Meeting of the Federal Open Market Committee

August 22, 1989

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, August 22, 1989, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Guffey
Mr. Johnson
Mr. Keehn
Mr. Kelley
Mr. LaWare
Mr. Melzer
Ms. Seger
Mr. Syron

Messrs. Boehne, Boykin, Hoskins, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Forrestal and Parry, Presidents of the Federal Reserve Banks of Atlanta and San Francisco, respectively

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

Messrs. Balbach, R. Davis, T. Davis, Lindsey, Scheld, Siegman, Simpson, and Slifman, Associate Economists

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

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Mr. Keleher, Assistant to Governor Johnson, Office of Board Members, Board of Governors
Mr. Smith,[1] Assistant Director, Division of International Finance, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Hendricks and Monhollon, First Vice Presidents, Federal Reserve Banks of Cleveland and Richmond, respectively

Messrs. Beebe, Broaddus, Rolnick, Rosenblum, and Ms. Tschinkel, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Richmond, Minneapolis, Dallas, and Atlanta, respectively

Ms. Lovett and Messrs. McNees and Meyer, Vice Presidents, Federal Reserve Banks of New York, Boston, and Philadelphia, respectively

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1. Left meeting after action to approve special reciprocal currency arrangement with the Bank of Mexico.

Transcript of Federal Open Market Committee Meeting of
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MR. CROSS. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Mr. Cross?

MR. FORRESTAL. Sam, are we under any particular pressure from the Japanese or the Germans to do anything in terms of monetary policy to relieve pressure on the dollar?

MR. CROSS. No, if you're speaking of--

MR. FORRESTAL. Well, it's just a general question. I wondered if they were agitating and--

CHAIRMAN GREENSPAN. I haven't heard anything from them. In fact, there has been a remarkable quiescence and lack of the usual discussions. Things are as quiet as I've seen them in a long time. Jerry, have you sensed anything?

VICE CHAIRMAN CORRIGAN. No.

MR. FORRESTAL. Thank you.

MR. JOHNSON. All of Europe is on vacation.

MR. FORRESTAL. Like Washington.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Sam, I'd like to get your personal view concerning two scenarios in regard to the exchange value of the dollar. Over the next six months, if U.S. interest rates remain largely where they are now, what would happen? Alternatively, what would happen if we had a somewhat substantial decline of, say, 100 basis points over the next six months?

MR. CROSS. Well, of course, the exchange market is influenced by a vast number of factors in addition to interest rates. But I would not differ from the statements in the Bluebook and all that has been presented, which suggest that higher interest rates would tend to add to the pressure on the dollar. But there are many, many other factors involved. It depends, of course, on all of the things going on in other countries. During the last several months, we've seen some fairly substantial changes in the interest rate differentials between the United States and some of the other major countries. And that has not taken away the structure--

MR. ANGELL. I don't quite understand your answer in comparison with what your report said. Your report seemed to indicate that during July and August there seemed to be quite a difference in perception about what direction U.S. interest rates might go. Now, you don't think that would be very significant in the next six months if there was--?

MR. CROSS. That was certainly a factor during this period, and the pressures on the dollar did change at about the time when there seemed to be a change in the market's perception of U.S. monetary policy. But I think what I said was that there are many, many other factors involved that are also going to affect the pressures. I don't think it is simply a matter of the interest rates.

MR. ANGELL. No, I don't know of anyone who thinks it's simply the interest rates.

MR. CROSS. All I'm saying is that over the past several months we have seen the narrowing of the interest differentials--it has been a couple hundred basis points--and there has continued to be pressure on the dollar despite that.

VICE CHAIRMAN CORRIGAN. I think a lot would depend upon why the market thought interest rates were going down. Just to take two contrasting possibilities: If the market really thought that the underlying rate of inflation was coming down, and interest rates were coming down in response to that, that would be one thing. On the other hand, if the market felt the economy was ready to fall out of bed and interest rates were coming down because of that, I think you'd get quite a different [slide]. It really does depend very much on perceptions as to why.

MR. ANGELL. I was more interested in the constant interest rate scenario than I was in the falling interest rate scenario. Thank you.

MR. CROSS. Well, at the present time, the market is [unintelligible] and continues to be reasonably bullish on the dollar; [investors] see the dollar as a good place to be. They compare the dollar with some of the [alternatives] and, as I say, there's relative stability here politically and economically as compared with Japan and elsewhere. Throughout most of this year there has been a tendency for [investors] looking very long term to see the dollar as a good place to be. And there has been some reassessment and shifting of portfolios with a tendency to have a greater share in dollar investments and less concern about hedging against it. So, in that sense I think the market has been pretty bullish on the dollar and continues to be.

MR. ANGELL. Okay, that's the response that I was looking for. In other words, you think that if the perception in the marketplace were that we would have no further interest rate declines, that would tend to be somewhat bullish for the dollar.

MR. CROSS. Well, that's not quite what I was saying. Given everything that's going on--and not just interest rates--I think there is a firmness and a strong support for the dollar.

CHAIRMAN GREENSPAN. Any further questions for Mr. Cross? If not, can I have a motion to ratify the transactions of the Desk since the July meeting?

SPEAKER(?). So move.

MR. JOHNSON. Second.

CHAIRMAN GREENSPAN. Without objection. I sent out a memorandum--basically a poll with questions on system foreign currency operations--in response to a discussion, as you may recall, at the previous meeting. I would be most interested in any reaction that anyone had to that. Is there any sentiment to change, alter, rethink, or the like?

MR. HOSKINS. Well, I think it was an appropriate request for information. It certainly helped me to understand the history of this development in terms of the swaps and the Exchange Stabilization Fund and our activity over the last--well, I don't know how far back we go.

CHAIRMAN GREENSPAN. Well, I think periodically we really ought to review the whole system, largely because our information base continues to change our views about how we affect markets and what the implications are. A general review and updating, I think, is probably desirable just to make certain there are no structural changes that have occurred and, accordingly, altered how we should view the whole process. Well, if there are no further questions on it, we'll just go--

MR. MONHOLLON. Mr. Chairman, would it be helpful to include in the outline a review of the academic literature on this subject?

VICE CHAIRMAN CORRIGAN. Probably not.

SPEAKER(?). Give us two years.

CHAIRMAN GREENSPAN. Yes, Jerry answered your question literally. Having trudged through most of that, the word helpful doesn't immediately strike me as [germane]. We will, however, make a bibliography so that one can go back and see the particular efforts in this whole area over the last decade or so; it's quite extraordinary. If there are no further questions, we'll just proceed further on that and keep you informed of the progress. The next issue on the agenda is the question of the Mexican swap drawing.

MR. TRUMAN. Mr. Chairman, we circulated a memo, which I hope was self explanatory, relating to the provision of a certain amount of bridge financing to Mexico in connection with the Mexican agreement in principle with commercial banks on July 23. It's a total amount of $2 billion: a billion dollar's worth would be a multilateral facility of which the U.S. share would be $250 million split equally between the Federal Reserve and the Treasury; the second billion dollar facility would essentially draw upon existing swap lines--our $700 million swap line and the Treasury's $300 million line for the full $1 billion--

The other half of it would draw, after the multilateral facility, on disbursements from the Fund and the World Bank. As outlined in the memo, there is a small anticipated shortfall--on the order of $86 million--of the full $1-1/2 billion that would be paid out of Mexico's reserves; or, if they somehow couldn't draw any other monies after the 15th of February, we could [if necessary] obtain repayment from proceeds of sales of oil as we have done in the past. The proposal here is to approve a special swap arrangement for the $125 million--a one-time only arrangement that would be drawn on once and then on repayment would expire. The proposal is also to delegate formal approval of that to the Chairman, and also to delegate to the Chairman the approval of the drawings once they [are requested]. The reason for the lag is that there is a desire to have a certain linkage--I think that was the phrase you used, President Corrigan--between this facility as a whole and the consummation of the term sheet between the Mexicans and the bank advisory committee. So, it is conceivable that that never will happen, in which case we wouldn't want to have this on the record, so to speak. That's why we have suggested this procedure in the first place; normally, when we activate these things, Norm would send out a telegram asking for the Committee's concurrence. We thought it would be just as easy to get your concurrence in advance, assuming none of the terms changed.

CHAIRMAN GREENSPAN. Any questions for Mr. Truman or Mr. Cross on this issue?

MR. GUFFEY. Ted, I guess I don't understand your statement that you prefer not to have it spelled out in the record. I assume this would take a Committee vote?

MR. TRUMAN. Yes.

MR. GUFFEY. And, therefore, it will be indeed on the record; and it will reveal not only the authorization for the full $700 million [swap drawing] but also this special--

MR. TRUMAN. Well, [that would occur] when it was activated. Our intention would be for the Committee to act to delegate this decision to the Chairman. And when he acts and implements the decision, then it would go on the record. But if this whole thing fell apart in the meantime, between now and your next Committee meeting, it would not [go on the record].

MR. GUFFEY. You ask for a vote now and it's not submitted for the record unless it's activated?

MR. TRUMAN. That's right. I've been told by the authorities that that's a reasonable procedure to follow.

MR. GUFFEY. The authorities?

MR. TRUMAN. Legal--that is, the General Counsel.

MR. CROSS. Legal.

MR. ANGELL. Well, that offends my sensibilities.

MR. HOSKINS. I don't understand why we need to make the change in procedure now when we--

MR. TRUMAN. We have done this before. We used this same procedure for the same reason in 1982 when we made an arrangement with Mexico; we weren't sure that the conditions would be such as to need this arrangement. If you want to do it the other way, you can approve the swap line [increase] and then explain in the policy record that because the conditions never were met we never [implemented it]. I don't have a strong [view on a] way of doing it. We had done it the other way in the past, and that's why we proposed this arrangement.

MR. GUFFEY. Okay.

MR. GREENSPAN. I think there's a certain advantage to doing it the way Ted is suggesting. Even if we put the vote on the record, in a sense, we are not effectively implementing the swap from our point of view; and then if it falls apart, we're sort of hanging out there with--to use your analogy--half a bridge. I think authorizing it and then delegating final approval to the Chairman leaves us in a position where, should the term sheet fail or something like that, then it is never implemented and there is no final action by this Committee. And we don't sit there in a sense having said yes, and a final yes in effect, and then having the thing unravel. It's really a cosmetic request.

MR. ANGELL. Well, Mr. Chairman would it not be possible to have a telephone conference call and do it that way? Then it would be on the record. It just seems to me--

CHAIRMAN GREENSPAN. Yes, but I agree with you on this. I'm saying that the vote that we would take this morning would be on the record.

MR. ANGELL. Fine.

CHAIRMAN GREENSPAN. But the action would be a two-stage action: authorization by the Committee and granting to the Chairman the ability to say that the Committee's action should be implemented because the other party or some third party accomplished a certain action. My sole authority is merely to make a determination on whether the Committee's requirements have been met. If they have not, then the issue is moot.

MR. ANGELL. Yes.

CHAIRMAN GREENSPAN. And there is no further action required.

MR. ANGELL. That satisfies me, yes.

MR. TRUMAN. That is what we intended. The other parties are doing essentially the same thing. The BIS, while it has gotten agreement of all the central banks, is not going to tell the New York Fed that it is in agreement to its part until everything is ready to go. So we're all on the same procedure.

MR. ANGELL. But if we take the vote, the minutes published [after] the next meeting would include the vote, then.

MR. TRUMAN. It's up to the Committee what they want to do. If it's never implemented, one might argue that you would not want to publish it. But you do it either way you want.

CHAIRMAN GREENSPAN. But there is a question; we did take an action. The issue of whether it is implemented or not is really a secondary question. The issue is whether we report the nature of this [decision] in detail and [whether] an official vote was taken. I think it would be appropriate to record that vote. I agree with Governor Angell on this issue.

MR. KEEHN. What are the disadvantages to having it show on the record?

VICE CHAIRMAN CORRIGAN. Si, this is still an important lever in the overall process. We had a meeting--about 10 days ago, Ted?--when most of the ducks were in a row in terms of this deal being done. But there are about 4 or 5 categories of things that have to be locked up, several of which are very difficult, by August 30th. There will be another meeting--the "lock-up meeting" either next week or the day after Labor Day, I'm not sure which yet. What we have said to both parties is that the official bridge will be activated and disbursed only when these other things are done, mainly that all of the detail is agreed to by both parties. I think the issue here is trying to keep as much pressure [as possible] on the process. And I think Ted's suggestion, the Chairman's suggestion, and Governor Angell's are all compatible with that, in that you authorize it but you don't give the impression that it's an absolute done deal. You keep the trump card in the Chairman's pocket. That's the rationale.

MR. KEEHN. Well, the fact that it would only be activated if those things happened, it seems to me, is consistent with what you want. Also, these minutes won't come out for six weeks.

MR. SYRON. They won't come out until after these discussions are all through.

MR. KEEHN. Long after your--

MR. TRUMAN. Well, unless everything falls apart; that's the only other contingency.

VICE CHAIRMAN CORRIGAN. Then we will have looked good not to have disbursed it, anyway.

CHAIRMAN GREENSPAN. Any further questions on this swap issue?

MR. MELZER. does that just largely give them reserves? I guess it gives them the appearance of more fire power?

MR. TRUMAN. That's right. There is another feature here--if they get everything done by the first of September they will then announce a bigger number for their reserves on the first of September. I think it's also partly the cosmetics of the number. When we looked at

That's how the structure was negotiated in July.

CHAIRMAN GREENSPAN. The implication is that flight capital, or reverse flight capital, might ensue if they show higher reserves. So it's a smoke and mirror scheme.

SPEAKER(?). [Unintelligible] hold his breath.

CHAIRMAN GREENSPAN. You do these [unintelligible]. If there are no further questions, would somebody like to move that action?

SPEAKER(?). Yes, move it.

VICE CHAIRMAN CORRIGAN. Second.

CHAIRMAN GREENSPAN. Without objection so ordered. The next item on the agenda is--

MR. TRUMAN. Mr. Chairman, for staff purposes could we clarify that the contingency was established--that this was an authorization of the special swap but also concurrence [on the delegation to the Chairman] of the activation? We will let you know when it happens. Otherwise we tend to send out a notice [requesting Committee action]. One of my housekeeping concerns is that this might happen around the Labor Day weekend when people aren't even around. So do we take it that all is encompassed in that action? Is that how people interpret it? Or do you want to have another round?

CHAIRMAN GREENSPAN. Maybe the safest thing to do would be for you to phrase the motion as you think it would be appropriate, for technical purposes, in implementing this policy--just to be sure we have it correct.

MR. TRUMAN. I think the motion was to authorize the special swap arrangement, with its activation subject to the Chairman's satisfaction that the understandings have been met and to concur in the activation of the two arrangements, again subject to the understandings being met. That would be the easiest.

CHAIRMAN GREENSPAN. That's essentially what's in the motion.

SPEAKER(?). It's in the vote.

CHAIRMAN GREENSPAN. Okay. Unless there is any objection, that will be part of the record. Our next item on the agenda is Mr. Sternlight on Desk operations.

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

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

MR. MELZER. Peter, when does this need to drain reserves end? In other words, how soon would you expect that? Generally, funds have been trading a little below 9 percent. When would you expect them to trade at 9 percent or above? And what have market participants discounted? Normally, they expect the funds rate to be soft when you have that need to drain.

MR. STERNLIGHT. That is a contributing factor. Just on the basis of the reserve outlook, we're very near the end--at least on the latest projections that I've seen, which were as of yesterday when we were nearly done with the prospective draining for this period. There's a small draining job of roughly half a billion or so for the next reserve period, unless things change because of the Mexican developments or foreign exchange developments. Any of those things, and some other factors also, could change our reserve outlook. As for the market people, there are two camps of thought about the funds rate. Some expect to see funds right around 9 percent give or take a small margin; others would be thinking more of 9 to 9-1/8 percent. I don't think there's that much expectation imminently of the Fed wanting to see the funds rate pushed down noticeably further to 8-3/4 percent or something like that. Some see that as something that could come further down the road, but not in the very immediate future. But I must say I have a little question in my mind currently, and we've had this question right along, about gauging the proper relationship of borrowings and funds rates now. It's hard to make a strong case on these things, in any event. But I have a slight doubt at the moment as to whether, with $550 million of borrowing, we really should be expecting funds to be 9 percent or a shade above or more right around 9 percent or maybe even a hair under. A lot depends on just what happens with seasonal borrowing, which has stayed pretty high; it has come off a little but is still pretty darn high.

CHAIRMAN GREENSPAN. Any further questions?

MR. HOSKINS. I just have one, Peter, on the size of the Treasury balances. Does [implementing] that drain when it comes cause ambiguity about the size of our easing move in the marketplace? Have you had any discussions with Treasury about perhaps their changing the variability of their debt issues as opposed to their balances at the Fed? Or is that not really a problem for you?

MR. STERNLIGHT. I don't think it has been a particular problem. They had high balances at the end of June; they were more or less forced to have the high balances because there are big seasonal tax receipts. And they had more than used up the capacity of the banks to hold these note balances; that capacity is around $31 or $32 billion, as I recall. And those balances did come off in July. They have been holding pretty well around their normal Fed balance of $5 billion as a working balance recently.

MR. HOSKINS. That's not really a problem?

MR. STERNLIGHT. It has not really been a great problem.

CHAIRMAN GREENSPAN. Well, I think Lee is raising a question, as I assume, that they have the capability of--

MR. HOSKINS. Issuing debt.

CHAIRMAN GREENSPAN. --funding directly out of their cash accounts or borrowing new money. The issue, I gather, is should they be more variable in borrowing new money to smooth out both the tax and loan account and their balances with us? I think the answer to that, as far as monetary policy is concerned, is that I assume it's easier for us to adjust than for the Treasury.

MR. HOSKINS. I think that's what's--.

MR. STERNLIGHT. Yes.

MR. JOHNSON. But [unintelligible], I think, is the issue.

MR. HOSKINS. That's what [Peter] implied.

MR. STERNLIGHT. Well, we have sometimes had discussions with them about whether it would be useful for them to make greater use of cash management bills that could get them by some of these post-tax date bulges in cash and the like. They traditionally have been reluctant to make much greater use of cash management bills, feeling that that was a relatively costly way to fund the debt. But, that's kind of an ongoing debate that we have with them.

MR. KOHN. I think there are one or two other points, President Hoskins. One is that I don't think the need to drain [reserves] has really hindered Mr. Sternlight's ability to let the easing show through over June and July. In fact, it may even help a little in the sense that it lets the reserves sit out there a little longer and tends to put downward pressure on the funds rate by waiting to take it out. In some sense it's helpful. The other point is that, to a large extent, our need to drain--although it has been revealed by the decline in the Treasury balance--resulted importantly from the warehousing of the ESF funds and also our own intervention. This sterilization, really, of that part of our balance sheet gave rise to a lot of this need to drain.

MR. STERNLIGHT. Yes, that's certainly true.

CHAIRMAN GREENSPAN. Also, the degree of instability that occurs is largely our inability [unintelligible] matter of using cash management bills or allowing the balances to move. Everything is exact, but we can't--. I guess you could argue, though, that the more variables they have to play with the more likely that the forecasts are--

MR. HOSKINS. Offsetting errors?

CHAIRMAN GREENSPAN. Yes, but sometimes they aren't.

MR. JOHNSON. Compounding.

CHAIRMAN GREENSPAN. Any further questions for Peter? If not, would somebody move to ratify the transactions of the domestic Desk since the July meeting?

MR. KELLEY. So move.

MR.JOHNSON. Second.

CHAIRMAN GREENSPAN. Without objection. We now move to the general economic evaluation. Messrs. Prell and Truman.

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

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

CHAIRMAN GREENSPAN. Questions for either gentleman?

MR. SYRON. Mike, I have a question about a prospective piece of data. The claims data have looked very good so far. My question has to do with the Nynex strike. I happened to talk to the fellow who runs the Nynex in New England and there's an issue about some people--I guess in New York State--who after seven weeks on strike are eligible to file claims. In some other states they may not be eligible to file claims but they may be filing the claims anyway because the company has to send someone into the employment office to dispute the claim or else it ends up counting against the company's experience rating. I'm wondering if that perhaps could have some effect on the claims data that we are going to be seeing over the next period--whether the markets know that and how they are likely to [react].

CHAIRMAN GREENSPAN. You mean if claims were to go up?

MR. SYRON. Yes. Claims could go up artificially because they would be--

CHAIRMAN GREENSPAN. That would almost surely be reported in the BLS weekly release. They do discuss technical reasons as to why claims move as they did. Should that be the case, they almost surely would put it in the press release. And it would probably be in our [unintelligible] and aggregate amount. It certainly would make it clear that--

MR. PRELL. I must admit you know more about this from your conversations than I do. Larry [Slifman], have you--?

MR. SLIFMAN. What the Chairman said is correct. There is the issue of whether or not the claim is accepted; then it shows up in the ongoing benefits. But the BLS in most instances knows who's filing the claim, so they can sort of monitor these things since it's an administrative count. And they normally will note it, as the Chairman has said.

MR. PRELL. I think the more important question is what effect this will have on the employment and hours numbers for August. I suspect there will be considerable [doubt] when we see, on net, a very low employment growth number. But we've also assumed that there isn't a lot of lost output with this [strike]. There will be a few phones that won't have been installed and so on, but the calls are generally going through. So this looks like something that won't have a large GNP effect.

SPEAKER(?). On the payroll numbers themselves, we estimate that during that survey week of the 6th to the 12th of August about 150,000 telecommunications workers were on strike.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Ted, a question about net exports: In Part II of the Greenbook there was an interesting discussion of the revision in the export numbers that was done for '86, '87, and '88. Analytically, how do you treat that when you're using a model or you're doing your analytic work since they haven't done a benchmark and you don't know what happened before that?

MR. TRUMAN. Well, first the answer is the add factors; we have reestimated our equations in any case. You are right that there is a problem because it creates a gap between '85 and '86 and you have a discontinuity here. In answer to your question about what we would do, we either would try to smooth it or [unintelligible] back. Normally, they take these things back.

MR. PARRY. I know.

MR. TRUMAN. For some reason they didn't do it this time because they ran out of resources.

MR. PARRY. So you have a whole year, too.

MR. TRUMAN. Yes.

MR. PARRY. Is there a similar problem in inventories because there were big changes there?

MR. TRUMAN. I don't know about inventories. It may have been [just] this particular area; what they did essentially was add new information that they collected on these exports and imports of various services that they didn't have [information on] before. They may have felt that they couldn't quite figure out how they wanted to feather it into the past. So, it's more than a correction of past numbers; it was [brand new] information.

MR. PARRY. Could it add a little uncertainty to the forecast?

MR. TRUMAN. Yes, we put them right in. We've discussed that here with the Board and to some extent that's good news. It is good news in the sense that the base on which we forecast our exports is that much higher and one might even argue that some of these services, which are education and medical services and travel, are ones that have rather high income elasticities. Therefore, the overall elasticities might be a little boosted by this.

MR. PARRY. They were moved out of consumption right into exports. It wasn't something that had been missed?

MR. TRUMAN. It was moved out.

MR. PARRY. And formerly it was in domestic consumption?

MR. TRUMAN. That's right, I guess. Yes, to some extent, that's right.

CHAIRMAN GREENSPAN. [Unintelligible] transportation services from domestic to foreign--

MR. SYRON. It's a reallocation.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Mike, [some] of the numbers that have been reported going back to the second quarter may be revised up, and there is some speculation that growth in the second quarter might have been as much as a full percentage point faster than you show in the Greenbook. How do you construct your forecast? Do you simply take it out of the third quarter or do you project the third and fourth quarters from that higher base, if indeed it is revised?

MR. PRELL. We do think there will be an upward revision. As best as we can do the arithmetic--making guesses where we need to about how BEA may interpret some of the data--we think an upward revision of about a point is in store. Basically, our forecast is a [net] change forecast and thus isn't affected by this. That means that the levels of some of these variables--if we were to redo the forecast with the revised second-quarter numbers--would look different. But in terms of the GNP growth path, it wouldn't be a factor.

CHAIRMAN GREENSPAN. Well, I gather that's not true for inventories.

MR. PRELL. It is true for inventories as well. If inventories were revised up, inventory investment throughout the forecast, all other things equal, would be revised up. That means it potentially affects inventory/sales ratios.

CHAIRMAN GREENSPAN. That's what I'm getting at. In other words, to the extent that you view the level of inventory/sales ratios as a relevant consideration of inventory investment then, unlike capital investment, the [net] change is not fully appropriate in this context.

MR. PRELL. To the extent, though, that we digest the incoming information and are aware of whatever surprises there are for BEA in the latest inventory data, for example, that conditions our thinking about whether inventory levels are too high or too low.

CHAIRMAN GREENSPAN. Well, let me give you a very specific example: BEA comes in with a major tripling of inventory change in the second quarter. Can you tell me that that does not affect the third- and fourth-quarter inventory changes?

MR. SLIFMAN. Clearly, if that were the case, under those circumstances we would have to do something that was a combination of a [net] change for all other items and then worry about the level of inventory investment. It turns out, however, that in this instance that's not really the case.

CHAIRMAN GREENSPAN. That is not the case; I understand that.

MR. SLIFMAN. So it's not a problem this time.

MR. PRELL. This is an issue that we've debated many times. In fact, recently, we have been debating whether we ought to anticipate changes in BEA's numbers and put down our guess instead of the last BEA number. But there's a long tradition; this problem has been going on for decades here and we have been discussing how one ought to approach this issue.

MR. JOHNSON. At least two.

CHAIRMAN GREENSPAN. No one has the guts to do it and the private sectors don't. President Stern.

MR. STERN. Mike, you made a passing reference to fiscal policy. What difference, if any, would it make to the forecast if you had CBO's spending number rather than yours? It's about a $36 billion difference but--

MR. PRELL. Well, a lot of those differences come from policy assumptions. We think it is unlikely that this agreement is going to fall apart entirely; but if it did, then presumably we'd have somewhat stronger aggregate demand over the next year in this forecast and less restraint coming from the fiscal side. Relative to GNP, I don't think that we're talking necessarily about numbers that are night and day differences; but they are potentially of some significance. Let me just add one thing. One of the reasons CBO is higher reflects their assumption that the thrift resolution expenditures in this fiscal year will be lower than the $20 billion that we've built in. That's largely a paper shuffling transaction, as we've interpreted it, so that would be of no effect in--

CHAIRMAN GREENSPAN. This is raising an interesting legal question. We are uncertain as to whether we have to spend that money under the statute. They have made a judgment that we won't, and it's not clear that it's that simple. We may find out that we're forced to make that expenditure in the RTC.

MR. PRELL. Their report suggests that they are aware of some question here, but they've interpreted this as something that can be carried over and will show up as a budget outlay next year.

CHAIRMAN GREENSPAN. That has not been clearly evaluated has it? It's a very interesting problem.

MR. JOHNSON. Following up on that: Do we know how much of that authorization has been borrowed already?

MR. STERNLIGHT. Well, I think it's very hard to categorize. Clearly, the Treasury did step up their borrowing when it finally emerged how the compromise was going to come out. They tacked on at the last minute some $5 billion to a cash management [bill]. It was rather explicitly tied to the need for the $20 billion of budget expenditure in this fiscal year. And they have rather promptly added to the regular weekly bills. They might have had to add, anyway. But my impression is that they added somewhat more to that and also to the 2- and 5-year issues that are being sold this week. I think it's planned, though, that some of that $20 billion, if not all, will be spent; my impression is that they're aiming to spend it. That would be coming out on September 30 and would lower cash balances by some $6 or $7 billion--maybe more than that.

CHAIRMAN GREENSPAN. Actually, we've only spent something like $1-1/2 billion so far.

MR. PRELL. You have your work cut out for you.

CHAIRMAN GREENSPAN. Well, we're behind the curve.

MR. JOHNSON. I think borrowings may be $5 or $6 billion. Is that where it--

MR. STERNLIGHT. Well, it's not tied dollar for dollar.

MR. JOHNSON. Yes, I understand, but I mean relative to what you had expected.

MR. STERNLIGHT. The way we're looking at it, from the Treasury financing standpoint, I'd say they already have come into the market for $6 or $8 billion.

CHAIRMAN GREENSPAN. Then how much [unintelligible] have they got to run down the cash balance after September 30th?

MR. STERNLIGHT. I don't know.

CHAIRMAN GREENSPAN. I guess the question really is: What's the normalized expected Treasury cash balance from the period through September and is there much leeway to run it much below?

MR. PRELL. We have in our forecast a $32 billion end-of-the-quarter cash balance, so there's [room].

MR. STERNLIGHT. My impression is that they were going to aim for $20 billion instead of $30 billion, or something like that.

CHAIRMAN GREENSPAN. Governor, are you finished?

MR. JOHNSON. Yes.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. There were some changes, I think, in the estimates of productivity. Has that led to any different views about what [potential] growth in the economy might be?

MR. PRELL. As all of these revised data washed through, the revisions really didn't have much effect on our assessment of trend productivity growth. Our guess about the trend growth in real potential GNP is still close to 2-1/2 percent, maybe 2.6 percent at this point.

MR. MELZER. I just wanted to ask about durable goods orders. Did they come out this morning?

MR. PRELL. Yes, they came out; I must say that based on the data we have it's a little hard to interpret these things. The overall durable goods orders were down almost 2 percent. Nondefense capital goods orders were up 5 percent and June was revised up to 5 percent from about unchanged. But there are--

CHAIRMAN GREENSPAN. Ex-aircraft there's a significant decline.

MR. PRELL. Ex-aircraft it is down 10 percent. But last month was revised up to 6.6 percent. The big swing factors in the last couple of months seem to have been a category called ordinance, ship building, and tanks, which is part of nondefense--

CHAIRMAN GREENSPAN. Part of [unintelligible] called domestic defense.

MR. PRELL. So these numbers are pretty murky at this point. It looks like there's a touch of weakness in orders for computers, and that doesn't come as a great surprise in light of the anecdotal evidence about what's going on in that industry. On the whole, though, at this point I'd only venture the guess that this report doesn't suggest a very big departure from what we have been tracking here. Overall, unfilled orders for nondefense capital goods continue to rise substantially month-by-month, really.

MR. GUFFEY. Do we have any indication of why these numbers have been revised so dramatically over the last two or three months? Is there something going on?

CHAIRMAN GREENSPAN. The usual.

MR. JOHNSON. Difficulties and errors.

MR. GUFFEY. Well, they are of larger magnitude. Are they orders?

CHAIRMAN GREENSPAN. I think it's [mostly] revisions from the ones on the military contracts, which are--

MR. PRELL. The release indicates that the average revision for new orders is about 2 percentage points, so this constitutes a pretty healthy revision. But this is a series that's very volatile, and on top of that you get these--

MR. HOSKINS. How do the markets interpret it?

MR. KOHN. The bond market went down on balance by a very small amount, about [unintelligible].

CHAIRMAN GREENSPAN. The bond market went up on the initial release of the July numbers; then when they got the revision it went down.

MR. PRELL. The market is going to be handicapped in interpreting this because some of the crucial detail isn't going to be available until the final release of manufacturers' orders and shipments next week.

MR. JOHNSON. I'd wait 'til the end of the day.

MR. PRELL. It's really difficult to sort through these numbers.

CHAIRMAN GREENSPAN. The question of the inflation forecast depends crucially on the [unintelligible] of the average compensation per hour forecast; when all is said and done, everything else pretty much washes out. How comfortable do you feel with the relationship between labor market tightness and the wage forecast? In other words, it's clear that it has been slipping, but how would one characterize it? Is it significant or is the relationship still there but muted? How comfortable do you feel with the [mutual] relationship between labor market tightness on the one hand and the wage forecast in the Greenbook on the other?

MR. PRELL. We don't perceive this as a simple relationship. Obviously, there is interaction here, and there are price surprises that could affect the inflation expectations that could in turn affect compensation. And then this all cycles around. Basically, it depends on what model you look at as to whether there has been a very big surprise in the behavior of wages. If you refit your models through the recent experience and you capture all the data revisions that have occurred along the way and you select your price expectations variables correctly, you can pretty well capture what has been going on in compensation inflation over the past couple of years--not quarter-by-quarter, but the general drift.

CHAIRMAN GREENSPAN. Well, let me put the question slightly differently. Did you say before that you are a percentage point lower than you were two Greenbooks ago?

MR. PRELL. Percentage point lower?

CHAIRMAN GREENSPAN. In the compensation [forecast]. Did I hear you say that?

MR. PRELL. No. In fact, there hasn't been much change in our compensation forecast since last fall. We have been projecting pretty much the same compensation increase this year as we have all along.

CHAIRMAN GREENSPAN. So, is the structural equation significantly changed? Or, in a sense, are you saying that with all the recent data we can now explain comfortably what has been happening in the last couple of years in the employment forecast?

MR. PRELL. My feeling is that it depends on which data you look at. There's the compensation per hour series, which has been showing about 5-1/2 percent increases over the past year. There is the employment cost index, which has been showing 4-1/2 percent or a little above that. That number looks rather low against the kind of consumer price inflation we've been having in an environment where we think the unemployment rate is essentially in line with the natural rate--fairly tight labor markets. Judgmentally, we would have expected to see that 12-month change in the ECI creeping up over the past year, and that hasn't occurred. On the other hand, I think the basic tenet of this forecast is that there was an acceleration here. We have not turned down, in terms of this trend; the labor market is remaining tight. It is very difficult, barring some significant price shock, to see why we would go lower on wage inflation. In light of the large increase in consumer prices over the past year, in particular over the past half year, we think there is going to be some pressure--self-inflicted or not--on employers to boost their wage increases a bit to keep their employees whole. And we think we're going to see some slight further upward movement in compensation per hour over the next couple of quarters. Then next year we have the hit from the legislative increases, which accounts for almost all of the further increase in 1990. So I'd say we are comfortable that we have assessed the risks properly and that it's most likely that we're going to see some edging up rather than stability or a downward movement.

CHAIRMAN GREENSPAN. Do we have any further evidence as to why the ECI, which has theoretically the same establishment coverage that creates the compensation per hour, [differs]? It can't be a mix factor, solely.

MR. PRELL. Well, but there could be a mix factor here.

CHAIRMAN GREENSPAN. That large?

MR. PRELL. I don't think we can fully explain this; we're not entirely comfortable with this.

CHAIRMAN GREENSPAN. Feel like making a judgment?

MR. PRELL. There are possibilities. One is, since the compensation per hour series doesn't collect the same kind of direct information on benefits, that it's missing something in that area. We have seen significant revisions in the past as, with a considerable lag, they incorporate that information. But it is a source of some discomfort. Looking at the ECI, I suppose we might feel that there is some upside risk because of the low level of that increase over the past year or so against the kind of consumer price inflation we have had.

MR. PARRY. Pursuing this a little further: you made the statement that the underlying rate of inflation really doesn't show any progress between now and the end of 1990. I know for the next meeting you will come out with [a forecast for] 1991. Have you taken any preliminary looks? Based upon the assumptions that you use, is there any improvement in the underlying inflation that occurs later?

MR. PRELL. Well, I must confess that in all likelihood there will be some decline in the inflation rate in 1991 in our forecast by design.

MR. PARRY. By design?

MR. PRELL. Because we are assuming--

MR. PARRY. That's the objective.

MR. PRELL. --that it is an objective of the Committee to make some progress in that direction, while avoiding recession. The question is what kind of economic environment it will take. If we assume that the dollar continues to appreciate, that argues all the more for our assuming that growth in 1991 will have to remain on the soft side. That will be the kind of forecast we most likely will be presenting; and that's in line with what we presented in our previous simulation, for example, in the Chart Show.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I just have one question about profits. As I've read some of these profit reports the last couple of weeks, basically, it just seems to me that for the second quarter of the year there are a number of very soft stories that came out. Now, maybe they weren't any softer than we expected; I don't know. But I just wondered if in fact there is a significant deterioration showing up, particularly in the high-tech area. That was the one that surprised me the most. And I wonder if the aggregate numbers forecasted here are sufficiently weak to reflect that.

MR. PRELL. We have a very pronounced drop in the profits share in our forecast. We think it is ongoing at this point; and by the end of 1990 in this forecast, the profit share is historically at a very low level. That's one of the factors in our thinking about the investment outlook. Overall cash flow will be constrained; the current profitability of businesses won't look so great. So we think there is going to tend to be some drag on investments going out through 1990. It's very hard to get a handle on what is happening in the aggregate from the stories about these [unintelligible] on unadjusted earnings and so on. But we think it is weak at this point.

MS. SEGER. I know you don't like me to look at quarterly numbers, but I'm going to do it anyway. It seems to me on a couple of these quarters looking ahead that you actually show a slight increase in profits--for example, in the fourth quarter of this year. I don't mean as a share of GNP; I'm just looking at the corporate profits with IBA and CCA adjustment.

MR. PRELL. I'd rather not look at the quarter-by-quarter numbers that closely.

MS. SEGER. Yes, I knew that.

MR. PRELL. As I look at it, the fourth-quarter number is up less than $1 billion.

MS. SEGER. Right.

MR. PRELL. Right off the top of my head I'm hard pressed to identify all of the factors here that explain that. But I think that is too fine a reading of these numbers.

MS. SEGER. In the third quarter of next year, also, you have the decline stopping and a bit of a rebound--or more of a rebound than in the fourth quarter of this year.

CHAIRMAN GREENSPAN. That's right; the fourth quarter is up because unit labor costs are down.

MR. PRELL. Yes. Gyrations from quarter-to-quarter in the rate of output growth in productivity feeding through here can lead to some bounces. But I think the real story here is that we are projecting a rather weak profits picture. It may be that private analysts have come around more to this view than previously. We felt we were much more pessimistic than most private forecasters previously. I think there is a greater sense now that, in terms of economic profits, there's something going on from the effects of the 1986 tax law on depreciation allowances--that operating economic profits are going to be relatively weak as one looks ahead.

MS. SEGER. Don't you think, though, that this profits story is tied into the inflation numbers? Many of these higher costs--whether they're wage costs or something else--because of the competitive environment are having to be eaten by the organization. And where it's coming from is out of profits.

MR. PRELL. Indeed.

MS. SEGER. In addition to just the cycle [phase].

MR. PRELL. [Unintelligible].

MS. SEGER. Thank you.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. Just a couple of things: First, you mentioned that you thought demand was going to be rather buoyant, and I'm having a little trouble with that. I see it picks up somewhat in the second half of the year and I think some of that is auto related--certainly, the third quarter is. Then you have it coming off in durables in the fourth quarter, but nondurables are much stronger relative to the past. What's causing that nondurable consumption [growth]? It has been trending down and all of a sudden it leaps up in the second half.

MR. PRELL. In the very near term I think it is much affected by the revised retail sales data, which puts it on a distinctly different path than we were on earlier.

MR. JOHNSON. But that's a level adjustment. You were talking earlier about unchanged growth rates, and I'm wondering why that would affect the growth rate.

MR. PRELL. It affects the growth rate of consumption in the third quarter because of the level [unintelligible] path and so on.

MR. JOHNSON. Okay, I see it.

MR. PRELL. We're at a much higher level and relative--

MR. JOHNSON. It's jumping all over the place.

MR. PRELL. In a sense. But beyond that, a month ago when we were looking at this before the GNP revision we were looking at a very steep drop in nondurables in the second quarter. I think I suggested at the time that that looked really peculiar and that we wouldn't be surprised to see a revision. When the GNP numbers came out they eliminated some of that decline; I think it went from minus 6 for nondurables to minus 4. Now, those numbers are going to go up still further. There is still going to be a pattern of about three quarters where we're running at rather weak nondurables expenditures. History suggests, statistically, that this sometimes occurs in the gasoline area when we've had a big run-up in gasoline prices and then you get a reversal as gasoline prices fall. It may be merely a statistical measurement problem. Be that as it may, the trend there just looks to be weaker than one would anticipate over time; so in the second half we do have, in effect, a bit of a catch up. But looking at next year we only have a 1-1/2 percent nondurables increase; this year as a whole we only have something in that vicinity, after the revisions for the second quarter. So, the outlook is for a very modest growth of nondurables.

MR. JOHNSON. Yes, thanks.

MR. SYRON. I thought some of the decline in nondurables was accounted for by food.

MR. PRELL. [Unintelligible] be at something in excess of 3 percent. So this is a fairly buoyant, as we characterized it, demand picture. And it's only in small part an automobile story because, while we get a burst from the third quarter, in the fourth quarter we're expecting a pay-back. So on net over that span it isn't an auto story. In fact, in the GNP forecast the automobile assemblies are taking a fraction off of GNP growth in the third and fourth quarters.

MR. JOHNSON. Now, let me ask: What is the difference between gross domestic purchases and just the private domestic final purchases? Is that taking out imports?

MR. PRELL. You take out the government. Then, with the private domestic final purchases you're getting down to just consumption, residential investment, and business fixed investment.

MR. JOHNSON. Okay. Another question I had was on your mention of housing starts and some potential pickup. There have been some really marginal upticks in [starts], but permits have continued to trend down. Even with the Board staff's adjustment, they're still somewhat below starts. I just wondered, with permits continuing on that trend, whether starts would show a turnaround. I know they are both sort of contemporaneous indicators but I would think that starts would adjust to permits, not vice versa.

MR. PRELL. Well, for the single-family sector, the time differential between the permit and the start is very short. Statistically you cannot find any lead-lag relationship in that data. I think our permits tend to be less volatile from month-to-month.

MR. JOHNSON. That's what I meant to say, statistics.

MR. PRELL. Statistically, [permits] in level terms [don't tend] to be all that far different from the starts story.

MR. JOHNSON. No, except that they haven't shown any turnaround.

MR. PRELL. Indeed. But I think if you look at the new home and existing home sales in June, the housing starts for the last couple of months, the single-family number in July, and the anecdotal evidence in the press and elsewhere regarding builders' attitudes and consumer attitudes, all of these things point to some upturn. And we have a modest upturn in residential construction beginning in this quarter and continuing into the fourth quarter.

MR. JOHNSON. Well, that's sort of what I wanted to follow up on, Mike. I can understand what you're saying, looking at the permit trends and realizing that you've got a turnaround in starts and housing investment, but in the broader picture on total investment--even when you take into account some of the revisions on orders--the orders data are very weak. And when you look at the fact that long-term interest rates have been down for quite some time now and have been trending down over a fairly long period--I guess they peaked out last August, about a year ago--

MR. KOHN. There wasn't much change until this March.

MR. PRELL. There wasn't much change, and they may not have declined much in real terms if you think there was some diminution in long-run inflation expectations.

MR. JOHNSON. Right. But there certainly has been no expectation of long rates rising more than expected. They had been trending down gradually, and then more recently declined more, I guess. Yet there is no sign of a pickup in orders or anything that looks like that's having [an effect], forward looking, on investment demand.

MR. PRELL. Well, I think I differ on that. One, on the structure side, we really have discounted this. If you just wanted to look at the data literally, there has been a considerable upturn in construction contracts in the last several months. We think that's just a sporadic movement that is not likely to be sustained, but actually it has strengthened. On the orders side it depends on how you want to look at the zigs and zags from month-to-month. You can look at the zigs and zags for the past half year or so and say that--

MR. JOHNSON. The level is about the same.

MR. PRELL. --for computers it's no better than flat, and maybe has edged off some. But remember, that nominal dollars there--given the price declines--translate into a sizable real increase in expenditures. So one needs to keep that in mind. If you look outside of computers at the non-aircraft, non-computer component, either we have had a persistently strong uptrend or, looking at the zigs and zags in the least optimistic view, one would say it has been rather flat. Somewhere in between is where we come out in interpreting this, particularly in light of the backlogs in that area. So we think there is some further growth ahead.

MR. JOHNSON. Regardless of the zigs and zags, if you just look at the current level--even taking today's numbers into account--I remember that the level looked about the same as it was 8 months ago. There has been some volatility month-to-month, but the fact is that the level is roughly unchanged over a half a year.

MR. PRELL. I don't want to get into a long debate, but let me refer you to the middle panel of the chart on page 16 of Part II of the Greenbook. That is the chart to which I was alluding; that's other nondefense capital goods and the solid line is orders. Last fall it looked like things were falling out of bed. That orders figure turned down. What we've had in the first half of this year is a tremendous increase in producers durable equipment outlays and pretty strong exports of equipment as well. As you can see, the shipments just continued to rise. In the first half of this year we zig-zagged on a flat path. But one could easily do an optical regression here and draw a trend line right through 1987-88 to the current numbers and say the trend is still intact. It's a judgment--

MR. JOHNSON. Yes, well--

MR. PRELL. As I said, the recent evidence has been rather mixed. The anecdotal evidence--the reports that we are hearing from some of the producers of capital goods--doesn't sound all that great. So, I don't want to make the case that this sector is unambiguously robust at this point.

MR. JOHNSON. Yes. If you look at it over a long period of time, I think you can run a regression right through the turning points and get a nice upward slope. But the point is that we have to worry about the [turning] points.

MR. PRELL. Indeed, but I think the history also tells us that one needs to be very careful.

MR. JOHNSON. True; and I don't disagree with that. Now, I have one other question, for Ted. You talked about the widening of the current account later on, and that leaves some of the reason for the dollar depreciation assumptions out. With the revisions, the current account and the trade numbers are dramatically down with the deficit. I just wondered: Why doesn't that really work in the opposite direction and support a stronger dollar over the horizon?

MR. TRUMAN. Well, presumably, the relatively good trade numbers and the current account revisions certainly have been factors --I would say largely the factors--that underlie the strength of the dollar we have seen so far this year. It's certainly positive in that direction. One might argue that if you want equilibrium, whatever you thought the current account had to get to, the revisions suggest that you need less exchange rate change ultimately to get there. I would accept that. But most of the models have this characteristic, and they may be wrong, that at unchanged exchange rates with approximately a slightly lower growth here [than] abroad you're going to have a widening of the current account. I think the only issue is how much. The models differ and actually ours is modest, I think, by the standards of most of them. And we have goosed up, if you want to put it that way, the thing considerably.

MR. JOHNSON. All I'm saying is, if you take that seriously, that we would have hoped the models were predicting 110 on the yen a year ago or so.

MR. TRUMAN. I'm quite modest about the nature of the underlying projection of the dollar, and that's one of the reasons why in our presentation Mike and I agreed that we should give you some sense of what difference it makes. I certainly don't mean to suggest it's a sure thing that this degree of deterioration is going to generate that much decline or that adding $15 billion more to it is going to mean that the end is near. I can't give you any assurance. We have the feeling that ultimately maybe it's like the budget deficit: ultimately a somewhat lower percentage of GNP is going to have to be imported. What the time pattern of that will be and how much of it takes the form of pure exchange rate adjustment and other factors as it gets there is up for grabs.

MR. CROSS. Certainly that number, when it was reported, was noted in the exchange market. And at least during that day it was certainly a supporting factor. They did pay some attention to that.

MR. JOHNSON. Yes. But I would say that the perceptions created by numbers like that [are one of] the reasons why interest differentials have worked one way and the dollar is going the other way to some extent. It's surprising. I think everybody has been grasping for reasons why the dollar has continued to hold up this well and even strengthened when interest differentials were working against it. And I would venture to say that improvements on the current account both in actuality and prospectively may be a major factor in that; rather than working against the dollar it may be one of the things supporting it.

MR. TRUMAN. Well, the fact of the matter is that we knew these [revisions] would come. In fact, the Federal Reserve [unintelligible] instigated this with Commerce Department five years ago to start looking at some of these things. As far as I know there aren't any more in the pipeline. So it's found money and it does change the base, as I said earlier; but I don't think there's any real chance that we're going to revise away a $100 billion current account deficit.

MR. JOHNSON. No, all I'm saying is that you may be at a point where people say: Hey, this thing is ultimately financeable now. How the financial burden, if we proceed--

MR. TRUMAN. If you put these numbers together, it's financeable but the problem is the level of our debt. You're worried about the base in all these numbers but it comes to something like 40 percent of GNP. That's where the steady state is. And that is a big number. It is as big as any major industrial country has had [except] Australia and Canada. And Australia and Canada have the advantage, I think, basically that their capital intensive exploitation of--

CHAIRMAN GREENSPAN. I'm sorry, what's 40 percent of GNP?

MR. JOHNSON. The current account deficit.

MR. TRUMAN. If you play it out, the $100 billion current account deficit as a percent of GNP would, assuming a steady state and making all kinds of assumptions about the growth rates and so forth and so on, you get something like 40 percent of GNP.

MR. SYRON. The debt or--

MR. TRUMAN. Net external debt as a percent of GNP. Now if you're worried about the base--and that's a big number--my feeling is somehow that probably we're not going to get there.

MR. SYRON. Something can change in the meantime.

CHAIRMAN GREENSPAN. Well, the crucial issue was the financing of that.

MR. TRUMAN. That's right.

MR. JOHNSON. Yes, that's what I was alluding to.

MR. TRUMAN. [Unintelligible.]

MR. JOHNSON. However big it is, Ted, it's a lot smaller than what people thought it was earlier, I think.

MR. TRUMAN. No, I don't think it's very much smaller.

MR. JOHNSON. Well, it's smaller. So what I'm saying is that the market people see the financing requirements as less than they did before.

VICE CHAIRMAN CORRIGAN. In my judgment, if we have external debt of 40 percent of GNP we're in real trouble.

MR. JOHNSON. Well, if you play that scenario out you come up with all kinds of [unintelligible]. But I think it matters what it's being used for, what you're doing with it. There are plenty of countries that finance that quite easily as long as it's going for sustainable private-sector investment.

CHAIRMAN GREENSPAN. $2 trillion and the interest cost of that--

VICE CHAIRMAN CORRIGAN. It's transferred.

MR. JOHNSON. But it's all relative to the return on the investment.

CHAIRMAN GREENSPAN. We haven't invested--

MR. SYRON. Well, that's the progress plan--from here to Australia.

CHAIRMAN GREENSPAN. Any further questions for our colleagues? If not, who would like to start the Committee discussion?

MR. PARRY. Thank you, Mr. Chairman. The economy in the Twelfth District continues to grow, although at a slower pace than earlier in the year. Some areas are enjoying robust growth. For example, the state of Washington is experiencing a sharp escalation in housing prices, booming construction, and rapid in-migration. Alaska is recovering at a rate of growth in employment that is twice that expected prior to [unintelligible] growth. District retailers characterize sales as satisfactory and inventories at desired levels. But other areas of the District are exhibiting weaker growth. Arizona remains weak, with construction slumping and defense-related manufacturing facing cutbacks. A rather new development is that growth has slowed in California, with declines in manufacturing and construction employment noted in the last several months.

Turning to the national economy, stronger growth now seems to be more likely than it did at our last meeting. Lower interest rates and declines in food and energy prices should produce a pickup in consumption. Moreover, it appears as though the downside risks to inventory accumulations have lessened because of the recent revision of national income statistics. We expect the economy to remain above its high employment level through 1990. Thus, similar to the Greenbook, we expect some further modest increases in wage inflation. And in the absence of any policy changes, we would expect the momentum of the current inflation rate to persist into next year. Thank you.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Thank you, Mr. Chairman. The signs of deceleration in the Sixth District that I've been reporting recently are now very clearly visible in the economy. Growth seems to be a bit weaker in the District than in the nation as a whole, and this comes after several years of much stronger than national growth and even stronger than sustainable growth. However, many business people, including directors that I've spoken to in recent weeks, report that this deceleration is in line with their expectations; and most report that they don't anticipate further softening. Interestingly, a number of these people--those on the manufacturing and commercial side--also report that they basically are not changing their business plans, particularly their capital investment plans. We may have a little exception in the banking community where their view is tempered by the fact that their loan demand has been very soft over the summer, as contrasted with the rest of the country. The weakness that we are seeing in the District pretty much mirrors what is going on in the rest of the country, and that is that the weakness is in retail sales, automobile sales, and home and office construction. Retailers are reporting poor demand for durables such as appliances and electronics; and the demand for furniture, as you might expect, has moderated significantly because of the slowdown in housing activities. Automobile inventories remain far higher than desired across the District. Auto sales in the Southeast have been far stronger than in the nation for several years. So the slow pace this year--in fact the almost depressed state of that industry--seems to have taken the dealers by surprise. On the production side in autos, GM and Ford have announced that they will idle or reduce production at additional assembly lines in several weeks ahead. The weakness in housing construction and autos has spilled over into the transportation industry where freight volume is down significantly, especially for trucking, and further declines are anticipated.

But even in this weaker climate we do have some sources of strength, and that I suppose gives rise to this optimism on the part of people that the deceleration won't go any further. Industrial construction remains quite robust and plant expansions are occurring in the chemical and plastics industry where world demand remains quite strong. Firms that manufacture the equipment used to automate production also report strong orders. However, the outlook for farm income is not very good at all in the District. Heavy rains have affected most crops, with the exception of citrus. And aside from cotton, prices for many crops grown in the region have softened so that farmers in the Southeast are finding themselves marketing reduced output at lower prices. In the energy sector, activity in the oil industry remains at a low level although natural gas exploration is continuing very robust, particularly in the Mobile, Alabama area. Once again, we've paid a lot of attention with our contacts to the wage and price and labor situation. And with very few exceptions they are reporting very moderate wage increases. The demand for labor is not particularly [strong] except at entry levels in some businesses like the fast food market. And prices seem to be moderating at every level. So, it's a mixed situation in the District, as I indicated; there is softening but apparently, according to the contacts, we are at the bottom.

Our outlook for the national economy is very close to the one shown in the Greenbook for the rest of the year and also into 1990. However, we show more improvement--although it's slight--in the trade deficit, in part because the dollar in recent months has not been as strong against the currencies of the NICs and Canada as it has been against the European and Japanese currencies. We also have raised our estimates of the unemployment rate a bit higher, although they are a little lower than in the Greenbook. Our forecast for inflation is somewhat higher than the Greenbook's as well. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Well, Mr. Chairman, there's really little new to report on the District economy at this point. It seems to be performing much like the national economy, as best as I can judge; that is, it's performing reasonably well but it is not uniformly strong at this point. We have had some reports that things in the labor market have changed a bit in the sense that it's a little easier to find and retain workers. On the other hand, there are some signs of growing labor militancy, although in general wages or even broader compensation matters are not the issues; it's really other things having to do with union shops and so forth. I have had a couple of business people mention to me--I presume tongue in cheek--that they would like to see the unemployment rate go up.

As far as the national economy is concerned, I think the changes to the Greenbook forecast relative to the view of the last meeting are in the right direction, but they are probably too modest. My own view is that we're going to get somewhat more real growth and somewhat lower inflation than the Greenbook suggested this time. I must admit I've been struck by what I've been hearing about the continued lack of build-up in wage and compensation pressures and by what I've been hearing about materials prices. Clearly, a lot of business people have reported that materials prices have leveled off or have been declining and aren't the problem they were earlier. So, allowing for the possibility, of course, that further data revisions may change what is rather a nice picture, it seems to me that things are going almost unbelievably well.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, it seems to me in a national context that the economy, as Gary has just said, is moving along just about on the track that we might have expected. I think the moderating growth trends are there; there are many industries that are certainly operating at lower levels than was the case earlier. Some of the interim data may be coming in a little stronger than we might have expected, or certainly than we expected the last time we met. That may be particularly true on the personal consumption side. But I think, basically, the situation is largely unchanged.

In a District context the news is a bit mixed but on balance showing signs of moderation. The steel business, for example, has been weaker but there were some seasonal issues there. Last year the steel industry and most of the major customers operated throughout the summer without taking the normal seasonal shutdowns. This year, though, they have been operating with somewhat normal shutdowns and I think this is having an effect on the numbers. Looking ahead a bit, the auto industry, as Bob [Forrestal] has suggested, [is planning] a very significant production cutback in the fourth quarter. That certainly is going to have a big impact on their numbers as well as those of their suppliers. The heavy truck business is much softer now and some of their main manufacturing suppliers were also scheduling layoffs. The Chicago purchasing managers' report for July reflected a pattern very similar to that in the national report. Alternatively though, I find that the construction business has been surprisingly strong, particularly for commercial and public works. There is a lot of activity going on there. Our numbers in that category are stronger than the national numbers, and I think to a lesser extent the same is true for residential construction. In the agricultural sector, the news is certainly much better now than it was earlier in the summer. We've had reasonably good rainfalls pretty much throughout the District. Production is going to be good. Farm land values are continuing to go up a little more modestly this year than they were going up last year. And in the improved environment, the agricultural picture is much better. Products are moving off the dealers' lots at a pretty good rate. I think the price picture is also good. Prices of some basic materials, which over the last couple of years had shown big increases, are now down. There are some chemical products--zinc and lead--that I think are examples of that; and others are showing smaller increases. The competitive factors remain pretty intense, so finished prices are remaining in pretty good check.

So at this point, I think the economy is developing very much in line with our expectations, at least. But I will say our forecast has been a little [unintelligible] than the Board staff's forecast has been. Some of the data are coming in on the positive side but I think the underlying risks are about the same as they have been. On monetary policy some things are working out just about as we'd like to have them.

CHAIRMAN GREENSPAN. Thank you. President Syron.

MR. SYRON. Thank you, Mr. Chairman. Well, as far as the national economy goes, I think in many ways it couldn't be much better. But there has been talk about New England and the phrase comes to mind that "this too shall pass." I hope it doesn't.

MS. SEGER. It hasn't yet?

MR. SYRON. It has in New England.

MS. SEGER. Oh.

MR. SYRON. In the First District, I think it's fair to say that overall economic conditions are quite soft and likely to get softer. The unemployment rate is up nearly a percentage point, or a little less, over about 4 months. There have been significant declines in employment, particularly in the high-tech and computer industries and in construction, which is at this point where one might expect.

CHAIRMAN GREENSPAN. What's the unemployment rate in the District now?

MR. SYRON. It's about 4-1/2 percent--still significantly below the national average, but that is up 0.8.

CHAIRMAN GREENSPAN. I understand.

MR. SYRON. There is only one state in the District which [unintelligible] population, which is Massachusetts; its low point was around 3 percent and it's now 4-1/2 percent. And that's the only significant jump--a monthly jump of around 0.4 of a percentage point. The thrift industry, largely the savings banks, has very serious asset quality problems which are now spreading to commercial banks. Unfortunately, more than one of our larger super regionals has substantially large [non]performing assets and is getting quite bad marks in terms of their asset quality--Bob Boykin is smiling here--which is going to be a problem for us in the future. There is some evidence, particularly in some of the northern states that the problems that people have had in the real estate market are making lenders more cautious now than in other markets, which is starting to have some cumulative effect. This accumulation of bad news, [along with] a rather substantial number of layoffs and a very bad fiscal situation in Massachusetts, has impacted somewhat. I don't know how much value one wants to put on these data, but a survey I saw breaking down consumer confidence by region showed consumer confidence in New England off 22 percent. And that's certainly had an impact on retail sales, which is corroborated by our state sales tax revenues. As one might expect, this has had a favorable effect on wage demands, particularly at the middle and upper levels. But at the entry levels we still have the McDonald's thing--a great deal of money.

In talking to manufacturers in the District, I find a really striking divergence in their views and their experience within and outside of New England. There are problems in the computer industry, which you referred to earlier, on a nationwide basis. Some of our firms are dramatically [unintelligible] industries--which is on the front page of The Wall Street Journal--and have experienced the problems much more so. These really are firm-specific, product-cycle, kinds of problems. Even our successful companies, like are suffering with the nation. But other manufacturers report that they are doing reasonably well nationally compared to their really cautious expectations; and they really have expected a fairly soft year. None of the ones that we have talked to expect a recession. They expect a continuation of slow growth, as referred to earlier. Suppliers of commercial aircraft are doing reasonably well and capital goods producers are arguing that their orders are holding up quite well. We look at the volume of exports out of Logan Airport because most of what we produce for export is shipped by air rather than by water, and that has shown a fairly striking decline in the level of exports. But some of that problem is mixed with this product-cycle thing. I think we realize in New England at the intellectual level--but it's a little more difficult at a visceral level--that this is coming off a high but unsustainable level. I may be stretching it a point, but I think there may be a little lesson from the region; the mechanisms are different from the national economy as far as what has happened in New England where we were substantially overheated for some period of time. Unfortunately, we haven't had the experience in New England that we are having nationally, where we seem to be going into a soft landing.

It looks to me, as far as the national economy goes, that it's right about where we want it to be. Looking at the data that have come in, we don't see the kinds of imbalances that would lead to a recession. As other people mentioned earlier, the Greenbook revised up growth in GNP in every quarter, I think, compared with the last Greenbook. And employment growth, particularly, is revised up. Using the model that we have, employment is close to the upper end of what we think is consistent with maintaining the current inflation rates and would have no [unintelligible] making substantial progress toward improvement. The Greenbook does have a slight upward movement of the unemployment rate over the next year, but very little really. This could be revised away; things could easily change. We know that the inflation outlook is quite good. Like Gary, I think the information we have would lead us to believe that maybe it will be a little better. But when you exclude food and energy, it doesn't seem to me that we would make an enormous amount of progress. I think we've been quite fortunate on the wage front, given the tight labor markets that we have. There is some concern on the national level about how long this luck is going to hold. It seems to me that policy has worked very successfully so far; we rather like what has been done so far and would be concerned about changing very much from that--I'm getting into the next part. Given the relative tightness in the labor market nationally, one would have to be concerned over the longer haul that surprises might well be more on the up side than on the down side. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. So, you think the surprises are more likely to be on the up side than the down side. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. At the District level, things have not changed greatly. We are still in a growth mode; to be sure it is at somewhat less than the national level, but considering where we started that is still a pretty optimistic report. Farm conditions in the District continue to improve, largely as a result of some crop prices, which had strengthened following the recently released agricultural report that the rebound in crop production this year would not be as large as had been expected. In the energy area, the District's oil drilling activity increased this summer but still remained below year-ago levels due to the continued uncertainty as to price for both natural gas and drilling. Manufacturing in the District is going full out, largely as a result of the aircraft manufacturing--both commercial as well as private aircraft. Manufacturing activity is at a very high level. Auto assemblage is back to being fairly fully employed, in the sense that there had been a shutdown of the GM plant as a result of retooling and some supply constraints but they are back running and are running at full capacity. Construction activity in the District weakened slightly in June and into July; but it is still stronger than it was in the first half of 1989 and is stronger than it was a year ago.

On the national level, our forecast is not greatly different than the Greenbook forecast; we feel that the upward revisions are appropriate but may not be enough. Similar to what Gary Stern mentioned earlier, we think that the risk of recession is not great. Indeed, instead of a soft landing, we may be executing a touch and go;

we think the last half of this year will be stronger than the Greenbook forecast. As a result, the outlook for inflation as revealed in the Greenbook--certainly through 1990--shows no improvement. And yes indeed, we do read some of [the data to mean] that the rate in the last half of the year could worsen. I understand the comments about constraints on wage increases. I think we can be fooled. We can watch it for a while and all at once it can be out of balance. I sense a greater militancy among the unions, although they are a smaller part of the work force. But they seem to be more willing to go on strike and stay out without compensation. I think the outlook for the latter half of 1989 is stronger than the Greenbook forecast and the outlook for an improvement in prices isn't any better, if as great.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, our District economy continues to underperform the nation. We are now estimating that we're doing about two-thirds as well; we had been doing about half as well. This improvement, though, is primarily because of the slowdown in the growth at the national level; on a [regional] level we're doing about the same. Geographically, the mix of growth seems to be a little different. Texas now appears to be growing more slowly than either Louisiana or New Mexico. Within Texas, Houston of course continues to be the bright spot. Having been down there recently, listening to the anecdotal information coming out of Houston, the mood is totally different. One large developer in home building said it was quite refreshing to worry about drainage ditches as opposed to other types of drainage. In the District, manufacturing activity has remained our strongest sector; employment has been growing in that area while it has been declining nationally. Textiles, apparel, plastics, rubber, and wood products have been doing particularly well. Most durable goods products have been sluggish; electronic components have been particularly soft and transportation equipment is a bit of a concern from our standpoint. Our GM plant in Arlington, Texas is going to be down for a while. We wonder about the GM truck assembly plant over in Shreveport. Bell Helicopter remains somewhat in doubt. And of course with the B-2 bomber, General Dynamics as well as LTV have some concerns. Construction remains the softest sector and is showing signs of bottoming out. Agriculture has been hurt by moisture conditions; we either had too much or too little moisture. I'd say all-in-all, our sluggish growth continues from a very low base. And outside of Houston and a few border towns on the Rio Grande Valley there is little or no sense of optimism. Of course, on the financial scene, we have had all of our major bank holding companies with their problems addressed in various fashions. Something good always comes out of something bad; we've had an opportunity to widen our acquaintanceships considerably. We've spent a lot of time meeting folks out of the Cleveland District and out of New York and out of Richmond and out of San Francisco.

MR. HOSKINS. Thanks, Bob.

MS. SEGER. Are you talking about cops?

MR. BOYKIN. On the national economy, basically we wouldn't have a great deal of difference on the forecast. If we would differ it is that for some reason we have a hard time being quite as optimistic on the national picture. Our guess would be that if we're going to err, it's probably that we are not going to get quite as strong a performance as projected. Of course, the inflation side is still worrisome; indeed [we don't see a] significant improvement for the next year and a half on the inflation front.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I would characterize the Middle Atlantic states as being flat to down a touch. Retail sales are running about even with a year ago; manufacturing is down some. The most serious problems developing are in real estate. And there, I think New Jersey has the biggest problems; they are showing up in the loan portfolios of banks. I think that we have just begun that cycle--[which will] run for a period in the Middle Atlantic region--where we're going to see increasing real estate loan difficulties. On the positive side, in the Delaware banks, which are very large in consumer credit through credit cards, I think the portfolios are better than they were a year ago. The banks there have been quite responsive to regulators' cautions and they do look better. Despite the slower growth rate in the region and the nation, labor markets remain very tight--particularly at the lower end. Our Bank, for example, has made much greater use of temporary help this summer and we are almost grateful that we've been able to get them. That, I think, has as much to do with demand as a shrinking labor force, particularly in the 18-24 year old area. And I think that's going to continue well out into the '90s.

As far as the national economy, I think we are doing about as well as we could hope to do. We are achieving the subpar growth with a reasonable risk of recession. It seems to me that that risk, if anything, is a touch less than it was the last time we met. The imbalances that normally lead to recession are not there. On the inflation side, I think that what we have done is to contain the growth of inflation. If you look at the basic rate, I don't think we have rolled it back. Maybe that's all we can hope to achieve with this subpar growth strategy. Whether we can actually reduce the rate remains to be seen. I think our challenge today is to gather up enough strength that we'll leave well enough alone.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. I think it's appropriate that we be somewhat pleased with the outcome of policy over the past few years. I'm sure it is no surprise to many of you that I had some strong disagreements in the first half of 1987 concerning monetary policy; but since that time it seems to me we have really put it together about as well as we might have expected, or better than we might have expected. On that matter [we've met] our highest expectations. Now, I've had a running friendly disagreement with some of our staff over some elements in the composition [of the forecast], but I don't disagree with the major impact of the real output numbers as forecast. I would say, Sam, that I probably should apologize to you for trying to bring you into the argument so to speak. But it seems to me that we should think more in terms of the global economy. And monetary policy, it seems to me, works primarily in the global economy in that perspective. I just do not believe that being the best Phillips curver does you much good in analyzing the global economy, with more flexibility in wages and prices than we would have otherwise. In that context, it seems to me that when Mike Prell said that he expects to bring in the inflation forecast lower for 1991 because he believes that's what we want, I think you're exactly right, Mike. That is what we want. But the way to get lower inflation is not to have the dollar depreciate. And I must admit that even though Ted has been wrong for two years in regard to the exchange rate forecast, I've also been wrong on the foreign exchange rate forecast for two years running. I've been wrong just as Ted has been wrong in forecasting a declining one.

CHAIRMAN GREENSPAN. How do you know that Ted has been wrong? I can't get it out of him what his forecast is!

MR. ANGELL. It seems to me that if we truly want to have a stable price level the way to get there is not to get into a period of dollar depreciation. I don't understand how we can have a period of interest rate stability and have a dollar depreciation in the forecast. That means, then, that I do expect domestic demand to be somewhat weaker on the consumer side. I believe we have turned the corner on the household saving rate; I believe there is a difference there. But it seems to me that we have to be aware that even though things are working out very well that there is a vulnerability. I think the vulnerable areas in our economy that will tend to show up will be in the problem area of housing. That is, if housing stays at its present rate then it seems to me that the soft landing scenario is fairly accurate. But I think there is some possibility that we may be entering a period in which housing prices nationally are in a much softer position than we realized; and if we have a period of declining housing values, that will show through on consumer spending more than the stock market showed though. So, even though things seem just about right now, we ought to be aware of that vulnerability. I'm very pleased with the staff's understanding of our wanting [lower] inflation. My goodness, 3 percent is not good. But I don't understand why we continue to believe that we can get there with a depreciating dollar scenario.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. Well, I guess I start out where a lot of other people do but I'm not sure I end up where others do. Certainly, I would agree that if one could take a snapshot of the first half of this year, especially after the revisions are all in, one would be very tempted to declare a victory and go home. One might even be tempted to do that looking at the staff forecast. Obviously, most forecasts that are being talked about are within striking distance of that one. But that forecast is for real GNP growth of 2 percent or so stretching out as far as the eye can see and an underlying inflation forecast of 5 percent or so stretching out as far as the eye can see. Even when Mike gets around to [forecasting] 1991, I think we'll probably still have something that looks like that. When I think about that kind of an outlook I have to say that it's probably as good as we can do. So it doesn't trouble me. But on the other hand, I say to myself: Well, how reasonable is it to think that things can just roll on in that fashion in perpetuity? I guess that's where I get into trouble. I just don't think we can either be that good or that lucky. Indeed, even right now I would say that the risks in the forecast are reasonably well balanced to the symmetric, but I don't draw as much comfort from that as I think some do. There is one risk that could be quite transitory but quite troubling and that is that we might get a spurt in consumer spending in the second half of the year over and above the little spurt that Mike has. I don't think that's at all beyond the realm of possibility. But if that did happen, I think it could really throw some other things out of kilter.

On the other side, I can at this point see signs of potential weakness in the economy that are more troubling to me. We've talked about exports a lot. Another area is construction. In part, the closer we are to the reality of the thrift industry liquidations and the tremendous overhang that will produce in real estate markets--not just in the Southeast or Southwest, but nationally--that seems to me more of a concern than it has been in the past. I hear comments around the table and I see in New York City commercial construction going ahead pell mell in a context in which vacancy rates, at least in Manhattan, are now higher than they have been in 25 years. I suspect, Si, that Chicago must be about in the same position by this point, though maybe not quite that bad. In the Northeast, housing prices still are rising like gangbusters. But the stock of unsold new and used homes is rising very rapidly too. And those two things are just obviously incompatible with one another. The irony of it is that in this construction area--whether it's commercial, the thrift overhang, or even residential in the Northeast--the problem ultimately is not that interest rates have been too high; if anything, the problem is that they have been too low. A lot of this construction really is excessive overbuilding, speculation--all the seeds of real problems down the road. Martha, I think, mentioned this corporate cash flow problem. If you look at the profile of corporate cash flow out to late 1990 into early 1991 there is a profound change there in terms of the relative capacity of the corporate sector to finance itself internally versus externally. My hunch is that even the numbers we have don't really yet take account of all the implications of these highly leveraged transactions, which are starting to look worse too. There again, the problem is excesses rather than interest rates being in any sense too high. So, there are a lot of things that bother me in terms of the real economy, even though on balance I would regard the risks as reasonably well balanced in the context of that steady-state 2 percent--except that I don't think it's going to happen.

Now, on inflation--and this is where I guess I differ with a lot of the views around the table--I don't see the light at the end of the tunnel. I would agree that the data through the first half of the year are compatible with the notion that the inflation rate probably has stopped rising. But I'm not even sure of that. When I look at the inflation outlook I tend to focus very heavily on the [unintelligible] compensation, the productivity mixes, and what can go wrong there. I think the risks are quite asymmetric there; the risk is that, if anything, the compensation numbers may tend to be on the high side and the productivity numbers on the low side, in a context in which the staff forecast continues to have a negative spread between unit labor costs and the GNP deflator. On wages, just as one example: If you look at the data on collective bargaining agreements where there have been either freezes or declines in wages in the first year or concessions on COLAs and other fringe benefits, there is a huge, huge change in terms of what we've seen in the first half of this year versus what we were seeing in the mid-1980s. In the mid-1980s up through 1987 the percentage of workers that either had frozen wages, declining wages, or givebacks of one kind or another were running [unintelligible]. Based on the first half of this year they are running somewhere in the range of 6 to 10 percent. Now, that too may turn out to be an aberration; but it does say to me that it is premature to declare victory in terms of the wage and compensation situation. So, I'm really in an uncomfortable position, despite the fact that I think the first half looks terrific and the forecast looks great. I think the probabilities are rising that we're not going to get that nice, neat outcome. And it's easier for me today to see some things that might develop--whether it's next year or even 1991--that are quite troubling. But right at this precise moment it looks great.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Let me start off with the District. The picture there is still a tad weak. We have had nonagricultural employment declines in the most recent quarter of about 1-1/2 percent. That also spreads to manufacturing, which relatively isn't as weak; but still, there was a decline of almost 1 percent. There was particular weakness in the construction employment area and, on the manufacturing side, in textiles and apparel. I just want to pass on a couple of anecdotal comments. One thing that has surprised me with the general weakness in the District and nationally is that when I talk to business people I have not yet, until recently, run into anybody who is terribly alarmed. Yes, things are slower; but generally they are not terribly concerned about recession and that sort of thing. a major manufacturer of consumer durables and for the first time about a week and a half ago he laid out a somewhat different scenario. Of course, demand there has been quite weak for some time. He said the initial response of people was to try to sell their way out of it, in effect, and maybe cut back hours a little. Basically, he doesn't really see that working and he thinks that we're now going to get into a phase of perhaps more layoffs, curtailment of capital expenditures, and so forth, as the difficulties of selling one's way out of it begin to sink in. The other observation he made, which really runs to some extent to this real estate discussion Jerry was describing, is that they have two major [sales] channels: homebuilders, which have really been soft for a while, and then retailers. They are noting particular weakness in both; and in the retailing area, considerably more credit problems are surfacing. And that, of course, will spill back into the shopping centers, which I think is one commercial area that has been notably overbuilt. Another piece of anecdotal information on the homebuilding side: the reports we get would tend to indicate that some of the pickup that's evident in the broader numbers is being seen in the trenches in our area as well. The second quarter was better than the first and July is showing continuing improvement.

On the national picture, I would align myself with those who generally are pleased with what's going on in the short run. In that connection, I would not be inclined to overreact to one month's data of somewhat stronger real numbers. I still think, as Jerry pointed out, that we have one heck of a challenge in front of us in terms of bringing inflation down; I don't know exactly how that's going to happen but I do think it's going to take some time. To pick up on another thing that you were saying, Jerry--your observation that you are skeptical as to whether this forecast through 1990 will actually work out--it just seems to me that this slow growth will, in time, begin to wring out some of the excesses that you described. In other words, the pressure is there but it's building up much more slowly than people expect. What I hear from people I talk to is an expectation that we've reached an inflection point, that policy is going to ease, and that somehow the floor is going to be pulled out from under rates and people are going to be looking at rates 100 basis points or more lower than where they are now. I just don't think that's going to happen; and I don't think people have adjusted to that. These pressures are going to build up over time. And I think the challenge we're going to face is one of not overreacting to the process of wringing out some of these excesses, which are going to be reflected in bad credits and the like because of the longer-run inflationary challenge that we still face.

CHAIRMAN GREENSPAN. First Vice President Monhollon.

MR. MONHOLLON. The upward revisions in real GNP growth in the Greenbook seem very reasonable to us in view of the recent strength in some of the economic indicators. Also, as has been mentioned, it seems like an almost ideal outcome. The July Greenbook predicted a soft landing and this one predicts even a softer landing; hopefully, it won't turn into a touch and go. As we assess the risks of the situation we think the risk is probably on the down side despite the apparent strength in some sectors of the economy. There are a couple of reasons for this: first, our directors and some of our other business contacts in the District have become more bearish in the last couple of months than they've been for a long time; second, and probably more importantly, monetary policy has been tightened significantly on net over the last 2-1/2 years, even taking into account the recent easing. The funds rate is still about 3 percentage points higher than it was in late 1986 and there has been a sharp reduction in the trend rate of growth in the aggregates. We probably haven't yet seen the full impact of this slower growth in the aggregates on real economic activity. So, while we think that the Greenbook forecast for real GNP is quite reasonable, we think the risk of error is skewed slightly to the down side assuming, as the Greenbook does, no further changes in monetary policy.

As far as the inflation picture is concerned, we were of course disappointed that the projections didn't show any significant decline in the net rate of inflation over the forecast period. We think that also is a reasonable forecast. But we think that there is a possibility of a lagged effect of the overall tightening in monetary policy since early 1987, and that it may show up more strongly than is generally expected in the period ahead. Consequently, we think that the quarterly rate of inflation may be slightly lower than the Greenbook has forecast. Thank you.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. I think we have had our usual excellent comments around the table this morning. I have very little to add to those. But it might be useful to take just a minute or two to look at the larger scene, if I may. My sense is that there are a number of very important and very major issues that are at or reaching the stage where there could be some major breakthroughs or major breakdowns, whichever that may turn out to be. The condition of the United States economy is a very, very important factor in every one of them and something that this Committee might well consider when it looks at policy. I will just run through a few of them in no special order. On the domestic side, we now have a bill in the thrift area and we're moving into the resolution stage. We all know it's going to cost an awful lot of money at the best. But it seems to me that the cost could just go completely out of sight if we get into a recession scenario, particularly given some of the other real estate conditions that have been alluded to here this morning. I think we all would probably agree that the fiscal budget deficit requires resolution, and it seems to me that somehow or another we are managing to approach a breakthrough there. I hope it's going to happen; there has been some progress, and it's in the balance right now. But one thing is certain, it seems to me, and that is that if we fall into a recession any resolution in the near term on the fiscal budget just goes into a cocked hat completely. I'm not sure that much has been mentioned here before on this war on drugs. But I think it has now gotten to the point where it has become a national economic issue. Indeed, I think it's tearing into the whole social [fabric] of the country. We're groping for a way to deal with that, but it's going to take money. And that's going to be all new money; it has to come from somewhere. Perhaps even more importantly, it needs to have the focus of our population and of our political leadership. If we get into a recession scenario, that will probably pre-empt almost everything else and the war on drugs might well go onto the back burner--and in the process get worse for however long it takes to get it back on the front burner again. And I think that would be devastating.

Internationally, we have the great agony of the situation of the LDC debt. We have managed, hopefully, to get a solution in Mexico--and very quickly I should extend my congratulations to all concerned. But on the situation in the Philippines there's a long way to go. If we fall into a recession scenario I wonder if the banks aren't going to turn out to be even more difficult to deal with than they already have been in those further negotiations. On an even broader conceptual basis, it seems to me that it's fairly clear around the world now that everyone agrees that communism has failed and capitalism is the way to go. We are past the stage where that had to played out but we're entering a new stage that may be even trickier. And that is: How do those communist countries get from where they've been to where they want to go? This country is a model for that and I think that we're going to be called upon to be of some help in various ways. Poland is probably in the lead right now, but there are any number of others trying to get on that track. And I think that it's important that we be able to demonstrate a steadfast strength in our economy as that begins to play out. A bit more specifically, it seems to me that there's an opportunity now at long last to have a really serious disarmament situation develop. We have made some progress on that; conditions seem to be right. But I think that we ought to realize that the USSR is still the same type of country it was before; and if they perceive weakness on the part of the United States, economically or otherwise, or some divergence of our attention, they would be as [unintelligible] as they ever have been. And we might well find ourselves in a situation where excessive defense spending has to keep on rolling. So, for all these reasons I think that we have to be very careful as we assess this economy and try to calibrate it, to the extent that we can do that. We have to be very careful that we don't push our luck too hard because there is a great deal at stake in this era that we're entering into right now. Thank you.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. In terms of the District economy, there is not a lot new to present here. It is still operating at a very high level of economic activity but there are definite signs of some slowdown. Let me give you just a couple of indications of what I mean by slowdown. LTV, for example, now has many fewer flat roll products on allocation and lead times are much shorter. There is a stainless steel [company], Timken, which had all its products on allocation during the spring and just about now has fewer of them and, in fact, is talking about potential layoffs later in the year if demand continues to go in the direction it's going. I would add, however, that they have a contract that expires on September 30. So, I suspect that's a position rather than reality. Westinghouse has very strong demands for the rest of the year for its electric utility industry. There is a small motor company up there that sees decreases in demand. I don't know how you sort this out. Overall, the economy is really quite robust yet, but there are some signs of slowing. The employment rate in Ohio is 5.4 percent; Pennsylvania is, I think, about 4.5 percent. So it's still pretty strong and there are very, very few signs of weakness in any particular sector of the District.

In terms of the national economy, we don't have much disagreement with the Greenbook. The only thing that I find a little disturbing is the focus on our short-term outlook for GNP. I continue to be concerned that if we fail to lift our eyes from that focus we will not see our price objectives through it. In fact, we will always move those objectives back in order to assure that we keep the economy going. So, my only concern is that we have no progress on the inflation front in terms of [unintelligible].

MR. JOHNSON. The recent revisions of some elements of the lagging data suggest that things certainly have been decelerating as much as would have appeared earlier. I'm comforted by that; it made my vacation a little easier knowing that the situation looked a little better than I had expected. But even taking that into account, all the forward looking data still are pointing toward a further decelerating situation--not that I think it's decelerating at an accelerating rate. As a matter of fact, I think it may even have slowed its pace of decline. But my view is that the forward-looking data still show [a deceleration] except for maybe the growth numbers in M2 recently, which have shown some turnaround. I think that is interesting and positive, yet the reserve aggregates and the base don't really show that kind of turnaround; there's some uptick but not very much at all. So I just wonder how much noise there is in terms of shuffling of accounts in the M2 numbers and the response to the change in opportunity costs from the recent decline in the funds rate.

But I am generally encouraged by the situation. We have been seeking moderation in the pace of domestic demand and I think we are seeing that. It's what we want, and I think that over the longer run we're going to see the inflation results. I'm more optimistic that we're going to see that in the intermediate term and not have to wait quite as long as in the Greenbook forecast. But if we're going to see that we're going to have to remain in a fairly restrained monetary policy posture. My major concern, though, is that we still may be in too restrained a posture. The yield curve is still inverted; the commodity prices are starting to shift sides and breaking on the down side; the dollar is continuing to show strength. My basic concern is that as long as the funds rate is the highest rate in town we're going to continue to run into weakness on the expansion side as we continue to absorb money and credit, at least in base terms. Credit aggregates are continuing to decelerate. As I said earlier in my questions, I still don't see any real signs of a pickup in investment on the horizon. I don't see signs of a turnaround; there may be a temporary pause and some slowing of the deceleration. My worry is that that will continue on. I guess the good news is that we have more time to think about that than we did in the past. But we still have to be vigilant on that front.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I'll warn you that my views were colored by conversations with my brother last week who happens to be in the construction business. I asked him how things were going and he said pretty good. The latest big project he had signed on for was a new bankruptcy court in southern Arizona! Anyway, that aside, I do agree with the comments around the table about the deceleration that is showing; certainly, the Beigebook referred to it and the Presidents here have alluded to it, and a number of individuals I've spoken with suggest the same thing. I have a little difference of opinion about where we're going. I think we are going to see more slowdown, despite the fact that there have been some upward revisions and some surprises in certain of the statistics for the last month. I don't think that establishes a new trend by itself. A couple of things concern me greatly and one is in the housing arena. Again, I realize that starts have shown some uptick the last two months but the real estate markets in more and more parts of the country are weakening. Builder friends tell me that eventually that does show through to new construction. It certainly impacts the attitudes of developers and builders. Also, I'm sorry to be unduly cynical, but I have an awful feeling that when the RTC gets rolling they are not going to make this any better. The markets are already having problems and I think the RTC is going to turn it into a worse disaster and probably create new problems where there weren't problems.

MR. HOSKINS. Well, we have a strong oversight over that.

MS. SEGER. Well, okay. In the auto area, once these new 1990 models come in, if any people can be pulled off the streets into the showrooms to look at the cars, I think they're going to fall flat on the floor when they see the stickers. I understand the adjustments that were made in trying to price the comparable options and accessories. I understand all that technical stuff, but for the average person who walks in all they know is that the bottom line is that they are going to have to write a bigger check to get a car--whether they want air bags or not they get them. And I think that will discourage numerous people. Also, there have been a lot of cars sold in the last 5 or 6 years and there doesn't seem to be any real demand stacked up that has been unfilled. When I read that sales of light trucks are now starting to show some weakness, that gave me some concern because they have been extremely strong. We had some plant closings announced in the area of heavy trucks--Si Keehn alluded to that. One of the major producers of heavy trucks, had a pretty negative report out on what they were experiencing. And I personally believe we're going to see some more of that looking ahead.

Even using our own statistics on exports, it looks as if they are not going to be exceptionally strong. I believe we're going to see less strength there because I'm not convinced by Ted that the dollar is going to perform as he thinks. Even though we have the trade deficit reaching its low point in the second quarter of this year and then getting worse, I think it will probably get even worse than what we're showing. Putting this all together, and also adding to it the concerns that Mike Kelley mentioned about the impact of a recession on many of our other problems, I certainly think we ought to be very, very sensitive to what's happening and to balancing these risks between inflation and recession--particularly when the inflation numbers do seem to be looking better. I really believe that there have been some major behavioral changes out there in the real world that are going to help to make the inflation numbers come in even better than we're now talking about. Thank you.

CHAIRMAN GREENSPAN. Governor LaWare, do you want to comment?

MR. LAWARE. Yes, I've been sitting here trying to figure out how I could get through this without having to say anything, because of the sense of--

CHAIRMAN GREENSPAN. Just say you agree with everybody!

MR. LAWARE. Well, that's about right too. There is a sense of frustration that one gets having sat here now for a year in these meetings. We have done so well on so much of this, yet we are still looking at inflation levels which are unacceptable, I think, and that is the principal thing that frustrates me and makes me feel kind of helpless in this process. At the same time, I am convinced that if the only way to really knock inflation down is to have a recession, that's a very unwelcomed alternative option. We talk about a soft landing, but this kind of landing looks more to me like being stuck in the mud. I question whether the very low rate of growth and the relatively high rate of inflation create the kind of environment that encourages the investment in the economy that we need to get out of our trade deficit problems and to generate the kind of growth that we all are anxious to have, with improvement in productivity and so forth. So, I'm at a loss to make that fatal decision as to which are the more important considerations and where the greater risk lies. On balance, I'm more concerned that the risk is greater on the down side than it is on the up side. So, I'm more worried at the moment about an acceleration in the decline of the rate of growth than I am about stimulating further inflationary pressures. But in the context of all that, I am concerned that we can't make any progress on the inflation front, at least during the time horizon that we are looking at here in the Greenbook.

CHAIRMAN GREENSPAN. I think what you're expressing is the fact that monetary policy can't do everything.

MR. LAWARE. No, we need some help.

CHAIRMAN GREENSPAN. Why don't we break here and return after coffee.

[Coffee break]

CHAIRMAN GREENSPAN. Like the rest of you, I guess, I'm looking forward to the final word from Don Kohn.

MR. KOHN. I hope you have had enough coffee to keep yourselves awake! [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Thank you, Don. I suspect that if we weren't at a meeting today we wouldn't think there was any need to do anything, particularly because when one looks at the data what's clearly obvious is that the economy is stuck in the mud or that it has fallen to sleep--I don't know which is the better description. There is a remarkable stability in this system, which has both pluses and minuses, I think. As I see it, at least, on the upward side I think we are running into a saving rate that was going up in the context of rising real income and now is flattening out; and I think we're getting some pickup coming in the consumption area. If there is a follow-through in the housing area--that is, if mortgage rates are low enough to really start to move even marginally any of the housing data--then I think it is clear there is strengthening going on, which is independent of the underlying structure of orders and prices and values. The odds at this stage, as I see them, are probably marginally plus that that will happen rather than not happen. But when you begin to look at the underlying structure of the manufacturing area and the crucial area of capital investment, the evidence is quite mixed. I think we were getting a significant deterioration in the order structure and in the economy when we met last. That has stalled. The pretty much day-by-day evaluation of order books in trying to get a notion of business sentiment with respect to capital appropriations and the like suggests that, after having come down, we have stabilized in recent weeks at a subdued level. But it is showing very little evidence of either moving upward or downward. I don't think it's actually clear at this stage--and it may not be for a number of weeks--whether or not the momentum is going to start up or down. I find it very hard to believe, as I think Jerry has said, that one has a credible forecast of 2 percent real growth, inflation at 5 percent, and everything freezes indefinitely in the future. That is not an equilibrium forecast. Something breaks in that environment; it either accelerates or decelerates.

Having gotten the money supply pretty much on track, in an odd way I think policy is probably as good as we can have it at this particular moment. My basic impression is that we are at "B" and should be there for a while. I'm torn myself between whether or not we should consider being symmetric or asymmetric toward ease at this point--not that I think it is going to matter as far as what we actually do, because if we get any type of acceleration or deceleration, this Committee will be meeting on the telephone to make some key decisions. How we write the directive, frankly, I don't think matters all that much as far as actuality is concerned. Since we are currently, at least technically, in a symmetric mode I would be marginally in favor of staying in that direction. But I can't honestly say to you that I feel very strongly about that. I do think we have to be careful about this basic softness--and it is soft--in the orders picture; I think it's soft enough that it could start to unwind on the down side. There is no evidence of that; almost anybody I speak to is complaining about the level of orders but nobody is complaining that their businesses are tilting over in a way that is reminiscent of the feedback one gets during a recession.

So, I am inclined to stay with "B" at this point; and just for technical reasons, I am perhaps supportive of symmetric language but, frankly, I don't think it means all that much. I do think more than any other time in the recent past we are going to have to watch the orders business awfully closely to get a judgment as to which way that is going to evolve. I just don't see any way it can stay where it is. This is just not the type of balance that persists indefinitely in an economy--with inventories in balance and backlogs barely doing anything; inflation at a steady rate but too high; and a stock market which, until the last couple of days, was getting a little speculative. I must say to you that the one thing that really bothers me and has not been discussed in the material here is whether or not we're going to end up with a tranquil economy which the stock market thinks is terrific and then the stock market does us in. Up until a couple of days ago that had been a scenario which I would have put a higher probability on than I would have liked. In any event, I would go for "B" with symmetric language; but if there is any concern about whether it should be asymmetric toward ease, I could support asymmetric. I would prefer to keep stable in our position and have "B" symmetric. President Guffey.

MR. GUFFEY. Mr. Chairman, I agree in that "B" would be my preference but I feel a bit more strongly than you do with respect to asymmetric language toward ease. I would oppose asymmetric toward ease. That view simply is based upon some of the comments that I made earlier: that I see the economy a bit stronger than others, perhaps, in the third and fourth quarters. To me, a change in the language now would mean something to the markets and mislead them.

CHAIRMAN GREENSPAN. That's the argument.

VICE CHAIRMAN CORRIGAN. I'm sorry, Roger, I didn't hear the beginning. Where did you come out on the symmetry?

MR. GUFFEY. I favor symmetrical and would strongly oppose an asymmetrical directive toward easing.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. I find myself in great sympathy with what the Chairman said. Given the uncertainties that we face, I just don't see a reason to change at this point in time. I also would prefer symmetric language because of concern about the potential market reaction and how the markets would read a change in the language. I don't feel as strongly as President Guffey does about that. Since things aren't going to stay this way forever, and maybe we're going to need something to help us, we should face the issue of where we are going over the longer run, because there's general agreement and a lot of frustration that the inflation rate is at an undesirably high level. Where do we want to go?

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I would favor "B" as well and I also would strongly favor the symmetric language. It seems to me that relative to the previous meeting there are fewer downside risks than we saw at that time. We have had a recent robust growth of the broad aggregates, so I think one can make the case that the risks are symmetrical. I certainly would not prefer asymmetric toward the side of ease.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, I agree with your recommendation and your statement. I have a mini preference for asymmetric language because, as we see it, the moderating trends are likely to continue. But I don't feel particularly strongly about it.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, I agree entirely with your prescription. And I, too, would favor symmetrical language. I would like to make two brief comments. There has been a lot of discussion by people around the table this morning about the vulnerabilities in the economy, and I certainly am concerned about those vulnerabilities. But as you pointed out very well, monetary policy certainly can't do everything. I think the way to avoid a recession is to have a period of subdued growth over time. In that way I think we will avoid a recession over the long run. If we were to stimulate the economy at this time, I'm afraid we would not only be sending the wrong signal to the marketplace but we would be having to take action later on against inflation that would be at a much higher level. So, I think we have to be very careful about what kind of message we send to the markets. At this point the credibility of the central bank is even more important than it ordinarily is. So, I strongly recommend the status quo, which is alternative B with symmetric language.

CHAIRMAN GREENSPAN. I'm glad you said that. I think we all are in agreement with the general thought that you put forth, but it has never been stated this morning. I think it's important to recognize that the solution to a recession problem is not necessarily easy money. If we were to ease and were to run into an unexpected acceleration in inventory accumulation, at that point I think we would be through. I don't know what we would do at that point, because the moment we try to tighten and prevent special forces from going on, there's just no way to prevent the economy from going sharply lower and really unwinding. It's not self evident at this point that resisting recession presupposes bringing rates down sharply. If any of us believed that, I think we would have heard a lot of "Let's flood the market" comments. And I haven't heard any of that around this table. Governor Johnson.

MR. JOHNSON. I totally agree with that and my sentiments on policy directly relate to that. The biggest mistake we could make is to get ourselves into a situation where we are over-stimulative with monetary policy and end up aggressively easing. But, I have a slight preference--well, I shouldn't say slight--I have a preference for asymmetric policy toward ease. I agree that alternative B is the right stance for now. I base that mainly on the notion that I still see our policy as relatively tight. The funds rate is still well above other rates. If you look at the movement of other market rates that react to expectations of future funds rates, as Don and Peter and others reported, the market is still anticipating some easing of policy based on the existing data that they have seen, including the recent revisions. Now, those expectations have been postponed, I think, from the immediate future out to one or two months ahead. But those expectations still clearly fall in the intermeeting period. So, my concern is that the market is still poised for some easing rather than a neutral policy. And I think it's basing those expectations on the data [market participants] have seen on the economy and what they think appropriate policy would be. Not that that's always right; obviously, the markets are wrong from time-to-time. But I do think that the markets, including the stock market, are poised for what they expect to be lower future funds rates; and as Don pointed out I think, they are expecting to see that some time during the intermeeting period. We could easily cause the markets to back off. If the data come out suggesting that that's the appropriate policy, that's okay. But I think the stock market and the bond market would be somewhat vulnerable if those expectations are frustrated with no change in the trend in the daily [unintelligible].

So, my concern is that the economy is still gradually winding down and that that requires an asymmetry. There are some slight downside risks and we need to be prepared to be flexible during the intermeeting period, in my opinion, to lean toward an easier policy. By all means I want to stress that I don't think we should be aggressive in that. I think we are not running a neutral policy now, but a relatively tight policy, and that's still going to have lagged effects on the economy. I would like to get us to a neutral position, one where we're not stimulative but we're certainly not restraining the economy at these levels. What we see now looks very good, but I think the trend is still headed down. So, my preference is asymmetry; but if the consensus is for symmetry I certainly wouldn't vote against that.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Alternative B; I prefer symmetry, but could live with asymmetry.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. I would prefer asymmetry toward ease just in recognition that not to ease at all during the intermeeting period would at some point in time mean a rollback to somewhat higher interest rates. I would be somewhat concerned that in that scenario we might very well end up with a housing market that would be adversely affected by those developments. I also think we need to be alert to the fact that M2 growth needs to stay within that cone. That is, we are expecting M2 growth to be within one of those--whether it's A, B, or C--between now and September. I would certainly not want to see that fall out of bed and I have no reason to believe that it will. I also think that the foreign exchange value of the dollar could quite likely come under upward pressure and that exchange rate intervention might not by itself be sufficient to hold that back. I believe it would be undesirable to have another serious leg up on the appreciation of the dollar and go through some of the marks we went through before. That taking place in a period accompanied by falling commodity prices I think would call for ease. Objectively looking at the situation, I think that we're more apt to ease than not; and I don't see any harm in having asymmetric language toward ease, Mr. Chairman, because we're not going to do it unless something would develop that would cause us to want to [ease].

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I strongly support "B" and I would prefer asymmetric language toward ease because I think if we need flexibility during this period it's probably going to be in that direction. So, why not build it into the directive?

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I too support "B." It seems to me at this point that the risks are evenly and rather finely balanced. It wouldn't surprise me if things went awry in one direction or the other, but I'd be hard pressed at this point to express a conviction about which way they might go. Given that, I favor symmetric language. I also favor it for another reason: it seems to me that the modest growth in M2 in recent years, coupled with the performance of the dollar, has served us well. That's the reason why I'm a bit more optimistic about the inflation outlook than some; and I wouldn't want to compromise that at this point. For that reason as well I would favor symmetric language.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I favor "B" with asymmetric language. I think we're much more likely in the intermeeting period to desire to ease than to tighten and I think the directive should reflect that. Furthermore, even if one assesses the risks as symmetric or close to symmetric, I think the consequences of an error on the down side are far more [severe] than on the up side. So, for both of those reasons I would prefer asymmetric language; but I could support symmetric.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I favor "B" with symmetric language. And I interpret "B" to mean 9 to 9-1/8 percent on the [funds rate]. Is that correct?

CHAIRMAN GREENSPAN. Yes. Governor Seger.

MS. SEGER. I can support "B" if it has asymmetric language with the tilt toward some slight ease between meetings, because I do think that the economy is going to move in one direction or the other from where it is now and is slightly [more likely] to go toward the weaker side rather than the stronger. Also, I'm convinced that we don't want the dollar to strengthen a lot more, even though it might produce good inflation consequences. It would be very bad for our export industries and our ability to cut our trade deficit.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Let me say first that I think monetary policy that always attempts to pre-empt recessions is going to end up biasing toward inflation and lower output over time. I'm afraid that our view around the table often expresses this focus on short-term GNP, which leads us in that direction. Our ability to forecast real GNP one quarter out has an error of plus or minus 2 percentage points, which means that we are already walking on the edge of a recession as it is. Our ability to forecast the inflation rate 18 months out has error terms that are not much different and I think that's where we ought to put our focus. So, I'm comfortable with "B," and I think it should be symmetric. The comfort comes from the slowdown in the rates of growth of the aggregates over the last couple of years, but I have some concerns about their growth rates in the second half. Last February the consensus that I, at least, drew from around this table was that we were supposed to come in at the bottom half of the range even though we didn't explicitly write that down. So, I'll be nervous going forward if we see the aggregates coming in much above fourth-quarter-over-fourth-quarter rates of 3 to 4 percent. One other question for Don Kohn, a side question: If seasonal borrowing is a problem and causes us to change, why don't we think about either eliminating seasonal or at least pricing it instead of subsidizing it?

MR. KOHN. That would be a policy issue for the Board to handle along with the Reserve Banks. We could bring that up. I know there's at least one Governor who has suggested that before.

MR. ANGELL. Oh yes, so do I!

CHAIRMAN GREENSPAN. Don says they will have a report pretty soon. President Boykin.

MR. BOYKIN. "B" and I would stay symmetric. Although my opinion is that if there's any change it would be toward ease, I'm not so convinced of that that I would want to put it in the directive at this point.

CHAIRMAN GREENSPAN. First Vice President Monhollon.

MR. MONHOLLON. I prefer "B" with symmetric language.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I prefer "B" symmetric, as well, although I accept the fact that we will do what we have to do in any event. I'm not terribly worried about that. But I guess I'm just not as confident as the majority of the Committee seems to be about the very near-term outlook. I think there is a possibility--not a likelihood but a possibility--that over the next couple of months the economy could be stronger rather than weaker. And what I really worry about is that therein lies the problem for 1990. That's really why I would prefer to be symmetric.

CHAIRMAN GREENSPAN. It doesn't matter whether we're symmetric or asymmetric.

VICE CHAIRMAN CORRIGAN. Well, I accept that. But of all the ugly things that we could think about that one gets pretty ugly.

CHAIRMAN GREENSPAN. That is the worst scenario that we could face, because I think at that point monetary policy becomes impotent. And then we would need other factors working and I'm not sure we would get them.

VICE CHAIRMAN CORRIGAN. As I say, I don't think it's the likely case.

CHAIRMAN GREENSPAN. No, but it's enough of a worry.

VICE CHAIRMAN CORRIGAN. It worries me.

MR. ANGELL. But it seems to me, Mr. Chairman, that if we decided to tighten before the policy announcement came out that people would see that we had changed our mind.

CHAIRMAN GREENSPAN. Oh sure.

VICE CHAIRMAN CORRIGAN. Well, I can accept that.

CHAIRMAN GREENSPAN. I think that's exactly--

MR. ANGELL. Frankly, I would never vote "no" over the question of symmetry. That means all we do can be done either way.

CHAIRMAN GREENSPAN. Yes. I collected the votes and come out exactly as I expected, marginally asymmetric. So, let's read it as "B," asymmetric.

MR. BERNARD. It would read: In the implementation of policy for the immediate future the Committee seeks to maintain the existing degree of pressure on reserve positions. Taking account of indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, somewhat greater reserve restraint might or somewhat lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with growth of M2 and M3 over the period from June to September at annual rates of about 9 percent and 6-3/4 percent, respectively. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 7 to 11 percent.

MR. LAWARE. Question: Which is bigger, "somewhat" or "slightly"?

MR. BERNARD. "Somewhat" is bigger.

MR. ANGELL. But that's an historical question.

MR. LAWARE. "Somewhat" is bigger. Okay then, do we really want to use "somewhat" or do we want to use "slightly"?

MR. BERNARD. "Slightly greater reserve restraint"?

MR. LAWARE. And "slightly lesser reserve restraint" on the other side.

MR. KELLEY. The way we're going--

MR. BERNARD. "Slightly" in both cases?

MR. LAWARE. No, asymmetric.

MR. BERNARD. [That is conveyed by] "might" being associated with greater reserve restraint and "would" being associated with lesser.

MR. LAWARE. Yes.

MR. PARRY. That's a double asymmetric.

MR. STERN. Double "A."

CHAIRMAN GREENSPAN. Does anyone have any objections to that?

MR. LAWARE. Probably.

CHAIRMAN GREENSPAN. There is one issue, however, that we ought to clarify and that's the positioning. We had a discussion the last time on the positioning of the various different variables and it was inconclusive, with the exception of the phraseology with respect to the use of the words "progress toward price stability" as a substitute for "indications of inflationary pressures." That was the only one that I thought should be raised at this meeting to get a judgment as to how the Committee felt about the choice of words. Why don't we just take a very simple quick vote? Those Committee members who would prefer staying where we are with indications of inflationary pressures please raise your hand. One, two, three, four, five.

MR. GUFFEY. Will there be a vote on the other language with respect to progress?

MR. JOHNSON. Yes, I'd like to hear the language one more time.

CHAIRMAN GREENSPAN. Okay, I'm sorry. Norm, why don't you--we're using "slightly" presently.

MR. JOHNSON. No, the progress toward--

MR. BERNARD. Taking account of indications of--

MR. ANGELL. That's what we're talking about; that's what we're voting for.

MR. JOHNSON. Yes, I know. I wanted to hear it just one more time.

MR. BERNARD. The current language is "Taking account of indications of inflationary pressures" and for that the substitute would be "Taking account of progress toward price stability."

CHAIRMAN GREENSPAN. Okay?

MR. JOHNSON. Okay.

CHAIRMAN GREENSPAN. All the members in favor of "progress toward price stability"? I think I counted seven, which has to be a majority. Well, can we call the roll?

MR. KOHN. Mr. Chairman, can I make one further suggestion? We had 6-3/4 percent for M3, which sounds excessively precise to me. Can we change that to 7 percent so it's a nice round number?

CHAIRMAN GREENSPAN. Without objection.

MR. KELLEY. I would appreciate having Norm run through the rest of that sentence, if he would.

CHAIRMAN GREENSPAN. Sure, go ahead.

MR. BERNARD. It would read: "Taking account of progress toward price stability, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, slightly greater reserve restraint might or slightly lesser reserve restraint would be acceptable in the intermeeting period."

CHAIRMAN GREENSPAN. You can call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	No
Governor Johnson	Yes
President Keehn	Yes
Governor Kelley	Yes
Governor LaWare	Yes
President Melzer	Yes
Governor Seger	Yes
President Syron	Yes

CHAIRMAN GREENSPAN. The next meeting is October 3rd. We will break for lunch.

VICE CHAIRMAN CORRIGAN. It's a long way off.

END OF MEETING