliances, and steel. A major exception is the agricultural equipment industry, which anticipates a better year than last year. Most of our key industries are expecting the first half of 1997 to be stronger than the second half, and current data and anecdotal reports offer very few signs that activity has declined so far. Manufacturing activity in the District continued to expand in early 1997, as indicated by the purchasing managers' reports for Chicago, Detroit, and Milwaukee. There has been some improvement in the heavy truck industry as noted in the Greenbook.

In terms of consumer spending, January looks like a repeat of December. The underlying sales rate for light motor vehicles in January appears to have continued at about the December pace, although the final aggregate sales number may come in higher for a couple of reasons. Some foreign name plates reportedly are including some December sales in their January numbers, and those name plates have increased incentives aggressively, aided by the strengthening of the dollar. Reports from retailers have been mixed but suggest on balance that January post-holiday sales are up from a year ago and about the same as in December. For some retailers that means that January was better than they expected, similar to what Jerry Jordan mentioned. Large District retailers and discount chains entered 1997 with lower inventory levels than usual, allowing at least some of them to avoid the heavy discounting often associated with January clearance sales.

Labor markets in the District are still very tight. Unemployment rates in each of our five states continue to be below the national average. Although there still does not appear to be a significant spillover into prices, reports of increased pressure on wages have become more widespread. The head of a major temporary help firm indicated to me that he definitely is seeing wage pressures. He expects wages of temporary workers to increase an average of 5 percent this year in contrast to the 2 to 3 percent gains last year and unchanged wages in 1995.

Turning to the national outlook, in December my assessment of 1996 was that GDP growth in the second half had decelerated from the pace in the first half. Even so, I expressed concern that output was still somewhat above potential and, looking forward, that higher inflation rates were a risk. With the fourth-quarter data now available, it appears to me that the risks are clearly on the upside and they seem higher now than they did in December. By the rules of the game to date, this Committee has focused most of its inflation attention on the CPI and the core CPI and in the time that I have been here a 3 percent inflation rate was viewed as progress toward lower inflation. With the recent methodological adjustments by BLS, however, we need to recalibrate that standard now to a lower number, probably about 2-1/2 percent. By this standard the Greenbook outlook for core CPI inflation in 1997 and 1998 has deteriorated substantially since last month.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. The burst of year-end 1996 economic activity that shows up in the national data and that people have already mentioned around the table is not reflected in either the most recent data for our southeastern region or the anecdotal reports that we are getting from directors and other people we talk to. While we would still characterize our regional growth as moderate, we clearly are seeing some slowing from the pace that we saw earlier when our region led the nation in job growth.

In manufacturing, I have reported at almost every meeting on the weakness and the significant loss of jobs in the textile and apparel industries, and that weakness continues. We are now seeing weakness in both pulp and paper. And as housing construction appears to have peaked, we also are seeing some slowing in the production of home-related products like lumber, carpets, and appliances. That in fact is a cyclical development that we have come to expect because an important part of our manufacturing sector feeds off the national housing industry. On the other hand, our relatively new and quietly growing southern auto industry is showing some modest strength, and the prospects are for more of the same in the period ahead. Reports of less robust capital spending plans by manufacturers in our region also suggest some deceleration in the pace of growth in the period ahead.

In construction, single-family home sales and construction have both slowed noticeably in our region and multifamily activity is now clearly past its peak. Retail construction also has slowed. At the same time, commercial construction remains strong, particularly that of office space where vacancy levels have gotten quite low. We are seeing some speculative building in Atlanta and some other southern cities but not yet at a worrisome level for a region that needs space to accommodate companies moving into the area.

Retailers, who are coming off what they characterize as generally satisfactory year-end 1996 sales, are telling us that they are comfortable with their inventory levels and their outlook for sales in 1997. The well-publicized freeze of vegetables in Florida was severe, the worst in seven years, with most of the crops damaged and losses around the state estimated at $250 million. Crops like corn and beans can be recycled in 45 to 60 days, but imports of food from Mexico and other Latin American countries are reportedly taking up some of the slack.

Finally, labor markets remain tight in our region. I would characterize the change since our last meeting as indicating somewhat less pressure and somewhat fewer shortages in certain skills like those in construction, but at the same time new geographic areas in the region are reporting tightness. Even with continuing tightness, extraordinary wage pressures are still isolated and do not yet appear to be spreading.

At the national level, like almost everybody else, we underestimated the strength of the economy in the fourth quarter. Like the Greenbook and others, we anticipate more moderate growth in 1997 and on into 1998. We are among those who see somewhat slower growth in

1997 than is projected in the Greenbook, and consequently we do not expect the unemployment rate to move quite so low as in the staff forecast. The good balance we continue to see is encouraging and happily it leaves the economy in a position that is less vulnerable with regard to the inevitable shocks that will come along. In my view, the risks to such an outlook for economic activity are slightly to the upside and--as others have indicated--consumer spending represents the greatest risk. If, despite the deterioration in consumer balance sheets, strong income growth and confidence fuel consumer spending beyond our estimates, we certainly could get increased overall demand pressures. In particular, if consumers add to their spending by lowering their saving rate or capitalizing on their increase in wealth, the pressures on resources will be exacerbated.

Of course, the tight labor markets that we have talked about and are watching closely, as well as the scenario that Ted Truman mentioned in which oil prices linger at higher levels, could among other things create pressures that feed through to higher price inflation if accommodated by monetary policy. As is always the case in judging inflationary risk, we must make judgments about the current stance of policy. While the recent experience with the growth of the monetary aggregates raises some questions, other measures of policy including real rates of interest do not suggest to me that our policy is clearly in an accommodative stance. Given that the broader measures of inflation and the adjusted CPI continue to hold at moderately low and relatively steady levels and are not projected to show any significant deterioration until 1998, we appear to be at a point where we can feel reasonably good about both the outlook and current policy. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, overall economic growth in our District seems to be moderating a little. The level of activity is still high, especially in manufacturing. Some of the information we have for our District differs somewhat from what Jack Guynn was saying about the Atlanta District. We see substantial strength in a number of industries--chemicals in Virginia and West Virginia, textiles for the first time in a while, and lumber and aluminum products as well. We hear that a number of plants in these industries are operating near full capacity.

Labor market conditions, as seems to be the case elsewhere, have not eased at all in our region as far as we can tell. Reports of rising wages and prices--and this is where our information may differ a little from some things that other folks have said--while certainly not universal are more widespread now than they have been in the last several months. To give you an example of the kind of anecdotal information we are getting along these lines,

of a large building materials and hardware chain told us that a number of his suppliers are now trying "to go up in price," to use his words. To be a little more specific on this, we did a special survey recently of about 100 firms in both the manufacturing and services sectors.

On the manufacturing side, strong foreign competition is still keeping textile makers and metal producers from passing along increases in wages and the cost of basic materials. But in some other industries--notably furniture and paper, electrical equipment, and machinery--we get reports that some of these companies are now able to pass along their wage and other cost increases more easily than had been the case in prior months. For example, one producer of electrical equipment said that his customers now see and understand that price increases this year are almost inevitable. A manufacturer of bearings reported that his customers seem now to be resigned to some price increase later this year. In the services sector, nearly two-thirds of the firms we contacted reported increased business costs, and half of these said that they expected to be able to pass through at least some of these higher costs to their customers. Again, this tendency is not universal but we see considerably more evidence of it and get more frequent comments along these lines than we did just a few months ago.

Turning to the national picture, the projections we submitted are fairly close to those in the Greenbook, but we got there by a different route. Let me quickly explain that. We used a small VAR model in developing our projections. When we initially generated projections under the assumption of no change in monetary policy, the result was an increase in the CPI to a rate above 3 percent this year and next year despite the likelihood of some diminution in energy price pressures over this period. So, we then redeveloped our projection on the assumption that the Committee will take whatever policy actions seem to be required to hold the CPI at or below 3 percent, starting in the period immediately ahead. In our particular model this requires an increase in the funds rate of about 50 basis points early on. The main point I want to make here, though, and I am trying to respond to the point that Jerry Jordan mentioned earlier, is that our 3 percent CPI projection is not just an unconditional forecast but a projected result for the year ahead. It is consistent with the Committee's longer-term projection for inflation based on the assumption that the Committee will take whatever policy action seems necessary to increase the probability that we will achieve our inflation objective.

With respect to the Greenbook itself, I have to say that the general contour of the Greenbook projection troubles me a little. It shows the core CPI rising to about 3-1/4 percent in 1998. As I think someone else has already mentioned, the rate would rise to about 3-1/2 percent except for the technical adjustments by the BLS. Moreover, the language of the Greenbook, as I read it, suggests that the risk of error is tilted a bit to the upside in the current forecast. What really caught my eye in the Greenbook, though, was a statement that our forecast has edged further in the direction of a more cyclical pattern of inflation overshooting, which typically has been followed by monetary tightening and then a period of economic weakness. I assume the tightening referred to here is the possibility of a very sharp tightening at some point down the road after we may have let things get away from us, and that tightening could then be followed by a very weak economic outcome. I hope we will do whatever we can to avoid that outcome. Thank you.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. District economic activity has picked up in the past few months. Auto dealers reported a flat November and December compared with a year ago, but most expect a pickup in the first half of 1997. District auto production, which benefits from the popularity of light trucks, is expected to rise 3.6 percent in the first quarter from its year-ago level and to rise even more in the second quarter. Most District contacts are optimistic about the near term. Many firms have announced plans for expansion, but tight labor markets remain a problem for many employers, especially in the construction and information technology industries. There are a few reports of rising prices, mainly in the transportation and public utility sectors where increased energy costs are being passed along to customers.

At the national level, the economy is on a relatively balanced growth path. With a 4.7 percent surge in the fourth quarter, the year's real GDP growth came in at a rate of about 3-1/2 percent, well above the 1-1/2 to 2-1/2 percent forecast range that we reported to the Congress a year ago. Momentum from 1996 and the absence of significant imbalances in the economy make us optimistic about the growth outlook for 1997. Our projections are for real growth at about trend, with a continued upward creep in the CPI by another couple of tenths.

Quite apart from Jerry Jordan's letter, I find this semi-annual forecasting exercise somewhat frustrating and potentially misleading. We are asked to assume what would be an appropriate monetary policy in making our forecast. In my view, an appropriate policy would be one that moves inflation systematically lower over the next several years and one that makes that objective explicit. This approach would certainly affect the inflation outlook for 1998 and 1999 and quite likely for 1997 as well. In fact, under such a policy regime our forecast for 1997 CPI inflation would be considerably lower than the one we actually submitted. But if I submitted that lower number knowing the FOMC has not shown much inclination to pursue the policy regime I just described, and let us say some other members did as well, what would be the result? The forecast range and perhaps the central tendency of the forecasts submitted by the members would be biased downward. It would look as if the FOMC as a group is more sanguine about the inflation outlook than it is in fact. I think we need to be concerned about how the public interprets these forecasts, because they could be used to decipher our implicit inflation objectives. What did the public learn from 1996? In February, we projected CPI inflation in a 2-1/2 to 3 percent range. As the year progressed, both output and inflation came in well above expectations and long-term bond yields rose, yet we took no policy actions. Instead, we raised the CPI inflation forecast in July to a range of 3 to 3-1/4 percent. So, what is the message about our inflation objective? I think one could conclude--I don't say I believe this--that we seem quite complacent with CPI inflation at or even above 3 percent, which I think is an unfortunate conclusion. In my view a far better approach would be for us to specify our definition of price stability. Presumably, it would be less than 3 percent. Some of us had suggested a 0 to 2 percent range, the midpoint of which happens to coincide with the Boskin Commission's estimate of the upward bias in the CPI. Setting such a longer-term objective and a timetable to achieve it would make our forecasts more meaningful for the public and ourselves. Thank you.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. The economy in our District continues to do well. Our directors and other contacts report solid growth throughout the District. Manufacturing remains quite healthy. Construction activity, while off slightly due to weather conditions, is keeping pace with activity of a year ago. I might mention that who is involved with indicated that they had a very strong year. covers much of the western part of the United States, and what is happening to them provides a pretty good idea of developments in the area's economy more generally. I would like to share some of that. In terms of monthly year-over-year data, had increased more than 6 percent for the sixth consecutive month in December. Shipments of the leading commodity groups were all posting increases, with energy products up 11 percent--a lot of that being coal hauled out of Wyoming. Intermodal shipments were up 8 percent; finished automobiles were up 4 percent despite some lingering effects of the auto strike, and automotive parts were up 11 percent. This activity continued through January, and while results were under budget last month they would have been on budget except for the weather conditions in the western part of the system. So, with this very good start for 1997, they are looking for a very good year again.

Reinforcing this generally favorable information from our District and from particularly, we also saw some pretty sharp increases in District employment for both October and November. And on the basis of some of the anecdotal information we are getting, such increases seem to be continuing in December. In our region's energy sector, drilling activity is up significantly over a year ago because of the effects of the cold weather on oil prices. Retail prices, I must continue to report, are not showing any sizable increases, but wage pressures continue to be reported in our labor markets and these are becoming more prevalent.

On the national level, while I may differ on the components, I am in broad agreement with the outlook presented by the staff here today. In particular, I expect real GDP to grow at or slightly above its long-run potential this year and on into next. With GDP growth coming in faster than expected in the fourth quarter of last year, I think the economy is further beyond its long-run production capacity than we thought in December.

I want to make one specific observation on the topic of inflation. Coming back to my question earlier to Ted Truman, I have some concern that the energy price increases that we saw last year may not be as transitory as we may have thought. Energy prices may come down but perhaps not as much we had originally thought, given some of the conversations we have had with contacts in the energy industry. I also am concerned that the moderation in compensation costs, particularly in the benefits areas, may be reversed as we go further into this year. Looking ahead then and given the current stance of policy, I would expect the economy to continue to grow above trend, perhaps only slightly so, and inflation to creep up systematically as we look forward to the next 12 to 18 months.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. New England's economic picture remains much the same. It is characterized by slow, steady growth overall and pockets of weakness in Connecticut, Maine, and Rhode Island that are offset by islands of strength, notably in Massachusetts. Overall employment growth is modest at a rate only about half that for the country as a whole. At the same time, unemployment rates are low and labor markets are very tight in certain areas, particularly for certain skills. This situation is especially true in the greater Boston area and some other areas in Massachusetts, where local labor markets have unemployment rates in the 3 percent and the low 4 percent areas. Rates this low were last seen there in the late 1980s. Added to this in the Boston area, we have rising consumer prices, rising housing prices, very low commercial vacancy rates, anecdotal reports of lowering credit standards and terms, and the general ease of financing just about anything. So, we get a picture of an economy--at least in the Boston area--that is poised for a boom.

Despite this, wage pressure seems small. Average hourly earnings in the region increased only 2 percent or so over a year ago, and the rise was even smaller in Massachusetts. Our contacts suggest that wages will rise 3 to 4 percent in the coming year, with some outliers--especially in manufacturing--granting higher increases. Benefits cost increases, however, are expected to be small, with actual decreases in workers' compensation costs.

Some of the anomaly of a growing, and in some areas close to booming, economy and very low wage increases might be explained by several anecdotes we have heard recently. At our regular New England council meeting--this is a group of small business people with some labor and social services representation--a common theme developed. In every case the small business representative, whether in the automobile, the jewelry, or the measuring devices industry, reported intense pressures from all their customers--particularly large customers but not just the GMs or the Wal-Marts--not just to hold the line on prices but to lower them year after year. In another conversation with a local consultant who does a lot of work for

I was told that cost plus is no longer used as a method of setting prices. Rather, follows a price-minus policy, which looks to adjust internal costs and prices paid to suppliers to maintain or improve margins in a constant final price environment. Clearly, the pressure that large customers exert on smaller suppliers in New England is limiting what price increases they can charge, what prices they will pay suppliers, what margins they earn, and what wage increases they can afford to pay employees. But these companies also face tight labor markets for skilled workers, even in small businesses. Even sophisticated clerical workers now are getting too expensive for some of these businesses. So, there is a considerable tension building, and I think we had a greater sense of that in our last meeting than we have had before.

I believe there are similar tensions on a nationwide basis, and they are very evident in the forecast provided by the Greenbook, in the data compiled locally for our own Humphrey-Hawkins forecast, and in many commercial forecasts. We are not as pessimistic about productivity as the Greenbook authors, and we are projecting somewhat higher potential growth rates. So, by 1998 our unemployment forecast does not drop down to 5 percent. However, even with that, we see trajectories for the core CPI and the ECI quite similar to those suggested in the Greenbook--a decided upturn in those measures of inflation. We do not see inflation rising now, though there are certainly signs of wage pressures. But given the solid path of economic growth suggested by the employment data, increases in personal income, rising consumer confidence, continuing business investment, liquid financial markets, and increased consumer wealth, we are led to expect very definite signs of capacity pressures on the economy that will lead to rising inflation. I recognize that there are restraining influences in the foreign sector, in government spending, and perhaps in residential investment, but I am impressed by the fact that the surprises in 1996, if one looks at the year as a whole rather than quarter by quarter, have largely been on the upside. It is hard to believe that the tensions within the economy are not building. The issue would seem to be when to address them.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The reports on the Second District's economy have been steady to slightly stronger in recent weeks. The region's job market, which had shown some signs of slowing in September and October, picked up a bit in the final two months of 1996. In New York State, private nonfarm payrolls grew at an annual rate of 1.1 percent in November and December versus 1 percent in the prior two months. Total payroll employment grew at a modest 0.5 percent annual rate in both of the last two months of the year, held back by ongoing downsizing in government. The unemployment rate drifted up from a 6-year low of 5.9 percent to 6.1 percent, but the entire increase was due to faster labor force growth. In New Jersey, private nonfarm payrolls grew at a 2.6 percent annual rate in the final couple of months of 1996, up sharply from earlier in the year. As in New York State, however, sharp declines in government employment restrained overall job growth to a still quite brisk 1.6 percent. The state's unemployment rate is 6.2 percent.

Consumer spending seemed to be rather good. Major retailers reported that holiday sales in the region were on or above plan, with November-December same store sales running 5.8 percent above 1995. Post-holiday sales seemed to be quite strong. A separate survey of small retailers across New York State showed same store sales up 4 to 6 percent from the comparable period in 1995, with even stronger reports coming from Manhattan. Sales there were perhaps not unrelated to the earnings in the securities industry; apparel and jewelry sales were particularly strong. New York State decided to take a 1-week vacation in its 8-1/2 percent sales tax and that helped to clear out the stores in the third week of January. Big-ticket durables, however, were somewhat slower sellers, especially furniture and electronics. Discounting by the retailers was lower than was required in the previous year, and so their earnings seemed pretty good.

Residential real estate markets are gaining momentum, led mainly by the multifamily sector. The apartment market in New York City is getting quite strong and the prices of New York apartments are going up. Another indication of the same sort of phenomenon is the old masters' sale at Sotheby's last week, which brought prices that were far above the expectations going into the sale. The office market in Manhattan continues to improve. The New York District therefore is looking rather good. The inflation rate for the greater New York area--2.9 percent for Q4 to Q4 in 1996--is a little better than that for the country as a whole.

On the national picture, we think GDP growth will moderate substantially from the unsustainable 4.7 percent rate in the fourth quarter of 1996. Consumer spending started the year with little forward momentum; housing is edging down; and we think fourth-quarter activity in nonresidential construction and foreign trade borrowed from the future. So, the central tendency of growth still looks to us to be near 2 percent, with a gradual drifting down as time passes and the expansion ages further. Under that scenario, the unemployment rate in our forecast remains in the vicinity of 5-1/2 percent. We think GDP is likely to grow at a very slow rate of about 1-1/2 percent this quarter. We do not think that there are any fundamental forces at work that are likely to cause a significant deviation from potential growth, which we put at 2 percent. Inflation both for prices and overall labor costs remains somnolent. We still see significant risks of some acceleration in inflation largely because average hourly earnings growth has picked up noticeably, and we do not have the data yet to see whether that is being financed by improvements in productivity. The more comprehensive wage components of the ECI exhibit less acceleration. The increase in the fourth quarter of last year matches a seasonal pattern, and therefore I am not sure that one should multiply it by four.

We continue to be very concerned, as we have been all year and as I think is appropriate, that the risks of inflation are on the high side. But in the context of the comments that some others have made about their Districts so far, I think one has to be very careful to distinguish between the risk of inflation and seeing it as a reality. We do not see it yet as a reality. Nor do we see the raw ingredients in labor markets, commodity markets, or other markets providing the warning signals that would tell us that inflation is close enough on the horizon to indicate that preemptive action is required at this time. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Thank you, Mr. Chairman. The Philadelphia District economy is growing moderately overall, with some strong areas and tight labor markets in central Pennsylvania, some Philadelphia suburbs, and Delaware. The rest of the District is improving for the most part but more modestly. Although there are examples of large wage increases, the general situation is still one of moderate wage hikes and subdued price increases. One sector where significant strengthening may occur is in commercial construction in the Philadelphia area. Current market values for commercial buildings have been well under replacement cost values for six or seven years. Current market values are now approaching replacement cost values in the faster growing suburbs of Philadelphia. Build-to-suit construction is picking up, and there is talk of the emergence of some speculative building. There is still caution from lenders and that is a constraint. REITs have been back for a while and reportedly are pushing up the values of some buildings. Given the time lags that are involved in purchasing land, zoning, permits, et cetera, the real strength in construction probably will not be in evidence until 1998 or 1999.

Turning to the nation, we clearly have a robust economy. The rapid pace of the fourth quarter is not likely to carry over in the near term because of slackening net exports. Nonetheless, there is an underlying momentum that is likely to keep growth at least on a moderate path.

On inflation, the basic question is whether we believe the models, which are based on past experience, or whether we believe that the most recent experience of remarkably good price behavior will continue in the future. We can speculate, but we do not know the answer to that question, and that is why "wait and see," despite its risks, is still a reasonable course for now.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. On the national economy, our estimates are very similar to the broad outlines of the staff forecast in the Greenbook. We are right on with real GDP, while our inflation and unemployment forecasts are just a little higher. There are a number of risks in these forecasts, however, and on balance those risks probably are slightly on the upside. With regard to one upside inflation risk, our conversations with people in the energy industry tend to support what Tom Hoenig said about widespread doubts that the prospective decline in energy costs is going to offset the earlier increases fully. The decline is likely to be a partial rather than a full offset. Furthermore, people do not expect the full amount of a decline in wholesale crude oil prices to be reflected in retail prices because of the tightness of refinery capacity all over the world. Another potential upside source of inflation is the decline in bond yields over the last half year and its effects in boosting aggregate demand in 1997. Fiscal policy may provide less of a drag on household spending with the end of the retroactive phased-in income tax boost that resulted from the 1993 budget agreement. The disinflation in medical costs seems likely to slow or come to an end fairly soon. It's hard to imagine it continuing at its recent pace. The rolling regional recessions of the last 20 years seem to have ended. All regions of the country appear to be in an expansion mode right now, and the ability of labor and other resources to move and damp the impact of shortages in certain parts of the country would seem to be more limited. We are feeling the effects of that in Texas now, where the reduced inflow of labor from the rest of the country and from Mexico is slowing our labor force growth and putting some limits on our output growth.

A federal budget balancing deal could cause a bout of exuberance in the bond market and could provide added upward momentum to the economy and equity markets. On the other hand, with regard to downside risks I didn't know that economists had a third hand until today--[Laughter]

MR. PRELL. We get desperate sometimes.

MR. MCTEER. It reminds me of the joke about the three kinds of economists--those that can count and those that cannot.

MS. RIVLIN. That is a new low in economist jokes. [Laughter]

MR. MCTEER. It has the virtue of being very short. On the downside, high debt burdens may induce households to restrain consumer spending. Banks are just beginning to get serious about tightening their consumer credit lending standards. The higher dollar and falling oil prices should restrain price pressures. The broader measures of inflation suggest more subdued inflationary pressures than are reflected in the overall CPI. Along the lines of what Bill McDonough just mentioned, "pipeline" inflation pressures do not seem to be there. Commodity prices, in particular the price of gold, do not indicate much in the way of coming inflationary pressures.

Turning to the Eleventh District economy, it has changed little since the December meeting. Employment growth has slowed over the past few months and now seems to have converged toward the national rate. District employment growth was at a 2 percent annual rate in the fourth quarter versus about 1.7 percent nationally. As I mentioned here before, typically Texas and the Eleventh District economy more generally have higher employment growth than the national average but also higher unemployment growth because of the inflow of labor from other parts of the country and from across the Mexican border. The health of the California economy in particular and the rebound in Mexico have diminished that inflow, and our employment growth has slowed but our unemployment level also has gone down considerably this year. Labor shortages and tight labor markets rather than weak demand seem to be driving the slowdown in employment growth in our District.

The energy sector has been running at absolutely full capacity for about a year now, with shortages of most types of drilling and maintenance equipment becoming more and more widespread. Companies are either trying to increase capacity or to stop producing products with relatively low profit margins. In our Beigebook survey, we had one interesting anecdote about a service company for the oil industry. They gave up on their attempts to hire local machinists and started importing them from England. They also wanted to expand capacity so their optimism led them to rip out their racketball court and put that part of the building into production. But their caution led them not to want to expand their building beyond its present footprint, so they limited their expansion to the area of the racketball court that they already had under the roof.

Labor market tightness has not eased. The unemployment rate fell throughout 1996 in spite of reports that a number of Texans are leaving the welfare rolls. I don't know whether they are leaving the welfare rolls because of the changes in welfare programs, but they are doing so in fairly large numbers. Reports on price pressures have been mixed. The people who conduct our Beigebook survey tell me that they are hearing more stories of price increases lately, but new capacity in construction-related industries has eased price pressures, particularly for cement. All things considered, the Eleventh District economy is in quite good shape and is expected to remain so.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you. I am hard pressed to report anything new with regard to the Ninth District economy. Overall, the economy is healthy, labor is in short supply, and the weather is lousy even seasonally adjusted. [Laughter] One interesting anecdote came from a couple of business people who reported that they have postponed expansion plans because they cannot hire laborers. That implies, of course, that they have been unwilling to pay the higher wages that presumably would enable them to hire those workers. They have not articulated the reasons why they have been unwilling to pay those wages. I assume it has to do with their estimates of the cost implications and what they think they can get in terms of pricing. In any event, a labor shortage clearly has been a factor for some time, and we have had some further reports of that.

As far as the national economy is concerned, I do think the growth of the real economy will slow to trend in 1997. From my perspective, however, that is perhaps not as favorable an outcome as it seems because my suspicion is that aggregate demand will continue to rise more rapidly than trend. I have what is essentially a supply-constrained forecast. That is, I do not think productivity will rise rapidly enough in 1997 to offset slower growth in the labor force and employment. If my assessment that demand will continue to increase more rapidly than supply is correct, then the risks of more inflation clearly are there and will intensify.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. I would dearly love to say something startlingly different, but I think I would have to be living in a different country. We really do seem to have accumulating evidence of a quite consistent picture. The strong growth in the fourth quarter, like the strong growth in the second quarter, clearly will not continue and will be followed by a significantly weaker first quarter. This back-and-forth pattern not only in growth but in some other statistics is superficially confusing, but overall we are getting a remarkably consistent picture of healthy and very broadly based economic growth, geographically and industrially. It is a more solid picture than I think we felt we had six months ago, but it is no roaring boom either. Tight labor markets are reported almost everywhere, wages are creeping up, increases in benefit costs are leveling out but the growth in such costs is likely to turn up and to rise more sharply as we get to the end of the shift in the provision of health services to managed care. The productivity data remain significantly mysterious; the low increases do not seem to fit with other indicators.

I have no major quarrel with the staff analysis or forecast. I might be a tad more optimistic about the prospects for relatively gimmick-free deficit reductions than they say they are, including something in the legislation that would contain significant Medicare and Medicaid restraints that might continue into the future. That certainly would be a desirable outcome and the bond markets probably would respond to it. I think, incidentally, that this good news might be threatened by the passage of a balanced budget amendment. I agree with the staff that the amendment is not likely to pass, and that probably would be a good outcome. I would be surprised if the unemployment rate got down quite as low as the staff forecast indicates. On the other hand, I share some of the nervousness about oil prices, which might feed into slightly higher inflation than the staff forecast.

The question before us as it was the last time is really how long we can expect this very favorable set of indicators to continue. I would agree that the risks are on the upside, but nothing suggests an imminent danger of inflation taking off. So "wait and see" is a plausible strategy, but if we really believe the staff forecast, and on the basis of what almost everybody has articulated around this table we do not differ all that much, the real question is whether we are taking a risk of waiting too long to tighten. The question remains: Is this low inflation with tight labor markets sustainable; is it a new situation that could persist; or is it some kind of temporary adjustment at the end of which more normal relationships will reassert themselves? If the latter is what is going to occur, we should be thinking ahead to what those normal relationships have always been.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. In the midst of the enormous plethora of data and impressions that one is subjected to, I have been asking myself what developments over the recent past seem to be significant. I would like to list six things--three of them because they are moving and three because they are not.

First are the three that seem to me to be moving, and I would have to put wage pressures at the top of that list. It seems clear that those pressures are present and probably are strengthening as time goes along. Where that is really important is in what it implies for unit labor costs, and I don't think that is quite as clear. I would like to know how many stories like are out there. I particularly like that example because I once ran plastic moldings plants and I understand them. I don't know how widespread that is and I don't know how productivity and these wage pressures interface, but that is a very powerful input, whatever it is, and it does seem to be moving in the direction of more pressure.

The second thing is the fourth-quarter GDP, particularly the message there that the consumer is back. The question is whether this strength in consumer spending is going to hold up and be long-lasting or whether it is just temporary and will follow the saw-tooth pattern that we have become familiar with throughout this expansion. Here again, I think we have a very powerful force, but one that at this point seems to me to be completely inscrutable. Consumer confidence, the wealth effect, and job formations seem to indicate that it might have staying power. On the other hand we have the high level of consumer debt and a question as to whether or not there exists a great deal of pent-up demand. Those questions would indicate that GDP growth might fade back to a sustainable rate. If some of the supporting factors start to go away, like the wealth effect through a stock market break, consumer expenditures could actually fade to less than a sustainable level and could become a possibly serious downside risk at some point.

The third thing is the recent movement of the dollar. As we know, the stronger dollar should tend to weaken exports. It also should tend to hold inflation in check.

There are three important things that do not appear to me to moving much. I would mention first the large number of inflation indices. We are all focused on the CPI; we have been talking about it a lot, but it is not necessarily that typical. There are many other price indices that are not moving up and indeed a number that are moving down. Now, that is not determinative in and of itself because the Committee has worked ahead of those series in the past, and I am sure it will again. I think it is significant that subdued inflation has been the trend for many quarters now. It has persisted in the face of what we have regarded over some long period of time as being considerable upward pressure, and yet inflation by these measures still stays pretty much the same. This raises a lot of questions in my mind about what may be going on in the economy, and I would love to get some answers somehow. I don't know if we will.

Another thing that does not seem to be changing much is that no new driving forces appear to be emerging. There are no new engines that seem likely to push the economy toward either consistent strength or weakness. We seem to be enjoying an extended stay on the mountain top that Governor Meyer mentioned a week or two ago, and who knows how long that may last.

Lastly, it does not seem to me that we have much pressure on capacity utilization, and without that I wonder how much inflationary pressure is likely to emerge in the economy. My bottom line is that I am very nervous about what may be happening as a result of the tight labor markets and the associated wage pressures. At the end of the day that may be more important than the other five factors or anything else. An enormously important question in my mind is the enigma of the consumer. I guess we will just have to wait and see how much that potential strength stays there. All in all, I continue to think that it makes sense to wait and see.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. As almost everybody has mentioned, the economy ended 1996 on a strong note. The question now is whether this is just a single burst of energy and the economy is about to settle down to the proverbial sustainable path, or does this burst of energy portend a stronger growth path that will strain resources and lead to inflationary pressures. I think there is a corollary question relating to the high level of economic activity at year-end, namely that even if the economy does return to a sustainable growth path, will we be seeing pressures because the economy is operating at such a high level, thus straining resources. During the current expansion, which is now in its sixth year, we have had several of these strong growth episodes and it is probably fair to say that monetary policy has had a lot to do with these above-trend bursts, particularly through at least the first half of 1996. So, it is up to us to make some kind of assessment of the current uptick in economic growth.

The arguments for a return to the sustainable path that are presented in the Greenbook analysis are reasonable. Exports, which accounted for much of the fourth-quarter growth, are unlikely to provide a sustainable boost. There were a number of unusual factors in the fourth-quarter trade results, and going forward the strength of the dollar makes U.S. goods more expensive. Turning to spending, although consumer spending was strong in the fourth quarter, consumer debt may provide something of a constraint in the future. This expansion is a bit too "long in the tooth" to look to pent-up demand and in particular to leveraged consumer spending on large items. On a related front, housing activity seems to have slowed recently, but I believe that the fundamentals are strong enough at least to allow housing to contribute to sustainable economic growth. Most forecasters have been looking to a slackening of business investment. Many businesses probably also recently expanded capacity and replaced equipment. So, it is questionable as to how long we are going to see large increases in business investment. I suppose that computers and communications equipment are the exception. They seem to involve a bottomless spending pit. Again, spending in this area should at least be adequate to keep us on a sustainable growth path. On the other hand, fiscal policy is likely to be a bit of a constraint.

Having bought into the arguments for a slackening of growth going forward, let me hasten to point out that there do remain some significant areas of strength in the economy and there may be some room for surprises. First of all, the labor market continues strong. Even if we do not get to that 5 percent unemployment rate forecast in the Greenbook, it is still a strong market. Although some households may be constrained by their personal debt levels, it seems reasonable to expect consumption to continue at a level at least in step with income growth. In view of the strength of income of late, consumer spending could feasibly create unanticipated demands. I think confidence measures support this scenario.

In another area, business investment has been a consistent surprise during this expansion and consistently underestimated. The same fundamentals that brought these surprises could still be present. These include strong profits and cash flows, the low cost of capital, a ready availability of credit, falling computer and communications equipment prices, and the emphasis on efficiency and productivity that has inspired a number of firms to continue to invest.

The stock market is another area where we always have to say that there is room for surprises. Either we have an irrationally exuberant market or it is fundamentally driven. No matter what the verdict, either could provide continued sources of investment funding for firms and the wealth effect should continue to support consumer spending.

Where does all of this leave us with respect to inflation? Although recently it has been benign, it is hard to believe that we can continue to enjoy this Goldilocks, just-right economy forever without feeling inflation pressures. Wage pressures already are being reported anecdotally and are showing up in wage and compensation statistics. Benefit cost constraints may have run their course. Maybe employers can make up the increased costs through productivity, but it is hard to count on this very broadly in view of the recently disappointing statistical history of productivity. The staff is now suggesting that they are being optimistic in estimating the new trend growth line at .9 percent. Energy costs--and several people have mentioned this--also have the potential for sustained pressures if crude prices do not fall back as forecast. I think the jury is still out there.

In sum, I think the arguments for a return to a sustainable trend level of GDP growth are fairly persuasive, but there are reasons to believe that the probabilities of stronger growth accompanied by building price pressures are increasing.

CHAIRMAN GREENSPAN. Governor Meyer, you are the cleanup hitter.

MR. MEYER. Thank you, Mr. Chairman. The fourth-quarter GDP report marks an extraordinary end to an extraordinary year. The defining feature of both the fourth quarter and the year as a whole was a pleasing combination of higher-than-expected growth and lower-than-expected inflation, including declines in core measures of inflation. How did we do it and can we do it again? Three developments I think contributed importantly to the extraordinary performance last year.

First, a sharp rebound in the participation rate and hence in labor force growth prevented the strong output growth from pushing the unemployment rate even lower and thereby pressuring inflation. Second, a coincidence of what I would refer to as positive supply shocks, including the further slowing in the rate of increase in benefit costs, the decline in nominal import prices, and the sharper-than-normal decline in computer prices collectively restrained core measures of inflation. And third, the level of NAIRU may have declined or at least we came to recognize during last year that NAIRU had recently declined from its average level over the last decade.

The message here is that while we should certainly celebrate last year's remarkable performance, we should not expect to repeat it. Growth must now slow or the risk to inflation will become unacceptable. True, I came with this message last July, but now I really mean it.

[Laughter] I also said then that even if growth slows to trend, there will remain an inflation risk from the prevailing low unemployment rate. Still, the immediate prospects are for a benign economy in the near term, assuming, of course, a significant slowing in growth and thanks in part to inertia in the inflation process and a projected reversal of last year's decline in oil prices. I am still in the camp of those who firmly expect a decline in oil prices.

The unexpected strength of fourth-quarter growth does, however, put back into the picture what I have referred to as the growth risk in the outlook--the risk that going forward growth will remain above trend and push utilization rates even higher beginning from a level already at or beyond capacity. To be sure, the growth in several components of GDP in the fourth quarter, specifically in consumer services, nonresidential structures, and exports, is unsustainable, and there is little doubt that the expansion will slow as a result in the first quarter. The surge in net exports, the most important contributor to the fourth-quarter growth spurt, in my judgment reflects importantly the residual seasonality in that component. But this means that the sharp rebound in net exports posted in the fourth quarter more likely occurred more evenly over the entire year. The bottom line is that although the fourth-quarter growth rate may be biased upward, the growth over the entire year is not.

In light of the likelihood that several components of GDP posted unsustainable spurts in the fourth quarter, I am comfortable with the staff forecast that growth is likely to slow to near 2 percent or even below in the first quarter. Still, what happens in the first quarter is not the key to the forecast. After all, growth over 1996 proved unusually bouncy--2 percent in the first quarter, 4.7 percent in the second, back to 2.1 percent in third, then back to 4.7 percent in the fourth. Reverting back to 2 percent in the current quarter will not, therefore, settle the bigger question: What happened to the second half slowdown and how confident are we that the economy will slow over 1997? If we could correct for the residual seasonality in net exports, we might actually see the second-half slowdown. At any rate, as my former partners at Macroeconomics Advisers have noted in their most recent weekly commentary, the second-half slowdown is evident in a variety of measures of economic performance not directly polluted by net exports--for example, industrial production, payroll employment, aggregate hours worked, light vehicle sales, housing starts, personal consumption expenditures, real gross domestic purchases, and real final sales to domestic purchasers.

On balance, therefore, I still view the economy as having slowed over the second half of 1996 and this helps me to be comfortable with a forecast of a further slowing to a 2 to 2-1/2 percent rate over 1997. This judgment is reinforced by my expectation that federal purchases and net exports will decline, that inventory investment will trend lower, and that key cyclical sectors such as housing and auto sales have achieved cyclical peaks and will decline at least modestly. However, I continue to believe that the most serious risk to the outlook does not come from continued above-trend growth but from the possibility that we are already operating above capacity and face as a result a gradual but progressive worsening of the inflation outlook.

My interpretation of inflation for the year is that, while sharp increases in food and energy prices boosted overall CPI inflation, the coincidence of positive supply shocks that I mentioned earlier put downward pressure on core inflation. I do not believe, therefore, that the decline in core inflation experienced over 1996 suggests that NAIRU is below the 5.4 percent average unemployment rate for the year. I suspect that NAIRU, at least for the near term, is near 5-1/2 percent. Assuming the coincidence of positive supply shocks will not be repeated this year, at least not as uniformly as last year, I expect an increase in core inflation even if the unemployment rate stays at its current level. Cost pressures on firms nevertheless appear to be well contained, given the modest acceleration of compensation over 1996 and the absence of pipeline inflation pressures coming from core intermediate and crude components of the PPI. Still, the acceleration of wages over 1996 indicated by the fourth-quarter ECI report is consistent with tight labor markets and prevailing excess demand. Some further acceleration of wages combined with a rebound in benefit costs certainly supports the staff forecast of an increase in the rate of compensation over 1997 to 3-1/2 percent from the 3.1 percent posted over 1996. The staff forecast is for slightly above-trend growth over 1997, a further decline in the unemployment rate to 5 percent, and a gradual upward creep in inflation that does not take on worrisome proportions until 1998. It is still a pretty benign outcome for 1997, with inflation measured by both the overall CPI and the chained GDP price index projected at just a shade above 2-1/2 percent. Still, the main message is that the unemployment rate is about to move still further below NAIRU and as a result inflation pressures are likely to build over the forecast horizon. However, because of the inertia in the inflation process and the reversal of energy prices in 1997 the consequences will not be very evident until 1998 and beyond.

Relative to the staff forecast I expect slightly slower growth over 1997 accompanied by a nearly stable unemployment rate. On the price side, I anticipate something close to the staff inflation pattern through 1997, including a small rebound in core inflation and a decline in overall consumer price inflation. I do view the risks relative to this forecast to be somewhat asymmetric, with a slightly greater risk of above-trend growth and a greater risk that we are already below the NAIRU.

CHAIRMAN GREENSPAN. Thank you. We are only six minutes over schedule, which is quite remarkable.

MS. MINEHAN. We are short two governors.

CHAIRMAN GREENSPAN. They took that into consideration. Unlike President McTeer's economists who may or may not be able to count, these guys can count! We adjourn until 9:00 a.m. tomorrow morning.

[Meeting recessed]

February 5, 1997--Morning Session

CHAIRMAN GREENSPAN. Good morning, everyone. Brian Madigan, would you start us off, please?

MR. MADIGAN. Certainly, Mr. Chairman. I will be referring to the package labeled, "Material for Staff Briefing on Annual Ranges." [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Brian?

MR. JORDAN. Brian, if we were to have a multiyear horizon as our objective for getting to price stability, perhaps along the lines of the price stability alternative in chart 2 of the Bluebook, money growth would be slower in that environment, based on current relationships. Whether inflation, properly measured, is 2 percent or 3 percent, we do not know. We know there are measurement errors that affect the implicit price deflator and other price indexes, but the answer is going to be 2 or 3 percent. Based on the information you have now, whatever assumption you make about own price and the evidence about how the Treasury yield curve behaves relative to the funds rate, how confident can you be that if we maintain a 5-1/4 percent funds rate, there will not be a deceleration of M2 growth consistent with a policy of moving to price stability?

MR. MADIGAN. Given our methodology for forecasting, I think that really is a question about how confident we are that nominal GDP growth would behave as projected in the Greenbook. We forecast money demand by looking at growth rates of nominal GDP, making an adjustment for projected movements in opportunity costs consistent with any changes in interest rates. Obviously, the staff could be wrong, and one source of error in projecting money demand or money growth would be our assessment of the likely growth in nominal GDP that would be consistent with a 5-1/4 percent funds rate. Another source would be errors in projecting money demand itself, given a forecast for nominal GDP and interest rates. Clearly, we are still very uncertain at this point on that score.

MR. JORDAN. But we can distinguish among forecasts of nominal GDP. We do not target nominal GDP, but you can say there is an implicit nominal GDP target if you have a price stability objective. If you say your objective is to get nominal GDP growth down to the area of 2 to 3 percent and if your analytical framework tells you that M2 growth also would be around 2 to 3 percent, then you can at least run the intellectual exercise as to what kind of interest rate path would be consistent with producing that outcome. In Gary Stern's words yesterday, if we have a supply-constrained economy, then to get to price stability our task is to constrain nominal demand growth to a rate consistent with that aggregate supply growth.

MR. MADIGAN. Yes. Certainly in the steady state, if you will, when price stability is achieved we would not see a 5-1/4 percent nominal federal funds rate as consistent with that outcome. I guess the question relates partly to what federal funds rate path will take us to a steady state with price stability. Chart 2 in the Bluebook presented one scenario where we gave what we consider to be our best shot at projecting that sort of interest rate path. That involved, as you know, a considerable increase in the nominal and real federal funds rates over the next year or two and then a reduction in the nominal funds rate as inflation came down.

MR. JORDAN. Okay, but chart 2 was developed within the NAIRU framework and the assumption that we know where the NAIRU is and where the current rate of unemployment is relative to it. I am asking you to think through the exercise for us and abstract from that. Have you or can you simply run through those interest rate alternatives presented in chart 2 and, based on the statistical relationships in a money demand-opportunity cost framework, trace out what kind of money growth would be produced? That is just an exercise.

MR. KOHN. I guess I am a little unclear about what you are proposing, President Jordan. In the staff's view, you would have to raise interest rates considerably to get the lower nominal GDP growth that you want. If you are asking us what would happen if hypothetically nominal GDP simply decelerated with the funds rate being held at 5-1/4 percent, obviously money growth would come in lower. That I agree is an arithmetic problem that we could solve. If we were to raise interest rates as in the chart 2 case, money growth as Brian said would come in even lower because we would be moving along the money demand function at the same time.

MR. JORDAN. Okay. We have run the exercise at our Bank where, if we take your price stability path and those related interest rate movements that we can pick off of chart 2, we produce an M2 growth of about 1 or 2 percent in about 3 or 4 years.

MR. KOHN. That is totally plausible to me, given that we had 3-1/2 or 3-3/4 percent M2 growth associated with the smaller increase in the federal funds rate in the stable inflation alternative. So, lower M2 growth could well be associated with those higher interest rates.

MR. PARRY. I think that the Bluebook with these alternatives was very helpful this time. Certainly, it provided a great deal of information about some of the issues that were raised in previous meetings and that we clearly are interested in. Don, there is one thing that I wanted to ask about chart 2. In calculating the real rate of interest, you used the PCE excluding energy. I know you cannot be completely comfortable with that measure because of the kind of real rates that it produces, particularly at the present time. The surveys, of course, indicate expectations of about 3 percent inflation one year ahead. Do you have any comments about some alternative price measure that would be a better approach to real rates than this PCE measure? I ask because I think that measure is very misleading?

MR. KOHN. I agree and we tried to convey that point in a long, complex footnote. Maybe it was hard to read through. I will be covering it in my briefing as well, President Parry.

MR. PARRY. Okay.

MR. KOHN. But I agree with you. I think that it is very likely that people, in forming their price expectations, look at the whole array of prices that they are paying and not just at the core measures. To us, the core PCE was a little more revealing of the underlying sense of what was happening to inflation, and it abstracted from CPI measurement changes and related problems. So, the core PCE was better from that perspective, but I agree that it overstates the decline in real rates in 1997. If you use total PCE, you see that real rates actually change very little in 1997. Indeed, they rise a little because of the assumed decline in energy prices, which depresses total PCE or total CPI. Real rates would then go down in 1998 as the total PCE starts to trend up again. But in 1997, it looks as if real rates actually rise a tick, if you just literally use the total PCE rather than the core PCE.

CHAIRMAN GREENSPAN. Any further questions for Brian? If not, let me start off by saying that I do not see any significant change from the dilemma we have had in recent meetings on these longer-run objectives. I would stick a little bush next to the tree in Brian's chart to reverse the pattern slightly. [Laughter] The moment that we alter the long-term ranges, we are effectively saying that M2 is back in play. We then have to start to evaluate how the markets will respond to what we are saying. If we go to Bluebook alternative II, which implies the monetary aggregates are back in play, that raises the question of whether we are willing to sanction what amounts to nominal GDP growth of perhaps 6 percent with the implications that has for prices. I seriously question whether we would gain anything of value in monetary policy debates.

Looking at the other chart that Brian put together, aside from its wonderful colorfulness, it does show something really fascinating--which we suspected a couple of quarters ago--namely that the slope of the new curve seems to be very close to the slope of the old curve. The presumption that what we have is merely some form of dummy variable type shift is not contradicted by those data, and indeed we may go back to where we were. You may recall that the last time we had this discussion the staff forecast for M2 was toward the upper end of the 1 to 5 percent range, and indeed the staff came out right on the button. The reason they did is that they assumed the new relationships, and indeed the new relationships have held.

I think there is very little to be lost by staying where we are with alternative I and watching what is going on merely because we would be indicating that the ranges are not something of significance. If we change them, I think we will put in play a wholly new set of issues that we have to address and for which I do not think we are prepared to come to any conclusion. As a consequence, I am close to where I was the last time, but I would be most curious to hear counterarguments from others.

MR. MEYER. Could I just raise a question, Mr. Chairman? When you indicated that a 2 to 6 percent M2 range would be viewed as sanctioning 6 percent nominal income growth, I was a little surprised. Would you say that, consistent with the way these ranges have been used in the past, it would take an increase in money growth above the range to justify a tightening of policy?

CHAIRMAN GREENSPAN. No, not necessarily.

MR. MEYER. You could say, after all, that the higher range is centered on 4 percent, which would be centered on 4 percent nominal income growth and on 2 percent real growth.

Could one justify a tightening of policy if growth moved toward the top of that range? That is my question.

CHAIRMAN GREENSPAN. You could, but that is exactly the type of problem I am not terribly certain we want to get involved with. In other words, why take on an added burden when we ourselves are uncertain about these relationships at this stage?

MR. MEYER. That is the key.

CHAIRMAN GREENSPAN. I do not think it conveys anything that we cannot convey by other means. Governor Rivlin.

MS. RIVLIN. I think it is really simple. It seems to me that unless we made terribly sophisticated arguments, moving to a higher range would be interpreted as less vigilance against inflation and that is not where we are.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. I can't offer a counterargument, Mr. Chairman, because I think it would be extraordinarily unwise to shift from the present ranges to the higher ones. First of all, it would give the wrong signal about monetary policy. Secondly, even on Brian's tree without your bush, we probably will need to tighten in 1997. And this would get us into a debate in which we would be talking about M's and Y's and foolishness rather than concentrating on price stability and the need to say more about the American economy. That is what I think we ought to spend our energy talking about.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, I agree with your analysis regarding M2, and I would favor alternative I pretty much for the reasons you stated. Whatever range we set for M2, though, I think we would all agree that the numerical ranges for the aggregates at this stage of the game are really not sufficient to convey completely our longer-run strategy to the public and the Congress. We have a void there. My personal preference would be for the Committee to fill the void with explicit multiyear inflation targets leading ultimately to price stability. The Committee has not been willing to do that yet. In this situation, Mr. Chairman, I think your biannual Humphrey-Hawkins testimony is the principal channel that this Committee uses to convey its longer-term strategy to the Congress and the public generally. And given that, I hope it will not be presumptuous if I make just a couple of quick suggestions regarding that testimony.

I thought your Humphrey-Hawkins testimony last July was particularly constructive because it included a fairly extensive section, you will recall, that reviewed the basis for the Committee's focus on price stability as our longer-term target. That section also asserted a couple of tactical principles to guide us in the short run: one was that we want to hold the line on inflation; the other was that we would be willing to take preemptive action, if necessary, to get where we want to go. I thought then and I do now that the discussion in that section was very helpful, very constructive, and I would urge you as a regular matter, at least for the time being, to have a section like that in your testimony as a way of building support for our long-term price stability objective and taking us a further step toward tying down longer-term inflation expectations.

With respect to the upcoming testimony, I think this would be an excellent occasion to make a couple of points. One could be to use this testimony as an opportunity to indicate the really remarkable degree of consensus among central bankers and professional economists--which I thought was especially evident at the Jackson Hole conference--that long-term price stability should be the principal goal of monetary policy. Also, I think it would be an excellent opportunity to note that this Committee has been discussing how to approach our inflation objectives for a couple of years. While we are still a long way from complete agreement on how this might be done, I think we have achieved substantial agreement at least on the point that, at a minimum, we want to conduct monetary policy in such a way as to hold the line on inflation. I thought there was really a remarkable degree of consensus about that one point at the meeting of this Committee in July. So far at least, I have not sensed any change in that general sentiment this morning. I think it would be appropriate to try to convey a clear sense of the extent and strength of this consensus, if we could. Beyond that, and here I am speaking strictly for myself, I would hope that you might consider taking the additional step of explicitly defining the line we are trying to hold with a number, specifically 3 percent on the CPI, as a way of pre-committing ourselves just a little more concretely.

In any case, I think making these points would help move us along the road over which we want to travel in the long run. Our longer-term strategy obviously must be credible if it is going to be successful. If it is going to be credible, it has to have the strong understanding and support of the Congress and the public, and I think your testimony is obviously a key vehicle for building that understanding and support. Thank you.

CHAIRMAN GREENSPAN. Let me respond briefly. I agree with everything you said, and indeed I will get to that in later remarks that relate precisely to this question. The one issue that I think we ought to begin to focus on is the suitability of the CPI as a measure of anything. The Bureau of Economic Analysis over at Commerce has long since decided that it is a flawed index, and in its PCE deflation process the BEA has deviated quite significantly from the structure of the CPI. After spending as much time as we have in looking at the biases in the CPI, we have come to view this index as going off on its own. It is becoming increasingly a political number and less an economic number. The reason I say this is that those who are making economic judgments, including the staff here, are beginning to move away from the CPI as a reliable measure or goal of inflation. So when we talk about our price objectives, I hope we will not lock ourselves into that index. I do agree that a non-numerical approach can be too vague and without merit. But there is some approach in between those two that seems far more sensible to me as a direction. That is the reason why a number of years ago I thought that defining price stability, not in terms of a number but essentially in terms of expectations and actions, was a more viable concept. Obviously, if we have a goal other than that, it has to be a number in some form. So, the only area where I disagree with the thrust of your remarks is in the implication that the CPI may be a guiding tool. I hope that within two years the CPI rarely will be discussed at these meetings.

MR. BROADDUS. Mr. Chairman, I did not mean to put too much weight on the CPI. I was really trying to emphasize that to the extent we can quantify our inflation goal that would seem to be one more step in the direction of tying down expectations. If there is a better number to use or some combination of numbers to communicate our inflation goal as you expressed it that would be fine.

CHAIRMAN GREENSPAN. My impression is that this Committee has in effect been focusing on a lot of different price indexes, and there is a growing consensus here, as you suggest, that bringing inflation down over time is healthy to the long-term growth and viability of the American economy. I agree with that consensus. As I said, I would be a little concerned about getting too explicit in putting out a number publicly. I do not mind talking about it internally. I think the more explicit we are in our discussions, the better, so that we all understand exactly where each one of us is. I am a little concerned about going public even in Humphrey-Hawkins testimony. I think we can address the issue you want addressed, and I agree that we ought to, without getting too explicit with respect to a number. If we start using a number, or any range of numbers, we will bring out of the woodwork people who want to get into what I would consider to be irresponsible debates with us. That would not do us much harm, but it would take away from the limited time that we have to do other things. So, as you know, I have always been very cautious about releasing a number to the public.

This addresses the issue that Jerry Jordan has been raising as well. I do not disagree with the concept of a reduction in inflation over time. It is just that I don't see the advantages of putting out a public timetable. I do not think the evidence suggests persuasively that doing so would affect the so-called sacrifice tradeoffs or any of the relationships bearing on our ability to bring the inflation rate down without concurrent slowing in economic activity. I think the evidence there is very muddled at best. We ought to focus on this issue, but I hope that we will not move in the direction of publishing price range targets with very long lead times. We would have great difficulty adhering to them, and I think they would make our policy of moving toward a stable price level more difficult because we would have more political problems to deal with along the way. I think we would be far better served by not creating numbers that we really cannot lock ourselves into in a realistic manner but could be forced to do so politically if we were to release them.

VICE CHAIRMAN MCDONOUGH. Can I make a comment? As I think all of you know, I have been traveling along my own road to Damascus on this issue. I believe that virtually every time I speak about anything, I refer to the theme of price stability, the wonders of price stability, and its merits for society. At a certain stage of my trip to Damascus, I thought that it would be helpful for us to establish publicly a price range objective. I have backed off from that view over time largely because, as the Chairman has been suggesting, I think that it would lock us into a horrendous political debate that would not greatly benefit the country and it would provide opportunities for those who really want to debauch the currency to come forward and have a forum in which to make their recommendations. They probably would be of more concern, or so it seems to me, than the people I sometimes describe as hairshirts who want to grind inflation down for fear of greater inflation. I think the Greenspan definition--that price stability is reached when people are not concerned about future inflation as they make their decisions--probably serves us a lot better in terms of forcing the debate in the right direction, not getting into a sterile numbers debate, and really getting to the goal we want to achieve. That certainly is pragmatism rather than anything disguised as economic theory. But having started with the notion that we would benefit from setting a number, not a specific number but a range, I now think that as a practical matter doing so could hurt our effort to achieve price stability.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I was just going to comment, Alan, that I understand what you are saying on the political side. On the other side, it seems fair to say that there is a rather large uncertainty premium in real rates with respect to future inflation. Expectations of 3 percent inflation seem to be fairly widespread, but my guess is that there is a considerable amount of uncertainty surrounding those expectations.

CHAIRMAN GREENSPAN. A 3 percent inflation rate as measured by the CPI?

MR. MELZER. Yes, I guess that is right. I'm talking about surveys; I believe some of those surveys and economists' projections are based on the CPI. But I think there is a fairly high uncertainty premium and some concern about where we are going with this. So, I believe there are some economic costs associated with our not being more explicit. There is a tradeoff between the political risk on the one hand and on the other perhaps some real economic costs associated with the uncertainty we may cause by not being explicit about--

CHAIRMAN GREENSPAN. The question, Tom, really gets down to the issue of what evidence we have that our making explicit statements actually alters that risk premium.

MR. MELZER. I understand what you said before about it.

CHAIRMAN GREENSPAN. I think that monetary policy action is what does it. There is no evidence in my experience that words have had the slightest effect. It has not helped the Bundesbank, and if it has not helped the Bundesbank, how is it going to help anybody? The Bundesbank has succeeded because it has taken effective actions. It is what we do, not what we say, that is going to matter.

MR. MELZER. In that regard you probably made the most significant point by suggesting that we ought to start with this by being more explicit among ourselves. I do not anticipate having that discussion in the next half hour or hour but in due course here. It may be something we could pursue in anticipation of the next Humphrey- Hawkins meeting. I think that getting more explicit among ourselves would be a good starting point because I am not sure everybody is on the same page with respect to where we want to go and how we think we are going to get there--over what time frame and so forth.

CHAIRMAN GREENSPAN. President Broaddus is not raising that. He is raising, I think, a more interesting question. I think everyone around this table shares essentially the same philosophical economic base. We all have the same view of how the economy functions. We have different views as to what is happening, but nobody here says that the best way to get inflation down is to rev up the economy. That indeed was once a view held by a substantial number in the academic fraternity. The argument was that an accelerating economy brought down unit costs and accordingly brought down prices. This view is rarely expressed these days, and I have never heard it expressed around this table.

MR. MELZER. I do not mean to suggest that! All I'm saying is that I think it would be useful if we were more explicit among ourselves with respect to what measures we ought to be focusing on, where we want to get to with those, and over what time frame. I think you said the same thing. You had no problem with our being more explicit with respect to using numbers internally, but politically you saw a risk in putting out a number to the public.

CHAIRMAN GREENSPAN. Yes, I think the more explicit we are internally and the more we discuss this issue among ourselves, the better. I can honestly say that if you asked me to go around the table and make a speech on this subject for everyone here that I could do it. You would be surprised at how explicit you have all been. So, I doubt that the issue is a lack of understanding of where we all stand. I think we are all pretty clear about who is where under different circumstances. No one would dispute where you are, Tom. [Laughter]

MR. MELZER. I wasn't worried about that.

MR. BROADDUS. Mr. Chairman, could I make one other brief comment? I don't want to push this too hard, and I certainly respect your views and the views that the Vice Chairman expressed as well. I would just make the point that although the actions of the Bundesbank are certainly key to their success they also have a mandate that I think is part of the equation. You are right in noting that the empirical evidence on the effectiveness of a precommitment to price stability using words is limited, but the number of data points is also limited. We really have not--

CHAIRMAN GREENSPAN. I did not say the conclusion was that it did not work. I said the evidence of it working is lacking.

MR. BROADDUS. Okay, I was just trying to soften the conclusions you draw from that point. [Laughter]

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. I think I have a somewhat different perspective on the monetary aggregate ranges, and I want to share that with you. Someone suggested that the main reason we do not want to raise the target ranges is that raising them would suggest less vigilance on our part with respect to inflation. That is not the way that I would make that decision. I think the real key here is whether we have more confidence in the reliability of M2 and its relationship to economic activity.

The important issue here is not just the target range; the central issue is the interpretation of that range. The way we are interpreting it today seems very contrary in my view to the Humphrey-Hawkins language. That language asks us, I believe, to establish a target range that is relevant to the current year and that is set in relationship to current and prospective economic developments. The way we interpret the current range is that it is relevant to a period --one that will perhaps occur sometime in the future--of price stability with normal velocity behavior. The justification for such an interpretation is very clear, namely, that it does not make sense to go back to our former practice until we believe that the relationship of M2 to economic activity is more stable. That is the key. In my view, were we to reach a judgment that the evidence was now consistent with the emergence of a more stable M2 relationship, we would have to change the interpretation of the range that we give in the Humphrey-Hawkins reports. The range that we should set would no longer be one that will be relevant to price stability at some time in the future. It should be the range for the year ahead that we expect to be consistent with prospective economic developments.

If that were the interpretation that we were willing to live by for this year, then I would say that the 2 to 6 percent range would make sense because it is centered on 4 percent: 2 percent trend growth in real GDP and a 2 percent rise in the GDP deflator, about where we have been. For those of us who take an opportunistic perspective, that is about where we are comfortable in being, and that is the sort of signal we would be giving. Now, I am willing in the near term to accept what I think is the judgment of the staff, namely, that the period of stability in M2 has been too brief to permit a firm evaluation and in particular that stability has not yet been what I would call "stress-tested" by more volatile economic times and by variations in opportunity costs. However, I think we need to continue to focus on M2 and to study its relationship to economic activity because, when the evidence does suggest that that relationship has stabilized, I do not believe that we will have an option. I believe we will have a mandate to return to the former interpretation. And when we return to that interpretation, the range that we set will become relevant. Right now we never have to change the range; we never have to discuss it. As long as we retain the current interpretation of the range, we never have to discuss it. The 1 to 5 percent range is centered basically on 3 percent, including 2 percent real growth and 1 percent measured inflation.

CHAIRMAN GREENSPAN. I am not sure anyone around here would disagree with your formulation. I ought to point out, however, that Humphrey-Hawkins also requires unemployment goals, which used to be discussed by the Administration and the CEA though I think they forgot to do that in the last couple of reports. What has happened to Humphrey-Hawkins is that many of the goals in that 1978 legislation were probably anachronisms when it was enacted. Remember, those who originally drafted that legislation explicitly took a Friedmanesque view of money relationships. They never contemplated

Humphrey-Hawkins developments involving the type of squiggly red line that Brian Madigan shows in his chart. Consequently, for us to fix on a 1978 paradigm that clearly has proved rather faulty in an historical context raises the question of whether we should slavishly adhere to something that has no legal force unless we think it is desirable. But, clearly, if we conclude that M2 is back in play, then I think the way you put it is exactly right.

MR. MEYER. Humphrey-Hawkins does not mandate us to do anything; we just have to explain why we do not.

CHAIRMAN GREENSPAN. I agree with exactly the way you formulated it.

MR. MEYER. One other thing if I might, Mr. Chairman: There has been some discussion about how explicit we ought to be with respect to inflation targets and inflation ranges. As I have thought about this, it has seemed to me that when we were very far away from where we wanted to get, a vaguer definition of price stability was perfectly adequate. And in fact such a definition was very desirable because it meant that we did not have to sit down and worry whether the appropriate index was the PCE or the CPI, and we did not have to worry about core or overall inflation or all those operational decisions. But as we get closer to where we want to be, then at least around the table, as Tom Melzer suggested, it might be worthwhile for us to share a little more what price stability means to us because I think that will help us to focus our deliberations on where we are going.

CHAIRMAN GREENSPAN. May I ask what is preventing us from doing that? Is there anything in the way we structure the meeting that is doing that?

MR. MEYER. I think in a way there is because in most of our meetings we are really focused on a decision about what to do with the federal funds rate for the period between that meeting and the next meeting and on a forecast that goes out one year ahead and at most two years ahead. The decision relating to inflation really does not come up as being relevant until we go out over a longer period. It is only at these two-day meetings where I think the vehicle is there, with our focus on the longer-term forecast, to have more detailed discussions about long-run strategy and how we bridge from our short-run meeting-to-meeting policy.

CHAIRMAN GREENSPAN. I don't think there is any disagreement about that, but let me ask you this. Does anyone have any suggestions as to how we might alter the structure of these meetings to enhance that kind of discussion? I am not aware of anything that is inhibiting such a discussion, but I want to make sure that I am not being blindsided by something. Vice Chair.

VICE CHAIRMAN MCDONOUGH. I think that we could make our meetings more of a discussion rather than a series of individual presentations. On occasion we discuss something that a member said. That has happened more this morning than in quite some time. You said something; I along with other members commented on it. We had a more useful exchange of minds and views this morning than we have had in a while, and I think that is very good. I believe it would be desirable to have a meeting structure that encourages more discussion. Part of it I think also is that the longer people are here--I have been here about five years now--the more they use shorthand. Somebody says something in about three words, and that is actually equivalent to about six paragraphs when we know, as you said, what everybody's views are.

CHAIRMAN GREENSPAN. Joke number 473.

VICE CHAIRMAN MCDONOUGH. Exactly.

MS. MINEHAN. And everyone laughs!

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I certainly support the recommendation for Bluebook alternative I and basically for the reasons that have been mentioned. It seems to me, and I would emphasize this, that raising the ranges would cause unwarranted focus on the aggregates. I am not confident at this point that velocity is sufficiently stable to warrant a change in the ranges. I also worry about the possibility that an increase would be misinterpreted in terms of our resolve to achieve price stability. So, I strongly favor alternative I.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Just to add a footnote to the earlier discussion about being explicit: We really have a remarkably good track record over the last 15 years, and I think that track record is based on a good combination of solid economics and pragmatism. It is not just the 15-year record; we have a good 5-year record, a good 1-year record. As we go forward, I think we need to be very cautious about changing the mix of what has made us successful in the past. We may need to do that, but inflation has come down, we have not had many explicit debates about what the number ought to be, and I think we have done it with deeds. This is one of those issues on which a full-scale debate could be good in an ideal sense. But this is also one of those topics that easily can be demagogued, and we can get thrown off for not very substantive reasons. So, I would be cautious about changing what has worked for us for a long period of time and has brought us so much success. In sum, I am generally sympathetic, Mr. Chairman, to your mix of good economics and pragmatism that has led us to this point. It is encouraging to me going forward, and I think we probably are going to achieve more success over the next few years.

On the specific issue at hand, I find Brian's exhibit 1 on the velocity of M2 very encouraging with regard to the potential future usefulness of M2 in monetary policy. But it is really just that--encouraging about potential future usefulness. We ought to continue to watch M2, but whatever decision we need to make in the next few months about monetary policy would be easier to make if it were not cluttered by M2, which is not all that secure a foundation. So, I support alternative I.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I, too, support alternative I for the reasons that have been cited, and I do not have anything to add there. But let me comment a little on a couple of other issues.

First, with regard to a more explicit inflation target that we would go public with, I would tread very cautiously in that direction and not just because of the political risks that have been identified. I also see operational and economic risks. What I am referring to is the risk of announcing an objective that, of course, we would be obligated to try to achieve. In my view, which is supported by some work done at our Bank, that could result in serious instrument instability and have adverse consequences for the real economy unless we are very careful about how we spell out what we intend to do. That suggests the need for a proposal that we have thought through very carefully, and I have not seen such a proposal. I do not believe we have done the analysis that would be required.

My second comment relates to the question of whether we can have more of these kinds of discussions. What I would suggest may not be quite as diplomatic as most of the discussion around this table, but I believe that what turns out to be a rehash of the Beigebook at the beginning of our economic discussions could be shortened or dispensed with so that we could spend most of our time discussing what I would describe as more fundamental policy issues.

CHAIRMAN GREENSPAN. Let me just say something that came to mind yesterday afternoon. I read the Beigebook, and I listened to the discussion around this table. They are two separate samples. Around this table, I thought that there was far greater concern about economic strength and associated inflationary pressures than appeared in the last Beigebook.

MR. STERN. Well, my suggestion would be that we not dispense with our District reports altogether, but I think we could highlight things that are different or outliers.

CHAIRMAN GREENSPAN. Let me tell you this. I don't know whether I can speak for the rest of us on the Board, but I can surely speak for myself. I find the individual reports and interpretations of what is going on in your Districts to be new information that is not available either in the Beigebook or elsewhere. I would be very reluctant to suggest that you discontinue making those reports because we will then end up with an academic discussion about how to conduct policy, and we will have fewer facts and more concepts. [Laughter] I am not terribly certain that that would improve the balance. So, if it turns out that we need more discussion, I think we should put it on as a separate element.

MR. STERN. All right.

CHAIRMAN GREENSPAN. If any of you have particular ideas that you want to put on the table for discussion, let us know. There is no reason why members of this Committee cannot present specific ideas they think are relevant. We can lay it out as part seminar. The rest of us can discuss it. And as the Vice Chair says, that will lead to other things. There is no need for us to maintain the existing structure that we observe at each meeting. On occasion we are very constrained by time; at other meetings we are not. If somebody had told me that I had to finish by 10:00 a.m. today, looking at the agenda that we have for this morning, I bet you we could have done it. [Laughter]

MS. MINEHAN. My goodness!

MR. BROADDUS. Three minutes to go!

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. At the risk of proving your point here, [laughter] let me just say that I agree with you on the alternatives. With regard to the issue raised in our earlier discussion, I too am a little nervous about picking an inflation number and target path. That's not because I wouldn't like to see lower inflation happen, but I see problems. I noticed in this morning's discussion that we had at least two interpretations of the monetary aggregate ranges within this group. And if we went outside of this room, the number of meanings would be multiplied by however much. We would have the same problem with inflation targets. In other words, when an event occurs, does it mean the same thing to me as it does to you? I think we could begin talking about some of the wrong things in an environment reminiscent of the debate about how many angels can dance on the head of a pin. I want to be very careful about that because I sense that right now we are migrating from the CPI to the PCE. We have not really discussed that issue but we appear to be migrating there. So, a 2 percent inflation rate may mean something different now as we migrate. That is why I am cautious about picking numbers. For me, the inflation number is zero whatever the measure, and then it matters what affects us in moving either toward or away from that number, whatever the measure. I think that is what we have to keep in front of us.

CHAIRMAN GREENSPAN. That is the issue Mike Moskow was raising yesterday about the CPI.

MR. HOENIG. I think so.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Alan, I favor adopting the provisional ranges, which is alternative I.

On the issue you raised about whether there is anything impeding these discussions or what we could do to foster them, it seems to me that it would be very useful to ask FOMC staff--Board and Bank staff--to research the issue Tom Hoenig was just talking about. Perhaps they could take a look at the various measures and lay out for us some of the pros and cons of the measures, indicate what might constitute price stability in their view, and--I don't know if this is possible--what might constitute price stability in one measure versus another to the extent that biases can be identified. I think that would be a useful starting point in terms of sharpening our internal focus. If we tended to gravitate toward a measure that seemed to make sense to us internally and we had a clearer idea in our minds as to what would constitute price stability under that measure, forgetting what the time frames might be or whether we would get there systematically or opportunistically, that would be a good starting point for a discussion at one of these meetings.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. I also prefer staying with the provisional ranges and getting there by the left leg of Brian's tree that we talked about. After sitting at this table for a year and working through the short-term options meeting after meeting, I guess I have gravitated toward wishing for a better sense and a crisper view of our collective long-term strategy. So, I am glad to hear that kind of discussion.

One other comment about our external constituencies: I don't know about the rest of you, but I have been running into more and more complacency among business groups, including directors, with regard to inflation. I think our success has left people feeling that we have won the war against inflation. All the debate in the last few months about the reconstruction of the CPI has undermined the arguments for an anti-inflationary policy even more. People are not sure that they know, or even that we know, where we are with respect to inflation, though there is a feeling that we are probably better off now than earlier. That attitude certainly makes it harder to sell the notion of pushing inflation still lower by 1/2 or 1 percentage point. So, I would argue that we have the ongoing job of doing whatever we can--and whatever you can, Mr. Chairman--to sharpen the external understanding of our focus on inflation. There is an awful lot of complacency, at least in the groups I talk to.

CHAIRMAN GREENSPAN. In fact, as I am going to note explicitly in remarks that I will make later, I find that complacency very nervous-making and in particular its reflection in the sharp narrowing of junk bond yield spreads against Treasuries, the level of equity premiums in the stock market, and various relationships that one can infer from the financial structure. That's because, unlike anecdotal information, which is often difficult to replicate over time, we have these series going back into the 1920s, and we have seen these patterns move up and down and up and down. Human nature being the only constant throughout, one begins to suspect when we run into a period such as this that it is not a new Nirvana. It is not even an old Nirvana, and it will change. The trouble unfortunately is that when the change occurs, it too often occurs abruptly and that is something we have to be terribly concerned about. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. I agree with the proposal to retain alternative I. I do think, in terms of full Humphrey-Hawkins disclosure, that we should expand the discussion in the Humphrey-Hawkins report and indicate that we think M2 and M3 growth may well be near the upper ends of our 1997 growth ranges but that we are not confident that there has been a return to a normal relationship between GDP and money growth. So, I think we should keep that discussion open.

CHAIRMAN GREENSPAN. We have to because we considered that.

MS. PHILLIPS. The other thing I wanted to mention is that I also, like you, find the discussions of District developments at these meetings very useful, though others may feel that they are a rehash of the Beigebook. I do think that we could relate what we see in each of our individual corners of the world to inflation and various measures of inflation either as a separate discussion or as part of our initial economic go-around. And I would like to see a broader discussion of the various measures of inflation and how we think some of them are progressing. We have had a lot of changes--going to chain weights, for example. In addition, there are the arguments to be considered about the reliability of the CPI and how it should be measured. A lot of shifting is occurring now in these various measures of inflation, and I think it would be useful for us to get back to a fundamental discussion of that. As for commodity prices, I understand that the world does not depend on corn prices, but for some people that is quite important. I think an analysis of some of those basic relationships and how they feed through from the initial commodity prices, or gold for that matter, to final prices would be useful. In sum, it would be good for us to get back to basics.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I also favor no change in the ranges for the reasons that you gave, Mr. Chairman. We certainly do not want to give the M's too much external play nor to give the impression that we are once again targeting any of them. On the other hand, not only do I think we should be watching them more internally than I believe we have been lately, I also believe that we should make occasional references to them publicly along with other things so that they do not die out in the public mind. It helps greatly in the rhetoric when tightening becomes necessary to be able to say we are having to tighten because the monetary aggregates are growing at an inflationary rate. That sounds a lot better than saying that we have to tighten because the economy is growing and because employment is growing and unemployment is too low. So, money is a very useful thing to have in our tool kit, and we ought to keep it before the public--we have to "use it or lose it."

CHAIRMAN GREENSPAN. As soon as we start to use it in that context, then when M2 starts to grow at a far slower rate, though we may not think that means anything, we have put it in play and the devil will come back to collect his dues.

MR. MCTEER. I think there is a difference, though, between hanging your hat on it and merely keeping it alive.

CHAIRMAN GREENSPAN. I think we ought to keep it alive, and I agree with that idea. If indeed we gain confidence in M2, then we should be willing to allow monetary policy to reflect our evaluations of what is happening to money. We could conceivably tighten if M2 growth is perceived to be excessive and ease if it is looking to be--

MR. MCTEER. I doubt that we will end up tightening today, but if we were to do so, I think that one of the main reasons would be that M2 growth is at the upper end of its range right now. In my view that is as good a reason as any of the other reasons that I could list. I would feel more comfortable with that than I would doing it on the basis of wage-cost push inflation.

CHAIRMAN GREENSPAN. I will tell you that if the reason is that the labor markets are getting too tight and wage increases are accelerating, there is a very large section of the population who would say, "Isn't that wonderful!" Governor Kelley.

MR. KELLEY. Mr. Chairman, I certainly support alternative I. The reasons have been well discussed and I don't have anything to add.

It may be redundant but I would like to add the following: It seems to me that we are entering a new era of appropriate intellectual focus in all our concerns here. I think we have had the first airing of it this morning that I can recall. For the last decade or so, we have been in the process of trying to work inflation down in an orderly manner, and that has been our entire focus. What are the appropriate ways to do that? We certainly have not yet fully achieved price stability, but I do think that we are now beginning to enter a zone where our focus should shift a little, and we should start to think in terms of how to maintain ourselves in that zone over time once we begin to get in it. I would like to see some staff work and see us begin to have some dialogue on such questions as what price indices we should be targeting or what combination of indices. As someone asked, what are the appropriate levels of those indices given the methodologies involved in their construction? At what levels of these indices can we feel comfortable that we are achieving what we want to achieve? If zero is where we would be comfortable, that would have to imply that there are some deflationary tendencies in some sectors of the eonomy. How do we feel about those and the impact they might have on the economy? How do we deal with an upward drift in inflation? Do we accommodate some of it or do we hit it over the head instantly when we are already in a zone of price level stability, however defined? These are the kinds of questions that I do not think we have faced before, and maybe it is a little ahead of the curve to think about them right now, but I would like to suggest that we start to do some work in that area.

CHAIRMAN GREENSPAN. A very good idea.

MS. MINEHAN. Yes.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. If you wait long enough to talk at these meetings, others have already said everything that you planned to say. I think Mike Kelley hit on exactly the right formulation here. We may be closer than we know to a maintenance situation that has its own set of difficulties. These difficulties differ perhaps from those that the Committee faced earlier, particularly in the 1980s, in its efforts to rein in inflation. That is especially true of the difficulties on the political side that you referred to in one way or another, Mr. Chairman, in many of your comments. I, too, would be very much in favor of a fuller discussion of what we are measuring and what it is we are talking about when we discuss inflation. We all know that we do not want inflation to go up, but I am not sure that we know what the rate of inflation is currently--or at least I know that I do not know exactly what it is. How do we translate that very useful concept of yours of not having inflation be part of economic decision-making into something specific that we can watch over time and anticipate over time? Maybe we have to have those discussions outside of a meeting, as we have before. In any event, I believe we need to do something along the lines that Mike Kelley discussed.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I guess I am a little out of step with the way the issue is being defined in this discussion because my first choice would be not to announce target ranges at all and to explain why not. Concurrent Resolution 133 and Humphrey-Hawkins were both adopted in an environment where, even in the economics profession, there was no consensus about our objectives. So, the purpose was to constrain the central bank's activities and reduce one source of uncertainty. To continue to announce a target range for an aggregate, I think, actually hinders its use in the formulation of policy. It would be a mistake to resurrect money as an objective or give the sense that any money measure is something that triggers a change in the funds rate. I think it was Herb Stein who once said, "It is certainly true that there is a stable relation between money and the price level; what is not stable is the definition of money." If we were to get back into a situation where people thought that our actions were being triggered by M2 or any other money measure, we would have the Goodhart's law problem or what Henry Wallich called the Heisenberg principle of people focusing on an instrument in drawing conclusions about our actions. This alters people's behavior and therefore changes the relationship between that instrument and economic activity.

CHAIRMAN GREENSPAN. I think Heisenberg would not have approved of that application of his principle!

MR. JORDAN. I think that this is the time, whether it is in your Humphrey-Hawkins testimony in a couple of weeks or not, to start to try to get money out of there. The legislation does not require that we announce any particular money measure--M1, M2, or anything else. It says something broadly about monetary aggregates. I think we could try to explain that using something like money growth to formulate policy to achieve our objective of price stability is one thing; setting it out there publicly as a target on an annual or even multiyear basis, I think, would be a mistake. I do not know how hard that would be to explain to members of Congress, but we could just tell them that we are not going to announce target ranges anymore because they miscommunicate our policy intentions.

CHAIRMAN GREENSPAN. It has always been the case that if we had new legislation to replace Humphrey-Hawkins, I do not think we would necessarily be pushing for target ranges. We would think that something else would be more relevant to what we would be doing. President Moskow.

MR. MOSKOW. Mr. Chairman, I agree with alternative I. If we did change the ranges, I think that would be interpreted as a change in policy and we really are not making a change in policy. No matter how sophisticated our explanation, I believe it would still be interpreted as a change in policy.

On some of the other topics that have been mentioned here, I do think there are a couple of topics that it would be useful for us to discuss. One, the idea of different measures of inflation and different targets for inflation using those measures, I would find very useful. As I mentioned yesterday, I am concerned that the CPI and the core CPI are being severely criticized now as measures. We all know there are biases in those measures and in addition BLS is in the process of making technical adjustments to them. All that obfuscates what the real target is. I think looking at a number of different inflation measures would be very useful for this Committee, and developing our own internal targets on those would be helpful as well. At least we would know within the Committee which direction we wanted to move as a Committee.

The second issue that I believe it would be useful for us to discuss is how to get to price stability. We have talked in the past about opportunistic approaches and other types of approaches. That type of discussion has been very helpful because I don't think any of us is satisfied in staying at the current level of inflation. We want to lower inflation, and it is not clear to me how we are going to accomplish that.

CHAIRMAN GREENSPAN. There seems to be close to, if not full, unanimity on alternative I. As a consequence of that, I would not differentiate between the M2, M3, and debt aggregates, but I would assume that all the ranges need to stay where they are. So, I think the simplest procedure would be for a reading of a directive that would encompass that.

MR. BERNARD. The wording is on page 21 of the Bluebook: "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at this meeting established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The monitoring range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets."

CHAIRMAN GREENSPAN. Call the roll on that.

MR. MEYER. Mr. Chairman, could I ask a question?

CHAIRMAN GREENSPAN. Certainly.

MR. MEYER. Will the report include the sentence that has appeared in the last several reports that these ranges are interpreted as a benchmark associated with price stability and normal velocity?

CHAIRMAN GREENSPAN. Do you mean in the minutes or the testimony?

MR. MEYER. In the testimony. How do we interpret these ranges because that is not in the paragraph that was read?

CHAIRMAN GREENSPAN. I would assume that we would do it the same way we did it the last time. The minutes would also indicate what that means.

MR. MEYER. Right, it is not in that paragraph.

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Broaddus	Yes
President Guynn	Yes
Governor Kelley	Yes
Governor Meyer	Yes
President Moskow	Yes
President Parry	Yes
Governor Phillips	Yes
Governor Rivlin	Yes

CHAIRMAN GREENSPAN. We shall now move on to current monetary policy and the domestic policy directive. I call on Don Kohn.

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

CHAIRMAN GREENSPAN. Questions for Don?

MR. PARRY. Don, if I were to paraphrase one of the first sentences in your briefing, it would say that the present stance of policy is too easy to contain inflation. With that as a background, I would like you to explain to me what opportunism calls for at this point. [Laughter] It seems to me that if your assertion is true and given the way opportunism was explained to me earlier, under conditions where we see inflation as likely to rise, we would take action. I am a little confused. Have we modified the definition of opportunism?

MR. KOHN. No, we have not. I think the question becomes one of how much confidence the Committee or the Committee member involved has in this projection that inflation will pick up. This is a forecast and there is a range of uncertainty around it. It is true that under an opportunistic strategy, there would be an inclination to lean very hard against tendencies for inflation to pick up and less hard against shortfalls. So, I do not think we have modified the definition. If an opportunistic Committee member became convinced with some degree of confidence that, in fact, policy was too easy, that member would need to vote for a change to be within this somewhat arbitrary definition of what opportunism means.

MR. PARRY. So, pursuing the current policy would require me as an opportunist to say that I just do not buy the forecast?

MR. KOHN. I think it would mean that you would have sufficient uncertainty about the forecast and a sense that it was desirable to wait a while to get more information, particularly given some of the factors we have talked about that will be holding down overall inflation and probably inflation expectations this year. You would have to weigh the costs and benefits of waiting to obtain more information, given your degree of confidence in that forecast.

MR. PARRY. There certainly is a danger in doing that.

MR. KOHN. The cost of waiting would be that in the event of some upcreep in inflation and inflation expectations and given the lags in policy, you would have to induce more slack in the economy to keep inflation at the current level. The benefit would be that if you had acted sooner on an incorrect forecast, you would have put some slack in the economy and caused some variations in output that were unnecessary to meet your objectives as an opportunistic policymaker.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Don, we have had only one issue of inflation indexed bonds, but are there any preliminary conclusions you could draw from that or is it premature to do so?

MR. KOHN. I think it is premature. As a general matter, the bonds were, as you know, in greater demand and better received than most people thought they would be. I think there is still uncertainty in the market about how to trade them, what they should be trading against, and what we as analysts should be comparing them to try to intuit what the difference is. We have done some analysis here that was shared in the Board briefings that you all have received. The analysis suggested that the bonds could trade like a floating rate note if all the shocks were inflation shocks, but they would trade more like a 12-year bond or a note with that duration if all the shocks were real shocks. My understanding is that in the UK they trade more like a shorter-term security than a longer-term security. We would have to get more experience and hopefully over time have trading occurring at more than one maturity to be able to analyze the behavior of these bonds in our market.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Don, you mentioned in your very good as always presentation that there may be some questioning as to whether we are still in the preemptive monetary policy business or at least we are beginning to get those questions. My own feeling from looking at the behavior of the markets and being in New York and therefore having a nonstop opportunity to talk to the people in the markets is that such questioning is still very tentative, if it has in fact begun. The people who think monetary policy can never be tight enough have always been worried about us. Those who never find monetary policy loose enough would, of course, be delighted if we got out of the preemptive business. But I think that the vast range of more serious people in the middle is still giving us the benefit of the doubt. I am not sure how much. That is a wasting asset, I suspect. My interpretation is that it is an asset that we still have in rather large supply. Do you have a different view?

MR. KOHN. I don't fundamentally disagree with your analysis. I guess I was motivated in part by my own concerns, and I did not have any good answers about how the Committee would act preemptively, particularly in a situation where we had a slow, steady upcreep in inflation and some market commentary that, because of the uncertainties, we would need the so-called smoking gun in order to tighten. But I agree with you that it is not the predominant market commentary now.

VICE CHAIRMAN MCDONOUGH. It sounds as if you would agree that there is a wasting asset quality.

MR. KOHN. Our assessment of the market's interpretation of us, this looking-in-the-mirror question, has become more complicated over the last few years because you folks have done such a good job. When you do not tighten monetary policy, people say the FOMC must know something that they do not know--that the underlying inflation pressures are not as intense as they might have thought was the case. It is very hard to sort out the effect of your actions on their expectations of the underlying inflation pressures from their reading of what your intentions are and whether you would act preemptively.

VICE CHAIRMAN MCDONOUGH. I agree with that.

CHAIRMAN GREENSPAN. Further questions for Don?

MR. GUYNN. Don, have you run any simulations, other than those reported in the Bluebook, with NAIRU specified at some lower level, perhaps the 5.3 percent rate that we have been at for some time? Even if you have not, do you have any sense about how sensitive the inflation path is to some lower NAIRU?

MR. KOHN. It would be symmetrical, President Guynn.

MR. GUYNN. It would?

MR. KOHN. You could look at that higher NAIRU simulation in the Bluebook and subtract changes rather than add them to get an idea.

CHAIRMAN GREENSPAN. Is there anything else? Let me get started by beginning with the bottom line and working backwards. My uppermost concern is the emergence of gradual, drip-by-drip inflation pressures. As Governor Kelley said the other day, there is no entry point where we can say conclusively that we should be tightening, yet we may find at the end of the day that the inflation dragon has nibbled us to death.

One of the reasons that I raised the irrational expectations issue earlier was in response to Jack Guynn's discussions with his colleagues and constituents about the sense of tranquility out there, which history tells us is to be looked at with a good deal of trepidation. I do not think that we have reason to move today because I do think, as I will get to in a minute, that inflation pressures are quite contained at this moment. But I think we are getting to the point--March may be the appropriate time--when we will have to move unless very clear evidence emerges that the expansion is easing significantly. I don't mean evidence that GDP growth is moderating to 1-3/4 percent or whatever the forecast is. The GDP is a nice number and it does have some relationship to the real world. I'm not terribly certain what it is, though everyone tells me it does.

The types of things I would be looking for are indications that orders were flattening, capacity pressures clearly were easing, and we had at least sporadic reports around this table that labor market tightness, the crucial issue that is related to everything we have been talking about, was beginning to show signs of letting up. We have not seen such indications yet, and if we don't, I would think that in the Humphrey-Hawkins report we would not only underscore our intention to hold the line on inflation and to take preemptive action as needed, which Al Broaddus was talking about, but we would have to prime the markets to anticipate that we might be moving quite soon even in the absence of clear evidence of upward movements in wage or price inflation. We would take such action largely as an insurance premium, which we have raised in other contexts. How that warning would or should be constructed, I do not yet know. I do remember that in the latter months of 1993 and especially in January 1994, I felt as though I was getting up on the table, jumping up and down and screaming, "Hey, we are about to raise rates." I did it three more times, and I said, "Hey, hey." [Laughter] We finally raised rates by 25 basis points on February 4th and the markets asked, what did you do, where did that come from? I don't know whether or not we can condition markets that do not wish to be conditioned about changes in policy, but I do think we have an obligation to indicate in advance of our move why we are moving. The old notion that we will explain what we did three weeks after the fact in Humphrey-Hawkins testimony strikes me as wholly inconsistent with how long it takes the world to turn. It is far better to say in advance what we are going to do and why than the other way around.

Having looked at the data, I must say that the general consensus around this table seems to reflect a bit more concern about an imminent acceleration of inflationary pressures than I think the data are telling us. There is no doubt that the wage drift is up. The question is how much is it up relative to what historical relationships have indicated it should have been. I think we are all acutely aware that the tracking of either the ECI or what I would call adjusted average hourly earnings, which attempt to adjust for industry employment shifts and overtime, shows an updrift but not one that squares with our usual wage/price Phillips curves, for example. Indeed, if we assume that the ECI wage/price Phillips curve has been exactly on target, meaning the actual and calculated wage inflation rates have been equal, but we let the NAIRU fall out as the residual unknown, solving for the NAIRU gives us a number well under 5 percent.

Now, I don't consider that an especially relevant piece of information because, as I have been saying over the last year and a half, I think a very special event unique to this particular business cycle is governing what we are observing, namely, the wage-change/job-insecurity tradeoff factor. This essentially stipulates that the rise in wages will be less than historically expected because of the markedly increased concern about job layoffs and that smaller-than-expected wage gains will convert to higher profit margins. That in turn will make it very difficult for a firm to raise its prices because profits are more than adequate at lower prices, thereby prompting other competitors to undercut the higher prices and increase market share. So, I think the argument is that job insecurity affects wages and in turn prices, and that is the process keeping inflation down. All the evidence at this stage, while not conclusively affirming that model, at least does not contradict it. Indeed, surveys by one organization have asked employees of large corporations if they were afraid of being laid off. In 1991, at the bottom of the business cycle, 25 percent of those surveyed by that organization said they were. In 1995, it was 46 percent despite the sharp intervening decline in the unemployment rate. And I might say that the more recent data for 1996 show it unchanged at 46 percent. We also observe that, contrary to historical relationships, the number of people who voluntarily leave jobs, become unemployed, and seek new employment--a proxy measure of the quit rate--has remained steady, not terribly far from where it was a number of years ago, despite the fact that it should have risen significantly if past relationships with the unemployment rate had prevailed.

With regard to the structure of costs and prices, I grant that the data are not terribly useful in certain respects, but I want to point out to you what is indicated by BEA's figures for unit costs and profits of nonfinancial corporations, with our own very rough estimates for the fourth quarter filled in. The prices that BEA uses to deflate gross corporate product are somewhat arbitrary, but our evaluation based on more sophisticated price deflators does not fundamentally change their result. In any event, the result for the last half of 1996 is that the estimated implicit price deflator for the gross domestic product of the nonfinancial corporate sector is unchanged, meaning the price change is zero. The estimated change in unit labor costs over the two-quarter period is zero. Of course, unit nonlabor costs plus profits, which incidentally take up approximately one-third of total sector income, are also zero. These numbers clearly have a range of error that is not inconsiderable. We also have to remember that this is a cost evaluation from the income side, not the product side. So, the productivity gains implicit in these data are larger than the ones we are getting in the official data. The one thing we know about the official data on productivity is that they are wrong. There are weaknesses associated with using the income side of the national income accounts data, but segregating nonfinancial corporations from unincorporated business and financial corporations gives us a far better insight into the underlying wage/price structure. What is involved here is that nonlabor unit costs plus profits have been little changed for a while, and since they account for a third of total costs, it would require some significant movement in unit labor costs to get prices moving.

Having said all of that, I do not seriously believe that this pattern can hold very much longer. I think we are getting to the point where it is just not credible to believe that worker motivations in labor negotiations are leading to a continued shift from wage gains to job security in labor contracts. We need to remember that it is not a requirement to get the old inflation-accelerating process to resume to have the wage-change/job-security effect return to where it was. All that is required is for the rate of decline in relative wage gains to slow, and it has to slow at some point. I said that a year ago and, to repeat what Larry Meyer said in a different form, I am saying it again. The fact that it has not happened is merely an indication of how powerful this force is in containing inflation. Therefore, I have not felt, and I do not at this moment feel, that there is a particular urgency about our moving. But it seems very questionable to allow the last 20 percent of this process, or whatever the percentage is, to play itself out without taking some form of preemptive action sooner rather than later. I don't know that I would put it in the terms that you did, Bill, when you raised the possibility that our credibility is a wasting asset. But something of that nature has to be there.

Another aspect of the current environment is that the financial markets look just too benign. I do not care what equity price model one uses; the simple model says that there is a single discount rate over an indefinite period and a constant growth rate is implied in the current level of stock prices. Then it is an algebraic necessity that the dividend-price ratio or the earnings-price ratio be exactly equal to the riskless rate of interest plus the nominal equity premium of stock yields over riskless rates minus the growth rate of either earnings or dividends and some factor for a payout ratio if the earnings approach is used. We know the earnings-price ratio and the riskless interest rate, and therefore we know the difference between the nominal equity premium and the rate of growth. Incidentally, they may be defined in either real or nominal terms; it doesn't matter because the inflation level cancels out of that relationship. We are looking at a rate of earnings growth that is very significantly above what is implicit in our nominal GDP forecasts. Indeed, in yesterday's Chart Show Mike Prell had a chart in which the I/B/E/S three- to five-year earnings forecast was rising very sharply, with the rate of growth something like 12-3/4 percent per annum over a five-year horizon. Since we cannot infer any significant drift between the S&P 500 earnings and the NIPA economic earnings, we have an implicit expectation of a continued rise in profit margins. Is it inconceivable? No. Could it happen? It could. Is it probable? I would not want to bet the ranch. If the earnings estimate is high, we have a sufficiently high equity premium, which puts that number somewhere in the range of recent history and not particularly out of line. If, however, we lower the earnings estimate, we also have to bring down the earnings premium and then that falls very significantly below any credible recent history, including 1987. This then means the market is overvalued in that regard. I grant Abby Cohen her little relationship, and I wish her well. I hope she spends her bonus, which I gather is very substantial this year, prudently.

VICE CHAIRMAN MCDONOUGH. We can certainly assume that it is very substantial.

CHAIRMAN GREENSPAN. If I were allowed to invest in the market, which they do not allow around here, I don't think I would be doing so very forcefully! It is that type of thing plus the various risk spreads, which are really quite narrow and have been that way for quite a while, that suggest that product prices alone should not be the sole criterion if we are going to maintain a stable, viable financial system whose fundamental goal, let us remember, is the attainment of maximum sustainable economic growth. It is the real economy that matters. Finance is all very interesting and financial prices are quite important but only because they affect the real economy. Ultimately, that is what our charter is all about.

We have to start thinking about some form of preemptive move and how to communicate that in a credible manner. I would not be inclined to do anything today. Indeed, were we to tighten policy now, I think we would really shock the market in a way that would be quite destabilizing and would not advance our goals. I don't think there is a particular urgency here. I don't think we are getting any evidence in the underlying price structure or on the commodity side that there is any pressure pushing through. It is not clear that wage growth, whatever it is, is significantly exceeding productivity increases in the real world. As a consequence, the evidence of a rise in unit labor costs at rates that suggest that it is eating into profit margins is not confirmed by any of the data of which I am aware. Indeed, the earnings forecasts for 1997 by Wall Street analysts show increases that are consistent with rising profit margins, not falling profit margins.

In short, I can see no credible evidence of increasing price pressures. And even though I listened to anecdotal reports of price pressures around the table yesterday, you were all talking about parts of your regional economies. I would suspect that if we had real data and did a full-blown evaluation of unit costs, the paradigm shift that Cathy Minehan mentioned, moving from preventing rising supplier prices to actually nudging them down, would turn out to be far more prevalent than I believe people realize. So, I think our policy implementation has to take account of a very complex set of considerations. I think we ought to reflect them as best we can in our Humphrey-Hawkins report and be prepared to move if we have to at the next meeting. I am not saying that we necessarily should. I am just saying that we have to be careful about the inflation dragon's nibbling capabilities, which I mentioned before, and that is what really concerns me above all. If we make this an issue at the Humphrey-Hawkins hearing and the economy eases enough so that no move is dictated, I don't think it would do particularly much damage to monetary policy. If it turns out that we get surprised by a quick acceleration of inflation, which means that we have been somewhat behind the curve, at least our monetary policy choice will be unambiguous. The most likely outcome is in the middle with the dragon lurking there, and he makes me very nervous. As a consequence, I would argue for staying at "B" today but with an asymmetry that is unlike that at the previous couple of meetings. There is no reason to change it, but it is a real asymmetry as I see it at this time. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I fully endorse the recommendation you have made, and I will try to fill in the gap while others prepare for the pop quiz on your evaluation of the equity market. I also think the asymmetry really is quite different because I now read it as meaning that we will tighten soon and probably at the March meeting. I believe we would wish to do so later than that only if the incoming information suggested greater weakness than we are likely to have, which will be the payback in the first quarter for a very strong fourth quarter. I think we would have to convince ourselves that the slowdown is more meaningful than one that just reflects that payback.

In the Humphrey-Hawkins testimony, I think it is very important that you prepare the way and explain to the world, both the market and the public more generally, what is likely to be coming. I think that market participants are more likely to get the message this time, largely because they did not get it the last time. They do tend to learn from that kind of experience. In what I think is the remote possibility of their not getting it, we might have to decide how we should make the message a little clearer. Since I make it an art form of not saying things that move markets, perhaps I could be of use in that regard by enhancing what you said or even just quoting it to help bring more attention to it.

Going to the message in the Humphrey-Hawkins testimony, I think we should hit some themes rather strongly, and you suggested all of them: Another theme is that our goal is price stability and that is how we achieve sustained economic growth. That at the very high capacity usage the economy is experiencing, potential noninflationary growth is really limited, as we all know, to the sum of the growth of the labor force and the growth of productivity. We could remind them that monetary policy in that environment can hurt sustained economic growth if it stays too accommodative too long and that we simply do not have the capability to produce higher real growth through an overly accommodative policy. That sort of approach would give you the opportunity to remind people that the Federal Reserve is very much pro-growth and pro-employment and if they want a higher growth rate the way it will be achieved is not by debauching the currency but by increasing the saving rate and therefore improving the economy's ability to increase investment.

Especially since we would be moving preemptively again, which I believe very much we should, we have to be very careful in the Humphrey-Hawkins testimony. I would hope that whatever the rest of us are saying between now and the next meeting that we not fall into the anti-growth trap. One particular tool that I think is very useful for us analytically but one that feeds the we-are-against-growth image, of which we are highly suspected in any case, is the use of the NAIRU. We at the New York Fed, you may remember, were extraordinarily accurate in 1994 in forecasting the real economy and extraordinarily inaccurate in predicting inflation, which we overestimated. The need for humility being a great teacher, this pushed us very hard in the direction of trying to figure out why we made that mistake. One of the things that we have become rather convinced of is that the NAIRU is a very interesting analytical tool, but it is a very poor forecasting tool. The more we talk about it as if it were going to tell us what we should do next month, however eloquently we express ourselves, the more I think we come across as anti growth. I see that as unwise because it leads the American people to believe that what we think we are doing to help them is in fact harmful to them. This does not help the public policy debate nor does it help the posture of the Federal Reserve.

I am sorry for being a bit long-winded, but I do think that "B" asymmetric, seriously asymmetric, is the right choice and that we ought to be girding our loins for a probable tightening at the next meeting.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I understand your argument. I have to confess, though, that I have some concerns about waiting. The market is now aware that we experienced very strong economic growth last year and that we are seeing some of the effects of that growth in terms of capacity use and so forth. As we go down the road, I do not think that the public will be able to distinguish between a growth rate that is slowing from 2 percent to nothing versus slowing from 3 percent plus down to 2 percent or a bit less. So, if we do not move now, I think people will be even more convinced that we will not take action under circumstances of slowing growth. We may therefore find ourselves more paralyzed at the next meeting, and that could cause us some problems that will be very difficult to deal with.

CHAIRMAN GREENSPAN. I would just comment that the last thing I want to do is to look at the last quarter's growth.

MR. HOENIG. I understand.

CHAIRMAN GREENSPAN. In other words, to cater to that point of view would be unwise.

MR. HOENIG. But I think that perception exists. In any event, we now see at least a reasonable consensus that higher inflation is in prospect, and that is what we should act on. If we do not move when we have that sort of consensus, I think we will find ourselves in a more difficult position in terms of taking action down the road.

CHAIRMAN GREENSPAN. The purpose of the Humphrey-Hawkins testimony will be to address exactly that subject.

MR. HOENIG. Okay.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the recent surge in economic activity has raised the level of output, which already appeared to be above its long-run potential. This has intensified my concerns about the outlook for rising inflationary pressures, and I think it has provided a stronger case for tightening policy. Moreover, the two monetary policy rules we consult at our Bank--one is an estimated version of Taylor's rule and the second is the nominal income growth rate rule--both suggest the need for an increase in the funds rate this quarter. Even if we accept a 3 percent target for core CPI, which I think is too high, these rules suggest that the funds rate should be raised by 25 basis points or a bit more this quarter. Of course, an inflation target of 2 percent, which I think is more appropriate, would involve stronger action. In my view, it is time to take an initial modest step in tightening policy, and therefore I would prefer a 25 basis point increase in the funds rate to 5-1/2 percent.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. The staff projects a decline in the unemployment rate to 5 percent, more than 1/2 percentage point below their estimate of NAIRU, and as a result they see progressive deterioration in the inflation outlook. Now, if we were all sure of this forecast, I think we would all agree to tighten immediately even though the sharpest increases in inflation do not surface until 1998.

I do want to respond to Bob Parry's question, does that "we" include opportunists or only those who prefer a more deliberate approach to reducing inflation? I use the "we" as an encompassing one in that case. Why not move now? Uncertainty about the forecast, about the structure of the economy or specifically about the value of NAIRU, justifies, I think, a more cautious approach. Fortunately, the usual inertia in the inflation process and the prospect of a decline in energy prices combine to yield a still favorable inflation outlook through 1997, reducing the need for immediate action. But the risk of above-trend growth and the risk that the current unemployment rate is already below NAIRU together strongly support an asymmetric policy directive to complement an unchanged policy.

There has been some very interesting discussion by Don Kohn and the Chairman of the question, if not now, when. I think that is what we really are talking about here. One perspective has been that, indeed, the time has come and the only issue is to prepare the markets. There is a widespread expectation that there will be no policy change at this meeting, and a tightening move would be a great surprise. So that is the only issue. I think we have to think about whether we are at that point or whether there is something we need to trigger an action.

Let me give you a perspective that relates back to the staff forecast. How would we respond if the staff forecast turned out to be correct? I would argue that if we do see a decline in the unemployment rate, specifically to the 5 percent rate in the staff forecast, that would be a reason to tighten independently of whatever was happening to inflation pressures directly. That is, a further decline in the unemployment rate would be an appropriate trigger for an increase in the funds rate. This is just a general view that as utilization rates increase short-term rates should increase. We should build in that procyclicality of interest rates that would occur normally, for example, under a money growth rule with a stable money demand function or under a Taylor rule. If in the meantime inflation pressures were to build, then still more aggressive action would be required. But that would be an example of a very clear trigger. Thank you.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, this morning's decision is a really tough one and frankly the comments of Bob Parry and Tom Hoenig have made it tougher. A number of the comments you made have given me some comfort, though, so I can accept your recommendation this morning. But let me say emphatically that unless we see a very marked change in the outlook and the balance of risks very soon, which frankly I do not expect, I think we are going to need to move to a tighter policy posture. I believe we will almost certainly have to do so at the March meeting, and I can think of some circumstances that might propel us to move even sooner than that. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Timing is everything, I guess. In the past year or so I thought a somewhat tighter monetary policy would be appropriate. I would have reversed the insurance policy, the final one we took out at the beginning of last year. But as the year progressed, and looking at third-quarter data, I began to believe that tightening could be postponed as the seeming slowness of the expansion gave us some breathing room. Now I feel I was misled somewhat by the unevenness of economic progress last year. As I look back over the year, I see an economy that clearly was expanding at a pace beyond the long-term trend and operating with constrained labor resources in a financing environment that obviously was conducive to excess.

Don and you, Mr. Chairman, have presented us with a couple of options, particularly Don's wait-and-see option and another that I would characterize as see-and-do. I am worried about the inflation dragon that is nibbling away. In my view, the wait-and-see attitude has become a little more dangerous than it was in the past. That is because of what we already see. We see an economy with a lot of life, driven by consumer spending and business investment. We do not see the sluggish residential investment picture that we thought we would. We see labor markets that are tight by any measure. I see financial markets that are too one-sided and frothy. I do not know how to measure inflation anymore after the discussion today, but any number I see anyplace seems to be expected to turn up. We see the signs of imminent excesses.

I do not see restraining factors that are going to pull them in, and like President Hoenig I am a bit worried about the variability of the numbers we keep getting. These are forcing us into or suggesting that inactivity is the right course and are prolonging the wait-and-see attitude and increasing the risk of the inflation dragon. I think we have a clearer picture of the economy's strength right now, and I believe now is the time to move. I know there is the issue of saying something to prepare the markets. I don't think they are as unprepared as they were in 1994. I believe there is some sense out there of a possible move; the forecasts suggest that people expect us to move; it is just a question of when. I think we should be proactive and we should be moderate in that proactivity. So, I would align myself with President Parry's suggestion of a 25 basis point increase in the funds rate.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. I completely support your proposal; I believe it is the right one. I also think that suggestions that we may need to move in the near future are probably correct, and I would support that as the most likely probability. But I am a little uncomfortable with what may be an excessive amount of prejudging that policy action. I am a bit haunted by the fact that we all saw emerging pressures that were clearly going to lead to an outbreak of inflation a year or 18 months ago, and here we are. I do not think we should forget that. The outbreak is still ahead of us. The pressures are still there. They may be more intense, and a rise in inflation may start tomorrow morning; it may already have started and we cannot see it yet. But I think we should be a little cautious about prejudging what we are going to have to do at any point in the future. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. I am delighted with last year's results even though they were not forecast by anybody. [Laughter] I hope for similar mistakes this year in the sense of more growth, lower unemployment, and less inflation than we are now projecting. But I also recognize that if we had been more accurate in anticipating the way 1996 was going to come out a year ago, then in spite of that more favorable inflation outlook we would not have notched down the funds rate early last year. And I would not have supported reducing the funds rate if we had been able to anticipate more accurately the way the year came out. Given that, logic tells me that we would have been better off with hindsight not to have recalibrated, and we probably would be happier today if the funds rate were at 5-1/2 percent. Certainly, if it were at 5-1/2 percent, we would not be reducing it.

I am very concerned, Mr. Chairman, about how you are going to be able to communicate this to the markets, to people in political circles, and to the public at large. The Labor Department tells us that there are still 6 million people who are not working. Fortunately, they do not live in my District, but I would like to see a lot more of those people find jobs. Most of the metropolitan areas in my District have unemployment rates of around 4 percent or lower, and this has been the case for a couple of years. I would be delighted if we saw more metropolitan areas out in Bob Parry's District with 4 percent unemployment. So, I would endorse fully what Bill McDonough has said--care needs to be taken to avoid communicating that we are concerned that there are too many people working, that unemployment of 6 million is too few, or that we would not be happy if there were only 4 million unemployed. I think that this is a very, very important communications issue as you try to prepare the markets and everybody else for what seems to be unavoidable.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I buy into your basic approach. I think the odds are that we will have to tighten. It is not an absolutely foregone conclusion. Some open-mindedness is appropriate, but I think your general framework is right. On the communications issue, all of us around the table have had a fair amount of training in economics and we use economists' shorthand. That shorthand has meaning among ourselves and among our academic peers. But I must say that some of the shorthand that gets used in public does not do us very much good. We ought never get ourselves in the position of saying that we are tightening because there is too much growth or the unemployment rate is too low. Whenever we tighten, it ought to be explained in a framework of pro-sustainable growth and pro-job growth. This NAIRU concept, while it means a lot to economists, is a very unfortunate way of communicating because 99.99 percent of the people just do not understand it and it comes across as meaning that we are against growth and against more jobs. While we as economists understand the NAIRU concept and its usefulness, we really have to recast our whole approach in terms of communicating that we are pro-growth, and it can be done. Our case is much more salable if we put price stability in that context. I would urge you in your Humphrey-Hawkins testimony, and I would urge all of us in the aftermath of that, to move strongly in that direction in our public comments because I think it is the most effective way that we can educate the public and further their understanding of the value of price stability.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, if we believe the Greenbook forecast, we will see core inflation accelerate from 2.6 percent last year to 2.8 percent this year and to 3.2 percent next year. If we add in the adjustment for technical changes, the number in 1998 accelerates to 3.6 percent, which I believe we would all find unacceptable. It really comes down to the question, as a number of people have said, of whether we have confidence in this forecast. If we believe the forecast, we should be tightening now, given the lags in monetary policy. However, labor costs and prices have not accelerated as we would have expected on the basis of past experience. So, I think it is understandable that we have some questions about the inflation forecast in the Greenbook. Given the uncertainty, I personally believe that the prudent thing to do is to wait longer at this point to see if some early signs emerge that inflation is closer to accelerating. At that time I believe we should be prepared to act immediately. I am concerned about the inflation dragon, as you artfully described it, nibbling away at us. It involves an insidious buildup of inflation at .1 percent or .2 percent a year. Of course, we have not seen that buildup yet in any of the core price measures, but it is something that I am very concerned about because once higher inflation gets built into the structure it may be very difficult to get it out of the structure. At this point, I clearly support "B" asymmetric.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. I also support your recommendation for "B" asymmetric. I would include a strong expression in your Humphrey-Hawkins testimony of our concern about the sustainability of low inflation with tight labor markets. I believe this is the best informed group about the American economy that one could possibly assemble anywhere, with the benefit of the best statistical analysis and a real feel for the economy from around the country. And yet we come back in the end to our gut feeling about what is happening. That feeling has changed since the last meeting. You pointed out that evidence of higher inflation is not very solidly based on the statistics, and the question is whether we are sure that we have to worry about the sustainability of this growth and its consistency with price stability. I cannot be sure, but I think everybody around the table would agree that the prudent thing to do if we had to do something today would be to move, and yet there are reasons for waiting a little longer.

With respect to your Humphrey-Hawkins testimony, I think a lot of very important things have been said around this table about how to couch it and how to communicate the importance of sustainable growth. I am not worried about our wasting credibility asset. I think our credibility and your personal credibility are so high right now that if you write strong Humphrey-Hawkins testimony, you may get a correction in both the equity markets and the bond markets that will make us less certain when we come back here in March that we need to do anything. [Laughter] We may be able to accomplish our objective without moving the funds rate. After all, what is important is controlling the economy. But that is a problem we will have to deal with when we meet again in March.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I agree with your recommendation. Let me just take a moment to elaborate. In my view, circumstances have not changed significantly in recent months, so I continue to think there is a reasonably high probability that we are going to want to adopt a more restrictive policy over the course of 1997. But if I ask myself why now, I think we do not have a reason that we can use that will garner any amount of support for acting at this juncture. I then ask myself the further question: What are the consequences if your soon-to-become-famous inflation dragon does start to nibble a little sooner than we expect and we find ourselves behind the curve? It seems to me the implications of that are that either we would have to move a little further at the end of the day than we otherwise would or maybe we would move by the same amount but in a more concentrated period of time than otherwise. Those costs do not seem to me to be very great. So, I am comfortable with your recommendation.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. I favor alternative C or at least something in that direction, and my reasons remain the same as I have been stating: I think inflation is too high, and I see increasing evidence that inflationary pressures are building, especially in labor markets. Finally, I do not think one can say that the stance of policy is at all restrictive right now; so I believe some action is called for. We clearly are not going to do anything at this meeting, but as we anticipate a possible move in the future, we might want to think about one that once taken would leave people in a position where they are uncertain about what the direction of the next move would be. In other words, we are in a much different position than we were last time when we were in these circumstances, starting at a 3 percent funds rate with a long way to go. We probably are not too far away from where we ought to be, and we should think about doing enough in one shot so that there is uncertainty about the direction of the next move. That might argue against a modest move as an opening salvo, one that simply would encourage people to speculate on the next move. Once we got enough tightening done the last time, we had a very beneficial impact on long-term markets. In fact, we raised the funds rate by, as I recall, 50 basis points at one point and actually got a drop in long rates. It would be nice to be able to get there sooner rather than later when and if we do move.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you. I support "B" asymmetric. It seems to me that the situation is fairly similar to where we were last summer. My guess is that we will need to tighten this year. I have the impression that employers have run out of room in terms of their ability to pass on price increases. So, I think the inflation dragon is getting closer. But I do believe that we have time to assess whether the fourth-quarter strength will necessarily result in strained resource utilization. We should take advantage of the Humphrey-Hawkins report to prepare the markets and also to explain our goal of price stability.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. I, too, am comfortable with the way you laid things out and I support your recommendation. It became clear to me as the go-around proceeded yesterday that I am at least a bit more optimistic than some around the table in terms of how the wage pressures may play out. My view may be colored by the nature of the economy in our region, which has topped off, and my expectation that a similar development may begin to show through elsewhere in the nation as housing and other sectors of the nation's economy begin to slow. I also want to associate myself with those who say that there is a good bit to be gained by preparing our constituencies for a policy move in the period ahead. I am not thinking just of the financial markets and Congress but the broader constituency. I think it can be very helpful to our long-term credibility to prepare the public, given where I believe people think we stand at the moment. So, I support the recommendation for no change and an asymmetrical directive.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I support your recommendation. Do you know yet when your first Humphrey-Hawkins testimony will be?

CHAIRMAN GREENSPAN. February 25 or 26, I think.

MR. KOHN. The first will be February 26.

CHAIRMAN GREENSPAN. So, February 26 and 27. A significant majority of the voting members seems inclined toward "B" asymmetric, and I request that the Secretary read such a directive.

MR. BERNARD. The draft wording is at the bottom of page 21 in 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, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the expansion of M2 and M3 over coming months."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Broaddus	Yes
President Guynn	Yes
Governor Kelley	Yes
Governor Meyer	Yes
President Moskow	Yes
President Parry	Yes
Governor Phillips	Yes
Governor Rivlin	Yes

CHAIRMAN GREENSPAN. Our next meeting is March 25. With respect to your forecasts, if you could send any changes you wish to make in those forecasts to Mike Prell by February 7, this Friday, he would be most appreciative. We have a lunch at 1:00 p.m.?

MR. BERNARD. Yes, the lunch in honor of Governor Lindsey is at 1:00 p.m.

MR. KOHN. We have scheduled a pre-lunch discussion of the surplus issue after this meeting.

CHAIRMAN GREENSPAN. This meeting is adjourned.

END OF MEETING