

Meeting of the Federal Open Market Committee

March 27, 1990

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, March 27, 1990, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Boehne
Mr. Boykin
Mr. Hoskins
Mr. Johnson
Mr. Kelley
Mr. LaWare
Ms. Seger
Mr. Stern

Messrs. Black, Forrestal, Keehn, and Parry, Alternate
Members of the Federal Open Market Committee

Messrs. Guffey, Melzer, and Syron, Presidents of the
Federal Reserve Banks of Kansas City, St. Louis,
and Boston, 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. J. Davis, R. Davis, Lang, Lindsey,
Promisel, Rosenblum, Siegman,
Simpson, and Stockton, 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. Keleher, Assistant to Governor Johnson, Office of
Board Members, Board of Governors
Mr. Ettin, Deputy Director, Division of Research and
Statistics, Board of Governors
Mr. Slifman, Associate Director, Division of Research
and Statistics, Board of Governors
Mr. Smith, Assistant Director, Division of International
Finance, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of
Monetary Affairs, Board of Governors

Mr. Bowen, First Vice President, Federal Reserve Bank of
St. Louis

Messrs. Balbach, Broadus, T. Davis, Ms. Greene, Mr. Scheld,
and Ms. Tschinkel, Senior Vice Presidents, Federal
Reserve Banks of St. Louis, Richmond, Kansas City,
New York, Chicago, and Atlanta, respectively

Messrs. Fieleke, Judd, Ms. Lovett, and Mr. Meyer,¹
Vice Presidents, Federal Reserve Banks of Boston,
San Francisco, New York, and Philadelphia, respectively

Mr. Weber, Senior Research Officer, Federal Reserve Bank
of Minneapolis

1. Attended portion of meeting devoted to discussion of foreign
currency operations.

Transcript of Federal Open Market Committee Meeting of
March 27, 1990

CHAIRMAN GREENSPAN. Governor LaWare has moved that it is a good morning. Are there any seconds?

MR. JOHNSON. Second.

SPEAKER(?). It's too early to tell!

CHAIRMAN GREENSPAN. Can I have a motion to approve the minutes?

MS. SEGER. I'll move it.

MR. SYRON. Second.

CHAIRMAN GREENSPAN. Without objection. Mr. Cross, would you bring us up to date?

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

CHAIRMAN GREENSPAN. Questions for Mr. Cross?

MR. BOEHNE. When is the last time that the Fed did not share in intervention with the Treasury?

MR. CROSS. Well, there have been occasions when we didn't share for brief periods and in modest amounts. For example, there was the time--not within the past 18 months or so, I guess--when the Federal Reserve had very few, if any, yen balances and we were intervening for Treasury. And there have been some other occasions where for one reason or another there has been some modest activity by one or the other. But basically, we have participated 50/50, roughly speaking, with the Treasury for a number of years. It might have been [since] about 1980, at the time of the Carter bonds. It has been pretty much that way with these minor deviations.

MR. KEEHN. Sam, related to that: Did they ask us to share, and what did we say by way of opposition?

MR. CROSS. Well, the Treasury is very interested in having us share; they regard that as very important. We told them that we had reached a point where it would require a further expansion of our authorized limits in order for us to be able to intervene anymore. As to taking that issue up at that point, particularly in the light of these doubts about the intervention with respect to the mark, we said we would wait and review the matter and look at the limits in the light of our discussion with the Committee since we already had set up this discussion and were planning to conduct a thorough review. So, we told them that we would not operate [for System account] until we had an opportunity to have this more comprehensive discussion with the Committee.

MR. FORRESTAL. Did that make them very unhappy when you told them that?

MR. CROSS. Yes.

MR. FORRESTAL. I had another question, Mr. Chairman. Going back to the yen: Part of the weakness of the yen has been attributed to the rift between the Bank of Japan and the Ministry of Finance, beyond the more general political problem. But they did do the discount rate increase of 1 percentage point. Does that suggest that that rift has been healed or is that ongoing and will it prevent the Bank of Japan from taking further anti-inflationary steps?

MR. CROSS. It's hard to say. The rift went on for so long that by the time the 1 percentage point change was actually introduced it already had been totally discounted in the market and market rates didn't change. So, rather than being seen as a sign of forcefully getting hold of the situation, it perhaps was taken by a lot of people as still a following of events--following the curve or trying to catch up and being dragged along belatedly when circumstances forced it. So, it did not come out with a result that was strong and positive. Whether these differences are going to be less in the future is a little--

CHAIRMAN GREENSPAN. Actually, there is really a quite important difference between the Minister of Finance and the Governor of the Central Bank of Japan.

I'm not sure they're going to be able to patch that back together immediately. As far as I can see, it is subject to continuing problems. Any further questions for Sam? If not, may I have a motion to ratify his actions since the February meeting?

VICE CHAIRMAN CORRIGAN. Move it.

CHAIRMAN GREENSPAN. Is there a second?

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. Mr. Sternlight.

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

CHAIRMAN GREENSPAN. Questions for Mr. Sternlight either on actions or on leeway questions?

MR. BOEHNE. I have a question. Peter, I thought that your Annual Report on Operations for 1989 had considerable food for

thought, and there were two points in that report that leaped out at me. One was your concluding comment, which I suspect you wrote with your own hand, in which you talk about how essentially we have moved back to federal funds targeting, even though we don't call it that, and an almost wistful philosophizing about how there ought to be a way to move away from that. I'd appreciate any comments that you might have on that. The other point that leaped out at me was the collateralization of currency. You made the really rather astounding point that for the first time since 1957 the System portfolio actually was reduced and that our leeway on collateral is really rather thin. I think that would be worth talking about. But beyond that, I think that is a sensitive political issue. Some years ago--I forget whether it was in '82 or '83--there was considerable Congressional interest in the use of foreign exchange as collateral for the U.S. dollar. We made some pledges, as I recall. I think Chuck Partee and some other people testified on that. If you link that issue with what was just talked about a moment ago--in effect, the first split with the Treasury in a long time, and the issue as to who is the senior and who is the junior partner, which was a very sensitive one Congressionally in the '73-'74-'75 period--it just strikes me that we may have a major issue developing. These two volatile issues were sensitive separately and I would think that when you put them together it could be a major issue. I don't want to step into the topic [on our agenda] later, but it does seem to me that we're opening ourselves up to bringing back some of those issues that we have fought in the past. If they come back together, we could have a big fight on our hands.

CHAIRMAN GREENSPAN. Let's leave that, because it does step over into the other area.

MR. BOEHNE. Okay. Then I will go back to my first question about the comments [in your Annual Report].

MR. STERNLIGHT. Well, I don't know that I have very much to add to the kind of philosophical comment I put in the Annual Report. I do think that what we do now is somewhat different than the overt fed funds targeting of the 1970s. But it certainly has become pretty darn close to it in substance. You can call it a wistful look at the past. I think there are regrettable things about fed funds targeting and I am hopeful of being able to get away from it more. I think it's going to be difficult to do until we have more confidence in something like a relationship of borrowing and the spread of the fed funds rate over the discount rate. But just in our day-to-day operations I think we can carefully seek out opportunities not to let ourselves be too tightly trapped into the perception that we target the funds rate, because part of the box that we get ourselves into is built up just out of our own interactions with the market. We carefully appraise each day's operation. What is the market expecting of us? What will they make of it if we do this or don't do that? And it's only by rather carefully taking opportunities to stretch their tolerance that I think we can begin to build away a bit from an excessive focus on the fed funds rate.

MR. HOSKINS. Peter, I was interested in your comments on Drexel. In particular, do you sense any change in security firms' behaviors coming out of the Drexel [situation]? Secondly, do we send any different signals to primary dealers now about how they manage their affairs or--?

MR. STERNLIGHT. Well, we certainly had been sending some very clear signals to Drexel, too, about how they managed their affairs. We felt very deep concern about the charges they took and the wrongdoing they admitted to, and we had them on very stern notice about what we expected of them just from the standpoint of being good citizens in the market. As to general changes in market behavior, as I mentioned, there is this greater tenderness about the financing of investment banking firms that does still linger in the wake of rumors that were rampant for a while but have quieted down now. It has made many firms look carefully at their own exposure just so they won't get themselves in excessively exposed positions; they will take that lesson to heart. In the areas that I regard as Drexel's greatest excesses, in the junk bond underwriting, I think that lesson really was being delivered well before their demise just because that market was virtually coming to a halt during much of last year. You just can't do those things, and probably shouldn't be trying to do those things, with highly leveraged buyouts to the extent that they were during their heyday.

MS. SEGER. I just want to make sure I'm listening correctly to what you said about Drexel. When a firm is a primary dealer do I understand that that gives us the authority to advise them on what they do in the area of corporate finance as well as securities? Is that what you're saying?

MR. STERNLIGHT. Well, I would say we have a concern about all firms. Obviously, we want to be sure that the entity we deal with is properly capitalized and that it conducts itself properly.

MS. SEGER. Right.

MR. STERNLIGHT. But we have said in our standards for primary dealers that we have a concern about their general financial standing and the reputation of the parent or other affiliates as well as the immediate entity that we deal with. It's not that we go out of our way to give a lot of advice on how they conduct themselves; but if we felt disturbed about their conduct in some other area, we would feel it was incumbent on us to say something.

MS. SEGER. Where do we overlap the SEC then? Isn't that their basic responsibility: to oversee these firms?

MR. STERNLIGHT. Well, our role is not a regulatory role. It's just part of our business relationship with a counterparty. We don't want to do business with an entity whose reputation we're not comfortable with.

VICE CHAIRMAN CORRIGAN. One of the things that the Drexel case shows is that if there are serious problems in one part of the firm, those problems cannot be isolated from the rest of the firm. In that case, even though the primary dealer that we do business with had capital in excess of regulatory guidelines and all the rest of it, once the name of the firm was so badly tarnished, people wouldn't do business with the government security firm even in a context of book entry transactions in government securities. So you can't fully isolate or insulate the primary dealer from the affairs of the firm as a whole.

But if we ever have a need to raise a concern about the affairs of a firm as a whole, we always do it in very close collaboration with the SEC. We go to extraordinary lengths in all of these types of issues through the day-to-day, at times hour-to-hour, very close if not intimate, working relationship with the SEC. The SEC is always center stage. Again, in the case of this company, it also happens to be true that some of the most serious problems that were encountered once the chute went up happened to be in entities that were not regulated by the SEC at all. So both we and the SEC had the problem of these unregulated entities being the focal point of some of the greatest sources of tension as they applied to markets generally. But, Governor Seger, we do try to maintain what we loosely think of as a fit-and-proper standard that's built into the written, published guidelines for primary dealers. What it essentially tries to say is that we recognize that even where, as in this case, the business entity that we're doing business with is fine--indeed, this was a good government securities dealer--if the rest of the firm gets into deep trouble, no matter how good the entity is that we're doing business with and even though it may be a business entity to itself, it will be contaminated by the problems of the rest of the firm. And that, of course, is precisely what happened. We try to walk that fine line, and there is no case where we would make the point about any other aspect of the firm without close consultation and collaboration with the SEC.

MS. SEGER. Well, that's why I asked: to see if I was understanding Peter's comment about junk bond financing correctly. Because whether or not they choose to underwrite junk bonds is--

VICE CHAIRMAN CORRIGAN. We would never say anything about whether a firm should be doing junk bond financing or not. We might make a comment, as we did in this case, about the overall liquidity of the firm--about the ability of the firm to meet its obligations in the event of adversity. And we might stress, as we did, that they ought to be thinking seriously about how they would respond to problems. But we would never say they should or shouldn't do this or that. We would always be very, very general. If we thought something specific needed to be said we would call Mr. Ketchum or Mr. Breeden or somebody [else at the SEC] and say: "Look, you ought to be aware of this." We were the ones that first called to the attention of the SEC the fact that the excess capital was being taken out of the broker dealer. We never told them what they should do about it, but we certainly informed them of it; and it was up to them what they did about it.

MR. JOHNSON. Jerry, don't we have a legal authority to set terms and conditions for primary dealer status when they do business with the Fed?

VICE CHAIRMAN CORRIGAN. Right.

MR. JOHNSON. So, if they don't want to be part of that club, they don't have to.

VICE CHAIRMAN CORRIGAN. That's correct. Oh, sure.

MR. JOHNSON. So it's not like we have regulatory authority; they don't have to be a primary dealer and buy and sell securities with the Fed.

VICE CHAIRMAN CORRIGAN. Technically, I don't think we have legal authority. I think it grows out of--

MR. JOHNSON. Is there any legal issue about the terms and conditions we might set for a dealer to do business with us? Legally, could we say we don't like the rest of your business and we're not going to do business with you?

VICE CHAIRMAN CORRIGAN. Oh, sure.

MR. HOSKINS. Have we done that? Have we pulled a primary dealer?

MR. JOHNSON. I don't know if we ever have. I'm just saying, as Peter pointed out, that as far as our business relationship with the dealer goes, I think we could probably set any conditions we wanted to.

CHAIRMAN GREENSPAN. That's right; that's because it's not statutory.

MR. JOHNSON. But of course they don't have to do the business.

VICE CHAIRMAN CORRIGAN. It's a very fine line. We agonized in the period after Drexel had pleaded guilty under what the U.S. attorney [unintelligible] and had entered into this agreement with the SEC. There was just no question that the government securities entity itself had nothing to do with all these problems. And we agonized about the kind of point that Governor Johnson is making: Should we, on the basis of general fit-and-proper standards, terminate in a public way our relationship with the firm? As I said, we talked about it at great length and finally decided that doing that in a public way, given all that was going on, probably in and of itself would have produced the immediate demise of the firm as a whole. So what we did, in effect, was put them on a formal probation. We put them on notice that if they failed to live up to all of the commitments they had made to the U.S. attorney and to the SEC, we would publicly stop doing business with them. But it was one of those very tough calls on an issue; I think in retrospect our instincts were right. Had we just overtly, publicly, stopped doing business with them instead of privately putting them on notice and putting them on probation, it's now very clear to me that that action, had we taken it, would have caused the demise of the firm; it was that tender. Now, it happened anyway. I must say I would rather that it happened the way it did than as a result of some overt action on our part.

CHAIRMAN GREENSPAN. Is there any new evidence as to whether or not, when the firm is fully liquidated, there will be any capital left?

VICE CHAIRMAN CORRIGAN. It's still hard to tell.

MR. STERNLIGHT. I don't really have a final answer on that.

CHAIRMAN GREENSPAN. I recall one of the major subs, which is the public side of the SEC regulation, has a note to the parent company that presumably would be the vehicle by which any excess

capital up in the regulated sub would go through the parent and back down. But if there are other obligations of the parent, does that line stand in any securer position, do you know? I'm talking specifically about the commodity stuff.

MR. PATRIKIS. The holding company you're referring to is called the Trading Corporation, which did foreign exchange, oil, and commodities [trading]. We can use as an example the Central Bank, which dealt with the Trading Corporation.

CHAIRMAN GREENSPAN. That's exactly the issue I wanted to raise.

MR. PATRIKIS. Say there's a \$125 billion loan, either gold or bonds. If the Trading Corporation is a general creditor of the parent because it [unintelligible] funds to finance the parent's holding of bridge loans and junk bonds, that sub would share with all other creditors of the parent equally. So, if there are trade creditors, whatever creditors [unintelligible] with the parent all come before the shareholders of the parent. The have an advantage over the in that they got a guarantee from the holding company. They have legally to collect two [unintelligible] for distribution with the sub and themselves and if the sub had distribution. At least from what the lawyers of the say, they are hoping to get at least 70 cents on the dollar. Now, if they get that, that means that the shells of the holding company don't get anything. All these central bank creditors of the Trading Company will all have to collect before the shareholders will collect, unless someone says that this subsidiary ought to be subordinated--that it's unfair for the other creditors of the holding company--in which case all of those who did business with that subsidiary will come in second. And that's what the fighting is going to be about in the bankruptcy court: who is going to stand first in the line of creditors. Then we may just see what's going to be left for the shareholders, if there's any equity left at all.

VICE CHAIRMAN CORRIGAN. One of the problems, too, in terms of what may be left is that you have to take the common things like their leasehold obligations. Their leasehold obligations, believe it or not, are in the area of \$11 million a month.

CHAIRMAN GREENSPAN. And there are a lot of leases.

VICE CHAIRMAN CORRIGAN. And there are a lot of leases.

CHAIRMAN GREENSPAN. Any further questions of Mr. Sternlight?

MR. FORRESTAL. Peter, are the market participants that you talk to expressing any concern about the Comptroller's examinations in various parts of the country? Are they talking to you about the possibilities of a credit crunch?

MR. STERNLIGHT. In our calls with some of the major money center banks we do hear some reference to that. But I think they're talking more just about what they hear generally. I don't get the sense that they're talking about their own situations having been impacted that severely, although some of them do tell us that they have been taking a more conservative view in their lending. It's a

mixed sense that I get. It's not so much because of regulators bearing down but more just that in light of general conditions in the last year or two they have wanted to take a more restrained view about their lending programs.

MR. FORRESTAL. But the nonbankers are not focusing on it very much?

MR. STERNLIGHT. Well, there have been some articles in the press talking about the whole subject and some of the market participants--nonbanks as well--will refer to that. Some of them see it as a factor in shaping their economic outlook to some degree.

CHAIRMAN GREENSPAN. Peter, is there any evidence that where American banks are pulling back on this issue the Japanese are moving in?

MR. STERNLIGHT. I have not encountered that, Mr. Chairman.

VICE CHAIRMAN CORRIGAN. Well, you do hear it in real estate.

CHAIRMAN GREENSPAN. I know of one instance having--

MR. SYRON. Mr. Chairman, I know of two or three instances in Boston where foreign loan production officers, foreign representation officers, have come in and taken over real estate deals with established developments in two cases and with a new development in another case.

MR. JOHNSON. I was just looking at those credit data yesterday. What's interesting is that everybody talks about the contraction going on in real estate financing, but in fact from what the data show that hasn't slowed down at all. It's really just the business credit that is slowing down, which is quite disturbing. That is the source of the credit slowdown; it's not in the real estate area.

MR. HOSKINS. One of the arguments bankers use on that is that they have commitments and that once you're in, you're in--you have no way to get out. So they keep putting new money in, and we won't see the real impacts of this tightening--

MR. JOHNSON. Until they're all drawn?

MR. HOSKINS. Yes, until what's in the pipeline dries up. John might--

MR. PARRY. Manley, were you talking about total real estate [financing] or real estate [financing] provided by commercial banks?

MR. JOHNSON. I think I was looking at both, but it was the total that I was talking about.

MR. PARRY. There has been some switching, of course, in the commercial banking industry.

MR. JOHNSON. I know. I looked at both of them. But I was thinking of the most aggregate numbers. If I remember, those numbers

were still clicking along at 15 to 25 percent annualized growth and it was business credit that was really slowing down.

MR. KOHN. Business credit at commercial banks slowed down around the turn of the year. Some of that was the slowness to [move to] lower primes, so commercial paper surged at the same time. And a lot of it was merger-related financing. If you take out the merger-related financing and add back in the commercial paper, you get a very sluggish picture in short-term business credit. But it's a picture that's been present since at least the beginning of 1989.

MR. JOHNSON. Right. What's real estate doing there?

MR. KOHN. Well, I just have the bank real estate data. We're estimating for March, on a very preliminary basis, about a 10 percent increase. That follows increases of 13 percent in February and 7 percent in January. The January number, however, was probably affected by writedowns. Last year we were running in the 10 to 12 percent area and that seems to be continuing pretty much.

MR. JOHNSON. Yes, I was wrong; it's about 10 to 12 percent annualized.

MR. PARRY. But there has to be a big FIRREA effect there.

MR. JOHNSON. Yes, it could be. That doesn't show any sign of deceleration, to me at least. There is that weak January relative to trend but February is as strong as ever in there.

MR. KOHN. And March is close to February; it's just a little [less].

MR. JOHNSON. Okay.

MR. SYRON. Manley, I think what's happening--if the evidence from our small neck of the woods has any relevance to this--is that some of the larger and pretty much creditworthy developers are finding alternative sources of credit and they really haven't slowed down a great deal. The smaller and medium-size firms in the C&I loan area are suffering somewhat as a fallout of this experience. They find it difficult to get working capital; [their access earlier] had existed on a relationship basis with institutions that now have difficulties because of the real estate problems.

MR. JOHNSON. Yes.

MR. SYRON. There's a change in the composition because the foreign banks are not coming in and picking up that financing.

CHAIRMAN GREENSPAN. Any further questions for Mr. Sternlight? If not, first can I have a motion to ratify transactions by the Desk since the February meeting?

MR. KELLEY. Moved.

MS. SEGER. Second.

CHAIRMAN GREENSPAN. Without objection. Secondly, can I have a motion to approve the leeway request of Mr. Sternlight?

MR. SYRON. Move it.

VICE CHAIRMAN CORRIGAN. Second.

CHAIRMAN GREENSPAN. Without objection. We now move on to the staff reports on the economic situation with Messrs. Prell and Truman.

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

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

CHAIRMAN GREENSPAN. Questions for either gentleman?

MR. PARRY. Ted, I have two questions. You mentioned the assumption about the path of the dollar. Is that the declining [unintelligible]? Could you give me some numbers? I can't remember what you were assuming before.

MR. TRUMAN. We're assuming from now on, [after] the first quarter, that the dollar will decline on average about 3 percent.

MR. PARRY. This year.

MR. TRUMAN. For the rest of the forecast period--taking account of the adjustment through the first quarter, which still is negative. And that compares with 5 percent in the last forecast. Then you adjust for the higher inflation abroad and that's where I sort of got the 1/2 percent.

MR. PARRY. You pointed to some areas of strength that may show up in Eastern Europe other than in East Germany. The second question is: Isn't there another side that perhaps doesn't get as much attention, and that is that there could be some very important sources of weakness as well? One gets the impression that in places like Hungary and Czechoslovakia orders from the the Soviet Union have declined very substantially in the steel industry and other areas as well. Isn't it conceivable that in 1990 growth in those areas may actually turn out to be less than was anticipated before the--

MR. TRUMAN. I think so. The major focus of our analysis has been on the German situation.

MR. PARRY. Right.

MR. TRUMAN. Basically, as far as the rest of Eastern Europe is concerned, we took the general level of exports of those countries with the United States and added on \$1 billion or something like that by the end of the forecast period just to get some sense of where one would be going in the future. But I agree with you that in the short run we could have some negative impacts. It's a little hard to factor all these things in because each country is moving at a different [pace.] In Poland, on the one hand, although things seem to have gone downhill in terms of domestic production, they have gotten, as a

consequence of the changes there, a great amount of increased access to foreign exchange. How that nets out in terms of their hard currency current account position and potentially demand from us and other countries is a little harder to estimate. And, of course, the oil question, which is in fact a negative impact in the forecast [unintelligible] oil price. It's one manifestation of [unintelligible].

MR. PARRY. It's even exaggerated in those countries because prices were being subsidized. Thank you.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. I have two questions. One is: In looking at the most recent CPI number, how much weight are you inclined to give to possible changes because of weather-related factors and seasonals in apparel, with much warmer weather early in the year? Will things potentially even out with the spring season earlier on? Is there a possibility that the seasonals were affected, perhaps biasing up the CPI excluding energy compared to the CPI?

MR. PRELL. Well, we've anticipated seasonally adjusted declines over the next couple of months in apparel prices, which would not have been the pattern with the customary introduction of seasonal apparel over the past couple of years. So, in effect, the answer is that we are taking this as something of a special factor that should unwind over the next couple of months to some degree. Indeed, we've lowered our forecast of the ex food and energy CPI increase for the second quarter from what we previously had. But the cumulative effect of the last few months of data in this overall category--even though there are special things like transit charges and other items that seem to be one-time events--has been that the trend is a little higher. It just seems to fit with the general circumstances of overall spending being stronger--knowing that that profit margin pressure was there, which businesses presumably would like to relieve to some degree. [Unintelligible] the context of import prices turning upward, thus relieving a bit of the competitive pressure. So it all seems to fit together in this direction. We've raised [our forecast of] prices ex food and energy this year; they change Q4 to Q4 by .2 percent, a fairly modest change.

MR. SYRON. The second question I have is that I'm rather struck by the change in the [unintelligible] of the Greenbook. Over the next two years where you come out at the [end] is not terribly different from what you had last month.

MR. PRELL. That's by design of course. I hope everyone--

MR. SYRON. But what is different is this assumption for quite a substantial increase in short-term rates. What I'm wondering is--you can answer this question either way--where we would come out at the end of this period in terms of the growth of inflation and also capacity utilization if we didn't have that increase in rates that's built into your forecast. What would your answer be? Conversely, if we wanted to have significantly more meaningful progress on prices--and I'll let you give the magnitude--how much higher would your assumption be for an increase [in interest rates]?

MR. PRELL. Let me say first of all that in terms of the change in rate assumptions from last time, as you may recall, what we indicated at the February meeting was that we didn't anticipate any significant change but in terms of what we had written down in quantitative terms there was a modest upward drift in rates. So the rate increase in this projection is not quite the 1 point and 1/2 point that I referred to. It comes more quickly. We had had rates just drifting up through the projection [period] pretty easily. Whether or not one would characterize this as substantial could be debated. Certainly, in terms of cyclical movements in interest rates that in the past have caused major changes in the direction of the economy, a 1 point change in the funds rate really wouldn't look all that dramatic. Using our quarterly model and holding the funds rate at the current level throughout the forecast period, we would end up with a higher level of real GNP at the end of 1991 by about .7 percent. And because of the long lag in the price effects, we probably would see an inflation rate next year only .1 or so higher than what we have in the forecast. As we've emphasized many times, it takes some time for those inflation changes to reemerge. One could--

MR. SYRON. What kind of unemployment rate would you have at the end?

MR. PRELL. We would have an unemployment rate about 1/4 of a point lower. That's really not a very big difference, and I guess that's consistent with what I've said about the kind of shock that a 1 percentage point interest rate change at the short end imposes on the economy. Clearly, if one wanted to move the inflation rate down, these can be applied in reverse. You'd need a substantial rise in interest rates to make significant progress within 1991 to bring the unemployment rate up much more quickly and reduce capacity utilization. The trajectory going into 1992, however, is an altogether different story. If the unemployment rate were to go in excess of 6 percent next year, presumably we would begin to see some significant deceleration in prices in 1992, all other things equal.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I guess this is directed to Ted. I still have a hard time accepting your idea that the dollar will depreciate, even though you're saying you expect it to depreciate less than you had expected a month or so ago. I really can't go through this whole scenario and get a depreciating dollar to be consistent with a tighter monetary policy and rising interest rates. I just can't seem to get that into my mind as something reasonable. I hope you're right because, as you know, I have concerns about our ability to export-- little things like that! I don't have a problem with the outcome; I just am worried about the likelihood of getting it.

MR. TRUMAN. I'm not sure what I hope, actually, at this stage! I think there are three points. One, which is the basic story, is that we had some improvement--and I'm excluding capital gains and losses--in the current account in the last quarter of last year. That was \$1 billion at an annual rate and some further improvement is projected there. We had the view that although this external adjustment problem is shrinking that the general adjustment problem would tend to weigh on the dollar. And we have essentially adjusted in light of the stronger [interest] rates. We moved from a

modest weight to 60 percent of the weight or something like that. I don't think there's any magic in this; it certainly is possible that the dollar could be unchanged over this period. It wouldn't make much difference in terms of the immediate forecast because most of the effect of the exchange rates, at least in the context of the forecast and how we put these things together, is the adjustment from the middle of last year--that part moving through the pipeline. So, one would take maybe .3 off the growth of GNP over this period if the dollar were unchanged from the first-quarter average levels and maybe \$3 or \$4 billion off the current account level, if you believe the way this black box works on these things. The one point I should mention is that to the extent that the dollar's nominal strength were associated with [higher] inflation abroad, then in real terms you would be in about the same place. If inflation went to 6 percent in the major industrial countries on average and the dollar was unchanged, or if it [depreciated] by 3 percent relative to where we are now, in terms of the way things worked out that would be about the same. The [depreciation] essentially would offset the inflation abroad. So, one needs to set that partly aside. That's the best I can do. We've been wrong before and no doubt we'll be wrong again--which way I'm not sure.

MS. SEGER. I'm just nervous about the 7 percent advance in the dollar vis-a-vis the yen since our last meeting. It reminds me how difficult it is to get these estimates right even over a short period of time.

MR. TRUMAN. Well, we don't even try to do it over a short period of time. One factor that hasn't been focused on very much is that the current account adjustment in Japan has been quite impressive in dollar terms. A piece of that is the J-curve. But they've had about a \$30 billion adjustment over 3 years in that current account position. So that's 40 percent, essentially--on the same order of magnitude that we've had, if you want to put it that way. Part of it is the J-curve; part of ours last year also was the J-curve effect. Some of that is going on but there are some questions about how that's going to play out. You could even tell yourself a story that the current account adjustment is going more rapidly in size in Japan overall--

MS. SEGER. Thank you.

MR. TRUMAN. --and that it continues here overall and, therefore, the expected level of the yen/dollar rate in the future is [unintelligible]. Now, that certainly is possible. There are a number of people who worry about the fact that we could get ourselves in a situation in which the U.S. current account position is in balance, however one wants to define that, and the Japanese current account position is in balance and we would be stuck with this large continuing imbalance in the [bilateral] trade balance. And that, I think, bothers some people for a variety of reasons. But it is something that can't be ruled out.

MR. PARRY. Another point is that in the first quarter the trade-weighted dollar was down at a double-digit [rate] in spite of what happened to the yen. So we have a very substantial decline in the trade-weighted--

MS. SEGER. Yes, but actual trade decisions usually are not based on the weighted average; they're based on movements in specific currencies and the arrangements between specific countries.

MR. PARRY. But they are weighted according to the amount of trade that's done.

MS. SEGER. Well, the weights are based on ancient history. I think if you look through how they--

MR. PARRY. Well, that would give more to Japan if they did it on [ancient] history because Japan had a higher weight.

MS. SEGER. All I'm saying, though, is that when you look forward I believe you have to think in terms of a very micro analysis of the foreign exchange markets if you're going to think about what the impact is going to be on our country and our economy.

MR. PARRY. Well, you'd use a lesser weight for Japan.

MR. TRUMAN. [Unintelligible] uses lesser or bigger weights. In fact we use two weighting systems. On the import side we tend to use import weights and on the export side we tend to use multilateral weights. We have looked at multilateral weights in the models in terms of whether changes in the weighting system give you much difference and the answer is "no," even though Governor Seger is correct that they are ancient weights that haven't changed that much over time. Obviously, the weakness of the yen is affecting the outcome and we tried to take that into account. On the other hand, the strength until very recently of the DM and other European currencies, and the Canadian dollar for that matter, is on the other side. We have a lot of trade with Canada and they have a huge current account deficit at the moment. They do even up. Whether we have gotten the balance right in terms of these aggregates is obviously an open question.

MS. SEGER. Also, Bob, I think you'll notice that more of our trade is with countries such as Taiwan and Hong Kong, etc. And the last I checked, their currencies were not picked up in the weighted average at all.

MR. TRUMAN. It is in the forecasting process.

MR. PARRY. Yes.

MS. SEGER. No, I'm talking about that series we run on the weighted average; I didn't think they were in there. Anyway, one final question for Mike: With tighter monetary conditions assumed and rising interest rates and the FIRREA effect, how are we likely to get housing starts this year of about the same magnitude as last year?

MR. PRELL. Well, last year was somewhat erratic; the course was generally in a downward direction even though interest rates came down in the latter half of the year. I would say that we have had a very hard time getting the base level from recent months, given all the weather effects, so there is clearly a bit of guesswork there. We've looked at the permits for the last couple of months, though, and they likely are not as affected by weather--particularly in the

single-family area where we haven't had the HUD effect. Using that as some benchmark, we thought that something that had an underlying level roughly consistent with that pace would be appropriate for the coming months. I don't expect some little payback for the faster starts of houses in January and February, but basically that's what guided us. And we don't have very much interest rate movement this year. So we're just assuming starts are going to be in that area. This is the area where some of the other forecasters--mortgage bankers, the homebuilders, and others--are putting housing starts, so we have some company. But, obviously, because of the construction loan issue, there's considerable uncertainty about these figures.

MS. SEGER. Thank you very much.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. I just want to follow up on some of the comments on the international side. First of all, responding to what Bob Parry said, I agree that the trade-weighted dollar is still--I don't know if it's down but it may be down slightly. It depends on what point you're talking about but--

MR. PARRY. I'll tell you: it's the fourth quarter of '89. If you compare that to the estimate of the first quarter of this year is it down, Ted?

MR. TRUMAN. 17 percent at an annual rate.

MR. PARRY. 17 percent on the weighted average.

MR. JOHNSON. From when?

MR. TRUMAN. The average of the fourth quarter of '89, which was 97 plus, to the average of the first quarter which is [93 on our index].

MR. PARRY. [Unintelligible].

MR. JOHNSON. Okay. You're right; one can play those base games. But what struck me was the trade-weighted dollar going back to the end of this huge swing in the dollar. When I pull out that chart and look at the long-term trend in the dollar in the last three years, since 1987, it looks like noise. It just looks like little fluctuations around a flat or maybe gradually upward drifting pattern. Pull out a long-term chart of the trade-weighted dollar sometime and you'll be struck by what you see; in the last three years it looks like just a little fluctuation. And it looks a little soft, too. I can't believe that anything can result from those kinds of fluctuations one way or the other. But going forward, I think there is a shift, at least in the atmosphere, along the lines of what Ted Truman indicated. At least it seems so to me. But what that tells me--and I'd like a response on this--is that there is a trend of upward pressure on the dollar, and maybe it won't materialize, for the following reasons. But as you said, Ted, there's serious doubt now about the deutschemark being the anchor for the EMS. They seem to be willing to accommodate the unification in Germany at the expense of some inflation. I don't know how much, but the fact that they haven't moved rates relative to expectations already is raising some serious

doubts. And the DM has even weakened; the dollar was at 1.64 and now it's around 1.71 from the low point. If you look at the Japanese situation, obviously, there's a lot of turmoil going on. There are a lot of expected inflationary pressures, financial market problems, governmental weakness--all those kinds of things. When I look at that setting, it's really hard for me to see the trade-weighted dollar depreciating in that scenario. Even if rates rise there, as you pointed out yourself, there's a good chance that those will be nominal rate moves that aren't even keeping up with inflationary pressures. And we've already seen that nominal rate differentials have narrowed dramatically against the dollar and the dollar hasn't weakened. There has been a rise recently in the trade-weighted dollar, but that's mainly because of the DM. The fact is that the dollar has come down against the DM over the period [since] last fall, but other EMS currencies have been tied into that to some extent. Looking forward, as long as we maintain our anti-inflationary policies, I can't see anything but upward pressure on the dollar. Explain to me how the dollar is going to depreciate in this environment.

MR. PARRY. Well, if you look at Germany, Ted did explain it in the sense that if there's going to be greater economic activity in eastern Germany, it's going to affect western Germany in that the return on capital is likely to rise. If the real rate of return on capital in Germany rises, I would assume that investors would make portfolio shifts into--

MR. JOHNSON. Yes, but I would argue that that effect has already taken place. That's why the dollar is down about 15 percent or so against the DM, from 1.9 to 1.7. But going forward, if they're going to have an inflationary experience out of this, then--

MR. TRUMAN. But there clearly is room for a different scenario, a more rapid inflation scenario, and that's why I put that forward as a risk. As the staff usually does on these things, we sort of bend part way in that direction in putting together the overall forecast, but not all the way. To the extent that we get both more inflation and more economic activity than we've built in, we are going to get more corrections on the current account. In addition to the real versus nominal split, we would get more in terms of just the adjustment process and the dollar could well appreciate. This is not a very finely-tuned point [estimate of the] deficit. There is another point, which your first comment illustrates, that I think should be emphasized. Again, it can be viewed in two directions. Given the fact that the dollar has been in this channel--a wide channel, but a channel--for three years now, one might argue that the current account performance has been remarkably good. Indeed, in the last year or so it has been much better than most models would have predicted.

CHAIRMAN GREENSPAN. Than what?

MR. ANGELL. Models.

CHAIRMAN GREENSPAN. You're talking about the adjustment process?

MR. TRUMAN. Yes. The U.S. current account position is doing much better than [predicted]. We were saying a year ago that with the dollar staying where it was the current account was going to

deteriorate and it has not. Now, you were saying that indeed a process is going on here which is outside of the exchange rate, however you want to weigh the process; or you could say that we have the [weights] all wrong and somehow the past will catch up with us. It is an area of uncertainty in terms of the whole outlook.

MR. JOHNSON. I can see it's definitely uncertain. I would say that's one plausible scenario; what seems to me equally plausible is that the dollar becomes strong from this point on.

MR. TRUMAN. But if it's on the inflation side, I don't think it will affect the basic forecast very much.

MR. JOHNSON. I certainly agree with that in the short run.

MR. TRUMAN. Okay. And if it's because of prospects for economic activity, then presumably that will help us. And one question is: To what extent is this featured appropriately in the 18-month forecast?

MR. JOHNSON. Just trying to create a little noise.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Mike, one of the interesting parts of monetary policy is that we have options of being sometimes correct and sometimes incorrect on the forecast, but we also can be sometimes bold and sometimes timid. I'm wondering why it is that in your forecast you have us being so timid. That is, you're saying 100 basis points higher on short-term interest rates toward the end of the year. Well, if you're correct in your forecast, why not bring that interest rate increase by and large into the second quarter? Wouldn't that produce a better achievement of Federal Reserve objectives? That would, of course, make Ted's forecast wrong. But wouldn't that be the bold thing to do, Mike?

MR. PRELL. I couldn't do that if it would make Ted's forecast wrong! I'd never hear the end of it! This is something we have to deal with every time we put together a forecast. Essentially, we're trying to give some indication of how we think monetary policy probably will have to move in order to bring about what we discern to be your objectives. One element in terms of how forceful an action we build in here is our assessment of whether the outcome we have would seem to be consistent with your objectives. Obviously, you all have somewhat different objective functions to some degree; and I think the key feature of this is that as we get toward the end of 1991 we don't have a discernibly different inflation trend than we did in the prior forecast. It's one where we feel the peak has been reached and things are turning toward a lower trend of inflation, but only very slowly. Indeed, one might debate whether that is the proper objective and whether we caught that right.

In terms of the timing of the interest rate increase, I suppose in this instance I've indulged in some effort to temper this somewhat with uncertainties that I've noted. I've reached the judgment that, given that the real boost to domestic production is forecast not to occur until 1991, there was an interval here in which one could await some clarification of some of these uncertainties

before moving what I characterized as a fairly moderate amount. If one felt you had to move 2 percentage points or 3 percentage points in order to rein things in, then whether it would make sense to have this all happening in about 3 or 4 months' time or to spread it out over a longer interval would have presented us with a different issue. But in effect, we've tempered this in terms of timing on the basis of the many uncertainties that we think exist right now.

MR. ANGELL. So--

CHAIRMAN GREENSPAN. So to interpret Mike, what he's saying is that he's not worried about Ted's forecast; he's worried that if we raise rates right now it will affect his forecast!

MR. PRELL. We've always recognized that possibility. I want to emphasize that matters of timing, given these small amounts, would not make a great difference in our projections. That's maybe one argument for why we should always do something smoothly. But we also try to capture the uncertainties and the policy realities that exist.

MR. ANGELL. Well, I'm reading into your answer that you're suggesting we be timid because you think you may be wrong. That's always the wise thing to do: to be timid if you think you may be wrong. But clearly what you've shown on the path in regard to the employment gap that you believe is necessary for price level stability is not occurring as rapidly in the 1990 forecast as you had anticipated previously. And I guess one [unintelligible] your lack of boldness in wanting to create that kind of employment gap so as to achieve the proper price level improvement for 1991, because clearly the 1991 price level forecast is unacceptable.

MR. PRELL. Some of my colleagues would argue that we've been bold, in a sense, in not raising our wage forecast more than we have. In that sense we have taken the lower unemployment rate and said it's not going to have a significant effect on the wage outlook because we've taken a fairly optimistic view of the incoming information. And I suggested that that was a risk. It's in essence saying we may be able to get by with a somewhat lower unemployment rate in the short run than we thought previously. I tried to highlight that risk. We mentioned it explicitly in the Greenbook. And that's one reason why we didn't feel the compulsion to put in a more aggressive move in terms of timing on the--

MR. ANGELL. Well, I may have done you a disservice because you may have been forecasting that we wouldn't be bold rather than--

MR. PRELL. We're always in this tough position and we try to be as neutral as possible, not injecting ourselves into the short-run tactical decisions.

MR. SYRON. I think that has something to do with the characterization of what kind of time period and whether [an interest rate move of] 100 basis points is significant or not significant. There's a difference between whether it's significant or not significant in terms of the real economy and whether it's significant or not significant in terms of how much the Committee moves in a relatively short time.

MR. PRELL. Well, I think we can look back to 1988-89 and see that the Committee really has moved significantly at times.

MR. SYRON. Come back to--

MR. PARRY. But you never incorporated change in policy in the intermeeting period just immediately ahead, right?

MR. PRELL. Sometimes we have when it looked like you had to move a considerable amount within a short period of time in order to head things off. Normally, we don't build things in immediately.

MR. PARRY. Sure.

MR. PRELL. But there have been times when we have.

MR. ANGELL. No further questions.

CHAIRMAN GREENSPAN. You were finding this meeting very dull and you're finding a way to stir it up! President Boehne.

MR. BOEHNE. My question has already been answered, or at least commented on.

MR. BLACK. You got reckless there for a minute!

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Well, I have a much narrower and less provocative question. It has to do with profits. We have seen this pressure on profits for quite some time now. Is that pretty widely distributed across the economy or is it concentrated in a few sectors of manufacturing or where?

MR. PRELL. There are some sectors in manufacturing that one can identify as having suffered relatively more than others. But it isn't only manufacturing where the profits have turned down. One can see utilities and transportation, for example, as sectors where profits have turned down. Within manufacturing it's a mixed bag, and we only have figures through the third quarter of last year. Some of the areas that stick out are in the machinery and equipment area and, obviously, motor vehicles. Chemicals seem to have peaked out. Surprisingly, primary metals and fabricated metals held up fairly well last year. So, there are many industries in which profits have been squeezed, but it's somewhat uneven.

MR. STERN. Thank you.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. One last point, just following up on what I think Governor Angell was suggesting--I'm not sure if it's in the [vein] of stirring things up again--on what might be the way to go about this since everybody, I think, is frustrated with the price numbers they keep seeing in your scenario. Why not take an improved price scenario and tell us what kind of interest rates and economic performance go with it? And then let us make a decision about whether that's an acceptable risk or not.

MR. PRELL. Well, we certainly have presented on several occasions specific alternative scenarios that will do more [on prices]. We had the lengthy presentation in December about longer-range disinflation paths. I think you--

MR. JOHNSON. [Unintelligible] that people want to see some improvement in this period of '90, '91, and '92 and they don't see it. And the fact is that they want to know what the cost is of achieving it. They basically are saying: "Look, this is what goes with no progress. What goes with the progress?"

MR. PRELL. Frankly, what we try to do is listen and hit as close to the middle of the Committee's expressed desires here in shaping our scenarios. I certainly will listen to what I hear today and we will adjust accordingly. As I said, my sense is that there are varying degrees of aggressiveness around the table with regard to going all out to bring down the inflation rate within the next year or so. And I guess we felt that the highest priority was on establishing a trend, and that's simply what we've done. But we can be more--

MR. JOHNSON. I agree with that, but the problem is--

MR. BLACK. Well, it's in the wrong direction.

MR. KOHN. You were presented alternatives in February and will be again in July.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. I'll ask Mike a timid question. We've had a pretty big surprise in terms of increases in the inflation rate--a full percentage point since the last meeting on the CPI as well as the fixed-weight. If we were to look at a simple forecasting model, not necessarily a judgmental one, wouldn't a surprise like that tend to be built into longer-term inflation rates? I'm just wondering--well, I'm asking that question of you. But secondly, I'd like your judgment about the issue that Wayne has raised. Even though you haven't done an alternative forecast, there may be some expectational effects from moving early and small as opposed to moving later and large. I think that kind of gets at Wayne's question. I'd just like to hear your observations on the latter and also your comments on what simple forecast models would do, given a surprise with respect to long-term inflation.

MR. PRELL. On the latter question, to the extent that you surprise people with your aggressiveness in responding to what might appear to be a stronger inflationary risk, then I think credibility is enhanced and maybe it does not take a large move but merely one that comes sooner than the market had expected. So, I would certainly grant that point. In terms of the surprise and what it would imply for prospective inflation, one aspect of the models would be that to the extent they have backward-looking expectations or lagged prices in their wage equations, that would tend to build the momentum in prospectively through markup models of prices. In effect, in our case we didn't feed this through to wages. Partly, it's quite conceivable that inflation expectations [unintelligible] a forward-looking expectations model in wage formation and that they really will not reflect the food and energy price bulges that presumably will unwind,

and we may not have as big a price expectation problem. In terms of errors and so on, it isn't necessarily inherent in the models as to how one should translate that. That's at the discretion of the model operator to decide whether to have negative or positive adjustments in future [unintelligible] to a surprise. But as I suggested, we have taken a somewhat more optimistic view than models would of the recent experience. And with [unintelligible] to prospects.

MR. HOSKINS. Well, I'd just like to compliment you on the boldness of your answer to the previous question, which I think was appropriate. That is, if you look at this Committee and try to deduce what it's going to do, I don't find anything wrong with your Greenbook projection.

MR. PRELL. You're not making my life easier! I badly feel [unintelligible] consensus here.

MR. BLACK. What does that say about your thoughts on the evaluation of the Committee?

MR. ANGELL. [Unintelligible].

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I only want to say that since Mike has said that he builds his forecast upon what he thinks to be the center of the sentiment of the Committee, I'd like to be counted on the side that has been set forth by Governors Angell and Johnson, and perhaps Lee Hoskins, for the period ahead. I think the numbers we are looking at with respect to inflation are discouraging over the horizon. As a result, if indeed it's going to take some snuggling up, the sooner we do it the better. That's a little into the next part of the meeting, but I just wanted to be counted in the group so that this center comes a little closer to what I'd like.

CHAIRMAN GREENSPAN. Any further questions for either gentleman? If not, I think it's time for us to do our tour de table. Who would like to start off? Ed.

MR. BOEHNE. I think our District is moving at odds with the nation, because various sectors are weakening and weakening relative to the nation as a whole. Manufacturing is quite weak and taking on some of the characteristics of previous recessionary periods for manufacturing. Housing is down and I don't see much happening there. Nonresidential construction is still growing but I think that's more of a pipeline effect of finishing the projects that already have been started. Out beyond that I think one sees a fair amount of excess capacity. Financial services, which have been leading the Mid-Atlantic region for some years, are characterized by layoffs. Retail sales are flat. Job growth is essentially nil and unemployment is rising; it now is about where the nation is as a whole and I would guess 5 or 6 of our various cities and towns are seeing unemployment rates of around 7 percent or exceeding 7 percent.

I think there is some basis to this bank lending phenomenon that we were talking about; it's more than smoke. I have talked with just about every major bank in our District in recent weeks and particularly in those that are examined by the Comptroller there is a

definite scaling back. Part of it is that people who are running the banks as well as the lending officers do not have that long a track record. Most of their top-level experience is in times of expansion and they're not quite sure how to react [now]. The other part is that the Comptroller's examiners really haven't done a very good job of examining banks lately. They are coming on like gangbusters. I have heard more than once the comment "They're scaring the heck out of us." Some of that I think is useful and constructive, but the risk of overreaction is there. I ask myself where some of these small and medium-sized businesses are going to go for their money. We have had about 40 or so new banks start up and many of them are state banks. I suspect that in their eagerness we will see some of those loans shift over there and they probably will not do as good a job in distinguishing between the good and the bad.

So, I think the District is out of phase with the nation. Inflation has begun to moderate and come down. As I look at the nation, clearly the inflation outlook has worsened; it's disappointing. We're not getting what we want; there's no question about that. When I look at the risk of recession, I would have to say that, yes, the risk is down. I think Mike did a nice job of summarizing the various national sectors in the Greenbook. But even taking his own analysis, except for personal consumption, one does not see much of a forward thrust. You don't see it in housing; you don't see it in [non]residential construction; you don't see it in exports. The only area in which you see fairly modest growth is consumption. While that is the biggest chunk of the economy by far, I would like to see a little more support than that one sector for me to say that we're out of the woods as far as the economy moving ahead. So, I think we find ourselves in a bad box: The inflation situation is worsening; and while I for one think the odds of a recession are down, I'm not willing to say we're out of the woods. I think we need some caution in making that assumption as far as policy goes.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the Twelfth District is also out of phase with the rest of the nation. The economy remains strong, although the sources of strength have changed. The growth of employment in the past year in the entire Twelfth District has been 3.4 percent, which is an extraordinarily large gain relative to the 2 percent for the rest of the nation. Economic growth in most parts of the region remains very high. As an example, over that period there are three states--Washington, Idaho, and Oregon--where growth rates of employment were 6 to 10 percent in the past year. Looking at all 9 states, even Arizona, which had a very respectable 3.5 percent growth rate, exceeded the average in the entire District. Construction employment is very strong; it was up 8.1 percent in the past year. And manufacturing [employment] rose .9 percent in the past year, compared to a fall of 1.4 percent nationally. There has been some shift, however, away from California to other parts of the District. Employment growth in California is getting much closer to that of the rest of the nation. Whereas in 1988 California accounted for 63 percent of all the employment growth in our District, last year it was only 44 percent. Also, similar to Arizona, we have seen some weakening of housing prices in some California markets.

If I may turn to the national economy: As we've all discussed so far this morning, real growth, inflation, and interest pressures certainly seem to be stronger than they were at the time of the last meeting. Even with some restraint from higher interest rates, which is in both the Greenbook forecast and in our own, we would expect real GNP growth of at least 2 percent this year. I think some of that strength is going to come from consumption spending, reflecting the past strength in disposable income. I would also anticipate that stronger foreign GNP growth will lead to greater strength in net exports than previously had seemed likely. We're expecting the GNP fixed-weight index to average something very similar to that shown in the Greenbook, around 4-1/2 percent both this year and next. Admittedly, part of this worsening is due to firmer oil prices and the effects of past weakness in the trade-weighted dollar. Of course, if these factors were to reverse themselves, then we could get a break on the inflation front. Moreover, the fact that wages have been performing well probably does limit the size of the inflation problem. However, it's our view that the best way to insure that inflation begins to subside--and that certainly is not something that we see in our forecast--is to maintain moderate economic growth. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, [unintelligible] the advent of spring weather, but within a District context I sense that the level of economic activity has improved at least modestly both in tone and in fact. January and February were really very weak, of course, mainly because of the auto business, and that has persisted. I think there has been some improvement. For example, the steel business is much better. Orders are coming in from a fairly broad spectrum of industries, backlogs are up, and in some cases shipments are being deferred. Those I talk to are continuing to forecast shipments this year of, say, 81 to 82 million tons, and if there are any revisions, they are more likely to be up rather than down. Construction activity in the District continues to be strong, indeed above the national numbers. There continue to be just an awful lot of commercial projects coming along in Chicago. Vacancy rates are still in line but I hope we're not beginning to replicate the New England experience. Downtown Indianapolis, the different part of the District, apparently is going through a very substantial commercial real estate growth phase. Home sales are ahead of last year and permits continue to be high, which is indicative of a continuing good level of housing. Machinery business is quite good, with agricultural equipment for example at very high levels. The outlook is good for that industry; production schedules would suggest an 8 percent increase over last year.

The big uncertainty continues to be the automobile sector. Certainly, the incentives of January are lame. The first 20-day sales of March were very much on the weak side. Unsold inventory is up a bit but not out of line for this time of year. Second-quarter production schedules look to be about 25 percent higher than the first quarter but still would be lower than the second quarter of last year. And in the case of one manufacturer, it's a substantial reduction from last year. The industry continues to forecast [sales of] cars and light trucks together of [14-1/2 million]. That number happens to be

a little higher than our number but they are anticipating a pretty good second half to come up to that higher number.

In the agricultural sector, there has been a very significant improvement over the last few weeks. At the last meeting I reported that the moisture issue was a significant concern. We've had very good rains over the last three or four weeks and at the meeting of our agricultural advisory council last week we heard that the planting conditions are the best they've seen in quite a number of years. For livestock, the outlook continues to be very good. Land values are continuing to move up fairly slowly, which I think is constructive.

On the credit side, I've talked to a number of banks within the last few weeks and, despite the numbers to the contrary, I think there's a difference in opinion on commercial real estate. I sense some shutdown on that. Also, I will say that I've heard of one project in Chicago in which a Japanese bank was going to participate and within the last few days it has backed out. Our small business advisory council last week reported that they do sense some tightening of credit conditions and attitudes on the part of lenders. More paperwork is required, more detail, more this and that; therefore, it's making it harder for the smaller companies to get credit.

On the inflation side, our outlook is perhaps a bit better than the staff forecast. Competitive conditions continue to be pretty intense. Price increases just aren't sticking, at least in the full sense. There has been enough new capacity in some industries--and I think paper is a good example of that--that the [competitive] price pressures will continue. Wage settlements seem favorable and are not in any way getting out of line. Offsetting that, though, just as a couple of negative items, I keep hearing about huge percentage increases in health care costs that are going through. Also, as a different item, we're starting to hear from some companies about the increase in transportation costs that they're beginning to experience.

We have had a somewhat more positive view on the economy than the staff and, therefore, we think the upward revision that Mike has gone through is appropriate. We continue to think that the outlook for inflation is perhaps a bit better than the staff forecast, but I'd have to admit that our worry level on the inflation side is certainly higher at this meeting than was the case at the last meeting.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. In the Sixth District, Mr. Chairman, things really have not changed appreciably since the last meeting, but I have the sense that they're getting a little better. Certainly, there's a bit more optimism among people that I talk to. A lot of our contacts are reporting that business is not only better in the early part of 1990 in actual terms, but much better than they had expected. But having said that, there is still a continuing concern about recession, and there's a lot of caution in the marketplace. The weak spots, of course, continue to be autos and related products. I think we also would have weakness in textile manufacturing, aluminum, and timber were it not for pretty strong export demand that is keeping them going. If that export demand were to subside, given the state of the housing market, I think those sectors also would be in trouble. Energy continues to get better. In fact, we have reports now that

some of the companies are finding it difficult to get skilled platform workers. I don't know where they've gone, but they've gone to other places and to other industries and they're not coming back. We also have had reports, which I found interesting, of some foreign interest in buying U.S. refineries. Retail sales seem to be fairly good--not great, but not bad either. We're not detecting any particular wage pressures or price pressures, although I put that in the context of what the expectation is. I think business people are building in a 4-1/2 to 5 percent inflation level in their contracts.

The big item, and it has been alluded to before in our discussion, is this fear among business people and bankers of a credit crunch. I find it a little difficult to evaluate whether there really has been substantial credit rationing. On the one hand, the banks in the Southeast that already have been examined are clearly increasing their provisions for loan losses and there will be some pulling back there. And I think the banks that are next on the list [to be examined] are apprehensive and perhaps are taking some defensive measures by pulling back. But the general sense I have is that the good loans are being made and the marginal ones perhaps are not. The good bankable loans still are going forward, as far as I can tell.

On the national economy, we agree with the Greenbook forecast. Our forecast had been stronger earlier on than the Greenbook's, so we're in agreement with them. There is still the risk of a downturn but I think the risk has shifted a little more toward inflation. I'm really very disappointed, as I'm sure most of us are, about the projection for inflation. Like some others, I find it very hard in the forecast horizon to see much of a depreciation of the dollar. We've talked about some of the economic factors involved in that. But what is uppermost in my mind are the political activities that are going on around the world that I think are affecting the dollar substantially. We not only have the situations in Japan and Germany, but the situation in the United Kingdom is very uncertain at the moment. And I must say that events in Eastern Europe are not turning out the way people had expected. This Lithuanian development could turn the whole situation around a great deal. With that kind of political uncertainty in the world, I think the dollar is still the safe haven and the place for investment. So, a depreciation of the dollar is not in the cards as far as I can see--in the near term, in any event.

With respect to inflation, not only are the people that I'm talking to complacent about inflation but I think that complacency is now turning into an antagonism toward Fed policy. More and more I'm hearing: "Why are you guys so concerned about inflation? You're really doing a lot more harm than good." So, while the risk of some recession may be there, as I said, the real danger is increasing inflation. And I think we have a difficult job not only in containing inflation and bringing it down but also in persuading the country that this is the right road and the one we should be on.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I think the changes in the staff projections are clearly in the right direction. As a lot of people have indicated, there is a great deal of uncertainty, but I do think we have enough hard information now to know that the inventory swing

from the fourth quarter of last year to the first quarter of this year was [more] than we thought. Consequently, it looks as if the rate of growth in real GNP in the first quarter is going to be correspondingly higher. One of the key points looking ahead, of course, is that the staff has projected that there will be some rise in interest rates over this period of time in order to get roughly the same rate of growth in GNP and more or less the same sort of inflation figures. I think that change in policy assumptions is quite correct. We've had a sustained growth in M2 for about 9 months now and this may well strengthen aggregate demand considerably. In addition, events in Eastern Europe have moved much more rapidly than anybody felt they probably would. So it seems to me that the transformation of these economies is necessarily going to lead to higher real interest rates throughout the industrial world. Given this assumed upward adjustment in rates that the staff has incorporated in its forecast, I think the risk is about evenly split between up and down. If they had not raised these rates, I would have placed the risk on the up side in their forecast. I don't think it will surprise anybody to know that my chief concern is that which was voiced first by Governor Angell: that there's no improvement in inflation over this projection period. Someone mentioned an absence of trend, but actually if you look at the fourth-quarter-to-fourth-quarter figures on the fixed-weight deflator and the CPI, they both are higher for '90 and '91 than they were in the last Greenbook. The CPI ends up in the fourth quarter of '91 at about 4-1/2 percent, and I think we have to do a good deal better than that. Someone--I guess that was Governor Angell too--used the term "unacceptable." If we want to maintain our credibility, I think we have to do better than that. I sense that despite our best efforts we have lost some of that credibility recently; we ought to think about that very carefully as we formulate our policy later on in this meeting.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. With regard to the District economy, as been the case for quite some time now, there is very little new to report. It's pretty much the same as the national economy: that is, continued modest expansion is under way. It seems likely to me to continue. The major concerns of the District at the moment are the continuation of drought in some areas and prospective problems in the commercial real estate area. But the latter is probably at least a year or two off just because of the level of activity that's currently under way.

With regard to the national economy, I largely agree with the Greenbook forecast. And as many people have already commented, as far as inflation is concerned that's unfortunate. It confirms my view that we're simply stuck at around this 4-1/2 percent rate of inflation that we've had for quite some time. With regard to the real economy, I don't disagree much with the Greenbook forecast. I think we have to be careful not to overreact to the latest month or two worth of numbers. We might find ourselves whipsawing policy and markets and so forth. On the other hand, as the Greenbook observes and as our own exercise confirms, if one takes the January and February payroll employment number seriously we can easily get 3 percent real growth in the first quarter; and there is some possibility that those numbers are right. If they are, and if that's telling us something not only about the immediate status of the economy but about its prospects, we might be looking at even more growth than the Greenbook suggests. I

would fear in those circumstances that there may be even more inflation.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. To deal with the District first, the New England economy is not in phase with the rest of the nation. Just this afternoon we were talking about regions and this perhaps is a good precedent for it because we're seeing a lot of difference by region. The New England economy is relatively sluggish and in my way of thinking probably will be that way for the next year or so. There had been some thought, by myself and others, that expectations were worse than reality; but unfortunately reality is doing a good job of coming up to expectations.

MS. SEGER. Coming up or going down?

MR. SYRON. Well, going down; that's right. There's some question about how much relevance it has to national policy because I think a lot of this has to do with a sort of classic bubble, particularly in the real estate area, and some problems that we had in manufacturing. And the accompanying financial situation, with the conversion of mutual savings banks to stock institutions, just put in place [unintelligible] in credit over a short period of time.

We just had the data for regional employment benchmarked and, unfortunately, they show that for the region as a whole employment actually declined about 1 percent in 1989. It declined dramatically in some states such as New Hampshire where it dropped 3-1/2 percent. Construction employment in that state dropped 25 percent. Now, that's obviously a small state; but still, those are meaningful numbers. In the short run we expect a continuation of this rather negative trend in the business outlook.

On this credit crunch issue, given the problems with depository institutions that everyone knows about, just any super regional in New England is very, very wary of extending further credit for real estate loans. I think that's going to be advantageous over the long run because we did have a bubble, but it means that construction, and to a lesser degree manufacturing, are going to act as drags on the economy in the period immediately ahead. In manufacturing, the outlook tends to mirror more the national scene. Firms tied to the aircraft industry account for a fair amount [of manufacturing activity] and are doing quite well. Firms tied to the auto industry, which we also have, are doing quite poorly. We have a sectoral problem in the [unintelligible] those in Bob Parry's District are doing, and I think it's going to take a while for that to turn around. Overseas sales by manufacturers have been stronger than domestic sales and that has still held up despite what has happened with the dollar; people are very optimistic there. Retail sales have softened but people are beginning to think that they are seeing some bottoming out in the softening, and there really aren't serious problems with inventories. It could be a degree of concern that kept people from building up inventories too much. Overall, there's a feeling of greater cautiousness among our manufacturers; I would expect that to be reflected in less vigorous orders for durable goods on their part in the coming year. One sees this particularly in the paper industry where capacity [use] is actually still high but they

are just very cautious in going ahead. Price reports, as you might expect in these circumstances, are quite good, with absolute declines in prices in residential and commercial real estate. Labor markets are much better behaved, with people being able to find work where they couldn't before. You don't see many \$6.25 an hour signs up in the McDonalds' windows anymore, and you don't even find as many crowded McDonalds' stores.

Nationally, we find our own forecast for the economy to be very similar to that of the Greenbook, with some slight difference in timing quarter to quarter. But as many people have pointed out, an exactitude of this process in timing really doesn't mean that much. We are concerned, though we don't disagree with it, about the outlook for inflation. As has been pointed out by Governors Angell and Johnson and others, this is really quite a cause for concern. I would say that in the absence of concerns about the international scene or in the absence of concerns about financial fragility and some of these credit crunch stories that we're hearing--not two negligible factors, though--I would be inclined to feel that it's time to be really serious about progress on inflation and to move more vigorously. Even with these considerations, I think on balance the risks nationally are for more inflation rather than the other way around. And I think that our token [move] should be in that direction.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. The picture in the Eighth District is one of continuing improvement. In January, for example, we had very strong employment in comparison to December. Even if you take away strong growth in construction and in retail and wholesale trade sectors, which I think benefitted from the mild weather, other sectors grew at least modestly. In manufacturing, for example, employment was up 5.2 percent and that included declines of almost 10,000 jobs in the automobile industry. So, virtually all major industries had moderate to strong employment growth. In both residential and nonresidential construction we continued to have strong growth in the most recent three-month period ending in January. In the area of anecdotal evidence, we recently had a group of chief financial officers of major corporations in the St. Louis area to lunch and the things that came through from that discussion were: (1) scarcity of qualified labor; (2) a sense of growing pressure on wages; (3) a margin squeeze--the feeling that any easy productivity gains have long since been realized; and (4) the feeling that the recent increases in the dollar have not really presented a problem in terms of export activity. Finally, and this is somewhat in contrast to what Bob [Forrestal] mentioned but I don't think either one of the views would be conclusive, I didn't pick up any sense of dissatisfaction with policy. In fact, some people expressed a preference for a diligently slow, stable situation in economic growth. So, nobody really is squealing about monetary policy being on an inappropriate course. I think it's right to question, though, whether people really would support the price of bringing down the rate of inflation significantly from current levels.

A final thought in terms of the general picture nationally: I have felt that policy has been erring on the side of ease for some time and that we are in the process of giving up some ground in terms of our progress toward long-term price stability, however defined.

So, I would agree with what the Greenbook says in terms of the need for some additional tightening. I'm somewhat ambivalent about whether that needs to be right away. I take some heart from the Bluebook forecast of a slowing in M2 growth. I have some questions about what the impact is going to be in terms of the profit margin squeeze, the general pressures of leverage on the economy, and the credit crunch we've heard about, and how that all may [affect] consumer confidence. So, while I think we need to move, I could be persuaded that it doesn't need to be right now.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Well, Mr. Chairman, the economy in the Dallas District continues to mend. Slowly but surely economic conditions are showing mixed signs of improvement. Finally, we even see Louisiana being able to reflect slightly better conditions. However, with regard to the improvements that we're seeing, while they're pretty much across the board, the extent of the gains is highly variable. Energy and construction continue to show modest improvement. The rig count in Texas has shown some significant gains. A lot of this is attributable to the horizontal drilling that's going on. The manufacturing picture has been somewhat mixed. On the construction side, while we have seen gains, they are possibly a little tenuous as construction values have fallen lately. On the other hand, this appears to be a correction related to potential overexpansion in petro-chemical capacity down along the Gulf Coast. The weakest sector of our economy is agriculture; that continues to be hurt by drought and other weather-related conditions. On the so-called credit crunch issue, we also hear some anecdotal evidence; but it's not all that different from what we have heard for quite some time with respect to our small businesses. And given where we've been in our District, we've been hearing this for quite some time. On a little broader issue, if the rationing really is going on and it seems to be primarily related to real estate concerns, I would question whether a slight change in interest rates one way or the other really would address that particular problem.

On the national picture, I feel pretty good about the staff's current forecast. It seems a little more in line at least with what we've been thinking and we would not take issue with it. I would associate myself with those who are expressing concern about the long-term prospects for inflation. I think that maybe something ought to be done about that.

MR. BLACK. Anybody you want to suggest to do it?

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. The Tenth District continues to improve [unintelligible], but nonetheless is showing improvement with some mixed performance in the various sectors. For example, in the agricultural sector there has been a turnaround in the moisture; there has been good moisture across virtually all of the Tenth District and particularly through the wheat region both from rain as well as snow. That has a diverse impact, however, on wheat prices. So in terms of net farm income it may wash out. But the prospects for the wheat crop, which will start to be harvested in about six weeks, look very good. On the other hand, there is some

weakness in cattle prices, as a result of a surge in the feed cattle production. There are some projections that cattle prices will fall about midyear. With the lower wheat price and lower cattle price, the outlook for net farm income may not be quite as good as some might expect. Nonetheless, the outlook is quite likely going to be very good in the agricultural sector.

In the energy sector, the rig counts have fallen again most recently. That is, in the Tenth District the rig count has actually fallen in roughly three [unintelligible] from 298 to 255 in number, although it is still higher than the count a year ago. So, there is some year-over-year improvement; it's better than it was before. The manufacturing sector is still fairly slow, particularly with respect to automobile assemblies. There have been some cutbacks in production in the plants in the District. In one in Kansas City they actually have laid off 700 people and cut [production] from roughly 800 cars a day down to 600 for the second-line adjustment. But the 700 layoff is already significant. On the other hand, aircraft manufacturing in the District continues to be strong and vigorous. As a matter of fact, Beech just received a new contract for \$1-1/2 billion to supply business-type aircraft to the Air Force for training purposes. That, of course, will stretch over time, but it is a new order of significance for that area. There is some improvement and strength in both residential and nonresidential construction in the District, which continues to amaze me given some overhang in the commercial [side] at least. But it may have been affected by the warm January temperatures. Nonetheless, there are those contracts out there and [work] will be performed in the period ahead. So overall, the District continues to improve--slowly to be sure, with disparate results depending upon what area of the economy you look at.

As for the Greenbook forecast, we really have no quarrel with it. It's a bit stronger maybe than we originally had thought, particularly in view of the fact that we ran these numbers and got about the same result but without any interest rate increase. So by building in an interest rate increase, maybe the Board staff's forecast is a little stronger than ours. But given the timing--as I understand it, maybe a 1/4 point late in the third quarter and maybe another 1/4 point in the fourth--it won't have a lot of impact in 1990. As a result, we're fairly close together; I have no problem [with the staff's forecast].

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. In the Fourth District, the pace of economic activity is continuing to improve in almost all sectors. Manufacturing employment now is back at its highs of mid-1989. A lot of that--about half of it--is auto-related, which had a pretty nice bounceback. In terms of auto production, everybody who has been on layoff has now been recalled, essentially.

MS. SEGER. Did you say auto employment is at a high in your District?

MR. HOSKINS. No, I said manufacturing. It has come back to its 1989 highs and about half of the rebound that we got recently was due to auto-related manufacturing.

MS. SEGER. Thank you.

MR. HOSKINS. My infamous stainless strip measure, which has predictive values slightly worse than the leading indicators--the direction is right--also has slowed fairly sharply. It had been reported at 20 percent below its seasonally adjusted levels in terms of new orders and now it's running about 5 percent above that. Price increases in that industry are likely to be forthcoming, given demand and the potential for some backlog. In terms of anecdotal information, the only good news I could dig out was that [BP] and Marathon think that inventories are going to be high and that going into the second quarter we will see some price reductions in petroleum products.

With respect to the Greenbook, as I said before, given the implicit policy assumptions I wouldn't have much disagreement with it. I have trouble with the policy assumptions that are in there. My concerns stem from the issues of inflation and inflation expectations. If people do begin to build this kind of inflation expectation into their decision-making, then we will pay a price in terms of lost output when we finally have to bring the inflation rate down. So, that's something that I certainly would want to consider in setting policy this time.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I think the tone of the business situation is better, judged at least by the decibel [level] currently of people who in preceding months were concerned that the economy was really going to go off the edge. I think part of that simply is a reflection of the view that, at least statistically, both the fourth quarter and the first quarter are probably going to turn out better than a lot of people expected. If you recall, it wasn't that long ago when it was quite possible to find a lot of people who were expecting a negative real GNP number in either the fourth or the first quarter or both. And that is no longer the case.

CHAIRMAN GREENSPAN. There's even a possibility that we will see the .9 in the fourth quarter revised up.

VICE CHAIRMAN CORRIGAN. Yes, I know.

MS. SEGER. You had a sneak preview?

CHAIRMAN GREENSPAN. No, it's just that we have a lot [of indications].

VICE CHAIRMAN CORRIGAN. Looking at the components, I think part of the improvement in the tone of the business situation that I detect is rightly characterized as the collective breathing of a sigh of relief. Now, how much better the situation is in underlying terms is a little tougher to tell. But my sense is that it probably is better in underlying terms as well. Some of the comments around the table are consistent with that. For example, Si Keehn talks about sales of 14-1/2 million trucks and cars, and that's not a bad year. That's a lot. Even before the meeting today I thought there were two sectors of the economy that at the margin could make quite a difference and those are agriculture and energy. I find it

interesting that Roger and Si and Bob Forrestal and Bob Boykin are suggesting that conditions in those two industries, even outside of the Southwest in the energy area, show a little snip of a pickup in activity. And at the margin, those two sectors of the economy can make a distinct difference. So in terms of the business outlook, the staff forecast is probably a reasonable depiction of the situation. It's very similar to our forecast; the difference probably is that one may have a little more confidence in it than was the case several months ago.

Now, on this credit crunch issue, I think there is something to it but I'm not sure it's as pervasive and fundamental as perhaps some think. I get a sense of it, for example, with banks in northern New Jersey and Long Island where we've had some excesses in real estate lending as well. On the other hand, I don't get much of a sense of it at all from the money center banks; the money center banks are simply complaining about a lack of business--period. There's another thing that we have to keep in mind about this silent credit crunch. During much of the second half of the 1980s we had a situation in the country when private credit demands were growing very, very rapidly and private credit growth was way out of line with historical relationships relative to GNP. And now what we are seeing is that a lot of that credit growth was bad credit. We're seeing it in chargeoffs in the banking industry, in the thrift industry, and in markdowns of prices of junk bonds. So, I'm not so sure that some margin of greater discipline in the credit origination process is something we should be terribly concerned about. It's probably a good thing. In terms of the small business side of it, again, I don't get the sense from our small business advisory groups and others that well-run small businesses are having any particular problem with credit availability. That doesn't mean there aren't some who are having trouble, but I don't think it's a general phenomenon.

On inflation, in underlying terms, I come out where Gary Stern does. We've been stuck at 4-1/2 percent or something like that for a long time. I think what is different right now is that if one expected that we were going to do better than that, what the recent information suggests, of course, is that that's not going to come about very easily. But I myself don't think that the inflation situation has deteriorated in any significant way; it just refuses to get better, which is a problem in its own right.

The biggest area of uncertainty in my mind continues to be the external side of the economy. Ted has one scenario built into the forecast; he described another. The fact of the matter is that you probably could put together three or four external scenarios, each of which would be strikingly different from the others and none of which could automatically be ruled out of hand. There is a range of uncertainties not just because of exchange rates but because of political developments, economic developments--the whole spectrum. So, I think the range of possible outcomes in the external sector out over the next six to eight quarters is really very wide indeed.

The only other point I would make, Mr. Chairman--I don't have to make it but maybe you do--is that the renewed discussion here about the budgetary situation is possibly interesting. Rostenkowski's pronouncement, of course, has gotten shot down, as I'm sure he thought it would. Nevertheless, I still find it rather surprising, and maybe

even a bit encouraging, that somebody like Rostenkowski was willing to put his cards on the table in the budget arena. I don't know whether that's just ceremonial or if there are some straws in the wind that would suggest that something constructive might happen on the budget front. As I said, I don't know if you want to comment on that later or not.

CHAIRMAN GREENSPAN. I'll comment now. I think that there is something going on. The question is: How far will it get? I think that the failure of Rostenkowski to get shot down immediately, which he did not, is suggestive of a willingness to take another look. I think that process is going on, but it's much too premature to argue that anything is going to come of it. But you're quite right: there's something stirring that had not been stirring before. Anybody else?

MR. JOHNSON. I'll comment. Actually, I've been impressed too that the economy hasn't shown signs of slowing to the degree that people had forecast earlier. It's still a little hard for me to tell at this stage how much of that can be attributed to our luck with the weather and how much is really a pickup after smoothing through those kinds of seasonal--unseasonal I should say--developments. Nevertheless, when you do smooth through it, you still have a picture that looks like sustained growth at a lower rate that doesn't look particularly scary.

I also hear these stories--as a matter of fact, I'm bombarded by such stories--of a credit crunch. I have hosted at least three or four different state bankers associations here over the last couple of weeks and have been besieged by people saying that that is going on. But it's very hard to find evidence in the data that that is in fact the case. You hear a lot of anecdotes about it and that's what they bring to the table, but you don't see any kind of general credit crunch going on. I agree with others that there is clearly a commercial real estate overhang. It's all over the country; a contraction is going on there. I'm sure because of the S&Ls that there is a lack of availability of credit from the S&L industry to developers; you hear that everywhere. But actually, that's healthy; that's not something to be afraid of. That consolidation really has to take place. There still may be something in the pipeline on this credit crunch; it's just not obvious in any data that we see. Our quality spreads surely don't show it on interest rates. In fact, you would expect, if there were some sort of pullback in banks' willingness to lend, to see upward pressure on bank rates. If demand were still there and the supply was being restricted, why wouldn't short-term market rates come under upward pressure? It certainly doesn't look like there's any dramatic upward pressure relative to the funds rate. On the other hand, you don't see a tendency for demand to be that weak either because you don't see these short-term rates falling against the funds rate either. Things actually look fairly stable around the short end and quality spreads actually look very good--unless you're trying to find some junk bonds that aren't quoted in the market. Compare those to AAA corporates and I'm sure they don't look good.

So, I think the economy is doing okay, at least in the period that we can see ahead. I don't have any disagreement with the Greenbook; I think it's about right, although I wouldn't want to project anything beyond six or eight months from now just because it's

too uncertain. On the inflation front, as I said, it's a little disappointing that there hasn't been more progress, although I do attribute most of the short-run pressure that we have had to seasonal developments. I think the effect that the cold weather had on food and energy costs in the December period is the primary factor on the total CPI and PPI numbers. If you actually look at the producer price index excluding food and energy, you do see some progress. In fact, the 12-month rate for the PPI excluding energy is now down to 3.7 percent, which is better than previous 12-month rates in the PPI. What is disappointing is the consumer price index, which doesn't show any signs of easing off; even excluding the food and energy components that still seems to be strong. As a matter of fact the [increases for the] last two months, at .6 and .7 percent, are very troubling. You can always find some special factor like apparel or something else that has had a major impact, but there's always something. I can live with separating out the food and energy components because those are volatile elements that are somewhat beyond our control in the shorter run. But as for these other factors, you have to draw the line somewhere. The fact is that the CPI doesn't look all that good. It makes me wonder, though, since the PPI seems to be improving, if there is just a lag before it eventually shows up in the CPI; I don't know.

The economy looks stable, although there's this atmosphere of concern about debt, a credit crunch, and things like that. But international events are developing, it seems to me, in a positive way. You can question how slowly or how fast [the changes in] Europe will develop, but unless the political climate changes dramatically--say, the Soviet Union gets tremendously tougher--in the longer run and maybe in the most immediate short run, that has to be positive. I don't know. But I'm convinced that East Germany is going to boom because West Germany is going to make it boom; they're going to throw money at it. So I think that is a positive in terms of external sources of economic pressure. Japan doesn't seem to be weak from a productivity point of view and I think their major problems are that they have been pushing the edge of capacity constraints and they have had a speculative bubble and all that is sort of fermenting over there along with the weak government. But I don't see external evidence of sources of depression coming from outside of the United States. So that should be positive. And the inflation picture seems to me to be somewhat stable but not improving. I don't know what that says for the immediate term for policy, but I think it does say that if we want to make progress in the upcoming period, we're going to have to have a tough look at that.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mr. Chairman, I'm persuaded that the Greenbook forecast is a very reasonable one, given the underlying assumptions; the interest rate construct, which is part of that, is certainly reasonable. I'm dismayed at the lack of progress that it reflects with regard to inflation. But my underlying concern at the moment--and this may sound like a disbeliever in the omnipotence of monetary policy--is that we may have witnessed here a transfer of at least part of the control of the growth of the economy as a result of this extraordinarily stringent application of examination standards to the banks. I'm concerned that that will, in fact, cause a contraction of credit that may deal a greater blow to inflation than our current policy. I think that in that kind of environment the supplying of

reserves and reducing of rates will not necessarily encourage expansion. I guess I'd end by paraphrasing an old saw and say "You can offer a banker wider spreads, but you can't make him lend."

MR. SYRON. That's not true of the thrift industry.

CHAIRMAN GREENSPAN. Try to top that, Governor Kelley!

MR. KELLEY. I would never, particularly coming from somebody who [was a banker] for 35 years! Mr. Chairman, we always are looking for one more piece of data; that goes on forever. But I am struck this time more than usual by the tentativeness of the data that we're looking at and the tentativeness of the forecast that we're able to make. I hear it from the staff and I hear it going around the table here this morning in both the area of the real economy and in inflation expectations. What's going on in the economy now is to some degree--and we don't know to what degree--the snapback from strikes and from storms and from the whipsawing in the auto industry. Some of the industries that are showing some strength, like housing, have big seasonals at this time of the year. And it's just really hard to tell how much of what is going on is sustainable and is real underlying strength. I also share John's and others' concerns about what we may be in for in terms of the extent of the credit crunch and what the results of that could be.

On the inflation front, the forecast is that what we have seen in the last several months is going to unwind to some degree. I've been very disappointed, as I think everybody else has, in the numbers we've seen the last several months. The expectation is that that's going to unwind to some degree, but by how much? We're going to have to see about that. Meanwhile, as Governor Johnson pointed out, the PPI really is not validating that bad result that we've seen in the CPI and in the deflators. So, I go back to what Bob Parry said a little earlier in the morning: that what we need to do is to maintain moderate growth. I agree with that. I'm not sure what it's going to take to do that, on balance, with the other objectives that we have. And like Gary Stern, I'm a little concerned that we not overreact to two or three months' worth of numbers and wind up whipsawing the economy. I certainly share the disappointment that I hear everyone expressing; I agree 100 percent about the last few months and I share the impatience that goes along with that. But given all that we cannot be sure of at this moment, I'm pretty cautious about what policy ought to do.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. Well, as I think I hinted with my questions earlier, I feel uncertain about the outlook and I hope that what's on these pages from the staff turns out to be right because I believe in having moderate growth. I think it's important in many ways to have that happen. But I would just like to tick off some concerns I have that I think are going to put these possible outcomes at risk. I mentioned the first concern I have: the dollar and the issue of whether or not it actually will decline in value relative to the other major currencies. If it doesn't, I'm old fashioned enough to believe that that will have an impact on our trade situation on both sides of the equation. And that, indeed, concerns me since we are counting on trade to help us, particularly in 1991. Also, despite the fact that

Russian tanks rolled into Lithuania, I think that we are still going to have some defense cutbacks and some actual cuts in the defense budget. I personally don't know how that will play out; I don't know which contracts will be cut back or which bases will be closed, etc. But I suspect that when that happens it will show up in somebody's District around the table here and also will impact the aggregates eventually.

Also, there's the question of state and local government finance. I hear more and more comments about the deterioration in state budgets from the Northeast to the Southwest--all over. I met with a legislator from Michigan very recently and they're having to redo their estimates because they were too optimistic about the revenue forecast. So, instead of having a comfortable situation, it now doesn't look comfortable. I would think that ultimately that would impact either on spending by state and local governments or on their need to raise taxes, neither of which would be supportive of economic activity. On the U.S. budget situation, I heard the Rostenkowski name come up, but if we do get a tax hike I don't see that [unintelligible]. Is that the correct assumption: that you have not built in a tax hike in [your forecast]?

MR. PRELL. We have only a few billion dollars of the--

MS. SEGER. Well, if by some miracle it happens, I would assume it would have some sort of impact. Also, I'm extremely concerned about the profit margin squeeze and what it will do; it's already going on and I think it will get worse. In my judgment that will have a significant impact on plant and equipment spending of all sorts.

Finally, with regard to the credit crunch matter, which we've heard about from a number of people, I think it is going on. As Manley said, we talk to a lot of these banker groups that come through and we hear those comments; I also hear them from many business people. I've observed recently that banks were even tightening terms on their home equity lines, which of course they have been practically shoveling out the door. Now they're using a smaller shovel anyway. Certainly, we are all hearing about the commercial lending tightness. For auto loans, there's less enthusiasm for the [unintelligible] 6-year or the 5-year loan and the idea is surfacing that maybe you shouldn't make a loan that's longer than the life of the car. So there's some tendency, at least among some lenders, to cut that back. In the small business arena--I have a lot of friends who are small business people, including my brother--I'm not sure that what's going on is going to show up in the numbers we're looking at because so far a lot of the changes involve the terms or the fact that lenders expect personal guarantees. If you have a small corporation they want your personal backing on a loan; there's this desire for extra security to protect the lender. It is certainly making business people feel a lot more conservative and I would suggest in some cases rather nervous. On the S&L side there's the FIRREA effect in the case of small and medium-size homebuilders and developers--I'm not talking about developers of big projects or major strip shopping centers but about homebuilders. And I thought we had a housing shortage, at least in some parts of the country. I think it's important to allow builders who have an active market to build those homes. Yet these are the ones who are feeling the impact of this single-borrower limit that has

been imposed on the S&Ls to match the limit on national banks. Frankly, I don't think we have much of that built into our housing forecast here. And finally, in the case of the captive auto finance companies, they too have been tightening some of their terms and standards; and some of these marginal auto buyers are not going to be able to buy a car because they don't qualify under the new standards whereas they might have under the old, more generous, ones.

Frankly, I don't know how all this will play out, but it's just a long enough list of concerns and question marks that I am uncertain and I wouldn't feel comfortable with a 90 degree swing in policy from where we are now. I might [not] even feel comfortable with a 5 degree swing, even though I certainly am concerned about the inflation situation. But I don't know how to pull out from these reported numbers what is transitory and what is really a fundamental change. I'm really impressed with the degree of competitiveness out there in the real world. I just don't think we can sit here and assume that every business can say: "Well, my costs are going up so tomorrow I'll just mark up all the prices of everything I sell." They just don't think that the market conditions would [allow] that.

MR. PRELL. Governor Seger, a clarification: We have \$8 billion of various tax [increases] in our '91 deficit reduction package.

MS. SEGER. Thank you.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Mr. Chairman, I don't have anything to say at this time. I'll listen carefully to your recommendation.

CHAIRMAN GREENSPAN. You can't wait to hear what I have to say! Do we have coffee out there? We're a little late for coffee, but--

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

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

CHAIRMAN GREENSPAN. Lee.

MR. HOSKINS. Don, to link your story up with Mike's: We have an increase in inflation even in terms of the Greenbook forecast, and my question revolves around the issue of how much of that increase in interest rates of 1/4 point or so over the last quarter you would attribute to inflation expectations versus real. What I'm really wondering is: If it is expectations about inflation, to keep policy neutral wouldn't we have to raise interest rates 25 basis points?

MR. KOHN. Yes. My sense is that in terms of long-term rates, we have a couple of things working here. One is, of course, that the fed funds rate hasn't moved since December 22 or whenever it was we last changed policy. Long-term rates have moved substantially higher. Inflation expectations may be an element there, but I would put them as a fairly small element. I think the response came

primarily in terms of a stronger economy here at home [plus] some of the pull from the European situation. We never did have good data but we have even less information on inflation expectations than we had before now that Mr. Hoey is between jobs, but my guess is that they'll do a survey in April.

CHAIRMAN GREENSPAN. That's the real damage from the [Drexel] failure! [Laughter.]

MR. KOHN. My guess is that people probably are holding off in revising upward their long-run inflation expectations on the basis of the last couple of months' data. Now, I'm sure there might be some short-run [effect]. So, I think most of this is a sense that real rates need to be higher just to keep inflation somewhat in check rather than an increase in inflation expectations. But it's certainly anyone's guess.

MR. HOSKINS. If you answered the question "Yes, it's all inflation expectations," then how would you answer the second part of the question? To keep policy neutral, what do we need to do?

MR. KOHN. If you thought that most of the increase-- particularly in long-term rates or even the short-term rates--was inflation expectations, then indeed you would need to raise rates.

MR. PARRY. Just continuing along that line a little: If a significant proportion of the increase is due to increases in real rates, what would be the implication in moving the funds rate [up]? How would you see the market responding?

MR. KOHN. Oh, I think the market would see that as a tighter policy and long-term rates would rise a bit. That's what we have in the Bluebook. The response might be fairly damped but I really would expect, if you surprised the market by tightening policy at this time, that bond yields would rise at least initially.

MR. PARRY. But that's the only rate that hasn't had an increase in real terms over this period--

MR. KOHN. But it's not as if raising the funds rate would be doing what the market expects you to be doing and, therefore, simply moving out along a yield curve. I think what happened before was that the market expected policy to ease. Now they don't, and they're doing what the yield curve says. So you would be surprising the market with an increase in the funds rate. It may be appropriate, but it would be a surprise.

MR. PARRY. Would you say the chance of such a move not affecting long-term rates or having them decline slightly is very, very remote?

MR. KOHN. Those odds are always there and, particularly if it strengthened the dollar, I think you'd get a feedback through the dollar. If you tightened policy and the dollar went up quite strongly --just ignoring what the reactions might be overseas for now--you could have a very substantial feedback on bond yields and bond rates. They might not rise very much at all and could even decline, depending.

MR. PARRY. Okay.

MR. SYRON. Could I ask Ted just what he expects the impact would be in the exchange market if the funds rate were to rise 25 basis points?

MR. TRUMAN. Oh, I think you'd get some considerable--

MR. SYRON. How much is considerable? I'm not going to ask you for a point estimate, but what do you think [the effect would be] on the yen and the DM generally?

MR. TRUMAN. It would depend a bit on the timeframe of all this and what kind of music went along with it, if I may put it that way, and as Don has already said on what the reaction was abroad. But if you take what policies are abroad [now], my feeling is that you could get 3 or 4 percent, anyhow, on the dollar in the short run. Then, as other things came into play that might be sustained or move the other way. It would be affected by what goes on later. But I think you could get quite a lot of movement at this juncture, if the funds rate went up that much in the short run.

CHAIRMAN GREENSPAN. I think [the yen is at] 157-1/2.

MR. JOHNSON. Today?

CHAIRMAN GREENSPAN. Now, or just below it. Since the market doesn't expect anything, if we were to do that, I think it probably would go right through 160 or better.

MR. JOHNSON. Yes; that's why I was curious.

CHAIRMAN GREENSPAN. The market would be fooled. Any further questions? If not, why don't I start the discussion. There's no question that the underlying business cycle numbers have improved. Not only the current numbers coming in but the actual revisions of recent history suggest that the current state of activity is better than we would have expected, certainly at the last FOMC meeting, though it's too soon to get a sense that this is anything more than a modest rebound from the end of deterioration. We're not sure at this stage exactly how to read all the various weather seasonals. If we were getting a stronger order pattern in the manufacturing area, we could presume that the pressure here was accelerating. But from the surveys we take and from looking at the various sets of order patterns, orders seem to have stabilized at a relatively flat level, which is consistent with very little change in manufacturing activity. The continued deterioration of profit margins has not yet turned, although I suspect that the improvement in raw materials prices that has come in recent weeks and that Governor Angell has been following may be suggestive of a first sign that the deterioration in margins may be ending. But as of now, from what anyone can see on the profits side we are right at the bottom of this pattern and it has not turned. What history does tell us is that the capital goods markets do respond to margins. And in that sense, to carry this thing forward in the usual business cycle recovery pattern I think is premature. It may turn out that way. In fact, I suspect that the most likely forecast is precisely that.

But we do have in the context of what is unquestionably an improving business cycle balance of forces--in a sense the cash flow part of the economy with the exception of profit margins--a lack of improvement in the balance sheets. That is, there is still the deterioration and the [erosion] in the balance sheet; in the overall balance sheet we're seeing leverage still growing. Don, I don't know whether or not the improvement in the liquidation of equity that you have in these flow of funds [projections] is going to occur that way. I'm really sort of asking why you still have -60 or something like that; I don't know why it's not going to zero myself. But the point at issue is that the leverage is still increasing and we're still dealing with a fragility in the balance sheet that is not improving. And when that overhangs the business cycle pattern, I think we have to be cautious in projecting any form of acceleration in the underlying demand forces.

I, like everyone else, am not sure whether the credit crunch is real. It has to be partly real unless human nature has been repealed because there has to be a fundamental response to what has occurred. I think the issue is how bad it is. As Jerry points out, some of that is probably good, or not bad, especially if you look at credit that has been extended inappropriately. The inflation issue is obviously the most disturbing part of the outlook. I don't think it has gotten any worse since the last time. The Social Security tax increase and the minimum wage hike are coming at exactly the wrong time. If one had to go back and look at this whole thing in retrospect, that's not helping. Probably it does mean that if we get past it without an acceleration, the compensation patterns will begin to fall off. I don't know whether I'm encouraged or not, but whatever data we see on the wage side do not appear to be accelerating. But then again, it's not improving in any material way that I can see either. I'm encouraged somewhat by this slowing down of M2; I was getting concerned that it was going to break outside of our 3 to 7 percent range; it seems to be constrained. Part of that, obviously, is the extraordinary pattern of the bill rate vis-a-vis the funds rate. And in that sense one can argue that the markets have indeed tightened--that there probably is some modest tightening in the markets if you look at the bill rate, other short-term rates, and the money supply. But it's probably a very modest amount because it makes [no] significant difference one way or the other.

My own impression, having said all of this, is that it's probably too soon for us to be moving rates up. The exchange rate effect, I think, would really be quite a destabilizing force. Even at this stage I suspect that it's probably premature to go asymmetric toward tightness in the directive, although I must say that I suspect the next move we're going to make is indeed going to be up, not down, and probably should be. At the moment I frankly would prefer that we stay symmetric but be very conscious of any evidence of inflationary pressures picking up, specifically in the price area, importantly in the money supply area, but most of all any evidence of acceleration in the business outlook. While it is very early in this turn from the weakness that we saw in the fourth quarter, and in my judgment far too premature to assume that we're looking at any acceleration, we are nonetheless at 5.3 percent unemployment. And that's a tight market. If we get acceleration in demand at this point, I think the price pressures will begin to move rather quickly. We have to be very conscious of that threat. But my own judgment is that it's much too

early to assume that. The order structure and the profit structure remain somewhat weak and at this point I would say that calling for more than leaving the directive unchanged and symmetric probably is premature. However, if it were the Committee's desire to move to asymmetric language, I feel that's not altogether an inappropriate move--certainly at the next meeting, if not sooner. Governor Angell.

MR. ANGELL. Mr. Chairman, I agree with your assessment. I would just as soon have "B" symmetric, with our watching it very carefully during the intermeeting period and being particularly tuned to any developments in any of the leading indicators that would help us to know [more] in regard to timing. It does seem to me that the transmission mechanism of monetary policy is increasingly through the foreign exchange rate and that having a somewhat higher foreign exchange value of the dollar does get us somewhat closer to the effects that we would have had with a somewhat lower dollar and with a 25 basis point increase in [interest rates]. It just seems to me, Mr. Chairman, that foreign exchange markets at this point would be destabilized by an unexpected move on our part; that would buy us more problems rather than less.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Well, we're in a very difficult situation, obviously, and when one is treading on eggs it's best to tread lightly. In that regard, there is much to be said for your recommendation in terms of it being premature to make any move in terms of absolute [unintelligible]. But I am concerned that the Greenbook shows what I think most of us consider an unacceptable inflation performance with an implicit assumption--whether it's significant or not you can debate--of a 100 basis point increase [in the funds rate] over the year. So, I would say that on balance, because I think this issue of maintaining our credibility is very important, I would want to give the markets some signal that we were worried about inflation and I would have a slight bias toward going with an asymmetric directive.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Mr. Chairman, you might have detected from some earlier comments that I made that with respect to this particular meeting I started out leaning a bit toward "C" or something in the neighborhood of a "B-C" directive simply because of the lack of evidence that we have made any progress on inflation--nor will we in the next two years. Nor indeed is there clear evidence that we have capped inflation as some people would like to believe. As a result, it seems to me that making some sort of preemptive strike, if you will, by moving rates up at the the present time would have some beneficial effect. But given a couple of things that will occur in the future, it seems to me that that probably is inappropriate. Given the closeness of the G-7 meeting, I think you might have some real difficulty during that period of time. Also, there will be an employment report that comes out April 6th, just before your G-7 meeting that will give some better information with respect to what happened in January and February; it will either confirm or not confirm those numbers, it seems to me. Therefore, I would like to propose that we have "B" with an asymmetric directive so that if we do get information in the intermeeting period that suggests that we have

a much stronger economy than we think we have, then we could move. Secondly, and perhaps more importantly, is that this would be a leading bit of information to the market as they see this directive following the next meeting. They would know which way the wind is blowing and what the next move could be. It has informational content, if you will, whether we move or not in the intermeeting period; an asymmetric directive seems to me to have some advantage.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, if I were the all powerful czar of monetary policy I would do exactly what you've prescribed. I'm basically content with where we are. I share the frustration about our lack of ability to move against inflation. But I think we have to have patience; that's the key point in my mind. For the reasons that you've mentioned, I think we have a potential for instability in the market. We have fragility, we have this possibility of the credit crunch, and [we have the possibility of a problem in the] foreign exchange markets. All of those things suggest to me very strongly that it is premature to move at this time. It's a natural reaction on the part of human beings to want to take action when frustrated by something like this inflation rate. But sometimes inaction is the better course of action, and I think that's the situation that we're in now. So for that reason I would heartily endorse your prescription, and I feel that it should be a symmetric directive as well.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I agree with you that there is some uncertainty about both the strength of the economy and also the extent of the inflation problems. However, I would prefer a small move in the direction of tightness somewhere between Bluebook alternatives "B" and "C." It seems to me that if the Greenbook is correct--and certainly our work would suggest that it is--there will be a need for some fairly significant, or at least eye-catching, tightening in the second half of the year. It might be easier to do some of that at the present time and have to do a little less in the second half of the year. If that's not in the cards, to me a fallback position is to support asymmetric language in favor of a tighter policy. That approach would ensure that policy could be tightened promptly if we had indications that indeed the economy is strengthening and if inflationary pressures look like they're even more of a concern in the seven weeks until our next meeting.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, I would lean somewhere between "B" and "C" but I'm certainly willing to accept the arguments of what the possible effects might be on foreign exchange rates. That being the case, though, I would feel pretty strongly about going asymmetric on the directive. Roger pretty well made that speech. It does seem to me that it positions us, if later events call for an actual upward movement in the fed funds rate. If that became necessary, we could move; or if that were delayed and had to come even after the next meeting it seems to me that that would tend to minimize a bit the surprise element that seems to be a matter of concern. If later information indicates that the economy and other factors are not what

I at least anticipate--if policy doesn't actually change over the intermeeting period--the markets would be able to read that; and following the next meeting, if nothing happens, they could tell that pretty quickly. So, I don't see any significant risk in going asymmetric, but I think there are a lot of good arguments for going that way.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Well, at the least we obviously have a difficult timing problem here. But I find that I come out where you do. We have seen that inflation is at least as stubborn, and maybe more stubborn, than many of us had expected; and that may require a tightening move. But at the moment, at least, I don't have a sense of urgency about it. I think, as Tom Melzer said earlier, it's probably low cost to wait until the next meeting; and indeed, if we get a lot of confirming evidence earlier than that, we always do have the opportunity to act if that would seem to be appropriate. I don't want to whipsaw the economy or policy by moving now and then finding out through a series of data revisions and incoming information and so on and so forth that we overestimated some of the improvement. Looking at inflation from a longer-run perspective, I don't know what it will take to start to bring it down. Obviously, the scenario in the Greenbook doesn't suggest any progress in the next year or two. But I think the best thing we can do under all these circumstances, as I've said before, is probably to see to it that M2 growth remains modest. And I am encouraged at least about the near-term prospects there although unfortunately, as Don mentioned, it may be a little hard to read M2 as the quarter unfolds just because of the tax payment issue. Assuming we get something like [the staff estimate], then we're on a rather sensible course and I prefer to wait a while longer and let some more evidence accumulate. I have a mild preference for retaining a symmetric directive just because I think that maximizes flexibility. I'm almost always in favor of that. But for now it's a mild preference.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, I think you summed the situation up very well; I happen to agree with your conclusions. As I said earlier, I think the risks on the inflation side may have shifted upward a bit, but I'm really still hopeful that as we get further into the year the numbers will show some improvement without our necessarily having tightened policy. Therefore, at this point I'd be in favor of maintaining our policy and would have a preference for symmetric language. I would only add that I don't in any way view symmetric language as limiting action on our part during the interim period if something should develop that would call for that.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Well, our long-term goal publicly stated is price stability. For 1990 the nominal GNP we're looking at is about 6.2 percent, I think; we're looking at a monetary growth rate of 6-1/2 to 7 percent. It seems to me that that implies no movement toward our long-term goal, at least in terms of our policy position. If you look at P*, I find no pressure from the P* model for moving toward price stability.

Moving toward more current kinds of considerations, it seems to me that we can always find a risk in the economy; we have done that consistently, at least over the last 2-1/2 years that I've been sitting here. If we're always going to weigh our decisions toward risk to the economic expansion, then we're always going to bias ourselves toward inflation. It seems to me we have a one-weighted risk scheme in here. We weigh only toward the economy until inflation is in some sense beyond our control [rather] than taking very aggressive policy action. I think it's very important to maintain credibility. I think what we've learned from the last 20 years is that the credibility of policymakers is probably the key element in successful policy. Given the lack of movement toward our goal, much less the increase in rates of inflation that we've seen, I don't think that we're providing any kind of credibility at all. I don't think we need a major move at this time. We may need a major move if we follow market interest rates up; if we are wrong and the economy is stronger, we will have to move more aggressively. So, I would favor a 25 basis point move now and let the markets sort that one out. I suppose as a fallback I could go for an asymmetric directive toward tightening if in it we expressed our concerns about the inflationary trends.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, when we've been faced with this degree of uncertainty about the business outlook I don't think we've ever tightened before. And yet when I look back through the history of the System, I think this is where we've made most of our mistakes. If we could take the Bluebook at face value and assume that we would get a growth of M2 of 6 percent for April through June, I think that would be an adequate slowing, given the rate at which the aggregates have been growing. But I'm a little suspicious that it might be a little stronger than that. So, I favor a bit of a preemptive strike-- somewhere between "B" and "C," a "B-" or "C+." But that clearly isn't going to happen. So, I would be prepared, if I were voting, to vote for a directive with asymmetry to the [tighter] side. I think we ought to do at least that much. If subsequent economic information suggested that that was the wrong way to have leaned, I don't see that we really would lose anything since that would not be released until after the next meeting.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. "B" symmetric.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. Well, my preference was for something along the lines of "B" asymmetric for some of the same reasons that already have been mentioned by Roger Guffey and others. But I can certainly go along with the Chairman's suggestion for symmetry. I don't feel that strongly; I have a mild preference for asymmetry. There are a couple of things on my mind along the lines of what Lee said. If we didn't have to worry [unintelligible] quite so much, then I think it would be a great opportunity to gain some credibility by shocking the foreign exchange markets. But in fact, I can see a lot of difficulties with that; I can see that that would be a difficult problem that we need to be more sensitive to. Along with what Don Kohn said earlier, I interpret what has happened to long-term rates as mostly real rate

pressures from some pickup in the economy, although in my opinion it could be because of some of the events that have taken place worldwide and not just domestically. It could be improvement in potential output and something like an increase in the net real return on capital. And if that is the case, the current funds rate would be a relative easing of policy. Although if it's an increase in potential, that wouldn't necessarily create a long-run inflationary problem. But it's impossible to sort all that out. It's just theoretical reasoning. We have to look for the data as they come in. I wish we did have a political setting in which to enjoy the advantage of having a strengthening dollar here and be able to get more bang per buck at this stage with some firmness. But I agree that it's not in the cards. We do live in a political economy, not a simple abstract situation. So, I can go along with "B" symmetric.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. "B" asymmetric. I could live with "B" symmetric.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I certainly support your recommendation. I think that it would be premature, based on the tentativeness of the data, for us to move as yet. The decision is obviously between moving a bit in the direction of tightness or staying where we are. And I would suggest that we're getting a little tightening through whatever degree of credit crunch is going on out there, and I think there's at least some. Also, unless the G-7 does something to turn it around, my personal bet would be that for awhile at least we're going to see a rising dollar. We certainly have it in the yen and I would bet that on balance we're going to get it in the trade-weighted calculation generally. So, I would enthusiastically support your recommendation.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. To move now on policy would be premature on domestic grounds and counterproductive on international grounds, I think. So I prefer a continuation of current policy. On the issue of symmetrical or asymmetrical, I prefer symmetrical. It turns on the question of what kind of burden of proof we want in order to make a policy change. I think a policy change over the next several weeks would be a major move, and there ought to be some burden of proof to make such a move; and that leads me in the direction of symmetrical.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I would support your position of keeping policy at "B" with symmetrical language.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I have no stomach at all for changing policy right now either, but I came here with a very, very mild preference for asymmetric language. My preference is probably a bit stronger for asymmetric language, but operationally I don't think it matters a lot. We can react to incoming data as needed in either

case. I think the only real argument that can be made for asymmetric has been made; as I say, I can be reasonably comfortable with "B" [symmetric].

CHAIRMAN GREENSPAN. What I hear is that there is some concentration for alternative B symmetric. The Secretary will read the directive encompassing that and we'll put that to a vote.

MR. BERNARD. "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 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 or slightly 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 March through June at annual rates of about 6 and 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 6 to 10 percent."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.	
Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Boehne	Yes
President Boykin	No
President Hoskins	No
Governor Johnson	Yes
Governor Kelley	Yes
Governor LaWare	Yes
Governor Seger	Yes
President Stern	Yes

CHAIRMAN GREENSPAN. Okay. We still have a large element of our agenda in front of us, so why don't we break for lunch, come back quickly, and get started as soon as we can.

[Lunch break]

SPEAKER(?). [Unintelligible.]

CHAIRMAN GREENSPAN. With that information, let's go ahead and get started.

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

CHAIRMAN GREENSPAN. Questions for either gentleman?

MR. BOEHNE. Well, I just can't let this pass. First of all, I think you are to be complimented for putting together in one place a review of this complex issue. Even if not much change occurs, I think the study is worthwhile and it is a well-done record. I've never approached this [issue] from a particularly ideological point of view.

I've always tended to be fairly pragmatic in terms of the politics as well as the economics about whether we ought to [intervene] or not. However, I must say that over the past year just the sheer amount of the transactions has struck me as being well beyond what is a reasonable number. I feel that we have just sort of slipped into this for good reason or bad reason. The number is something like \$20 billion. It goes well beyond a narrow, or even a moderate, interpretation of disorderly markets; it goes well into trying to manipulate exchange rates. And it's difficult to see what we have gotten out of it. I personally don't think we can continue for another year with that kind of volume. It might be helpful as the Committee looks at this to try to draw a distinction between intervention to counter disorderly markets--as ambiguous as that is--and intervention aimed at manipulating the level of exchange rates. I, for example, would think that intervening to counter disorderly markets is a fairly routine, even technical, kind of thing over which the Desk, the Chairman, and the Foreign Currency Subcommittee ought to have fairly wide discretion. But when we get into the issue of whether we're going to intervene to manipulate the level of exchange rates and we commit the magnitude of dollars that we have, it seems to me that that kind of decision ought to be laid on the table as explicitly as when we change domestic policy rather than just come to the point where we ratify transactions. So, what I get out of this is that we ought to try to draw this distinction. If we're talking about anything that comes close to what we've been through, we ought to have a procedure in the Committee where that policy decision is aired and discussed and we either ought to go on record as favoring it or not favoring it.

MR. PARRY. Ed, are you saying that those are both valid reasons for intervention?

MR. BOEHNE. I'm not prepared to make a decision for all time and in all circumstances that says what is or isn't. It seems to me that the case for this narrow definition of intervention to counter disorderly markets is well within the bounds of what a central bank ought to do. I think it's fairly routine business [for a central bank]. On the broader issue, I think one would have to look at the circumstances in which we were trying to do it. It's more than economics involved here. When we start to commit billions and billions of dollars, as we have this past year, for the clear purpose of trying to manipulate exchange rates, I think that is a decision that ought to be made consciously. Maybe we would do it and maybe we wouldn't. I would just have to wait and discuss whether I would be for it or not for it depending on the circumstances. And I wouldn't make any [prior] judgment.

MR. PARRY. Implicit in your comment is that you think it's effective.

MR. BOEHNE. I think in some circumstances it might make sense for us to do it. And those circumstances may go beyond economics. I'm just not prepared to close the door on its potential effectiveness for a broad range of reasons. We ought to face up to that head on when the time comes.

MR. PARRY. Is your concern about the \$20 billion a foreign exchange risk concern?

SPEAKER(?). It's a political concern.

MR. BOEHNE. Well, first of all, \$20 billion is a lot of money to spend even for a central bank. Second, I think that there are some political accountability issues here, one of which we're going to run into on this currency [collateral] business, I would think, some time this year. We at least ought to have thought through what we're doing and why we're doing it before we commit to that kind of money.

MR. HOSKINS. Is the agenda here to go through Ted's four policy questions, which I thought were quite good?

CHAIRMAN GREENSPAN. Well, the first thing we [normally] would do is to ask questions, but they didn't say anything to ask a question about. So, if you want to comment on the substance of the issues, please go ahead.

MR. HOSKINS. Well, let me just start where I think Ed was going. There are a number of points that could be raised around the issues that Ted put down; we probably ought to discuss those because I think they're fair and to the point. I suppose one response to Ed's statement is that we did approve those limits regularly, and there was some protesting along the way occasionally. But sooner or later we found ourselves in a situation of [spending] \$20 billion. And I'm uncomfortable with it, as Ed is, for some reasons that are political. I think it attracts attention. And I think we ought to ask the question: Does it allow influence by the Treasury on us because of that relationship? I don't know the answer to that but that seems to me one question that we ought to deal with. Ted started off with the [question as to whether] we should be doing it for our own account. It's one thing to execute [transactions] as agent [for the Treasury]; it's another to give tacit [permission] to manipulating or trying to maintain exchange rates.

CHAIRMAN GREENSPAN. Let me just say one thing now. To the extent that we at the Board raised concerns to the Treasury, I think we were more heard than not. In effect, I would say that in this most recent endeavor to suppress the decrease in the yen against the dollar about which we raised very strong [objections] and had extended discussions as to why that was desirable or appropriate, it actually paid off. In other words, the Treasury did pull back. As best I can judge, that was largely the result of our reluctance to go along and of the arguments we were making. So, even though in a legal sense we have to interpret ourselves as junior partners, it has been my impression that we do have a significant effect on the overall Treasury decision. Were we to pull away and be strictly [the Treasury's] agent, I think by that very nature we lose completely all of our capability of influencing decisions that could affect our monetary policies. My impression is that, if we were to poll this Committee, the extent of belief that there is any really significant benefit coming from [intervention] would be extremely mild to nonexistent. The question that we have before us is not whether it works in any substantial way; I don't think you'll find many people around here who believe that. Therefore, leaving aside the issue of intervention where it seems appropriate to curb disorderly markets and raising the much broader issues of pegging-type intervention, including G-7 coordinated intervention to drive the dollar down, for

example, the question is whether or not we lose our ability to influence those decisions if we pull away. And I must tell you my impression is that we do. Sam, is that your impression?

MR. CROSS. Well, there's no question that our discussions with the Treasury at all levels are very much influential on their views both because they do want to have the Federal Reserve involved in there with them and also because we can bring to the discussions some [insights regarding] the point of view of the markets and the point of view of the issues that the Federal Reserve is interested in, which have an influence on them. So, my assessment would be very similar to yours. There are a lot of times, of course, when we start off agreeing anyhow. But there are many, many occasions when we do influence their views. I think this recent experience is a case in point. But as in any arrangement of this sort, it's not going to happen every time. Looking back over a longer period of time, I think we have been very influential and quite helpful in influencing them in the directions that we have.

CHAIRMAN GREENSPAN. Yes, I think we've succeeded in shutting off some of the extreme elements of policy that they tried to implement.

MR. CROSS. I think that's right. We mentioned in [the Task Force report] that the Federal Reserve frequently seems to be somewhat of a balancing wheel; sometimes Administrations tend to go off a little in excess in one direction or another. I think over the years that certainly has been the case.

MR. HOSKINS. I don't disagree with what you said, but the balancing wheel this time seems to me to be in order of magnitude completely out of proportion to what we've done in the past. It's roughly four times the level relative to our portfolio that we've experienced.

MR. CROSS. Well, certainly, the \$20 billion we did last year is the largest we've done in one year. But if you [compare it with] periods in the latter 1970s [relative to] the size of the foreign exchange markets at that time, for example, the \$20 billion was not big. If you look back at the size of the current account deficits in that period, there were periods of intervention when relative to those conditions the intervention figures were high, though they certainly did not approach the \$20 billion total.

MR. JOHNSON. [Unintelligible] the current account deficits will make it work the other way? [Unintelligible] selling dollars with a large current account deficit.

MR. CROSS. Well, that's right. I was trying to give a comparison of the [conditions] within which--

MR. HOSKINS. But you can only relate it to our portfolio because if you're looking at channels of influence, it's true we can influence the Treasury. But the other side of that coin, it seems to me, is that Treasury can have some influence on us. One of those influences might have been that it had to get very large before we got our backs up.

CHAIRMAN GREENSPAN. Is there any question that we can't totally sterilize our activities in exchange markets? Are you raising the question of whether or not they can influence us because we can't sterilize or what?

MR. HOSKINS. No, they can influence us in the size of our foreign currency holdings.

SPEAKER(?). That's a separate issue.

CHAIRMAN GREENSPAN. That's a separate issue. Sure.

MR. HOSKINS. It's not clear to me in what other ways, once we have a position of that size. Could we be influenced by a potential loss in that and would we adjust policy in order to avoid a potential loss? It's just a number.

MR. JOHNSON. I think in fact it can complicate the sterilization process. Technically, we can definitely do it, but we already have found that we had some collateral pressures. Now, I know we could suspend that and reinterpret our collateral, but that complicates the process. Also, in my opinion, at times it can create a significant amount of uncertainty about policy in the open market because if the market doesn't know the degree to which we have undertaken exchange rate intervention then it can confuse the market's understanding of what the reserve need is on any given day. That can add volatility in the market and it can confuse the market at least in the very short run.

CHAIRMAN GREENSPAN. You're referring to intra-week I assume?

MR. JOHNSON. Yes, absolutely; because it comes out eventually in the reports. But I think it could have a substantive effect if we ran into serious collateral problems. If we try to change our definition of collateral and expand what we consider collateral, we could open up a whole Pandora's box of questions about the substance of our policy.

MR. TRUMAN. Just to come back to the collateral issue, since it has been raised twice now: It was a self-denying ordinance that the Board imposed on itself, given the circumstances as they existed in the early 1980s. And I suspect that the proposition that you--

MR. JOHNSON. Well, I'm saying we still have to change it [even if] it was self-imposed.

MR. TRUMAN. You'd have to change your policy. The question is whether you--

MR. JOHNSON. You could raise a lot of questions about that.

VICE CHAIRMAN CORRIGAN. But the issue shouldn't swing on that question.

MR. JOHNSON. I couldn't agree more. All I'm saying is that it can complicate the sterilization process. Tentatively, that's true.

CHAIRMAN GREENSPAN. May I just ask a factual question? Has there been a significant or meaningful political change since we initiated that on the basis of the concern that we shouldn't back the dollar with foreign currencies? Is that spoken of politically as an issue? Does anybody have a sense of that?

MR. TRUMAN. It tends to be associated with one or two people in Congress at least one of whom, Ron Paul, is not there anymore. It was also associated with concern and confusion in the outbreak of the debt crisis and the misuse of that power to bail out Brazil, Mexico, or any of your favorite or nonfavorite LDCs. It is not currently an issue. I'm not saying that it wouldn't be noted--

MR. JOHNSON. It could quickly become an issue if it looked as if we were bailing out the currencies of other countries.

MR. TRUMAN. If the circumstances were such that the Congress felt that the dollar should go up and we were excessively buying foreign exchange--which I think is what you're talking about--it would become an issue. That is correct. Generally the bias in Congress has been the other way, however.

MR. SYRON. It's very easily demagogued; that's the really dangerous thing from our perspective.

CHAIRMAN GREENSPAN. Look, the truth of the matter is the reason we built up at least part of that \$20 billion is that in the early stages it just did not seem credible that the dollar would firm as much as it has. And the early accumulation of both yen and deutschemark balances was considered to be a good speculative investment that we would get rid of relatively quickly. Part of the problem is that the markets have behaved in a way that turned out not to have been expected. I think that has gone against us.

MR. JOHNSON. Mr. Chairman, that raises a very important point along the lines of what Ed Boehne was talking about initially. It seems that there ought to be some understanding in the Committee about where we cross over the line from just providing intervention to resist disorderly conditions and at what point we decide that it has gotten out of control and the fundamentals are really working against us. It seems to me that if we accumulate \$20 billion in foreign exchange reserves over a relatively short period of time, that's a signal that we've crossed over the line.

CHAIRMAN GREENSPAN. Well, I wouldn't disagree with that; in fact, that's precisely the reason we increasingly fought the Treasury as these sums began to rise. In other words, as soon as they began to get into double-digits it was a signal that we were doing precisely that. My own judgment is that if we were not there, the total, which is now what--\$45 billion?

MR. CROSS. Yes.

CHAIRMAN GREENSPAN. I would bet you that the total would be \$60 billion at this stage.

MR. JOHNSON. I guess the question is: What do we do, if they keep doing this? We have \$20 billion of a \$45 billion total. What if they keep wanting to sell dollars?

MR. ANGELL. There's no problem because they are out of money in their Exchange Stabilization Fund.

CHAIRMAN GREENSPAN. No, they could warehouse anywhere, if they wanted to. However, the political exposure of the Treasury to losses in that fund go directly, dollar-for-dollar, into the budget deficit, and I think there's sensitivity on that issue.

MR. BLACK. Well, losses on our books could go directly in there too.

CHAIRMAN GREENSPAN. What I'm trying to say is it's an issue both ways.

MR. SYRON. In that regard, Mr. Chairman, how big is the breadbox in the sense of the \$20 billion that we're talking about now relative to the position that we've had in the past vis-a-vis the amount of trading that's going on in the market? Sam started to talk about that and that's what I wanted to ask him. Is this just an extraordinary buildup?

CHAIRMAN GREENSPAN. Well, if you adjust for the size of the market--

MR. HOSKINS. But it is extraordinary relative to our portfolio.

SPEAKER(?). To our portfolio.

CHAIRMAN GREENSPAN. That's right, that's where the difference is; but it's not relative to the size of the market.

MR. CROSS. That's right.

CHAIRMAN GREENSPAN. One of the issues that we have to confront is that there is a globalization going on; there is no question that the amount of cross border transactions of every type is rising secularly against the nominal GNPs of the countries. And this is an irreversible process. So I think the issue is that were we to keep the proportion of intervention relative to the transactions constant, I would suspect that consumer and commercial banks are not going anywhere. But the ratio of our holdings relative to our total assets also would be rising secularly, and that's the problem.

MR. HOSKINS. If we continue to intervene, that's true.

MR. TRUMAN. May I come back to one point that Mr. Johnson raised? We did look at this question of volatility, which is related to the sterilization; it's the very last three or four pages in the book. In fact, much to my surprise, we did not find a correlation between interest rate volatility and the scale of our intervention whether we were in the market in a moderate way or a big way. The volatility of interest rates, whether long or short, seems to be the same. I was surprised because in some sense it was a biased test. I

would have suspected that [unintelligible] in the market because there were certain other things going on. It's not a strong test, but there isn't [a correlation].

MR. JOHNSON. Okay.

MR. TRUMAN. There seems to have been less confusion than I would have thought.

MR. JOHNSON. Well, that may be true as an empirical matter; but the potential is certainly there for it to create mysterious volatility problems, especially if we're intervening in large amounts. I concede that empirically that may not have been the case so far, but potentially it clearly could be. And that's something we should take into account. But I think we ought to go back to what Bob Parry was saying. I wouldn't worry so much about this whole thing if I thought it was totally ineffective. I think generally sterilized intervention is grossly ineffective. But there are times--and I think even this research shows that--when it can be effective at least in the short to intermediate term. The time that it is effective, at least temporarily if not even into the intermediate term, is when there is concerted multilateral intervention, which basically gives a signal to the market that there's a coordinated effort by all the major industrial countries to achieve some exchange rate level. Now, whether they ultimately achieve it or not, it creates in my opinion potential turmoil in the market in the short to intermediate term. And it can even change the psychology of the fundamentals in my opinion.

MR. PARRY. But it seems that we all agree with this. I think the issue is: How can we be effective in getting that viewpoint across--by playing the game or by picking up our mitt and going home?

MR. JOHNSON. Well, I can cite you an example that I have cited before. You can argue both sides of that. I think there have been times when we have been effective playing the game and there have been times when we have been totally ineffective. A good example is from my experience when I was at the Treasury. I have mentioned this to Ted and others before. When I was at the Treasury, Beryl Sprinkel was Undersecretary and there was a policy of non-intervention. Yes, there was some modest intervention at times when the Treasury decided that it was useful, but only when they decided it was useful. The Fed's views during the whole period were completely shut out. From my experience, I don't remember any cooperation or any plea by the Fed during that period having any effect whatsoever.

MR. PARRY. But you agree that there are times when it does have an effect?

MR. JOHNSON. Yes.

CHAIRMAN GREENSPAN. Well, there's a crucial difference. Beryl Sprinkel is different from all others. I was going to use an econometric term on how one can apply that but I decided not to.

MR. JOHNSON. Sure. What I'm saying, though, is that you probably could cite other times in the past where playing the game has not gotten us anywhere. And there are times where you have to draw

the line and say you're going to make a stand. I would completely agree that playing the game up to a point is a practical thing to do. The question is: What are the guidelines as to where we draw the line and when we decide to make a stand?

SPEAKER(?). Can you know a priori?

MR. JOHNSON. I think we can have some guidelines to say in general what kind of intervention we find acceptable. No, I wouldn't tie anyone's hands. It ought to come to this table and there ought to be a discussion once we cross over some threshold we consider to be outside the frontier of what we thought was reasonable. We ought to decide it, though.

MR. PARRY. Would you sketch out what the environment will be like after that point? In other words, what would be our role when we've reached that point where we say we're not going to intervene? What influence would we have? How would that be preferable?

MR. JOHNSON. Well, I'll be honest. My view is that we've had considerable influence standing firm. The fear at the Treasury of the Fed pulling out of this process in my opinion has been as strong a disciplinary force as anything else.

MR. PARRY. I don't disagree with that, but you say we will pull out at some point. After we've pulled out what kind of discipline can we exert?

MR. JOHNSON. Well, there are several things we can do. I'm not saying I would prescribe these, but we have a lot of tools. One is that we don't approve any further intervention limits or intervene on our account. We say, okay, Treasury, you have independent authority to intervene as a matter of Treasury policy and you can do it for your account. But the other point is that we also have the authority to approve their warehousing of foreign currencies. Now, they can warehouse, as the Chairman says, in other places possibly. I'm not sure where.

MR. ANGELL. Where?

MR. JOHNSON. Other central banks?

CHAIRMAN GREENSPAN. The BIS.

MR. JOHNSON. But I can't conceive of the BIS doing that.

MR. ANGELL. Yes, that would be risky for them.

MR. JOHNSON. But the point is there are tools. First of all, we don't have to do it for our account and that becomes clear to the market. We don't have to warehouse their foreign exchange reserves. Those are basically the disciplinary tools we have. And I think before the Treasury would risk confronting that, they would listen to us. But we've got to be willing to use those tools or we're not going to get them to listen. The Chairman has been very effective in my opinion in getting them to listen at times, but I think you would concede that they have been pretty stubborn.

CHAIRMAN GREENSPAN. Well, Mr. Mulford has been.

MR. JOHNSON. Messrs. Mulford and Sprinkel fall in the same category.

CHAIRMAN GREENSPAN. No they don't. We have to distinguish. I happen to agree more with Mr. Sprinkel's view on how this should work; I don't have any trouble with Mr. Sprinkel. But most Treasuries have been heavy interventionists. The reason I want to say leave the Regan/Sprinkel [period] out is that it's a real outlier; it's really beside the point. There have been occasions when we've butted our heads to little avail, but I must tell you that the vast, vast majority of occasions we not only argued but I think to a large extent prevailed. There have been two or three occasions when we objected to heavy intervention largely directed at beating down the dollar. We were bypassed for a few days. But after they got the point that it wasn't making any difference, they dropped it.

MR. JOHNSON. But I feel that it was the fear of our pulling out of the process that scared them more than anything else.

CHAIRMAN GREENSPAN. I don't think so, Manley. I don't think we ever even remotely suggested that we would pull away. Basically when Sam, for example, or some of us from here argue with the Secretary, I think it does have an effect. It has not been 100 percent effective in the sense that we are not fully in control. Frankly, I would be quite fearful of what they might do if we weren't there to harass them toward some degree of sensibleness.

MR. JOHNSON. But then I think it would become clear to the market if we got to that point. If I were a market participant and I were sitting out there seeing the Federal Reserve talking about price stability and yet selling massive amounts of dollars, I think eventually I'd decide that was a joke as a policy. It seems to me that our policies have to be reasonably complementary and that we have to make some stand ultimately if the amount gets beyond the point of reason. I'm not saying that within a range we should not participate and act in a practical way on disorderly markets, as Ed Boehne said. But what do you do when you build up \$50-\$60 billion of foreign exchange reserves?

MR. BLACK. There are at least two dangers. One is that we can lose our credibility and the market will assume we're going to ease policy in order not to take the losses. The other is that members of Congress become concerned about the losses and try to exert political pressure on us so that we don't have to take those losses, which would mean pressure to ease policy.

MR. HOSKINS. There's another issue here it seems--

CHAIRMAN GREENSPAN. Listen, I have this old piece of paper that says on it Wayne Angell [wants to speak].

MR. ANGELL. It seems to me first of all that the very first principle is that the Treasury, with its official foreign exchange capability, and the Federal Reserve are inevitably linked in an endeavor. Even if we did not engage in foreign exchange operations, we could still have the possibility of a conflict between Treasury's

official foreign exchange position and basic monetary policy; and it could become a conflict at the Congressional level if we decided that monetary policy was going to be for a strong dollar and if the Treasury said they wanted a weak dollar. So, I don't think we can back away and say somehow or other let's wash our hands of it. That won't work. I think it is important that the Federal Reserve continue its educational process. Now, I'm very happy with what has happened. I'm happy on two scores. In the first place I'm happy because the Federal Reserve is now, it seems to me, at a consensus position regarding the dollar. The problem that I had for so long was that we had so many in the Federal Reserve who saw a foreign exchange depreciation as a technique to resolve the foreign trade balance, which was in conflict with our price level stability goals. And I'm delighted, Mr. Chairman, that today this organization now seems to be together for the first time, which says that depreciation is not going to be used as a device to solve the trade balance problem. We're going to solve that problem some other way. So, it seems to me we've made tremendous progress.

Now, when the Treasury wishes to engage in dollar depreciation in order to satisfy a short-term political objective, that's very dangerous and we ought not to participate in it. We ought to be willing to join in when we believe that the purposes are reasonable and give them some allowance in that regard. But when it comes to the point of having it appear to the nations and the capital markets of the world that the Treasury and the Federal Reserve want a depreciation of the dollar, that invites catastrophe and we can't be a part of that. Now, it seems to me we've made progress on that score. We no longer have that high risk. Selling dollars to drive the dollar down is a process that a central bank can engage in without a limit. We can create all the dollars we want to create and there's no stopping it. Frankly, when it is published that the Federal Reserve did not participate, I think that's going to give the Treasury a great deal of pause; I think they're going to be more careful and are going to listen to us more carefully than they did before. The fact of the matter is, Mr. Chairman, that in 1989 they continued to the point of building up balances that are unprecedented and those balances subject them to foreign exchange speculative risk and they subject us to that risk. And sooner or later, if you stake those kinds of positions, you're going to have a Congressional inquiry and the whole operation is going to be tarred. I think it's very [unintelligible] that we're setting out to do. When we first did the Plaza Accord that seemed to be somewhat well understood. When we first did the Louvre Accord that seemed to be somewhat well understood in regard to broad ranges. But we've been asked to engage in the selling of dollars at a time in which no one knew what the down side was in regard to the deutschemark market as we were selling yen, and in this [untenable] position that the Treasury was in I think we had no choice but to separate ourselves from that risk. Mr. Chairman, I'm delighted we have. But I will be more delighted when we get some kind of reasonable plan to deal with the large balances that we now have and some notion as to how they can be worked back down. There are uncertainties that really are impacting this market. No one understands what's happening to the yen at this point. At one time we had some reasonable understanding as to why [exchange rates] were moving. But we are now in a period of risk. And I think it's just extraordinary that we've made this kind of statement; it's going to be significant when it's announced. I think it is going to have an impact when it is published that the Federal

Reserve stepped back from it. Now, I believe in doing this that we ought to be careful not to do it and turn out to be wrong. [Unintelligible] then, of course, we would lose credibility. But I think we've protected ourselves. But I would like to see the next plan, which is: Where do we go from here? What is to be done with the balances? When are we ever to sell currencies? That's what I think would be helpful to have your comments on.

CHAIRMAN GREENSPAN. Okay. Before I comment, the Vice Chairman wanted to [speak].

VICE CHAIRMAN CORRIGAN. First of all, I very much agree with Ed Boehne. I think we have to be pragmatic about these matters. It's quite clear that every central banker that is worth his salt, regardless of country of origin, is going to want a strong currency. And that covers even [unintelligible]. But against that backdrop and the immediately past history, I would go even a step further, Ed, in the distinctions that you made. There are intervention activities that are aimed at countering disorderly markets in the historical context of that word. There are intervention activities that may aim at trying to check what seems to be an unsustainable rise in currency x. But then there are also intervention activities that are at least perceived as seeking to beat down your own currency. I think in the immediate past a lot of the tension, not just between the Federal Reserve and the Treasury but between nations--including both central banks and finance ministries--really has focused on that point. Indeed, I think much of the dissatisfaction around this table has been targeted at that point: i.e., intervention tactics or strategies that seem to have as their sole purpose stomping on our own currency. So, that is a third distinction that I think is useful in trying to put these issues in perspective.

MR. HOSKINS. May I ask a question? You asked me before about policy and how we could be impacted by this. When you read the newspapers or listen to the discussion this morning, there is an expectation that the Fed won't tighten because of dollar concerns--that is, that the dollar is getting too strong. We heard it at the table to some extent just this morning. Suppose we have an increase in the inflation rate like we've had and we continue to have additional increases and we continue to say that we're supporting the Treasury in terms of intervention? It seems to me that we'll have no credibility at all. At what point do we decide to fight inflation here? The yen may continue to fall even if our inflation rate rises, even if they raise their interest rates 100 basis points. We don't know what's going to happen there. And I think Wayne's point is right about separating ourselves to some extent from the process because then the expectation is that we run monetary policy--that the Treasury may intervene, but the Fed will fight inflation when necessary.

VICE CHAIRMAN CORRIGAN. I was going to get to that issue in a minute.

MR. HOSKINS. I'm sorry to interrupt.

VICE CHAIRMAN CORRIGAN. Given the kind of institutional background that we operate in, it seems to me that with respect to the distinction I tried to draw as to the motivation for intervention in the first place, the first kind of troublesome threshold we all come

up against is this debate as to whether intervention works. Indeed, there are very sharp differences of opinion even around this table. Some people are against intervention because they say it doesn't work and other people are against it because they say it does work. I don't see quite how you square that circle. Then, you look at the great body of empirical analysis, some of which was summarized in Paper 11. That paper seems to say that it's pretty hard to find evidence that it does work. I have to say that I'm a little agnostic on that point. And I want to try to make the point that my agnosticism does not grow out of my place of origin, Liberty Street. I've asked my people to look at this question for me in some detail and I was very scrupulous: I asked some of the old timers like Dick Davis to look at it knowing their institutional biases; but I asked some people whose roots actually are here, like Bonnie Loopesko, to look at it. And they both tell me the same thing. What they say, basically, is that while maybe you can't draw a clear conclusion that intervention works, you can't draw one that it doesn't work. Moreover, they make the point that there is also a non-empirical foundation that tells us what determines exchange rates in the first place--whether intervention does or doesn't [work] or whether anything does or doesn't [work]. So, I think one has to have at least a healthy element of skepticism or agnosticism in terms of drawing sweeping conclusions on that threshold point.

My own view is not unlike Governor Johnson's in that intuitively I think it can work at least in the short run. And because it can work I think we should treat it as though it does work. Now, in that setting, the questions about profits and losses, opportunity costs, size of portfolio, and amount of balances in some sense are secondary. We can find ways, I think, to deal with those. But it does seem to me that the threshold questions are: What role should this institution play in the process, if any? And in addressing that question, it's important to keep in mind that for most of this decade we essentially have been operating with a currency that has been strong rather than weak. But it wasn't that long ago--the latter part of the previous decade--when things were distinctly the other way around. And we went hat in hand to the rest of the world asking them to help defend our currency. Now, whether that worked or not, whether it was an expedient or not, or whether we were short-sighted or not as a nation, is beside the point. That's what we did. And there is no guarantee that we might not have to face those circumstances again at some point in the future. So, I think that in itself is a reason not to throw the proverbial baby out with the bath water.

As I see it, the biggest danger with intervention--whether it's done by the Federal Reserve or the Treasury or both--is the danger that it can ultimately co-opt monetary policy. That, I think, is the ultimate risk. And that has a bearing on this question of whether we should be a part of the process or not. To me, the danger of co-opting monetary policy in some underlying sense is greater when we're out of the picture than when we're in the picture. I think it transcends the question of whether the Chairman with his considerable persuasive powers, or Mr. Cross and Mr. Truman with their persuasive powers, can browbeat the Undersecretary or the Secretary of the Treasury into a more sensible position day-by-day. It's much more fundamental than that. And I think that alone is more than a sufficient reason why the Federal Reserve should maintain a

continuing, active, involved posture and presence in these matters. I also think that our international relationships lead to the same conclusion. We may think we'll scare the heck out of the Treasury by telling them we aren't going to play, but if the world at large-- including our sister central banks--felt that that was our attitude, it would scare the heck out of them too. That in itself might produce precisely the problem that we're most interested in avoiding, and that is a weak currency rather than a strong currency.

MR. HOSKINS. I don't understand that, Jerry.

VICE CHAIRMAN CORRIGAN. If the international community of central banks thought that the Federal Reserve was throwing in the towel and leaving this whole business to the Treasury, I don't think they'd be very happy. As a matter of fact, I don't think the international financial community would be very happy.

MR. JOHNSON. The Bundesbank would be happy.

VICE CHAIRMAN CORRIGAN. For now they might be, but I don't think that the perception that the Federal Reserve was jumping ship on the process would be well received.

MR. JOHNSON. No, I agree with you.

CHAIRMAN GREENSPAN. [Unintelligible] he could be quite disturbed.

VICE CHAIRMAN CORRIGAN. Well, I think he probably would.

MR. ANGELL. But by and large, Jerry, if the Federal Reserve had pursued a rigorously tight monetary policy in 1978 we would not have had to go out with our hat in our hand.

VICE CHAIRMAN CORRIGAN. Well, I concede that we--

MR. ANGELL. If we pursue a rigorous monetary policy toward price level stability, the fear of a weak dollar is gone.

VICE CHAIRMAN CORRIGAN. I concede that, especially in the case of 1978 policies in general, we probably were short-sighted. But I don't think things are quite that one dimensional. Again, in the immediate circumstance, would it be a good thing, unambiguously good, if the yen [fell] from 157 to 200? It's not at all clear to me that that is unambiguously good.

MR. ANGELL. Oh, I agree with you.

VICE CHAIRMAN CORRIGAN. And with those circumstances, it seems to me that we have a constructive role to play in terms of--

MR. ANGELL. But that's why we shouldn't add to our stock of yen at 138 and 142, because then we lose the ability to do it when we need to do it to stop an overshoot.

MR. JOHNSON. But, Jerry, there is still the question: Say that that was the trend, that the dollar was rising toward 200--

VICE CHAIRMAN CORRIGAN. Well, let me just finish here. I'll come back to that. The point I was making was on the threshold question of whether we as an institution should maintain a meaningful presence in this arena. I'm suggesting that we should. And the last reason I cited as to why I thought we should was not just for fear of loss of monetary policy autonomy in a domestic context, but that it would not be well received by the world at large if they literally felt that we had jumped ship on the process. Indeed, I for one could not [imagine] asking the Chairman of the Federal Reserve to go off to a G-7 meeting next Saturday with his hands tied squarely behind his back. I don't think that's in the interest of the Federal Reserve; I don't think it's in the interest of the United States of America; and I don't think it's in the interest of the well being of the world economy. So, the threshold question I'm trying to address is: Are we in or are we out? And in my judgment we're far better off in.

MR. JOHNSON. Let me pose this question to you. Look, I don't disagree with that, but I think the question is: What are we in for? Let's say that the yen was weak for whatever reason--I could name half a dozen reasons why the Japanese may have continuing problems--and the dollar does continue to strengthen against the yen. It could turn around tomorrow. But say it [weakens] and we already have \$8 billion of yen reserves.

VICE CHAIRMAN CORRIGAN. The threshold question is: Are we in or out? You know where I come out on that. Then we get to the question of procedures, the question of tactics, the question of portfolios and so on. Now, as far as I'm concerned, I have some sympathy with what Ed Boehne said: that there probably is room for some more systematic procedures at the Committee level to try and help members' comfort levels with what we're doing. But even there, at the end of the day I think the Chairman in particular has to have an appropriate degree of flexibility. And I'm not quite sure, Ed, how you square the circle in terms of what I interpreted your suggestion to be. Now, whether it means there should be a more systematic review or reports after the fact of G-7 meetings and other things like that or whether--and I personally hope not--we have to go so far as having a directive that mirrors the domestic directive, I'm not sure. But if you're saying, Manley, that we ought to have some better mousetraps within a context along the broad lines that I think we're all talking about, I don't have any problem with that.

MR. JOHNSON. All I'm saying is that the Chairman should be able to go into a meeting like that with some demonstration to the Treasury and the G-7 of where we [unintelligible] acceptable path.

VICE CHAIRMAN CORRIGAN. The problem with that is none of us can anticipate what the Chairman is going to run into at one of those meetings.

CHAIRMAN GREENSPAN. That's right.

VICE CHAIRMAN CORRIGAN. You cannot anticipate that.

MR. JOHNSON. I still want to finish this example just as an illustration of what we might be faced with. Let's just assume that the yen continues to weaken against the dollar and we already have \$8 billion or more of yen reserves. And let's just say that the reasons

the yen is weak are internal to the Japanese market: they're not confronting inflationary pressures; they have a weak government, without much credibility; their stock market is overvalued. I could name off a few others. Let's just say they have all those problems and yet they don't want to confront those problems. They want us to help them on the foreign exchange markets. What do we say if, let's say, the Treasury wants to go along with that?

VICE CHAIRMAN CORRIGAN. In those circumstances, you're painting a picture not unlike what was true in the United States here in the late 1970s. We were unable or unwilling to face up to our problems. Now, that's going to break at some point. But in those precise circumstances that you described, if you asked me whether I would be willing to support modest intervention in the context in which the dollar is rising in a major way, I'd say "Sure." I wouldn't have any trouble with that. I would have no illusions about what it was doing but if it was doing nothing more than keeping us in the ballgame in terms of having some influence on the fundamental ways that these problems ultimately were to kick out, I'd say that's a small price to pay.

MR. JOHNSON. All right, you've answered that. But what if the G-7 wants a multilateral concerted effort to drive the dollar to lower levels?

VICE CHAIRMAN CORRIGAN. I would not support that.

MR. JOHNSON. You've answered my questions. There's where you draw the lines.

CHAIRMAN GREENSPAN. The G-7 in this respect is not the relevant vehicle. The relevant vehicle is the Treasury. In other words, to the extent that we get confronted with that issue it's not the Federal Reserve in the G-7 fighting this issue. We ought to be able to turn the Treasury on this because if we can't, then it's dubious what it is that we have, basically. As far as I'm concerned, our crucial issue is to try to affect what the Treasury's position is. The question that was raised before about what it is they are doing I think we ought to discuss in a minute. But I do have two names, which have been sitting on this piece of paper, who deserve to get called upon: Dick Syron and Tom Melzer. So, after you gentlemen--and Governor LaWare. After the three of you--

MR. LAWARE. I withdraw.

CHAIRMAN GREENSPAN. Okay, after the two of you get through, I would like to call on our colleagues to define as best they can what the Treasury's position is, and then let's confront that specific question because I think that's where the real issue lies.

MR. SYRON. Following my esteemed colleague from Massachusetts, I withdraw.

MR. MELZER. I don't have a colleague from Missouri.

VICE CHAIRMAN CORRIGAN. You have Roger [Guffey].

MR. GUFFEY. You can withdraw now, Tom!

MR. MELZER. Before I make some comments, I had a question for you, Jerry. Could you explain what you meant by the Treasury co-opting monetary policy if we weren't involved? How would that work?

VICE CHAIRMAN CORRIGAN. Well, I think the danger of the Treasury getting us into entangling alliances through G-7 type mechanisms escalates in a circumstance in which the rest of the world thinks we're on the sidelines. So, there's that danger first of all. Second, I do agree with the Chairman that any form of intervention can be sterilized. But I think Governor Johnson's problem and Lee Hoskins' problem--about the markets interpreting what the policy of the United States government is--gets greatly heightened in those circumstances. Even now, quite apart from the dollar situation, there's this drift in newspapers and elsewhere about the Administration wanting the Fed to ease. Now, that's enough of a problem in and of itself. But if that same problem surfaced in a context in which the markets knew that we had gone on vacation insofar as exchange rate policy is concerned and in effect had abdicated to the Treasury, I think those concerns would be amplified in a very significant way both internationally and domestically. So, while I agree that even the Treasury's intervention can be sterilized by us, I think the psychology of the marketplace changes in a way that is very detrimental to the interest of good monetary policy in a context in which we simply decide we're going on vacation.

MR. MELZER. I see it as an uncertainty risk, but we still have all the cards, I think. But they're--

CHAIRMAN GREENSPAN. Well, no. Remember that the people who own the decks, the Congress of the United States--

MR. MELZER. No, I understand.

CHAIRMAN GREENSPAN. --will [use them] if we don't use them.

MR. JOHNSON. You're talking about monetary policy cards, though.

CHAIRMAN GREENSPAN. Yes.

VICE CHAIRMAN CORRIGAN. But even there the Congress still holds the deck.

MR. MELZER. Yes, I think that's a good point.

MR. JOHNSON. The historical work shows that it wasn't until 1962 that we even got involved in intervention.

MR. CROSS. Neither one of us was involved [before 1962].

MR. MELZER. [Unintelligible] for us to ease or tighten if we don't want to in the short run, but the uncertainty would be damaging. Let me just make my point. I don't disagree with the general idea that we ought to be involved in this and we can bring a constructive influence to the table. But I think we have to recognize that we have a finite institution here in terms of the resources and that there is a responsibility for these resources in a sense that goes beyond this room in terms of [Reserve Bank] boards of directors and--I don't want

to make this a government [unintelligible]--but there's a basic institutional question in terms of how we commit our assets and what the risks are associated with those assets. Clearly, I hope we never get to the point where we have to draw that line in the sand. But there is, I think, a line in terms of what is reasonable with respect to an ultimate commitment of the Federal Reserve and its resources to foreign assets.

Now, I think there's another area where we ought to have a better understanding of some of the rationale for this and that is: What is a prudent war chest to have on hand if we need some foreign currencies on hand? But that's a much smaller issue, in my mind. And finally, I don't know what the implications would be if the Treasury went elsewhere to finance [their currency holdings] and how it would be handled in a government accounting sense. But I'm a little troubled about the issue that some other people have mentioned--that if there is a large exchange loss and all of a sudden Congress and other people wake up to it then they will look to see how it happened. And if it happened not only because we intervened for our own account but--under this somewhat questionable authority on the theory that it's an open market purchase--we also warehoused roughly an equal amount for the Treasury in what could be painted as sort of a secret transaction, I think there's a--

CHAIRMAN GREENSPAN. They set the exchange rate.

MR. TRUMAN. That's their loss.

MR. MELZER. No, I understand that, but--

MR. CROSS. It's the Treasury's loss.

MR. MELZER. If somebody wanted to do a job on the Fed they would say that we really, through some sort of a subterfuge, financed this behind the back of the Congress and the taxpayers.

SPEAKER(?). Absolutely.

MR. MELZER. And that puts us in a position now where the American people [could] have this huge exchange loss.

CHAIRMAN GREENSPAN. Tom, I think you're reaching. I doubt that very much. Should there be a major problem with respect to loss in the budget from the exchange rate operations, the Treasury will get it all. I don't think we'll get anything on that because it's very clear where we have stood on this question. In fact, I think the best chance that we have to cap de facto some of this is to really raise this specter. I raised it early on when the numbers were \$10 billion and didn't make very much progress because essentially we were making money. And so long as we're making money it's very difficult for us to get anybody's attention. I tell you: At these levels a 10 percent move in favor of the dollar is \$4-1/2 billion and that's direct budget money. That is a program, a child care program or something like that. I know [unintelligible] and I said the only tool that I think we have at this stage that effectively could operate at this point is this issue. I don't think that existed back at \$10 billion. It exists now and, frankly, I think that's an issue that we should get re-surfaced as soon as we can.

MR. ANGELL. But, Alan, you don't think the Treasury wants to be out there floating in the wind by themselves on this issue. They really want us in, don't you think?

CHAIRMAN GREENSPAN. They want us in, but they don't want us in because of this.

MR. ANGELL. All right.

MR. JOHNSON. Why do they want us in?

CHAIRMAN GREENSPAN. Well, I was about to ask my two colleagues down at the end [of the table] about the motives of the Treasury Department.

MR. MELZER. Could I just get in one final thought, which is simply that I don't view it as either we're in or we're out at this point. I don't think it's reasonable to say: "That's it; we're not going to warehouse anymore." But I think we really have to try to draw some ultimate line in the sand and then work very hard to get a different understanding with the Treasury. I know you've been trying to do that but I think with that ultimate [unintelligible] power that Manley and Wayne were referring to. To me it's not a theological issue. We're charged with running this institution prudently. I know volumes in the foreign exchange markets have gone up. But the fact of the matter is there are not enough resources in this central bank or all of them combined to stand in the way of those markets for very long, whether you think [intervention] works or doesn't work. And we have to understand what those limits are. In my opinion that's a very defensible position and one we have to take. In order to leave ourselves enough room and time to get it done, [we need] to get a better understanding with the Treasury on how this can be used and how it can't be used because I could very easily, on the course we've been on, see this going to \$60 billion, \$80 billion. Who knows?

CHAIRMAN GREENSPAN. Well, unfortunately, we are missing Treasury representatives. So, I think we'll use the two proxies.

MR. CROSS. Well, let me say one thing. Obviously, we have had difficulties from time to time with the Treasury, which have been referred to, and we have been absolutely unable to reach agreement in a particular situation. But in my view that has been an occasional thing and certainly not a continuous thing. It would not be right for us to think that the Treasury is totally unreasonable in their approach to these matters. In the circumstances that we were talking about here a few minutes ago, I don't think that they would have an interest in pouring billions into a yen operation when it was totally a Japanese domestic problem. I don't think they have any reason to do it and I don't think they would argue it. That's quite apart from all of the points that we would be making on it. In fact, if you look back over these past several weeks, Japanese intervention as I mentioned earlier was about _____ which is a very substantial amount for that period. Our intervention was \$1-1/2 billion, about half when we were involved and about half when the [Desk] had suspended [its participation for the Federal Reserve]. But even with regard to the Treasury's own views it seems to me that they have become much more diffident in terms of the quickness with which they

want to jump in and participate in an intervention operation in the yen when they are beginning to wonder themselves about some of these questions that you've mentioned--and which are becoming more apparent as time goes by--that there is a big domestic element. It's just a question about the political structure of the country and the problems that they're running into. We've had in the past two or three weeks two meetings with the Japanese--one by the President with Mr. Kaifu and one by Secretary Brady with Mr. Hashimoto. They didn't come back after those meetings and say "Let's go in and bash the market." Quite the contrary. We did a modest amount after the Kaifu meetings, and I can understand the need to show some cooperation, given everything that had happened. But it was certainly not a major push or anything. After the Hashimoto meetings, we did none. We did zero, absolute zero. And so--

CHAIRMAN GREENSPAN. And this I might add was [at the initiation] of the Treasury because Mr. Brady asked me basically: What should we do? I said the ideal thing to do is zero; however, if you feel for political reasons that some token amounts are required, we will be supportive of that but we would prefer zero. And he came off with zero.

MR. HOSKINS. But maybe the evidence is that by our being [reluctant]--

MR. ANGELL. Made a difference.

MR. HOSKINS. --that Treasury won't do it.

CHAIRMAN GREENSPAN. I don't think so; I disagree with that.

MR. CROSS. I don't think it was based on a feeling of our being in or out. I don't think that he had an interest in doing it for some other reasons.

CHAIRMAN GREENSPAN. Let me raise one thing. Before Mr. Brady went off to see Mr. Hashimoto, I spent about 20 minutes with him here on the way to the airport. And I went through what I thought was weakening the yen: namely, the effect of the stock market and the portfolio adjustment process that was pouring yen into the international financial markets--an activity we could scarcely stop no matter how hard we tried. I said that the problem was essentially a Japanese problem, that we would in a sense be [spitting into] the wind trying to stop any of this and that we would be perceived as ineffectual in endeavoring to stop any really major move. As best I can judge, he went off to Los Angeles and took that position because when he came back everything he told me was perfectly consistent with that. While it may well be that the lower echelon technical people are aware of what we're doing with respect to participating or not, during that 20 minute or half-hour meeting Brady didn't mention it once. And he has not mentioned it to me since then. I will tell you that he is not disinclined to scream and yell at us when he doesn't like what we're doing. So what I will tell you is that it's not in his consciousness. And unless I'm mistaken, unless Sam tells me I'm wrong on this issue, I'd say that essentially Sam's views and my views did penetrate--or maybe more importantly the real world penetrated--because they got the message. And that's--

MR. TRUMAN. Just to give my answer to your question, I think one thing that needs to be recognized is--and I don't think the situation in 1989 was any different, quite frankly, from the situation in 1978 in this regard--that there is a desire if you're sitting where the Treasury is to think that you have another instrument, a very strong instrument. And in the more recent period that has been complemented by the sense that they have an additional dimension of that instrument that's associated with something called the G-7 process. They see that as an instrument of dealing with a trade problem, which could be viewed either in terms of short-run policy or in protectionist terms or a longer-run build up of liabilities [unintelligible] of the United States that will bankrupt our children or grandchildren.

MR. ANGELL. You believe that?

CHAIRMAN GREENSPAN. That's what they say.

MR. TRUMAN. In fact, the Chairman recently asked Charles [Dallara] why he was concerned and that was the answer he gave.

MR. JOHNSON. No. That's what scares me.

MR. ANGELL. Yes.

MR. TRUMAN. They see it as a device, I would argue, that gives them another degree of freedom. I don't want to get into a debate with President Corrigan about what the technical literature says on this matter, but the Treasury officials certainly are on the side that says that intervention is and has been and can be and should be--certainly should be--effective. And if it is over the longer term, then they have a tool to deal with the problem that they see, the perceived problem. I don't think it's any more complicated than that. We were in exactly the same situation in the 1978-79 period.

CHAIRMAN GREENSPAN. Well, let me finish. I'll follow up on what Ted is saying. In all fairness, early on in the process when we had a current account deficit we also were concerned about the accumulation of assets, which ultimately would kill the value of the dollar. It turned out that the willingness on the part of the world to absorb claims against the United States without disgorging them was much larger than we had anticipated, which meant that we did not have to view the trade imbalance as the indispensable number one adjustment process that a number of us thought--not that we chose to but we would have thought that a couple of years ago.

MR. ANGELL. But proper monetary policy is behind the world's willingness to take our claims. If the Federal Reserve had not tightened and grown our money stock at a 4 percent rate for two years, the world would not have taken those claims.

CHAIRMAN GREENSPAN. Well, that may be true; we don't know that for sure. But what we do know is that the original view that a lot of us, in fact almost all of us, had early on was not [unintelligible] to the most recent view of the Treasury. Now, we may say that the Treasury is behind the times in understanding the facts, and frankly I think they are; but they probably are changing at this stage. And our recognizing that, while the current account deficit is

not something particularly desirable, we do have a little more time to adjust it and hopefully adjust it in nonexchange rate terms is a new view. It's a view that I don't think we have any reasonable expectation to be able to hold. We've all misjudged the propensity--

MR. ANGELL. Not all.

MR. HOSKINS. No, there were some--

MR. ANGELL. Right. Some of us said that was not to be--

CHAIRMAN GREENSPAN. I alter my statement to "most." I would say the most general view was that that was something we had no alternative to and, therefore, that the Treasury held that view up until recently is not something that's utterly bizarre. Now, we may think they are wrong; we may think they are late in adjusting that--

MR. JOHNSON. It's one thing to hold that view, which I think is an acceptable view in terms of the theory, but it's another thing to try and force it to happen with exchange rate intervention. If you believe in theory that it's going to happen, not--

CHAIRMAN GREENSPAN. Well, no. If you believe it's going to happen, you try to cut it off at \$500 billion net debt exposure before it gets to a trillion and a half; that's the theory. The theory may be right or it may be wrong, but the [presumption] is what the argument essentially is all about.

MR. JOHNSON. But if you believe that that equilibrium adjustment has to take place, you wouldn't believe that intervention can change that.

CHAIRMAN GREENSPAN. Well, no. If you believe--and there are a lot of reputable economists who do--

MR. JOHNSON. I agree that there are. But reconcile for me this notion of the belief that the current account deficit requires some equilibrium adjustment and that intervention matters.

CHAIRMAN GREENSPAN. Well, suppose the equilibrium adjustment comes into exchange rates--and that's a debatable question--and the intervention works?

MR. JOHNSON. Okay.

CHAIRMAN GREENSPAN. And intervention drives the dollar down, closes the current account deficit, and chokes off the growth in net claims against the United States. It may be right and it may be wrong; I think it's wrong, but it's not a crazy idea.

MR. JOHNSON. But I'm saying: If you believe it's got to happen why would you intervene? Why don't--

CHAIRMAN GREENSPAN. You'd intervene because if you believe it's going to happen and you want it to, you believe that if there's less net debt out there, the adjustment process is less disruptive.

MR. JOHNSON. Maybe I'm missing something. Is there some simple mathematics on the size of the debt that you're talking about?

MR. TRUMAN. If it's a problem, it's a smaller problem. I think that's all the Chairman is saying.

CHAIRMAN GREENSPAN. That's right.

MR. TRUMAN. If it's going to be a problem, it's either a \$500 billion problem or a trillion dollar problem.

MR. ANGELL. But the foreign exchange intervention works because it has monetary policy behind it.

MR. HOSKINS. It's not sterilized.

CHAIRMAN GREENSPAN. That's the other question.

MR. ANGELL. The possibility that you're gaining time by the Treasury [intervening] without us is a paper floating in the wind. They can accomplish nothing.

MR. JOHNSON. But, Ted, I still want my question answered about why the Treasury wants us involved.

MR. TRUMAN. That's a different question.

MR. JOHNSON. Well, but that's the question. Why do they want us involved?

MR. TRUMAN. I would agree with what I think Sam said here implicitly and what President Corrigan said earlier. The Treasury recognizes--all Treasuries, if I may put it that way, have recognized --that they need the stature of the Federal Reserve or the central bank behind them and that it is not in their interest to go to international meetings, whether it's G-7 or G-10 or G-22, at loggerheads with the central bank. The Japanese are proving that today.

VICE CHAIRMAN CORRIGAN. That's right.

MR. TRUMAN. So, therefore, they feel that they're better off keeping peace in the family; it's not any more complicated than that.

MR. JOHNSON. But that just tells me that that's the reason we should be worried. They want us involved because they want us to be partners in this crime.

MR. TRUMAN. Was it a crime, to use your word, in the 1960s when we were partners with the Treasury in protecting our gold stock by getting back into this business and creating the swap network? Now, some people will read history and will say that it was a mistake of policy to--

MR. JOHNSON. Protect the gold stock.

MR. ANGELL. The mistake was that they did not use monetary policy consistent with that.

MR. TRUMAN. The world was very different.

MR. BLACK. We didn't do that.

MR. TRUMAN. But I don't think that the motivations of the Treasury and ourselves [yesterday] in terms of working together to deal with what was perceived as a common problem or common threat are any different than their motivations to work with us today. I don't think they have any ulterior motives. It's not in their interest to do so.

CHAIRMAN GREENSPAN. Can I try something? I think we have the sense of where everyone stands. Let me make a specific proposal and let's discuss that particular proposal. I think that we're all in agreement that we should stay involved. Well, let's say that's the sentiment of the vast majority; I don't want to speak for everybody. The vast majority think it's probably better that we stay involved than not. There is considerable discomfort on the part of this group about the policies and the policy orientations of the Treasury. We all are concerned about the accumulation of the System's [foreign currency balances]. I would suggest that in order to limit the size that the Treasury continuously endeavors to get involved in, in large part because they are driven by our counterparties on the other side-- in Japan to a much lesser extent than Germany--that we endeavor to resurface in some detail the potential risks that are involved in holding this much in the way of foreign currency assets. I will take a position and try to [unintelligible]: First, the extent that it affects our balance sheet and our technical capabilities of functioning, including the issues that Ed was raising; second, and I think far more conclusively, the risks that both we and the Treasury are taking with respect to potential backlashes should significant losses occur as a consequence of the holdings. I don't know with absolute certainty that those arguments will prevail. I think they are already beginning to prevail but I cannot know for certain. Ultimately, the Treasury has the constitutional authority to run international exchange rate policy. If we endeavor to confront them on that issue in an immediate confrontational way, we will lose in the Congress. We almost have to lose in the Congress because any bill that the Treasury offers that moves to the Hill almost has to pass. I don't see how that can be avoided even amongst those on the Hill who are very sympathetic to us. So, we cannot win that battle in any way with which I am familiar. All I can suggest to you is that I will put my best efforts forward, including communication of the not unimportant content of the discussion of this group today, which I will convey in some detail to them. Having said that, I would like for us to agree in principle: (1) to respond favorably to a request for an expansion, say, up to \$15 billion, in the warehousing facility; and (2) to raise the limit on the System's overall [open] position to \$25 billion and agree that the System's participation with the Treasury is discretionary, but with the strong presumption that the System will join the Treasury as long as there is reasonable two-way communication about U.S. policy objectives and tactics in this area. If we can agree on that, I think we will find ourselves in the best position that the System can be in. So, I'd like to put that on the table as a recommendation.

MR. JOHNSON. May I ask one question, though?

[CHAIRMAN GREENSPAN.] Sure.

MR. JOHNSON. I would feel a lot more comfortable with that proposal if it had one extra provision, which would be related to what Jerry was saying about where we draw the [line]. What do we say if there were an effort for concerted intervention to put the dollar at lower levels? I'm not saying that would happen, but what do we say?

CHAIRMAN GREENSPAN. I'd say we say "no."

MR. JOHNSON. Okay. I'm for it.

MR. MELZER. Could I just ask another question? What does the Treasury think we're doing at this meeting? Do they think we withdrew for technical reasons or do they know at this stage how fundamental these concerns are?

CHAIRMAN GREENSPAN. Nothing has been communicated to me from Treasury. So as far as I'm concerned we have gotten no response. Sam, do you know?

MR. CROSS. Well, they know that we are having this meeting. They know, obviously, that we suspended our participation as of March 2nd and they know that we are looking at these issues because of some of the concerns we have.

MR. TRUMAN. But I think it's fair to say that the Treasury does not know--and no one else, I think, outside this room essentially knows--that we have gone through this exercise and that the timing was of a nature that these two practically came together. We did not think it was in the System's interest to communicate with the Treasury that we have planned all along to have a big pow-wow on all this and, therefore, we're holding up [our participation]. So, in that sense it was technical; it seemed appropriate under the circumstances, including the uncomfortableness that has been building over the last six months, to say that we would pull out and re-examine this and would come back and tell them where we [stand] after the meeting. At least that's my--

MR. CROSS. Yes, they certainly don't think that there's any consideration being given to a drastic change in the--

MR. MELZER. In view of that and of the fact that these are fairly substantial increases in the limits, it might help us--and I don't know whether you'd be prepared to do this or not--if you were to indicate that though we never say never this is pretty much an outside limit at this stage and that to go beyond this really would require some very careful consideration.

CHAIRMAN GREENSPAN(?). Tom, I think it would be [unintelligible] because the one thing we don't want to do, if we want to maintain continued presence, is to threaten them. And that could be perceived as an ultimatum or a threat.

MR. MELZER. My point--

CHAIRMAN GREENSPAN. Remember, that if push comes to shove, we will never prevail on this.

MR. MELZER. Well, I didn't mean it to come across as a threat. But on the other hand, they may well view this as just that we had these limits and an FOMC meeting was coming up, so as a technical matter we approved new limits.

CHAIRMAN GREENSPAN. Oh no, no.

MR. TRUMAN. I think that's what the Chairman--

CHAIRMAN GREENSPAN. That's what I'm going to communicate.

VICE CHAIRMAN CORRIGAN. There's no danger of that happening.

CHAIRMAN GREENSPAN. [I'm going to communicate that] the absolute size of what we're beginning to deal with is now getting to very dangerous levels. It's beginning to have potential systemic effects in the Federal Reserve balance sheet; it's beginning to have potential political effects in the--

MR. MELZER. Yes. And I'm not saying that you should say that's an outside limit. But to the extent you were comfortable with it, you could say something to the effect that you're really not sure what kind of a reaction you would get going back to [the Committee for more]. That's--

CHAIRMAN GREENSPAN. Oh, I can say that.

MR. MELZER. That might be helpful.

CHAIRMAN GREENSPAN. I can raise it in a somewhat uncertain way.

MR. ANGELL. Mr. Chairman, could we vote on these separately? The Exchange Stabilization Fund, it seems to me, is a somewhat different question than the \$25 billion.

CHAIRMAN GREENSPAN. We have to vote on these separately.

VICE CHAIRMAN CORRIGAN. In terms of Tom Melzer's question, just based on discussions that I know you've had and one that I've had, the Treasury--or at least the Secretary of the Treasury--knows full well about both the policy and philosophical views that are at this table. Now, they may not know that we have this big fat book in front of us. There's no danger--zero--that they would misconstrue what the Chairman would be saying to them; no danger of that at all.

MR. MELZER. It might be very helpful in influencing their behavior if they thought in terms of having this much left and of operating within that limit. Having managed traders, I know how that works.

CHAIRMAN GREENSPAN. Yes, but you were managing them. And the question is that some part of the law reads [unintelligible] you have a problem. Are there any other comments?

MR. BOEHNE. Well, just to comment on your overall proposal: I think it's a reasonable proposal, given the realities of the world

that we live in. It may not be as easy for everybody around the table to digest as they would like, but I think it's reasonable and I'm supportive of it.

MR. FORRESTAL. Mr. Chairman? I too would support your proposal. When I look at the alternatives, it's the only way to go. But a point of clarification: Governor Johnson posed a question about our response to concerted intervention and you said you would say "no" at some point. I didn't quite understand.

CHAIRMAN GREENSPAN. No concerted intervention to drive the dollar down. In other words--

MR. HOSKINS. As opposed to holding it down?

CHAIRMAN GREENSPAN. That's getting too subtle. They don't say that; they just say drive it down.

MR. FORRESTAL. What I'm really looking for, Mr. Chairman, is what are the consequences of saying "no"? What does the Treasury do then?

CHAIRMAN GREENSPAN. Well, I would say at that particular stage I think we would have a confrontation.

MR. FORRESTAL. Well, I would just make the point that--

VICE CHAIRMAN CORRIGAN. I don't think they'd push it at that.

CHAIRMAN GREENSPAN. That's probably right.

MR. ANGELL. I don't see why that needs confrontation.

MR. FORRESTAL. They probably wouldn't push it, but before we get to that point I think it's very important to think through the implications for this institution. I think you were implicitly saying, Mr. Chairman, what a confrontation can mean in terms of what they do on the Hill. We have enough trouble with people--

CHAIRMAN GREENSPAN. On that particular issue they would not bring it to the Hill because trashing your own currency is something you never want to go up to the Hill to get--

MR. JOHNSON. Well, I agree.

CHAIRMAN GREENSPAN. That happens to be the one--

MR. JOHNSON. We could win that. Exactly.

CHAIRMAN GREENSPAN. That's the one issue that would not bother me.

MR. FORRESTAL. But in the broader context, what I'm getting at is that I think for the good of this institution we need to avoid a confrontation, as you said, that we probably can't win. There are people who want to put the Secretary of the Treasury on this Board, or did. You're going to have that throughout. And if we have that kind

of problem with domestic policy, I think we can throw the foreign exchange thing in as well if we're in a no-win situation.

CHAIRMAN GREENSPAN. Well, when I say we'll have a confrontation I don't mean a big one. We'll have a big dispute and I think the highly likely occurrence is that they would be unhappy but they would back down.

MR. FORRESTAL. Could I make just one other comment? This is more of a suggestion. We have been participants in these discussions about intervention but I don't remember that we've ever had any discussion like we've had today, which takes into account the Treasury's feelings about intervention or what's going on at the G-7. I raise the question: Would it be possible for us to have some systematic discussion at our meetings about the attitude of the Treasury and maybe some debriefings about G-7 [discussions] to the extent that that's appropriate?

CHAIRMAN GREENSPAN. I don't see why not.

MR. FORRESTAL. I think it would be helpful to get the flavor--

CHAIRMAN GREENSPAN. The debriefing about the G-7 [meetings] I can promise you; the systematic [unintelligible] sensible list from the Treasury--

MR. JOHNSON. But I can tell you we'll have hearings. There were hearings over this G-7 exercise last September when the foreign exchange reserves had built up after that. I had to testify right after David Mulford and Mulford was roasted in both houses of Congress over that very issue. So I can tell you on the political front, the Chairman is right: Taking the position of [not] debauching our currency is something that we can win every time.

MR. ANGELL. Mr. Chairman, I certainly don't want to put you in a position of in a sense not having the authority you need to go to the G-7 or to the Treasury to work [unintelligible]. From the very beginning on this I've wanted to take actions that strengthen your hand, not those that cause you to be disempowered. I think that's very important. I do believe there's another alternative. I believe the first question we need to face is the Exchange Stabilization Fund. That was created by an act of Congress. Is that true, Virgil?

[MR. MATTINGLY(?)]. Yes.

CHAIRMAN GREENSPAN. That's true, in 1934.

MR. ANGELL. All right. And in a sense there was an appropriation of money, maybe out of another fund?

MR. TRUMAN. No, they used the profits from gold sales.

CHAIRMAN GREENSPAN. [Unintelligible] \$4 billion or something?

MR. TRUMAN. Yes.

MR. ANGELL. Nevertheless, it was an act of Congress that made the funds available. But it's also true is it not, Virgil, that there is some question in regard [to the warehousing]? That is, our engaging in foreign exchange operations is, we believe, something that we have sound grounds on. As our attorney you can say we can go with that one. But you don't know whether we have sound grounds in regard to the warehousing, do you? You don't know in a court that we could win on that one, do you?

MR. MATTINGLY. Hopefully, it'll never get to a court. But--

MR. ANGELL. But I want to understand what the constitutional principles involved here are, or the law.

MR. MATTINGLY. As you know, Governor Angell, the Board's General Counsel in 1962 issued an opinion with respect to the System's authority to resume foreign exchange operations.

MR. ANGELL. No, I'm not talking about operations.

SPEAKER(?). All three.

MR. MATTINGLY. It was all three. Warehousing was part of that opinion; there's no question about that. That opinion justifies the warehousing of open market purchases of foreign exchange from the Treasury. For that purpose the Treasury is in the--

MR. ANGELL. No, I wasn't asking about the history. I'm asking you as our General Counsel. I don't know the answer to this question. I'm asking you as General Counsel: Is there a reasonable prospect that if it came to court, that we would win in court? Or is there some doubt on the warehousing?

MR. MATTINGLY. I don't think so. Again, that's been the Board's position for 28 years and the Congress has passed a statute which, in effect--I don't want to put too much emphasis on this--sanctions the System's practice. The statute authorizes the Federal Reserve to invest the proceeds of its foreign exchange operations in foreign government bonds and obligations. It specifically enacted [this legislation at the] request the Federal Reserve for that purpose. And it seems to me that that act by the Congress very much [strengthens] the System's position on this--

MR. ANGELL. But it has never been tested before?

MR. MATTINGLY. It has never been tested, no.

MR. ANGELL. Well,--

MR. TRUMAN. A lot of things that we do have never been tested before.

MR. ANGELL. But my view goes beyond that to say that I believe the Constitution gives the Congress of the United States the power to appropriate. I believe for us to do warehousing, which in a sense removes from Congress this appropriation power, is at best a [legally] risky proposition. I know that I've voted in the past for increasing the warehousing authority, but I didn't know what I was

doing in voting for such a proposition. But now that I know that in doing that it eliminates the necessity for the Treasury to go to the Congress to get an appropriation, I can't do that as a matter of principle until the courts tell me that we can. Now, the courts told me on another issue that I thought was an issue but--

MR. TRUMAN. I don't want to play lawyer here but it does strike me that there was one act of Congress that created the Exchange Stabilization Fund and gave it some capital. Okay? And [that was] 50 some years ago and since then there have been no appropriations. In fact, the appropriations in the meantime have taken some of that capital away and given it to the IMF. It was used to pay for our IMF subscription. Subsequently, [Congress] did give it capital in the sense that they assigned the holdings of SDRs to the Exchange Stabilization Fund and at the same time, after a big tussle with the Federal Reserve, authorized the Exchange Stabilization Fund to be able to sell us SDR certificates. So, they already created one area in which they can expand the balance sheet of the Exchange Stabilization Fund.

MR. ANGELL. On the SDR certificates?

MR. CROSS. And gold certificates.

MR. TRUMAN. And the gold certificates.

MR. ANGELL. But, you see, I'm worried that the Shadow Open Market Committee and others are waiting to pounce because when you hold currencies in the size that we hold them, at some point in time you're going to have some losses.

MR. TRUMAN. Yes, but that seems to me--

MR. ANGELL. And I believe that in that atmosphere at some point in time this is apt to become a political issue. And if it becomes a political issue, I believe it is incumbent upon us to protect the Federal Reserve's position, which is not to go around the Congressional appropriation that other warehousing would tend to do.

MR. TRUMAN. Yes, but the warehousing is public, the Shadow Open Market Committee notwithstanding. It was public at the time that they passed the Monetary Control Act. Just because the Shadow Open Market Committee can't look up in the policy record and see when the [amounts] have been changed, they have been changed. It's part of the policy actions of the Committee. In fact, it dates back 28 years. It strikes me that the notion that the warehousing is a flimsy legal reed just doesn't [wash]. A different question, which I think the Chairman has addressed, is the risk to the United States of these large balances; that is a separate issue. It certainly is one that the Treasury Secretary as the chief financial officer of the United States ought to address in that capacity. And indeed, the Chairman has said that he plans to raise that even more forcefully than he has in the past.

MR. ANGELL. But I do not believe that members of the Appropriations Committee understand this issue. I do not think that they know their appropriations power is being subverted by our warehousing arrangement. And I for one choose to stand in the more

pure position which is to say if in doubt, let's ask the Treasury to go to the Congress. And when the Treasury goes to Congress and the Congress appropriates the funds or if the Congress passes a law saying [it is appropriate] for us to be warehousing them, then the Federal Reserve's risk is gone.

CHAIRMAN GREENSPAN. You know what the law will state: [unintelligible] the Treasury has full unquestioned authority to execute exchange rate decisions period.

MR. ANGELL. Well, but I don't see that the present arrangement really has proved superior to that. We either make some gain here, Mr. Chairman--because if that's what we wish to accomplish, we would never have ended up with a \$45 billion fund if our view had been very persuasive.

VICE CHAIRMAN CORRIGAN. Is your concern about the \$45 billion the risk of loss or is it something other than that?

MR. ANGELL. Well, it goes beyond that. The fund has become so large that it does have a risk; in a sense it puts us in a position of what I would call speculating in foreign currencies because it goes beyond what it seems to me is the demonstrated need as a reserve currency country for us to have this facility [to conduct] our operations.

VICE CHAIRMAN CORRIGAN. There's a chart or table--I forget which--in one of the many studies here that indicates, for what it's worth, that our foreign currency balances relative to our sister central banks are really quite small.

MR. ANGELL. But, Jerry, we are the reserve currency of the world and that's quite different than other countries who [unintelligible] have to look to a dollar exchange standard and historically held--

MR. TRUMAN. The current system really is not that. We were the reserve currency; the dollar is regarded as that in a certain sense, but the current monetary system is not built on the Bretton Woods system where the rest of the world is obligated to defend the dollar. That's not true anymore.

MR. ANGELL. Well, I prefer to take the cautious view.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. My views on this issue won't come as any surprise to you or to the Committee. I was concerned about the level of both our warehousing and also the Exchange Stabilization Fund when we hit \$10 billion. It may come as a surprise to you that I do have a pragmatic bone in my body. I am willing to suggest that there is some level at which we should cooperate with Treasury and be involved. However, the level has gone beyond the bounds that I'm comfortable with in either case. I voiced the concerns when we went from \$10 to \$12 billion and from \$12 to \$15 billion and then from \$15 to \$20 billion or wherever it went along the way. And now we're going to \$25 billion. And much the same arguments were made [each] time as to why we were going up and the necessity of going up. My concerns are that

we'll be here for the October G-7 meeting and we'll be talking about a \$45 billion Exchange Stabilization Fund limit. And it seems to me that where this [discussion] started, at least the way I interpreted Ed Boehne, it's the size of our involvement that attracts the attention and that we could probably get away with cooperating with the Treasury at a much lower dollar figure. So, my concerns are in a sense political concerns [unintelligible] surrounding the sheer size of what we're getting into and the likelihood of that unless we get lucky and the dollar goes the other way. I suppose that's not lucky for some people--sorry, Wayne--that we can wind it down and use that "stuff," to use Gary's word. I just think it's a matter of facing up to it either now or later in terms of the crunch with Treasury. I prefer a Treasury/Fed Accord II now rather than down the road when in some sense we're already implicated in this process of, to use Wayne's words, appropriations around the Congress. And as Tom Melzer said, [we are charged with] responsible management of our assets and accountability to our directors. So, I am not in favor of increasing either one at all. I don't want to tie your hands unnecessarily. I suppose a way around it would be for some indication that we will wind this thing down over the course of the next year. But, given what you've said, I think the Treasury would find that totally unacceptable and threatening.

CHAIRMAN GREENSPAN. Well, Lee, all I can tell you is that as best I can judge the ultimate legal authority is theirs and should they choose to implement it through the Congress they would probably effectively put us out of the operation. You may find that attractive; I frankly don't.

MR. HOSKINS. I don't find that attractive but what I'm saying is that we did the \$45 or \$50 billion and at what point do we draw the line?

CHAIRMAN GREENSPAN. Well, let me say this. All I can do is employ my best efforts. I hope we don't get to that position. If we do, I think we reopen the issue. We'd have to rethink this whole thing. I think it's premature to do that. I hope at this particular stage that we will be able to implement the principles I suggested here to resolve this issue. But it's not wholly in our hands. It is conceivable that this may not resolve the issue; in that case we then will have to revisit it with different conclusions.

MR. JOHNSON. Mr. Chairman, may I just ask Ted Truman a technical question on warehousing?

CHAIRMAN GREENSPAN. Sure.

MR. JOHNSON. In the past has there normally been some sort of maturity associated with a warehousing instrument, similar to a swap agreement?

MR. TRUMAN. Well, I can only speak for the last 15 years. When you first did this operation in the late '70s, in 1976-77 in connection with sterling balances, in the second and third sterling balances agreement there was a maturity on the arrangement. When we came to the point where the Carter bonds had been issued and the issue was how the Treasury was going to hold those proceeds, which initially were being held pending intervention and later were held pending

repayment since the Carter bonds were 3 or 3-1/2 year notes, the Committee eliminated that restriction. So at the moment there is not that kind of restriction. Speaking only from what I've heard in this discussion one component of resuming the discussions with the Treasury would be the question of dealing with the warehousing sooner rather than later. And presumably if that were the desire of the Committee, warehousing of foreign currencies would be dealt with before other foreign currencies would be dealt with. So, if you used foreign exchange--as has been done in the past--to pay our next increase of IMF quotas, it would come out of the warehouse if that were the choice of the Treasury. And we would certainly have the grounds on which to insist on it. We even have the grounds to insist that they redeem SDR certificates; that's written into the legislation. We can't force them but we do have the grounds because there is the legislative history on that point. So, it's the same type of issue. But at the moment there is no maturity. I'm not even sure it makes any sense to have any maturity unless you wanted to approach the Treasury and say "Okay, \$45 billion is too much and we want to get rid of \$10 billion over the next 10 months." We could no doubt work out a program in which we did that. I'm not sure it would make much sense, but we could do that.

MR. JOHNSON. I was just asking what the history was.

MR. TRUMAN. It was taken away when it didn't make sense in the context of the Carter bonds.

MR. HOSKINS. Just one more technical question, I guess to Peter.

CHAIRMAN GREENSPAN. Go ahead.

MR. HOSKINS. If we increase the warehousing limit to \$25 billion and we use it, what do you see in terms of collateral problems?

MR. STERNLIGHT. Well, that would pretty clearly put us beyond our ability to collateralize except by looking to the foreign currency, if we were up by that.

CHAIRMAN GREENSPAN. Except by what?

MR. HOSKINS. We'd collateralize with foreign currency.

MR. STERNLIGHT. By looking to the foreign currency for use in the collateralization because even at present levels we see--

MR. HOSKINS. The risk.

MR. STERNLIGHT. --the risk later this year of coming down to, say, the \$3 to \$5 billion area of margin.

MR. TRUMAN. So you could argue, if you wanted to raise this general question with Congress in a nonconfrontational way, that that in one sense does give you the basis to raise this question. The Chairman of the Board made this promise in 19--whatever it was--

SPEAKER(?). 1982.

MR. TRUMAN. --in 1982 in connection with [unintelligible]. The circumstances have changed; these are why the circumstances have changed; and this is what we're now going to do. That invites the Congress to decide whether they're serious about the collateral issue, which was not a matter of law but rather a matter of procedure, including Governor Angell's warehousing.

MR. ANGELL. And yet we would know--

MR. HOSKINS. We could also use it to argue that we know right now that we're going to exceed our collateral in terms of the securities, and we will be going ahead and using collateral in the near future and that may or may not be acceptable to Congress, so perhaps we should not do that.

MR. JOHNSON. How far would the \$25 billion put us over, Peter?

MR. STERNLIGHT. Right now as we look ahead for the rest of this year, if we don't make use of the foreign currency holdings for collateralization of the currency, as I said, we would come down to a margin of \$3 to \$5 billion.

MR. JOHNSON. By when would you say?

MR. STERNLIGHT. Well, there are a couple of low points. We [project] one low point in late May, another in July, and another in October; it depends on the ups and downs of the Treasury balances and reserve requirements.

CHAIRMAN GREENSPAN. Well, if we are required to go up and essentially reverse the Board's official position, it will surface some of these issues, which would not be all bad.

MR. BOEHNE. Yes, there's a lot of good to say about it,

MR. ANGELL. Well, yes. But if we're going to surface them, why don't we surface them before we do it? Why are we waiting until it's a fait accompli before we surface them?

MR. SYRON. Why wouldn't we want to wait until we reach the point where there's a reasonable chance that we're going to have--?

MR. HOSKINS. Because Congress may tell us that it was completely inappropriate to do that. At this point we're asking for counsel and advice.

MR. ANGELL. If we have a reasonable chance, it's going to be on the Exchange Stabilization Fund in the immediate future. If we're going to ask about it, we better ask them now.

CHAIRMAN GREENSPAN. No, it's quite possible that we will have agreed on raising these limits and that this may be close to the peak. I just don't rule that out; that is a possibility. And I'd feel more comfortable up on the Hill if we were up against some real problems with respect to foreign currency and they asked how this was happening rather than raise a contingent type of thing.

MR. MELZER. How are warehoused currencies treated? Is that a Treasury obligation or is it a foreign currency?

MR. TRUMAN. Well, it's on our balance sheets.

MR. CROSS. It's on our balance sheet as foreign currency.

MR. TRUMAN. Right.

MR. MELZER. Well, in answering that question on the \$25 billion did you presume that it jumped to \$15 billion as well or is that--?

MR. TRUMAN. It doesn't matter which way it's done the way we do it.

MR. ANGELL. Now we're claiming that is an open market operation, as I understand it. Is that correct?

SPEAKER(?). Collateralized [RP].

MR. ANGELL. Is that what we're claiming? So what we're claiming is that the Exchange Stabilization Fund is a foreign exchange operation. Now, do we do that on Treasuries? When we buy do we buy new Treasury issues from the Treasury or do we buy them from--?

MR. STERNLIGHT. Only in exchange for maturing issues.

MR. ANGELL. In exchange for maturing issues. But we never buy new Treasury issues directly because we're not sure we have the power to do that kind of an open market operation, is that correct?

MR. STERNLIGHT. We definitely don't have that power.

MR. HOSKINS. We don't have the power.

MR. ANGELL. Okay. So, we don't have the power to do that open market operation and now everyone tells me we do have the power to do this operation because we've done it in the past and nobody's caught us on it?

MR. CROSS. It's not a Treasury issue.

MR. HOSKINS. See, that's the answer: they're not called Treasuries!

MR. ANGELL. But it's not open market operations.

MR. HOSKINS. Yes, but the principle is the same, so I think you're right.

CHAIRMAN GREENSPAN. [Unintelligible.]

MR. BOEHNE. Well, I think all of this business with the collateral is really rather fortuitous because we agreed that if there were a confrontation between the Treasury and the Fed that the Treasury would win. In fact, we promised the Congress in the '70s that we would be supporting it.

CHAIRMAN GREENSPAN. Yes.

MR. BOEHNE. [We] also promised the Congress that before we use foreign exchange as collateral, we'll let them know. And at the right moment we'll let them know and it seems to me that we will air the whole issue. We've kept our word on both and now we can air it and it's aired in a way that's not confrontational. If we get turned down, that's not all bad.

MR. ANGELL. Well, Ed, I'm not seeking a confrontation with the Treasury. I simply want the Treasury to go to the Congress and get the appropriation power. I don't agree with the rest of you who have opinions about the political outcome as to what the political outcome will be.

MR. BOEHNE. My concern about that, Wayne, would be that the Treasury won't do that.

MR. ANGELL. Of course they won't do that.

MR. BOEHNE. They won't do that and, in effect, that gets us to the same point. And we don't have to try to get them to do something they're not going to do anyway.

CHAIRMAN GREENSPAN. You may not seek confrontation with that, but it will create confrontation. That's very unfortunate since we--

MR. ANGELL. Well, the Treasury is not going to go to Congress over this issue. I feel certain they will not.

MR. JOHNSON. The thought of holding Argentine australs as collateral against the dollar--well, who can say? Eventually, one day it might be--

VICE CHAIRMAN CORRIGAN. We can [unintelligible] it now.

MR. JOHNSON. But who knows in 10 years.

MR. TRUMAN. The Committee has to take a separate vote to warehouse Argentine australs.

CHAIRMAN GREENSPAN. I now ask that Sam consider [formulating] two appropriate motions that effectively would read in principle: (1) that should a question occur we would expand the warehousing limit up to \$15 billion; and (2) that we would raise the System's open position to fund that. The third issue, which is basically best efforts on my part, I assume does not require a vote. Is that correct?

MR. BOEHNE. It does not require a vote, but it's the most important part.

MR. JOHNSON. It's the most important part of--

CHAIRMAN GREENSPAN. What I meant by that is: Everyone is in favor, right?

MR. CROSS. Well, Mr. Chairman, to go ahead with the unimportant parts of the resolution, I would recommend that the authorization for the System's [overall open position in foreign currency] balances be increased from the present level of \$21 billion to \$25 billion effective immediately, because we do have interest earnings that come in all the time on these balances.

CHAIRMAN GREENSPAN. Would a member of the Committee make that motion, please?

VICE CHAIRMAN CORRIGAN. I will make the motion.

CHAIRMAN GREENSPAN. Is there a second?

MR. BOEHNE. Second.

CHAIRMAN GREENSPAN. All in favor say "aye."

SEVERAL. Aye.

CHAIRMAN GREENSPAN. Opposed?

MR. HOSKINS. Nay.

MR. ANGELL. No.

CHAIRMAN GREENSPAN. We have two nays?

SPEAKER(?). That's all I counted.

SPEAKER(?). Three.

CHAIRMAN GREENSPAN. Three. Do we want a roll call on this?

MR. TRUMAN. Yes.

CHAIRMAN GREENSPAN. I think so. Let's take a roll call.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	No
President Boehne	Yes
President Boykin	Yes
President Hoskins	No
Governor Johnson	Yes
Governor Kelley	Yes
Governor LaWare	No
Governor Seger	Yes
President Stern	Yes

CHAIRMAN GREENSPAN. Okay. Would you now formulate--

MR. CROSS. Similarly, Mr. Chairman, I would request that the Committee express an agreement in principle to accept a further request from the Treasury for additional warehousing authority and to raise the present limit on that from \$10 billion to \$15 billion.

MR. TRUMAN. It's up to them; they may ask for less.

MR. CROSS. Yes. That's the upper limit, which would be raised from the present \$10 billion, of which \$9 billion has been drawn, to \$15 billion.

CHAIRMAN GREENSPAN. Will a member--

MR. ANGELL. An extension of that limit--

CHAIRMAN GREENSPAN. Will a Committee member make that motion, please?

VICE CHAIRMAN CORRIGAN. I'll move it.

CHAIRMAN GREENSPAN. Is there a second?

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	No
President Boehne	Yes
President Boykin	Yes
President Hoskins	No
Governor Johnson	Yes
Governor Kelley	Yes
Governor LaWare	No
Governor Seger	Yes
President Stern	Yes

CHAIRMAN GREENSPAN. Three [dissents] on each.

MR. BERNARD. Yes.

CHAIRMAN GREENSPAN. I can't believe this, but this brings us to the end of this meeting! However,--

MR. HOSKINS. I have a question.

CHAIRMAN GREENSPAN. You do?

MR. HOSKINS. We did the first one; there are three other [questions] on the [the list].

MR. CROSS. Four of them; you didn't read page 2.

MR. HOSKINS. There are a number of issues that Ted raised that I didn't think we addressed. Are we going to come back to them at some other date or--?

CHAIRMAN GREENSPAN. I guess we could. There's no reason we can't do it at luncheon. Would the Committee want to continue that at the luncheon of the next meeting?

MR. BOEHNE. With all due respect, I think we've milked this one for a while. I think we have [addressed] those other questions implicitly. We talked about what the implications are for domestic policy; you've already agreed to keep us informed about G-7 meetings; and there's the other one--

CHAIRMAN GREENSPAN. Let me suggest this. I will at the luncheon of the next meeting report on the G-7 meeting. And if you wish to bring up those collateral issues at that time--.

MR. BOYKIN. I don't think we have a luncheon.

MR. TRUMAN. If I may be allowed to advise you in public, Mr. Chairman: I would suggest that since the [G-7] meeting is going to be held very shortly, on April 7, if there is anything even remotely substantive, you might want to have a telephone conference at least to report on the G-7 meeting.

CHAIRMAN GREENSPAN. Well, no. Suppose it's nonsubstantive?

MR. TRUMAN. We'll have Norm call everybody up and say there is nothing [substantive to report].

CHAIRMAN GREENSPAN. Why don't we leave that issue open? If there's a substantive question, we'll have a telephone conference; if not, I will try to review it at the next luncheon. We can come in and have lunch first.

END OF MEETING