

Meeting of the Federal Open Market Committee  
May 19, 1992

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 19, 1992, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman  
Mr. Corrigan, Vice Chairman  
Mr. Angell  
Mr. Hoenig  
Mr. Jordan  
Mr. Kelley  
Mr. LaWare  
Mr. Lindsey  
Mr. Melzer  
Mr. Mullins  
Ms. Phillips  
Mr. Syron

Messrs. Boehne, Keehn, McTeer, and Stern, Alternate  
Members of the Federal Open Market Committee

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

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

Messrs. J. Davis, R. Davis, T. Davis, Lindsey,  
Promisel, Siegman, Simpson, and Stockton,  
Associate Economists

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

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

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

Messrs. Beebe, Broaddus, Lang, Ms. Lovett, Messrs.  
Rolnick, Rosenblum, Scheld, and Ms. Tschinkel,  
Senior Vice Presidents, Federal Reserve Banks of  
San Francisco, Richmond, Philadelphia, New York,  
Minneapolis, Dallas, Chicago, and Atlanta,  
respectively

Mr. McNeese, Vice President, Federal Reserve Bank of  
Boston

Mr. Thornton, Assistant Vice President, Federal Reserve  
Bank of St. Louis

Transcript of Federal Open Market Committee of  
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CHAIRMAN GREENSPAN. Good morning, everyone. Would somebody like to start us off by approving the minutes?

SPEAKER(?). So move.

CHAIRMAN GREENSPAN. Without objection. Bill McDonough, would you start off please?

MR. MCDONOUGH. Good morning, Mr. Chairman, ladies, gentlemen. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. I think it's apparent that we're moving in the direction that the Committee very strongly urged in the last year or two. My own personal impression is that we should move in the direction in which [Bundesbank Vice President] Tietmeyer is suggesting with regard to selling U.S. holdings of marks. The second question that you raised, namely the balance of what we have in our portfolio, is really quite important to address because I get the impression--indeed, I'm sure--that no coherent mechanism was employed in accumulating these foreign balances in a manner that was in any way related to what was a rational portfolio for long-term intervention purposes. Now that we're finally getting to the point where we're slimming down toward a reasonable aggregative level, it's probably wise to put back on the table what in fact should be the long-term--both strategic and tactical--position of the Foreign Desk. And I think it might be useful to have some recommendations coming from you in that regard.

MR. MCDONOUGH. Certainly.

CHAIRMAN GREENSPAN. I open up the meeting to questions with the specific hope that each member will use the occasion to indicate whether he or she is still on board with the position that we have taken to streamline significantly the aggregative holdings that we had as of a year or two ago. Who would like to start off?

MR. SYRON. I think there's an opportunity to move further in the direction that we want to go, and I concur that once we're closer to where we want to be it will be worth thinking [more precisely] about what that position should be.

MR. KELLEY. I concur with Mr. Syron.

MR. ANGELL. I not only concur, but I really want to express appreciation for Bill McDonough's capturing the spirit of the Board and the FOMC position and very well representing that. It's very comforting to me to know the direction we're going, and I've had time to worry about other things!

CHAIRMAN GREENSPAN. Does anybody have any questions?

VICE CHAIRMAN CORRIGAN. I have no problem with the broad direction we're going, and I completely agree with the point on the structure of the balances. But I have to say on the D-mark balance itself that if I extrapolate out this next \$10 billion, I do have a

nagging sense of uneasiness that we might be getting to the point where there's some danger of being too thin.

CHAIRMAN GREENSPAN. We still have \$20 billion DM.

VICE CHAIRMAN CORRIGAN. Not after the next [transaction], i.e. the further sales proposed by Tietmeyer.

MR. MCDONOUGH. It would leave about \$14.7 billion equivalent in DM after the next transaction, which would be about 24 billion deutschemarks.

MR. TRUMAN. Bill is using dollar equivalent figures and combined Treasury/Federal Reserve figures. That's at current exchange rates.

VICE CHAIRMAN CORRIGAN. I make this observation knowing, and I think broadly sharing, the sentiment of the Committee. There probably are only a few of us who were around in the late '70s when we had to approach the world hat in hand [to obtain needed foreign currency balances], and that was a very uncomfortable feeling. I would not like to find us in that position again.

CHAIRMAN GREENSPAN. Well, I think we still have a very large block of holdings.

VICE CHAIRMAN CORRIGAN. I agree with what you're saying. I just want introduce a little element of caution, that's all.

CHAIRMAN GREENSPAN. Caution noted.

MR. MULLINS. It's worthwhile for us to give some thought as to what is the appropriate balance, where we should start and stop, and how far we should go. I know that's difficult, but as we move forward I think that's something that we should start to confront.

MR. BLACK. Mr. Chairman, I agree fully. I've never had very much sympathy for intervention, but I do remember the days that Jerry has alluded to when we had to draw on the swaps to get money to support the dollar. And if we are going to continue [to intervene], which I hope we won't, our holdings could come in useful, as he says. But I have never been sympathetic toward intervention and I'm glad we're going in the direction we're going.

CHAIRMAN GREENSPAN. Does anybody else want to express an opinion or raise a question?

MR. JORDAN. I'm new to the process and didn't participate in your discussions before, but I like the direction. The desirable level, I think, is so far below \$20 billion deutschemarks that I'm perfectly comfortable with getting down there.

CHAIRMAN GREENSPAN. If there are no further comments, I believe the content of what I just heard indicates that Bill ought to go ahead and see whether or not he can formulate the appropriate longer-term strategy. I guess the next meeting would not be an inappropriate time to resurface this. If there are no further

questions, I'll take a motion on ratifying--no, we don't have to ratify anything. Let's move on to the Domestic Desk, Peter.

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

CHAIRMAN GREENSPAN. Questions for Peter?

VICE CHAIRMAN CORRIGAN. Mr. Chairman, as you are generally aware, I wanted to bring to the Committee's attention the fact that the multiple investigations of the Salomon Brothers incident from last summer may be coming to a head in the near future. I say "may" because this is a very complex matter and things could change even at the eleventh hour. I don't think I can characterize the bottom line of that process except to say that a major effort is being made by all of the official agencies--the U.S. Attorney, the Justice Department, the SEC, the Treasury, and the Federal Reserve--to act in a way that puts this unhappy event behind everybody in a coordinated fashion. As I said, any number of things could change, including the most obvious--the precise timing. But the specific issues of primary dealer status and the status of Salomon's relationship to the Treasury in a context of the bidding restrictions that they put on them last year will be addressed as well. The intention is to try to address those issues in a context that is consistent with the entirety of a solution. Again, I can't characterize the likely bottom line, because I still don't quite know what the pieces of that bottom line are, but I thought it important that the Committee be broadly aware that it seems likely, but by no means certain, that this could get put to bed in the near future.

CHAIRMAN GREENSPAN. Any further questions for Peter or Jerry?

MR. LINDSEY. You have to help me with my memory on this. As I recall from the last time this issue came up, if there was a felony involved in this, a suspension is automatic, isn't it?

VICE CHAIRMAN CORRIGAN. Well, first of all, Governor Lindsey, in the new guidelines there is a reference to the fact that if a firm pleads guilty or nolo contendere to a criminal charge, a sanction would follow automatically. However, in Congressional testimony we went to rather great lengths to say that that specific provision would not necessarily apply ex post to the Salomon situation. Therefore, even if a firm were not indicted for a criminal charge, we still would have the flexibility to impose a sanction even though that specific provision, which followed the event, is there. But we were quite clear in saying that we did not feel that we were necessarily bound by that in the context of the events of last August.

MR. LINDSEY. Thank you for that information.

CHAIRMAN GREENSPAN. If there are no further questions, I will entertain a motion to ratify the actions of the Domestic Desk since the March meeting.

SPEAKER(?). So move.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection.

MR. STERNLIGHT. I'd like to make a recommendation on leeway for the next [intermeeting] period, Mr. Chairman.

CHAIRMAN GREENSPAN. Sure, go ahead.

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

CHAIRMAN GREENSPAN. Is there any objection? We'll assume the vote is in the affirmative. Let's move on to the economic discussion.

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

CHAIRMAN GREENSPAN. Questions for Mr. Prell?

MR. PARRY. Mike, you went through some of the risks to the forecast. It seems to me that there are some areas where the economy could turn out somewhat better. Some of the work we've done suggests that perhaps we could get greater strength in the residential sector. It's conceivable that the dollar may end up being somewhat weaker than was estimated in the forecast and then net exports would continue to be somewhat better as well. And the equipment area could be stronger. And finally, inventories--though they are not likely to get back to a traditional relationship--could perhaps not change as much as seems to be implied in the forecast. When you look at the risks, do you see a real symmetry of risks in this forecast or do you think there might be a predominance of risks on one side or the other? What strikes me now as opposed to the [forecast at the time of the] prior FOMC meeting is that, at least in terms of visibility, there seem to be some upside risks that weren't there before.

MR. PRELL. Well, we've felt that the balance of risks also was more even in the last couple of forecasts than it had been through much of last year. And I think we repeatedly flagged what we perceived to be the asymmetry of the probability distribution through last year. We are reasonably comfortable with this forecast as presenting fairly balanced risks. I think each of the items that you mentioned is a plausible story. The one reservation I would have in light of the recent data is that the latest housing market data are disappointing relative to even our meager expectations. We probably had about as low a forecast for second-quarter housing starts as anyone and yet the April figures--one month admittedly--do paint a weaker picture.

MR. PARRY. Although rates have come down.

MR. PRELL. Rates have come down and some observers sensed that people were beginning to look at home buying as they would look at car buying: They had to feel there was a bargain. You know, the government offered rebates early in the year and people rushed to buy. We had not attached a lot of importance to that at the time, but in retrospect it may have pulled forward some housing starts from later

in the year, or certainly some home sales. And we're not exactly sure where we are.

MR. PARRY. So, you would say the risks still are relatively balanced?

MR. PRELL. I think they're reasonably balanced here.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mike, in reading the Greenbook, I concluded that you thought the first-quarter GNP, or rather GDP--I haven't made that transition completely--increased at a 3 percent rate. Then in reading the briefing papers last night, I thought at first you were going to say 3.3 percent but then I looked at the chart and it appeared that it might go as high as 4 percent. What is your best guess as to what that figure really might be?

MR. PRELL. Let me give you the arithmetic [to the extent] that we are able to do these translations. Every number that has come in since the BEA's initial estimate has been higher than they had anticipated, at least until the revision for the March housing starts, which had only a small impact. If you cumulate those figures, you come out at this point with about a 4 percent increase in GDP. That's assuming that the merchandise trade figure comes in right on their assumption. It could be higher; it could be lower. Our feeling was that all these additional goods being sold might be tilting the risks toward some lower [trade figure]. So, that's where we are, and I think it's a fair statement at this juncture. Now, BEA will confront the same anomalies that I noted, and they will have to take that into account. They have some room to maneuver, but I think we should expect a substantial revision.

MR. BLACK. That really would be something of a surprise to the private economy if it were that much, wouldn't it?

MR. PRELL. Indeed. It's looking backward, but I don't think everyone has caught up with this. I see that a number of private analysts have been talking in the last week or so about growth of around 3 percent, and they will probably refine that a bit. So, it's unlikely to be a total shock, but it's coming in on the high side of expectations, well on the high side.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mike, in the forecast you have an implicit decline in long nominal rates.

MR. PRELL. Explicit decline!

MR. LINDSEY. Explicit decline, excuse me! I forgot where it was in the Greenbook. Yet long rates seem to [be stuck in] a trading range; I think we all find them awfully stubborn. Suppose they stay in the same trading range. How much risk is there to the forecast if there is no decline over the next year in long rates?

MR. PRELL. Well, I'm not sure how one would define the "recent" trading range. If you look at the period since early

February until recently, I think we're pressing against the lower limits [of that range] this morning, and we could conceivably break below that. Looking at the broader time frame going back, with bond yields having gotten down to about 7-3/8 percent, that's about the dimension of the decline that we're anticipating in our forecast by early next year. I think the answer to your question depends on what circumstances bring about this failure [of long rates to decline]. If it is a buoyant economy and strong demands for capital, then obviously it's not a problem. If it is higher inflation expectations, we get into some more complex issues about how that might affect the affordability of housing and so on; but if it's inflation expectations and not real rates, again it may not be a compelling negative. If it's risk premia brought on by political uncertainties--and this may be a year of tremendous political uncertainty--or just the wrong expectations, as we've had on some occasions, that could be a negative. So it's really hard to say ex ante.

MR. JORDAN. May I follow up on that question?

CHAIRMAN GREENSPAN. Sure, go ahead.

MR. JORDAN. In the Greenbook, Part 2, on page III-3 you list the indirect effects of Larry's question. You say "velocity rose further despite declines in opportunity costs. Recent weakness in M2 occurred in the face of still small opportunity costs." You refer to a chart and so on. But then I flip over to page III-5 in the paragraph at the top of the page where it says "the lack of aggressive pricing for these deposits evidently has encouraged investors to move from retail CDs into stock and bond mutual funds in order to take advantage of higher anticipated returns." That says, at least for some components of M2, that the real opportunity cost is not the short-term yield change in the chart on the prior page but rather these longer-term yields and that those components of M2 are more like investments instruments than they are like money instruments. So, that paragraph says that you've got the wrong opportunity cost, at least for those components of money.

MR. KOHN. Well, I think that's right. There are several Reserve Banks, including your own in particular, that have used other opportunity costs that took into account the intermediate- and longer-term time deposit rates. And that does a little better. Although it doesn't pick up all the unexplained shortfall in money, it does help to explain it to some extent. Now, it has always been the case that the division between money and investment assets--particularly for money after deregulation and after Reg Q was taken off NOW accounts--is very hard to see. It's hard to draw a bright line between something you would call money and something you would call investment assets. Other checkable deposits, NOW accounts, have elements of investment assets; people hold them because of rate expectations. So, that has always been a somewhat fuzzy picture. I agree that our measurement of opportunity costs probably could be improved. I think one issue here is what that is telling us when banks aren't competing for these intermediate- and longer-term CDs. It's telling us in part that they don't see loan demand; they don't intend to make a lot of loans out in the future. Then we have to go back and ask whether that means something: whether it is just a relatively benign redirection of credit flows or whether it is saying something about the intermediation process that could feed back on aggregate demand. So,



I agree with your point on opportunity costs; but once you cut below that point, it still leaves a lot of ambiguity about the meaning of the slowdown in money.

MR. JORDAN. But the reason for asking comes back to what Mike was saying [about whether] what the Greenbook says this month is right. The Greenbook says long bond yields have come down because of lower inflation; Mike termed that very appropriately [unintelligible] very hopeful outlook for 1993. I'd like to believe it. But the question was: What are the risks to the forecast? Can you connect up what is going on with these components of money and [say that] part of this optimistic outlook on inflation reflects the economy or is there something a little stronger than that to tie it to? Part of it, I assume, is also because of slow growth of M2. Given this reason for slow growth of M2, how comfortable can you be with that?

MR. PRELL. Well, let me just say that I think we noted in the last Greenbook, not this one, that we didn't find the narrower monetary aggregates nor the enhanced narrow monetary aggregate that you're implicitly describing as providing strong evidence on the outlook. Historically, we haven't found that these provide all that much better guidance than M2 as it is, with all of what I view as flaws in the logic of its construction. But I'd also argue that in telling the story about how money affects inflation, there's a short-run transmission mechanism which I think would run through the pressures of aggregate demand on aggregate supply. Thus, I think our assessment of the pressures in resource markets is very relevant to the short-run outlook for inflation through 1993. So, I can segment these questions to some extent.

MR. JORDAN. With symmetric risks?

MR. PRELL. Well, I guess I'm skeptical about the meaning of the monetary aggregates right now. I'm not inclined to assign a large asymmetry to the risk just because the monetary aggregates have been running low. Clearly, that's a judgment call. Others have differed, and perhaps wisely, in looking at the progress of this recovery. But one also needs to interpret why the aggregates are behaving the way they are and whether it is demand shifts or changes in the structure of intermediation and so on that may be neutral in terms of their implications for the cost and availability of credit to support it.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Mike, I have two questions, which are somewhat technical in nature, dealing with historical [precedent] in data series. One is that just in talking to people and getting anecdotal information on the housing market, [that information] is consistent unfortunately with the pattern of data that was announced this morning. What I was wondering is whether there is any evidence of increased sensitivity to mortgage rate changes in housing and how that fits in. I remember in one of your earlier nonfinancial reports that you talked about almost a change in the relationship between prices and purchases. That is, as prices stopped declining in some markets, there was a hypothesis at least that people were more willing to buy because they were less concerned about the [potential] loss, which was a different sign on price than we thought.

I have a second question, but I wanted to get to that one first to ask how this fits in with our historical experience and whether there has been a change in habits.

MR. PRELL. Well, as a general matter, we would perceive the interest sensitivity of the housing sector as being reduced from what it once was, in part because of reduced market segmentation--the elimination of the non-price rationing effects that occurred a couple of decades ago when rates moved above Reg Q ceilings and we got disintermediation. The introduction of ARMs might work in the same direction, but how important that is isn't clear. There's a question on mortgage rates. Some people have been able through considerable effort to tease out of econometric equations some suggestion that people will wait until the rates have come down and they don't think rates are going to go down any further before they will move. But that is a very short-run phenomenon and it doesn't seem to be a very important result over significant spans of time.

On the price side, it depends on which model you think is most relevant. There's an affordability model, which clearly does have some importance. That looks at mortgage rates and prices and at that combination relative to income; and that says that we have had a considerable improvement in affordability over the past couple of years. On the other side, if you look at an investment model, a user-cost model, it says that it's cheaper to own a home when you're getting capital gains. So expected price movements would be important in that model. Basically we've taken a middle-ground view saying affordability is better and the fear that people will be losing their shirts in owning a home is probably abating because house prices generally have firmed some over the past year. It's a hard call to make as to which of these things is most important. I think what we've seen recently, as I was suggesting, is that people are very sensitive to a number of aspects of this. They jumped when they saw those mortgage rates get down to low levels and when there was the first-time home buyer credit [proposal]. They seemed to have pulled back very sharply when rates backed up and the credit [proposal] evaporated. An environment in which people are still rather uncertain about their employment and income prospects is a fragile situation. And, going back to President Parry's comment, if we can begin to get, without generating strength solely out of the housing sector, some reasonable growth going here and some confidence in employment prospects, then people may move in response to this vastly improved affordability, and we could get a significantly stronger housing expansion than we have forecast. We're certainly operating at low levels even given the prevailing demographic trends.

MR. SYRON. For what it's worth, I think your analysis is probably correct and that we don't necessarily get symmetric behavior. But after we have a period of declining prices, the relative weight on the investment side becomes somewhat more important.

The second question I'm trying to figure out is whether to take much encouragement in the household data. I've always been inclined to look more at the payroll data but I'm just wondering whether we do have an historical precedent to some extent or if there has been a shift there because of all of the restructuring that's going on. Again, one hears these anecdotal stories of many new smaller firms starting, etc. I just wanted to ask you if you could

explore that a bit more because we are seeing quite a diversion in patterns [between the two series]. I'm grasping for encouragement here if you can provide it.

MR. PRELL. Well, it's not bad news. The question is how much good news there is in these numbers. We've looked at the history and a lot of other analysts have too. Some have declared that there is some lead, particularly in the early phases of an upturn, in the household employment series relative to the payroll series. Others have said that's just not a very robust relationship. We find hints, but [the relationship] doesn't seem to be highly reliable. The fact is that in the payroll series the Bureau of Labor statistics make an allowance for new business formations as well as the closing down of businesses. And it is a little murky how they do this. It is conceivable that they're underestimating the rate of new business formations if the economy is picking up and that that is biasing the change downward. But as I suggested, looking at corollary evidence entirely separate from these things--such as initial claims and the responses in the Conference Board surveys about job availability--all these other things don't suggest that employment is growing at 300,000 plus a month. [Actual growth] may be somewhere in between but I'm more inclined to think it may be closer to the payroll trend at this point than to the household trend.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Mike, looking back at the chart on page III-3 on M2 velocity: Last fall some around here were quite concerned that M2 growth was quite a good indicator of where [the economy was] and yet these first-quarter numbers I presume [raise] nominal [GNP growth] for the first quarter up to somewhere between 6 and 7 percent. That makes V-2, with a one-quarter lag, shoot up to 4 percent. Doesn't that really cast a lot of doubt on all that concern about slow M2 growth?

MR. PRELL. Well, as you know, I've not been an enthusiast of that view and have worried that that was more a coincidence. Typically, we have thought of there being a lag between changes in money growth and changes in GDP. So, the close timing last year I think was not necessarily in line with what we normally consider the relationship to be. Whether a one-quarter lag in velocity gets at this or not is another question. I think we're looking at a period of slow growth of money that stretches back a few years now. And in a sense we haven't gotten some of the payoff [in] disinflation that some might have anticipated. If [the economy is] growing at the rate it appears to be, that doesn't quite seem to fit. But I don't want to state the case excessively strongly either. There may have been a message--and it may show up in the second quarter or the third quarter--from that weakening money stock growth last year.

MR. KOHN. Governor Angell, I had some work done, drawing it with the two-quarter lag that people like to use and assuming that the Greenbook is close to right for GDP. That also shows some pretty sizable increases in velocity in the first half of the year, unlike last year when velocity was a bit flatter. So, after a while, as I'm about to say in my briefing, I think there is some reason to believe that the weakness in M2 we see this year is not sending us the same kind of signal, whether it's coincidence or not, that it seemed to be sending last year. But there is a question of confidence here. The

weakness is extreme and even if the signal-to-noise ratio is very, very low--

MR. ANGELL. I calculated the two-quarter lag also and had the same conclusions. Thank you.

CHAIRMAN GREENSPAN. There's another way to come at this, which yields much the same results, in the sense that we've got this long-term trend, the  $P^*$ , tracking the general price level. The existing pattern of  $P^*$  at this stage is at virtually zero if not a negative price level. If one is going to presume on the basis of the data that we are seeing a resistance to coming down under the 3 percent level or even that it is somewhat off the zero base, then the question essentially is whether we are incorrectly measuring [M2] in the same context. Namely, if M2 is artificially deflated and [that] created this particular zero [or slight] decline, we have the wrong M2; we have the wrong proxy for money. If we had the right proxy for money, it would be growing much faster than the numbers we are looking at; it would be much closer to the opportunity cost even in the context that Jerry Jordan is raising the issue. It would also mean that  $P^*$  is back on track with exactly where the equation numbers are. So, it seems as though the financial system in a general way is more in line with the real economic system, with the outlier essentially being M2. If we alter M2 everything else falls into place. It's a disturbing consideration, but it sort of leads to the conclusion that all of our theoretical judgments with respect to the effect of the RTC on M2 have not been exactly correct and that there is a significant element of technical erosion in the data as a consequence of the liquidation of the small CDs and the thrifts. There has been a fairly significant reduction in the thrift area without a spillover--as we all would have expected with the eliminations of the thrifts--from the thrifts into the commercial banks and other depository institutions. Governor LaWare.

MR. LAWARE. Mike, I'm puzzled by the corporate profits projection in the Greenbook. It looks like fairly steady improvement during 1992 and then it goes rather blah in 1993 with a fair amount of swing back and forth from one quarter to another. What is the rationale behind that projection?

MR. PRELL. Well, without being too precise in this, we've seen some evidence in the first quarter of a very big jump in profits. A sizable move at this point wouldn't be surprising in terms of the historical relations, which suggest an acceleration in output growth that produces an acceleration in profits. As things level out, as productivity increases begin to move back toward trend, we get a little additional pressure on the profit margins even though the rate of compensation increases is diminishing. And thus we get this leveling out of the profit share and in the pattern we see for total corporate profits. It may be that profits should be trending up a bit more. That certainly would be more consistent with the view that I think prevails among private analysts, which has consumer price inflation stabilizing or increasing in 1993. Those people tend to see continuing upward movement in corporate profits.

MR. LAWARE. The stock market would seem to indicate that that's the view on the whole.

MR. PRELL. I think it's very difficult to read what the stock market is building in here. But looking at this year's profit forecasts, recognizing that the PE ratios are distorted by extraordinary factors in 1991 that may be unwinding in 1993, we can see a movement of PEs at current stock price levels back into the high teens, still at a high level historically. But later on this year things will not look as out of line as they do now. And if interest rates are stable or coming down, this all hangs together fairly plausibly. It's on the high side of history but plausible. I sense the market probably is taking a view that with expansion come firmer prices and that profits will be a bit better in 1993 than we forecast.

MR. LAWARE. Thank you.

MR. HOENIG. Mike, just to follow up on your comment on inventories: You say that in the revised first-quarter numbers inventories are playing a more important role but that should not have an adverse effect going forward. That is what I think I heard you saying. Can you go through that again as to why we would not have some repercussions from that?

MR. PRELL. Well, the repercussion is that had we ended up with the level of sales we are running at with lower inventories as per the initial estimate, that would have been a bullish factor for the economic outlook. As it is, though, we don't see that there is a gross inventory imbalance coming out of the first quarter except for the wholesalers. And in fact in the nondurable wholesale area there are not very many signs of inventory/sales ratios being high. Our expectation is, though, that inventories are going to be managed very cautiously and that quite possibly wholesale inventories will run off some. Manufacturers show no inclination to see their inventories rise. We expect to see some runoff of inventories for a little while longer but at a lower rate than even the reduced pace that we think the first quarter produced. So that means that inventory investment makes a small positive contribution in the second quarter in our forecast and a considerably greater contribution in the second half of the year as we see a swing to a mild rate of accumulation as sales trends continue positive.

CHAIRMAN GREENSPAN. Any further questions? If not, let's move on to the Committee discussion. Let me make a request to those of you who have any insights into the commercial real estate area to put them on the table. Very specifically, I think it would be useful to know if there are any indications of a pickup in commercial real estate transactions, [because] what we have been looking at is a decline in offerings and appraisals. And until we see the bids coming in, we will be getting no indication of any stability. Obviously, as the bids begin to move in, that will engender transactions and it may be a far clearer signal that we're getting closer to the bottom of [the decline in that sector] than any rather dubious price index for commercial real estate. So, for those of you who have any sense of this, it would be useful for the Committee to get a better view of an area that has been crucial to us and for which our data sources have been less than correct. Who would like to start off? Jerry.

MR. JORDAN. To comment exactly on that point, the commercial bank I was with conducted eight auctions before I left. They were all in the Southwest and on the West Coast. But the process was: Once we

did the first auction and generated the interest that there is a market out there, each one went better than expected and better than the prior one because it was clear that there was a core market left; [we started] in Texas and then we went over to Arizona, Nevada, Utah, and Colorado. It appeared to us that there were a lot of people who had been waiting for the bottom, figuring that this was going to be the buy of the century in commercial real estate, in particular. Some of it was raw land but most of it was in structures. As they saw each successive auction going better, with greater interest than the prior one, they became concerned that they had missed the low point and it tended to feed on itself with great success.

MR. KELLEY. What is the time frame you're talking about, Jerry?

MR. JORDAN. The first one was about 18 months ago, and then about 4 months elapsed before we tried the second one. And from that point it picked up in pace.

CHAIRMAN GREENSPAN. Jerry, would you like to comment on your general view on the District while you have the floor?

MR. JORDAN. Well, just over the last 10 weeks the sense around the Fourth District is that things are definitely improving. The comments from all parts of the District have been of a uniformly upbeat nature. The negative tones come in on the lack of robustness--not on the direction but the vigor--and still with expressions of concern about the durability or sustainability of the expansion. There are frequent references by full-time directors and members of our small business advisory and small banker advisory councils to having been disappointed last year when they thought the recovery was under way, and they are concerned now that we could have another false start. Most of the durable goods manufacturers, especially the capital goods firms that have the ability to export, are experiencing very strong order books. Some are exporting to Canada and some to Europe with some surprise at the strength, especially in Germany, in their capital goods [orders]. A number are expressing pleasure at having recaptured domestic markets, especially those in the auto sector who now are able to start selling to Japanese transplant companies and finding success against foreign competition in that area.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, the staff forecast has changed really just a little since the last time. We thought it was a good forecast then, and it still seems to be a reasonable forecast to us. Certainly, most of the anecdotal and other information that we are getting in the Fifth District and also in the country as a whole is consistent with this relatively moderate rate of recovery that the staff is projecting.

On the point regarding commercial real estate transactions, our Vice Chairman is a big real estate operator. He does a large volume of business and also is a solvent real estate developer, which makes him an unusual breed. He has been reporting for about two months now that commercial real estate is beginning to move. Nothing new is being built, but it is beginning to move; the prices had

dropped to the point that they looked attractive. He also always adds "and there's plenty of financing out there for it." This was not true a while back, but that's the way he has seen it for some two months. And I think that's a pretty [reliable] reading because his firm operates in a lot of cities throughout the country.

It's certainly true that both manufacturing activity and retail sales did appear to have decelerated a bit since we had the gains earlier in the year. Nevertheless, most of our contacts believe that the recovery is here to stay this time. That view was universal at our last board meeting, for example. And for the most part they expect their own businesses and industries to grow at a solid, if something less than spectacular, rate over the months ahead. These contacts cite a wide variety of leading indicators; they all seem to have their favorites, and those range from increasing trucking activity to reduced loan delinquencies to rising telephone hookups, and on and on.

Even though I think the staff forecast is reasonable, it's certainly true that reasonable forecasts don't always come true. So we have to ask, as we always should, where the risk lies. And I think the risk of errors may be on the down side. I'm bothered by this sharp deceleration in the rate of growth in M2, although I think your explanation comes very close to explaining why it has misbehaved, and I'm very sympathetic to that. The apparent continued sluggishness in May is obviously a further risk on the down side, and it's a risk I worry about a great deal. Still, I believe we can be fairly certain that the weakness that we had results from these special factors such as the lower non-withheld personal income tax payments and the movement into other kinds of assets, this substitution for M2-type balances. My 85 year old mother-in-law, for example, is now out in the longer end of the market and that is something I never thought would take place! And I think we'll be better able to gauge--

CHAIRMAN GREENSPAN. She's holding until maturity?

MR. BLACK. Well, if we get the lower interest rates that the staff has projected she might take capital gains on that! Anyway, I think to be better able to read the significance of M2 we have to get a little further past April and the tax date.

Now, on the other side, I think it's worth noting that the main differences between the staff forecast and most other forecasts is that the staff expects inflation to decline further this year and then hold steady next year. Many of the other forecasters think inflation is going to bottom out this year and is going to be higher in the next few years. The staff is also projecting, as I just mentioned, lower long-term interest rates over the period ahead and it seems as if most other forecasters expect interest rates to continue on an uptrend. I see the Greenbook projection as more desirable, and it is certainly plausible. But I believe the chances of achieving this are going to depend pretty highly on whether or not we make the right policy calls in the critical months ahead. In particular, I think we have to convince the markets and the public that we are still determined to reduce inflation further even as we try to foster this budding recovery we apparently have under way. The credibility of our long-term strategy is at a very crucial point right now and it's really on the line. So, I think we need to do all we can to reinforce

this commitment that I think all of us in this room share to working inflation down over the longer run.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Thank you, Mr. Chairman. The Twelfth District economy is experiencing varied signals, with weakness in California offset by modest growth in other District states. In California, there is some improvement in the north, with continued problems in the southern part of the state. I guess that latter comment is something of an understatement. The five-county Los Angeles area accounts for 50 percent of state employment and it also accounts for 80 percent of the 550,000 jobs in the state that were lost between May 1990 and March 1992. So, it's clear that not only is there weakness in the state but it is highly concentrated in the southern part of the state. The riots in Los Angeles are estimated to have cost \$1 billion in total property damage and to have resulted in additional job losses of around 25,000. Now, I have seen estimates as high as 40,000, and that may be referring to a peak that endured for just the number of days immediately following the riots. But the number that we're going with is 25,000; and expectations are that in a number of weeks that could fall below 10,000 as some buildings are repaired and some stores are restocked, because some stores were just looted and not seriously damaged. There is also obviously further concern about the effects of the riots on tourism and firm location decisions. And while I'm still talking about Los Angeles, I don't think I can give you any of those glimmers of hope with regard to commercial real estate. Last year 9 million square feet of office space was added in the Los Angeles area. It caused vacancy rates to shoot up quite a bit; it depressed lease rates and property values; and projects under way indicate that the problem is going to get somewhat worse before it gets better. So, I have not been able to pick up any improvements, at least in the Los Angeles area. I would agree with what Jerry Jordan says in terms of some other areas in the District. We even picked up a few optimistic comments coming from some people in the state of Washington where there also was a fairly serious condition of over-building as well.

For the state [of California] as a whole, indicators of economic activity are mixed. Existing home sales reports indicate a modest rebound; payroll employment rose in April; and it appears as though agricultural conditions are improving. However, manufacturing employment continues to contract. And while construction employment has risen for two consecutive months, nonresidential construction awards and residential permits are below their year-earlier levels.

There is a very big issue that you may begin to read a bit more about in the month ahead. Reflecting recent economic weakness, the state faces a severe shortfall of \$10 to \$12 billion through the end of the next fiscal year. Not surprisingly, revenues have fallen substantially below projections. The law in California requires that they enter the new fiscal year with tax and spending plans to produce a balanced budget. And this is before July 1st. There obviously are some things that they can do that are of a rather tricky nature, but in large part they have to find \$10 to \$12 billion of reduced spending or higher taxes. And that's not exactly the Keynesian approach to dealing with California's problems.



Outside of California, District states have performed relatively well over the recession, and they continue to show modest growth. Construction activity is rising in several District states as are home sales. Cutbacks continue to be reported, unfortunately, in aerospace, with job losses of 6,500 projected for Boeing this year. I should point out that Boeing employs over 100,000 in the Seattle area. In addition, Boeing continues to have a large backlog of orders and actually has a very strong long-run forecast with growing demand from the Pacific and Asian region. Contacts that we have in nondefense manufacturing report a modest rebound, with lumber and wood products manufacturing currently bottoming out, and that was a considerable source of weakness in the past year.

If I may turn briefly to the national scene, incoming data since our last meeting seem to add to confidence that a moderate recovery is under way. Indeed, as I [noted] in my discussion with Mike, it's not difficult to come up with an outlook that is a bit stronger than is indicated in the Greenbook. For example, our analysis points to somewhat greater strength in inventory investment, residential construction, and net exports. And we end up with a growth rate over the next year and a half of a little over 3 percent compared to the Greenbook expectation of 2-3/4 percent. I agree with the Greenbook that inflation is on a very slow downward trend, but I fear that such slow progress will make others question the resolve of the Fed to deal with inflation longer term. It seems to me that we might be at a point soon where we'll have to be more forthcoming about our inflation objectives. And probably we can't do that until 1993. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, in the Sixth District, conditions clearly have continued to improve. The business people I have spoken to over the last several weeks are much more upbeat than they were and they have more confidence that the recovery is going to be sustainable. I hear much less talk about a stalling of the economy or a double or triple dip, whatever you want to call it. There also, I think, is a recognition among business people recently that the recovery is going to be modest. They are no longer looking for that historical type of recovery that we've had.

We've had gains in a number of areas in the District--retail sales among them, especially in apparel. And that's in spite of the fact that we had a late Easter and some bad weather. Auto sales have also been relatively good, as have other durables, particularly those related to housing. Home sales have been fairly decent also and that has reduced [housing] inventories and led to greater growth in housing permits. Capital spending is projected to be fairly modest, but manufacturers are reporting that orders and shipments are turning up. A couple of other areas that are important to us are tourism and [convention] business, and we see gains in both of those areas.

On the commercial construction question that you asked, anecdotally I've been hearing from people that commercial construction perhaps is at the low point. I can say that commercial space is much less of a drag than it has been. We've had some absorption of space and that is beginning to stabilize lease prices. And that's pretty much [the case] around the District's major cities. On the price

side, prices for finished goods are holding relatively steady, and in other industries we see stable input prices and no pressure on wages. The two geographical areas that are dragging a little are Florida and Louisiana. Florida is suffering from reductions in defense spending particularly, as well as the lower interest rates that are affecting the high number of retirees. I guess there are a lot of mothers-in-law in Florida!

MR. BLACK. Tell them to go long!

MR. FORRESTAL. Louisiana continues to suffer as a result of the energy situation. So, with respect to the District, Mr. Chairman, things are looking relatively good and more sustainable, as I said, than they had been.

With respect to the national picture, the Greenbook forecast is quite a reasonable one and, in fact, I would be very happy if we could achieve it, especially on the inflation side. Our forecast is about the same as the Greenbook in terms of GDP but we see somewhat lower unemployment and higher inflation. I think the difference is basically that productivity gains [are lower] and labor costs are higher in our forecast than in the Greenbook. I do think the expansion is likely to endure. The efforts we see on the part of people to get their balance sheets in order lay the foundation for a more sustainable expansion but, of course, we haven't seen the full effects of that, and I guess that leads to some questions about the risks to the forecast. I was prepared to mention that but Mike did a very good job of detailing those risks in the forecast, so I won't go over that again.

I would say with respect to the slow growth of M2 that a lot of this, if not all of it, we hear is principally the run-off of small time deposits. Banks are not bidding very aggressively for funds in this current environment and that suggests the process of financial disintermediation is still constraining. Putting all of this together, it seems to me that the risks in the forecast are more evenly balanced than they were. They are more symmetrical, and that suggests to me that we don't need a change in policy at the moment. I continue to be concerned about the outlook for inflation. Maybe participants in the market are wrong, but it seems to me that the yield curve is telling us something about future prices that we need to take into account. The price numbers themselves are somewhat disappointing and we don't know at this point whether we are looking at a temporary blip or whether we are on a trajectory toward a higher level of prices. So, I think as we approach the policy discussion we should move very, very cautiously. Thank you.

MR. STERN. With regard to the District, the modest but steady progress that has been in place for quite some time continues, and I won't go into details except that there are a few concerns around. One is in agriculture where, of course, this time of year moisture is always the major uncertainty, and that is the issue in some parts of the District. Beyond that, there is some concern in the timber industry where environmental issues are limiting activity, and we've seen some marginal mining operations go out of business. But otherwise the District economy is in pretty good shape, I think. Attitudes are also in pretty good shape.

With regard to the national economy, my views do not differ from most that have been expressed so far. As Mike Prell indicated, if anything, we've done at least as well or better really than we thought we would over the last couple of quarters. That [improvement] does seem in my judgment to be continuing; I'm referring to the real side, and I don't see any reason at this juncture for renewed or additional concern in terms of real activity. The disappointment, to the extent there has been some, has been on the inflation side, at least as measured by consumer prices or the employment cost index. In talking to business people in the District, for the most part they continue to describe a very competitive environment and they don't give any impression that it's easy to raise prices or pass along cost increases or whatever. But it's a little hard to know in light of all the data whether they simply mean by all this that they can live with 3 or 4 percent inflation and thus that's what they mean by a very competitive environment. It's just hard to know what they have in mind as they describe that situation.

With regard to commercial real estate, the situation is quite mixed as best I can judge it. I have heard of some renewed activity in the construction of warehouse and manufacturing space; it's not a lot, but there do seem to be some signs of life there. With regard to office space, one of our directors, with whom you're familiar, has been "bottom fishing" in terms of buying office space in various parts of the country for a couple of years now. He also has bought some raw land in some locations. I think he feels quite positive and comfortable about this. On the other hand, I do come across investors and developers who tell me it's still difficult to find financing. They're not talking about financing just for new projects but to refinance or to purchase existing buildings; although when I express a counter view and basically describe what one of our directors has done, a number of people will admit that they've been doing that too. It leads me to believe that perhaps there is a little more activity around than we might appreciate, but perhaps it's a little subterranean. Olympia and York has not been a topic of conversation in the Ninth District, but we have our own interesting situation: The so-called Mall of America, a mega mall, is nearing completion. The first part of it is supposed to open in August and now that it's too late there is growing concern about how successful it is going to be. So, we'll just await developments.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Thank you, Mr. Chairman. In terms of the national economy, our forecast for growth this year is very consistent with the staff forecast. We get there in slightly different ways. Our consumption numbers are a bit lower. I think the differences in durables probably relate to the fact that our housing numbers are a little lower than those in the staff forecast but, offsetting that, our export numbers are a bit stronger. There is a difference, though, in the outlook for inflation. Our numbers are more constructive than the staff forecast. We expect in terms of the CPI that we would be getting down to the 3 percent area by the end of this year and then perhaps see continued improvement next year.

With regard to the District, there seems to be slow but steady improvement in the major segments of our economy. But I must say the magnitude of the improvement between this meeting and the last

meeting is not quite as great as was the case at the time of the last meeting. In that prior period there had been pretty good improvement. In fact, in some cases there are signs of moderation appearing. As an example of this, our housing activity is down a bit but from very high levels. Seasonal factors had a big effect on January and February housing activity. Also, that was a period in which mortgage rates had come down quite substantially and that gave housing in the Midwest a push; but we're now seeing some softness in housing. Retail activity also has slowed a bit; it is still positive compared to last year but the momentum has slowed, again from a very rapid pace in both January and February.

On the other hand, the manufacturing sector continues to show slow but steady improvement. Second-quarter production in the auto industry is continuing to run well ahead of last year, but of course the second quarter last year was comparatively weak. Third-quarter schedules have been set a little higher than the third quarter of last year, but the magnitude is not as great as the pace of the second quarter. Current dealer attitudes are good, I'm told. Their order rate from manufacturers is very much in line with the production schedules. But I will say the dealer order rate is a bit ahead of the retail sales level. Still, the inventories out there don't seem to be out of line, particularly for this time of the year. I must say that in this overall category I have heard from just everybody that the demand for light trucks is very, very strong. The industry sales forecasts are a little stronger than ours. They are expecting a very good third quarter and an even better fourth quarter. So, there is more to come on that. The heavy truck business continues to be better than last year. The current order rate is running about 10 percent ahead of last year, but of course that's an increase from a very low level. And heavy truck manufacturers are operating at about 70 percent of capacity. They are forecasting an improved sales level this year of only about 119,000 units and that's versus a good year of, say, 165,000 to 175,000 units. The steel business also is doing a little better; orders, particularly for sheet, are coming in at good levels. That I think is reflective of the auto production schedules and also a bit of strength on the appliance side. The steel industry is operating at about 83 percent of capacity. They're going to ship 40 million tons in the first half and are forecasting 42 million tons for the second half, so it ought to be a good year in terms of the [tonnage] being shipped. But the pricing is just terrible. I find this somewhat of a contradiction: They're shipping a lot of metal but they're just not making any money.

With regard to the real estate question that you asked about, the firm I talked with feels that we may be getting to the point of stability but we still aren't there yet. They are seeing some increased interest on the part of funds to buy real estate. There's a greater level of interest but not a significant volume [of sales] is taking place. They think we're going to have a continuation of price declines this year, perhaps as much as 10 percent for the year as a whole. That's lower than in previous years, which again is indicative that we're getting to a point of stability. The vacancy rates in Chicago are going to go up. We have two or three big projects that are still finishing up, so our already fairly high vacancy rates are going to go up. This firm does not anticipate a return to normal vacancy levels until 1995 or 1996.

In the agricultural sector, we've had a very unusual planting season. It has been cold and wet in most of our area. But in one week, the week of May 10th, some 50 percent of the corn acreage was planted, which was pretty phenomenal. However, given the carryover stocks, which were fairly low, and the significant uncertainty with regard to weather, our expectation is that it's going to be a year in which prices are going to be very, very weather-related, but at least we're off to a pretty good start. I might say that the ag equipment business is sour. Contrary to earlier expectations, retail sales of major agricultural implements have slowed significantly. It's down about 13 percent currently from last year. As a consequence the production schedules, which had been set at a pretty conservative level, now are being reduced.

With regard to inflation, I do think that the outlook is increasingly constructive. Price increases are just not sticking. In the manufacturing sector, I continue to be impressed by the major manufacturers who are continuing to get decreases in their prices for purchased products or, if there are increases, they are pretty modest. The same also is true in the retail sector. People who supply the major retail stores know that they just can't get price increases through. The consumers in turn are very tough. So, I must say general attitudes in the District are that rising prices are just not a major danger. Labor contracts continue to be negotiated under favorable terms. Three-year contracts are the norm. The occasional six-year contract in the paper industry and the wage increases under these contracts are easily managed through productivity improvements. After months of bitterness that I have commented on from time-to-time here, the Caterpillar strike just went "poof." When the company threatened and then began to bring in replacement workers, the union attitude just collapsed. They have not, of course, settled the contract yet, but they're back at work. This won't necessarily set a pattern for the UAW negotiations with the auto companies this fall, but certainly it's going to have an effect on the tone as they go into those discussions.

Net, while I think the economy is continuing to show signs of slow but steady improvement, without more strength in some of the major segments the question [of sustainability] has to be a significant one. Therefore, as we see it, the risks in terms of growth continue to be on the down side. And with the improved outlook with regard to inflation, it seems to us that our policy response should be geared to dealing with signs of deterioration in growth should they begin to emerge. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I'd say the District is mixed. Manufacturing has been up for several months running but there is some slowing in the pace of advance. In retailing, there just isn't much of a trend either up or down; it seems to be fairly stuck. Residential [construction] is growing but not robustly.

As to your commercial real estate question, I have the sense that the District is either at or approaching the bottom of the hole but that there is not much sign of a pickup. The general [view] is that this is a three-to-five year problem to work our way out of before we get vacancy rates at the point that they will stimulate much

construction. The bankers, I think, feel that the worst surprises are on the table; but the most optimistic feeling is that we may be at about the bottom.

The bankers see some evidence of a pickup in loan demand, although not much in the hard numbers; it's more at the inquiry stage. Attitudes, in contrast to this mixed view of the real sector, are more upbeat than the hard numbers would support underneath. There just is a sense that things are going to move, and that's an improvement over a couple of months ago. But I suspect that this sentiment is not firmly based and that one or two months of poor sales or shrinking orders would change the attitudes. Nonetheless, I think the attitudes are better.

For the national economy, I think we do have a moderate recovery; if anything, it's faster than expected. And it's hard not to feel better about the sustainability issue and feel that we have a sustainable recovery. The money supply issue strikes me as one of those things we can argue about day-in and day-out. We have some good reasons not to worry about it, but it is a shadow that hangs over us. I think the only way to settle it is not to worry about it as long as it's an outlier and the economy picks up. But if we start to see some weakening in the real sector, then it's going to mean something. It's almost an agnostic approach in terms of how we should deal with it.

On the inflation side, my sense is, much as Si just expressed, that it's awfully hard to see upward pressures in prices. The other side of that is that, particularly in large cities, the unemployment problem looks as if it's just stuck. There is an attitude both from the business side as well as those people seeking jobs that there just isn't going to be much improvement. How all that will play its way out through the warm summer months in these cities is something that one has to be uneasy about.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Relatively speaking, the Eleventh District economy remains one of the stronger District economies, at least in terms of employment. From the bottom of the recession in April of 1991, employment has grown about 1-1/2 percent in our District. Within the District the weakest, and the declining, sector is energy and the main source of strength is exports, especially exports to Mexico, which account for a third of Texas exports to foreign countries. Between 1990 and 1991, Texas exports to Mexico were up 16-1/2 percent; and exports to Canada, which is our second largest international trading partner, were up almost 8 percent. The number of businesses requesting information on assistance with exporting from the international marketing division of the Texas Department of Commerce was as great through April as they had expected for the entire year. So, there's a lot of activity gearing up for the prospective North American Free Trade Agreement, which is very important to our part of the country. And given the present economic environment and political climate, freer trade--even though we would all agree that it's desirable--is becoming a harder sell politically. That's not so much true in our area because our business people expect to benefit disproportionately from NAFTA, but I hope that all of you throughout the country will give it a plug in your speeches and in your publications and your economic education efforts. I think it's

very important to the near-term and long-term health of the economy. Prospects are pretty good for continued growth in our District based on the confidence that we hear increasingly expressed in the business community and based on our leading indicator indexes.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. Our District economy is growing, but it's still very slow and somewhat mixed. As others have mentioned here, the agriculture area is subject to some uncertainty due to the dry weather. Also, in our area cattle is a very important industry and, although prices are up, there's a lot of uncertainty there. With this environment of uncertainty there has been some very reduced activity in the agricultural sector; in fact our banks' loan-to-deposit ratios in that sector are at their lowest levels in some time, at just over 50 percent. Manufacturing is mixed to flat, I would say. In the aircraft industry there has been some slowing in shipments recently. And in our auto industry, there has been activity but no real expansion in activity, with some modest gains overall in employment. Our energy industry is suffering very significantly. The level of drilling activity in both oil and gas is at post-World War II lows and [the outlook is] not at all good. Everyone one talks with is blaming it on some of the regulatory restrictions as much as on some of the economics, so that is a very sore point in our area. As to the construction side, construction activity in the residential sector has been very high but our anecdotal information now suggests it is backing off from those highs just as you hear is happening elsewhere.

On the commercial real estate side, there is some increased absorption but still enough vacancies out there that we're not seeing any significant pickup in prices. An important factor we've heard in very recent conversations is that in some of our areas the lease rates remain extremely low. And until those pick up we don't really expect that the price levels are going to pick up at all. That includes Denver, where there has been some activity; still, lease rates are very favorable, and though we have had some sales we're not seeing a real pickup in the prices or bidding to any large extent.

On the national economy, our projections are very similar to those of the Greenbook. There are some differences. We are looking at a little weaker consumer spending and residential investment, and a little stronger government spending and stronger still business fixed investment. On the inflation front, we're very much in line with the staff forecast; we may be a little more optimistic on inflation but not enough to make a real difference overall at this time. Thank you.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I'd like to make two general comments; the first relates to M2 and how to interpret that. One comment that I don't think has been made in the comments we've heard today is that some work we've done would indicate in our view that the relationship of M2 to nominal GDP is stationary only over very long periods of time. I think we're talking five or more years. It follows from that that the ability to predict velocity shifts in the short run is not at all good. Therefore, the idea that--and I'm not suggesting anybody has advocated this--M2 can be used as a short-term targeting tool for

monetary policy, as far as I'm concerned, just doesn't fly. To some extent, I think the emphasis that we have placed on that target has perhaps in a public relations sense painted us into a corner somewhat, and there are probably ways to deal with that by citing some other factors. But the fact is, when push comes to shove in the short run, I would have a hard time justifying a policy action aimed at trying to get M2 into the target range or to some point in the target range for these very reasons I've cited. Obviously, it's better to be in the target range, but if we have questions about whether M2 is [outside the range because of] technical or fundamental factors--and we're pretty confident there are some important technical factors--I would be inclined to explain those and take the heat for missing it. That's the first point I wanted to make.

The other point, which relates generally to the economy, is that we're a year into the recovery now and my sense is, both in terms of the statistics that we see and what I hear anecdotally, that the pace is picking up. Obviously, the recovery is not in line with other post World War II recoveries, but I think it's well in place and picking up. And I'd say that in general other forecasters are probably looking for the best inflation performance in 1992 with some pickup in '93. Now, we all know what the Board staff's forecast is; but even there Mike has seen fit, based on some recent information, to ratchet the forecast up. And I think we've seen from time-to-time, not at the present moment, in the bond market and perhaps to some extent in the foreign exchange markets some questions about the Fed's resolve with respect to long-run price stability and so forth versus short-run fine-tuning of the real economy. The point I would make with respect to that is that I don't think one can get terribly alarmed by anything we've seen in those areas as yet, but once it's clear in those indicators that we've lost credibility it's very hard and very expensive to buy it back. So, in my view we want to stay ahead of that. All of this is to suggest that I think the time really has come for us to focus not on when we're going to ease next but on when it is we are going to tighten. And my final point on credibility is that while words can help, this is one of those times when people are going to watch what we do, not what we say.

Just very quickly on our District, the picture is the same as I presented last month. We are continuing to have moderate growth. On the employment side, [growth] is coming primarily in the services area. Manufacturing is still sluggish. In particular, strength on the nonmanufacturing side is coming in construction; we have residential and nonresidential contracts up 20 to 30 percent from the prior three-month period. My sense is that in the nonresidential sector it's primarily in the industrial area. I don't have any sense of [much] going on with transactions in office buildings and so forth at this time. Finally, just the tone of the comments I pick up is improving. The anecdotal information seems to confirm this picture we've been looking at for some time in terms of improving economic activity in our District.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Thank you, Mr. Chairman. I must say that over the last six weeks or so I have become more of a cautious optimist about what is going on in the economy. It seems to me that these most recent figures on consumer attitudes forebode a much brighter outcome.



Consumers have been gradually reducing their debt load, which I think has helped to improve their feeling of confidence as reflected in their attitudes toward housing, auto, and appliance acquisitions. At the same time, long rates most recently have shown some slight improvement, and we have some reason to believe that that may now continue. The banking system I believe is substantially recovering from the problems that have plagued it the last four or five years. Operating margins, net interest margins have improved; earnings have improved. The restructuring of many of these institutions toward greater efficiency is beginning to take hold. Balance sheet values are certainly much sounder and much closer to reality today than they have been, although in some isolated instances there is still a ways to go. Clearly, they have better access to the capital markets so that the capital shortages that still exist certainly can be dealt with much more easily now than they could have been up until this time. I believe that these bankers are still cautious lenders. I think the burns haven't completely healed and the memories about recent events will be long. But I believe that they are now able, and to some extent willing, to respond to legitimate demands. So, I think the banks will be able to finance whatever level of recovery is coming along.

Corporate conditions, I think, have improved significantly. Again, restructuring has had a very salubrious effect on corporate balance sheets. Corporations have eliminated in the process not just people, but some poor businesses. The divestiture or even shutting down of businesses that have been otherwise a drag bodes well for future profitability. Also, the reduction in debt service has been appropriate. They have done this through much more favorable debt financing and by replacing debt with equity. So, I think the general tone there is better and that's why I'm a bit skeptical about the 1993 projection for corporate profits. I think there may be some fundamental improvement there that can be very helpful.

Having said all that, I think the progress on inflation is disappointing in view of the length of time that we have had a fairly restraining hand with regard to policy. And it's particularly disappointing and puzzling that the figures are better when you leave food and energy in right now than when you take them out. They've always been seen as the wild cards.

It seems to me that the Greenbook forecast is a reasonable one. My own would be somewhat more optimistic but only marginally. But I don't think we should be discouraged by a modest growth rate in the GDP. I think it is fully consistent with a continued move toward price stability, which should be our objective. We must be sure to stop pouring drinks while everyone is still sober, and probably the next policy move will have to be toward restraint rather than ease.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Thank you, Mr. Chairman. To start with the District, I'd say the New England economy remains lethargic. It's no longer in a pronounced decline but it really has little momentum going in the opposite direction. It's interesting actually to hear Bob McTeer talk about things being more encouraging in Dallas. We've said that things are more encouraging in New England because on a moving

average basis the decline in employment last month was only 2 percent at an annual rate. But we do think things are close to the bottom.

As far as different sectors go, after a fairly good opening of the year, the retailers now seem--I've talked to some of them myself--a fair bit more concerned. In housing, we don't know if this has to do with weather or what the story is, but there does seem to be--"softness" is too strong a word--an attenuation in the growth that we've seen in housing. It had done quite well; now, it's slowing off again, which is why I asked the question about interest rate sensitivity. And, of course, the expected depreciation is a very big issue in New England.

As far as your question on real estate goes, it's a very interesting pattern here. It depends a great deal on the sectors that one looks at. In the pure office space sector, absorption now is about flat; we don't have negative absorption any more. I hope none of you has too much money in TIAA-CREF because you're going to take some loss in the Boston market. We have an interesting phenomenon going on with the zero absorption; people are trading up at the same price to higher quality space and there just isn't going to be a market for some of the B+ quality space to [say nothing about the] C space. The retail market is really quite interesting in that it shows that real estate is very local. We have a couple of new small shopping centers being built with new retailers coming in at the same time that we have great excess capacity in retail space elsewhere. To come back to something that Jerry Jordan talked about, the one area where there has been some success in auction type sales has been in the condo market. It hasn't held true in the commercial or the retail or office building sectors, but in the condo market finding a price floor has produced the same sort of pattern that Jerry talked about for some of the markets.

We hear less about the credit crunch than we did a year ago, although I think it's still somewhat of a residual drag. There are some tentative signs of a pickup in lending. Some of these companies that John LaWare talked about are in a better competitive position. Some of our institutions have raised capital and there's nothing like a little competition. We're hearing now about beating the drums of who will be the next aggressive lender.

As far as the manufacturing sector in the region goes, that's mixed. Well, that's true obviously of anything that's tied to defense, and we have a lot that's tied not only to defense but to commercial aerospace, which is also somewhat weak. Until recently, autos and housing-related manufacturers had been doing relatively well. An encouraging sign we just had is this: Digital puts on a show every couple of years where they bring people in from all over the country. And actually they sold more equipment on the floor there than they expected by a fair amount, though other manufacturers we talked to are concerned about seeing their backlogs decline.

For the U.S. economy overall, I have little reason, as usual, to disagree with the Greenbook. I can quibble on the unemployment rate, which we think might be a little higher in the out period than the staff has it, but the difference is minimal. Also, I reflect everyone else's concerns about disappointment on inflation. Looking ahead, while I don't have any disagreement with any individual

forecast--and this doesn't hold true just for the Greenbook--in most forecasts there has been a serial correlation going out two to three quarters, and we've all been overly optimistic. Again, it's not a criticism of any individual forecast but it makes me wonder why that has been the case and whether it's more inertia and whether there has been more of a shock to the economic system in some confidence sense [than was anticipated]. And it makes me worry, particularly since we're counting a bit [on] even the relatively anemic growth we see in this quarter, [about] what is going to happen to PCE in the durables sector and autos and in final sales generally. That leads me to the view, even if I agree with this [forecast] that the probabilities are fairly evenly balanced on the outlook, that I'm not sure the risks are relatively evenly balanced. The reason is that if we were to get another negative surprise regarding the pickup, I'd be quite concerned about the impact that could have on confidence and for building in this inertia in terms of trying to get things moving. Another part of that, though, is that I don't think there's very much we can do about it. Just looking at what is happening in several asset markets, there is a potential for disappointment, an incongruity between the rate of growth we expect in the economy and some asset [market behavior], particularly in my own mind the securities markets. Now, I'm not saying it's our role to ratify it, but I think we have to take into consideration that that's a potential disappointment that is going to come along and is going to have a negative pull on the economy.

I agree very much with Tom Melzer's comments on the Ms. I've always been pretty agnostic about that. But I think we're in this difficult position in that we've said that we're watching the Ms, and I worry about a situation in which we might have a combination of the economy coming in soft and the aggregates being out of their ranges. I'm worried about that even in a world in which we do want to get to lower inflation. I think we all agree on [the desirability of] getting to price stability, but the problem I have is that we could see something snap in the process here that would lead to protectionism, fiscal policy [moves], and other kinds of things that would make it more difficult in an ironic way for us to get to price stability. At some point I think we're going to get some happy surprises in terms of this correlation of the forecasts, and I'm looking forward to that and will be happy to deal with those when the time comes. Unfortunately, I have no reason to believe that there should be any bias toward a happy surprise more than a continued negative surprise at this point in time.

VICE CHAIRMAN CORRIGAN. Thank you, Dick. Governor Angell.

MR. ANGELL. I've always been very sympathetic to watching the monetary aggregates, and I believe that they really are a very [integral] part of our fundamental program against inflation. But as you know, from time-to-time I have looked carefully at other means to determine whether or not there is a shift in demand for any one of the aggregates. And I've concentrated on commodity prices as probably being the most sensitive in showing whether or not monetary restraint truly is in place or whether [policy is] characterized by monetary ease. At the present time commodity prices, although they have the reputation of being very volatile, seem rather stable to me. If there's any trend it's probably slightly upward but not as strong as ordinarily would be seen in a recovery phase. So, on the surface that doesn't seem to show great inflation signals out ahead.

Gold prices probably need to be looked at some, particularly since there are those who view the declining gold prices as [unintelligible] into growth rates. This thesis holds that M2 growth has been very slow and it shows up by following gold prices. I think it's important to recognize that gold is always [unintelligible] in regard to its monetary properties and for a long period of time gold prices were lower than market forces would have dictated due to the fact that many governments wanted to sell out their gold stocks. Consequently, gold stayed in the [\$340] range a lot longer than it otherwise would have. Costs of production in many places in the world were way above that, and so there was no technology going into that industry. When gold prices are running up so the optimists believe the price is going to be in the \$500 range, then you get a surge of technology into that industry. And it seems to me we're experiencing the impact of that surge. Indeed, the surge has been primarily a U.S. surge. In the United States, we've had during the 1980s over \$8 billion of investments in gold mining, just as an example of what technology can do when the price outlook is favorable. That has resulted in a very quick [advance] for the United States from nowhere in the park of gold producers to the number 2 position. Indeed, production in the United States is now above 60 percent of that in South Africa and very well could exceed South African production before the decade is over. A new technology involving heat-bleaching means that the cost of production with that new technology runs closer to \$250 an ounce rather than to \$350 an ounce. When you look at what is happening in Chile and other areas around the world, it looks as if this same technology probably is catching on in other places. One would then expect the price of gold to fall closer to its cost-of-production in the marginally efficient areas. I give this explanation I suppose partly because I've begun to receive "hate mail" [accusing me] of having been unresponsive to falling gold prices and [saying that I] should have been an advocate of monetary ease based upon that.

CHAIRMAN GREENSPAN. How did you answer the question?

MR. ANGELL. Well, I answered the question by saying that I have never supported \$350 an ounce gold; people just think that I do.

MR. LINDSEY. I thought it was in support of gold \$10 below wherever it is now!

MR. ANGELL. I see. Well, it's all right to be in that direction. It seems to me that we ought not let the current information on inflation, disappointing as it is, cause us to move to precipitate action. It seems to me that sound money is something we accomplish over a long period of time. But it does suggest to me that the level of restraint that's out there is probably not as great as many have thought it to be and that we do need to be in a posture of maintaining constant restraint over time until we get the producer price index numbers behaving better than they're behaving. There's no reason for us not to get inflation in the goods sector quickly down to zero. And I think if we maintain the kind of posture that's needed, that will occur. I do think there will be a time lag between [that and] the adjustment of inflation in the services sector to zero.

Looking at the real economy, the Greenbook forecast is one with which I would have no strong arguments. I would expect exports to be somewhat stronger than in the Greenbook and I would expect

productivity gains in 1993 to be more of a continuation of the patterns seen in 1992. I would consequently expect corporate profits to be in range similar to what John LaWare has outlined. It's a very disappointing period in regard to those inflation numbers. I think we do not stand ourselves in good stead by representing too strong an interest in movements in the real economy from quarter-to-quarter.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. In terms of the national economy, our forecast is very similar to what Mike talked about earlier today. And as he indicated, and others have also, I also have a feeling that the risks are distinctly more balanced. That seems broadly consistent with the kinds of things one hears on the anecdotal side with this nagging question about sustainability, which is a question that nags at me a little too. But in talking with business people, especially to the multinationals, most of them are now saying that things are better and a few are saying that they're better with emphasis. And that, I think, is different. Several people have cited exports; again, the anecdotal comments from these companies are quite consistent with that in terms of being surprised at how well their export activity is holding up. And as Ted or Mike or somebody said, a lot of it is to Latin America, Asia, Eastern Europe, and Japan.

On the commercial real estate question, I have reported over several meetings a sense that the decline in prices in the New York area had abated and perhaps even bottomed out. And I think I mentioned at least once that there were very specific transactions, quasi-auctions, for very large buildings where they had cleared the market. I know of at least a couple of cases [of property] sold by banks where they cleared the market at prices that exceeded the charged down level on the books of the banks--in other words, the provisions which they had taken for [loan losses]. Now, at least in the New York area--and someone may have touched on this when I was out of the room--I think the Olympia & York situation does cast a bit of a cloud over that. Their total real estate in New York is enormous and I think it's a little too early to make a judgment on that. But that could represent a further dent here, certainly in New York. The jury is very, very much out so far as how that is going to play out. As I said, that introduces a new element of uncertainty.

Looking more broadly--a number of people have already touched on this and I don't want to beat a dead horse--let me comment on this inflation outlook issue. If I look at the 1993 forecast that Mike has, 3.2 percent I think in the CPI ex food and energy, I sense that that is a reasonable number. I think it is going to be darn hard to do better than that, and it's not so hard to see how we can do worse than that. Again, and John LaWare touched on this, in a broader perspective of what has happened going back to 1988 in terms of the CPI ex food and energy, we've essentially gone out through 1993 in the forecast from a 4-1/2 percent core inflation rate to 3.2 percent. So, we will have brought about, if you will, a 1.3 percentage point decline in core inflation. And if you look at it in terms of cost, it's five years of cumulatively very modest growth at best; the last two years, 1992 and 1993, are a little better but for the five years as a whole, it's not much. Now, if you look at M2--and I agree with a lot of people in that I think that's not the right thing to look at--we will have had seven years of distinctly modest M2 growth going out

through 1993. What I keep coming back to here is that no matter what we look at we also have to look at what is underneath, such as compensation costs, productivity, and unit labor costs, and there's a lot of slippage there. But when you go underneath, even if you look at it simply as arithmetic and not as economics, it's still hard to see--at least I find it hard to see--how we're going to do a heck of a lot better, if at all better, than that very costly process that we've seen over the last five years. I don't think that should alter our commitment to work toward that goal of price stability, however that's defined. But the evidence is rather overwhelming that this is a very slow, costly, tough, grinding out process. I don't see much that's going to change that.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. I guess I have nothing especially useful or new to add. I generally agree with a lot of what has been expressed. I think we have a weak recovery. And as I understand the Greenbook, the recovery is projected to be fueled by growth in consumption driven by growth in income. The only difficulty is identifying where the growth in income will come from. I guess the answer is sort of everywhere and nowhere. Everything grows a little and the whole juggernaut gradually moves forward and momentum will carry us. It seems to me that the concern about sustainability is really the fact that we can't point to an engine driving this. Perhaps we thought it was going to be residential housing; I think there's evidence that the steam is coming out of that. And there are still concerns about losing steam especially if the first-quarter growth rate turns out to be 4 percent and the second quarter is 2 percent; that might have some impact on confidence. It is encouraging that consumer buying attitudes, as John LaWare mentioned, in all three of the major categories of the Michigan survey have steadily strengthened. But the overall confidence index is still below where it was in the summer through September, though that's still progress. When I look at the picture, I don't see much that is robust on the real side or the financial side, but there is relatively broad-based progress in terms of moving forward. And, with the ample slack in production resources, echoing a little of what Jerry Corrigan was saying, I don't see too much risk on the up side. The economy still has an adjustment to make on defense spending, in state and local governments such as California, and in commercial real estate; we still have some further financial adjustment to go as well. I think Bob Parry is probably right: The economy could easily be stronger with growth above 3 percent, but the consequences of that sort of upside risk would not bother me much.

It is discouraging that after the long period of slow economic growth and many years of slow money growth we haven't made more progress on inflation. I should point out that I think we've only had significant slack in the economic system for a little over a year and a half now. When I came on the Board the unemployment rate was 5-1/2 percent and capacity utilization was 85 percent or higher. It is also interesting to note that inflationary expectations as measured by the Michigan survey in the near term continue to come down gradually; but it is still true that core CPI is 4 percent, where it has been for eight years. I think it is probably deeply embedded.

On the financial side, short rates in real terms look low now and less low for lending to bank customers because the prime rate is

6-1/2 percent; it still has the margin built into it and consumer rates have that margin as well. So, I think we still have something of a dichotomy where I see easy conditions on rates in the financial markets and somewhat tighter conditions in the intermediated markets. I think it's fair to say that the yield curve is still very steep, and it's not clear to me that this is driven by inflationary expectations. It's pretty clear that people are betting big money that rates are going to be a lot higher in a year or so. And I think it's not at all unlikely, even if inflation doesn't re-emerge when credit demands re-emerge, that we will be joining the global village of high real rates just as everyone else has high real short-term rates. We're really the outlier in the world, and it's primarily because we have such weak loan demand.

As far as M2 is concerned, I'm certainly not here to praise it; I thought we buried it last summer but someone dug it up again. I'm fully prepared to accept the notion that the traditional relationship between M2 and GDP has been distorted by weakness in the financial system associated with restructuring. Just because the traditional relationship is altered does not mean that a sharp deceleration of M2 conveys no useful information. Obviously, I'm a bit biased by this coincidence last summer. We've only had a handful of months in recorded economic history where M2 has been negative or zero. We had one last July and then August and September were essentially flat. In the fourth quarter, we did get some deceleration but now in March and April it is negative. Clearly, the traditional relationships don't hold, but dramatic decelerations still make me nervous. Now, since the RTC has shut down temporarily, M2 should snap back smartly, presumably. And we're over the tax season. I don't know how much comfort to take in Tom Melzer's observation that the relationship holds only over a long period of five years. I tend to conclude from that that we're going to have five years of stagnation some time in the future. The only other thing I would add to the M2 debate--other than saying that it's a mystery and I'm less concerned with it being low than with the deceleration--is that it's not only M2 that is weak and not only M2 and M3 that are weak but L is weak. It's not just intermediated liabilities that are weak. Domestic nonfinancial nongovernmental debt is, I would suggest, about as weak as it has been in any period we've recorded. Even when you throw in the government, who is usually a dependable borrower, it still looks relatively weak. So, my view is that with projected GDP growth in the second quarter of 2 percent, with 1 percent of that coming from autos and 1/2 percent from inventories, without a dependable engine to keep the momentum going, with this weakness in credit pretty much across the board, and less concern for capacity to overshoot at this stage, I still think the most prudent stance is to remain sensitive to the risks of losing momentum.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, we are now five months into the year. At the very first of the year, there was an extremely strong consensus that [economic activity] was going to start out very slow and then begin to gain a bit of momentum in the second quarter and be much stronger thereafter. A contrariness instinct at that time was to ask the question: "Where is the surprise going to come from?" because the consensus was too strong. There was some indication that the surprise might be on the up side, and by the time we met in March it

was fairly clear that we were getting an upside surprise. News over the last six weeks has been that it looks as if the first quarter was even better than [expected]. So, it seems now that the question has shifted just a little to: "Is what we've seen so far something of a false dawn or are we going to continue to be favorably surprised on the up side?" There is the usual array of factors and we've certainly been through them this morning. On the concern side are the aggregates and the fact that housing has again slowed a bit. Several sea anchors are still [restraining growth]: commercial real estate, the defense slowdown, net exports, and the disappointment we all feel in the year so far with regard to the CPI ex food and energy. As I look at that array it seems to me that people might say in the market that most of that has been there for a while. And while it's still there it has had its impact.

On the other hand, I think one can say that there may be, and hopefully are, a couple of emerging trends on the favorable side that haven't really had a chance to catch on yet. One may be employment growth. I've been taught since I've been here that the payroll survey on employment is more reliable than the household survey, and I accept that. But it may be that early in a recovery here we are getting some leadership from the household survey. I wouldn't suggest that employment has grown 350,000 a month, but it may be that the household survey is telling us that [employment growth] is somewhat stronger than we thought. If the household survey is telling us good things, they are coming from the places that traditionally have helped a lot and that is small-business entrepreneurial activity and so forth, [and the statistics] may lag a little [before] the payroll survey picks that up. The other [favorable trend] that may just be beginning to set in is in the area that we've called in short hand "the credit crunch." An array of factors is there. As John discussed a while ago, banks clearly are stronger: Their profitability is up; their liquidity is high; their balance sheets have come back; the loan officers survey indicates that they are getting a little more ready to lend money, and there are indications that that should continue. On the demand side, there's a lot of anecdotal information that small and medium-size business credit demand is beginning to come back. We know that balance sheets have been restructuring generally across the board, and consumers have been very reluctant to borrow; they might come back. So, it seems to me that we could well be seeing an incipient trend toward a better climate for credit extensions. There are some other things, too. The dollar has been on the weak side. We may get a little better [performance of] net exports as a result of that. Consumer confidence is not high but it has been rising steadily, and it seems to me that it's very responsive to employment. And if we do get the good news on employment that I hope is going to come, then maybe that will give a further boost to consumer confidence.

So, I think it's possible to build a rather plausible, rosy scenario here around employment growth and a thaw in credit conditions more than anything else. I'm not buying into that wholeheartedly; there are too many negatives still out there to do that. But I think the odds are improving that real activity is going to continue to improve. And there's a fair to good chance that we can hold policy where it is. I certainly hope so because, if that's the case, I think that improves the chances [for continued expansion] for a while without our tightening too much as the economy strengthens. And the



longer we can do that responsibly the better news there will be over the long haul.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, growing up I never thought I'd be an economist; I didn't know what an economist was. I think my mother is still waiting for me to make something of my life and go to law school! But I always liked math and I liked history and I found them together in economics. And my first comment is on math.

I don't think anyone thinks velocity is stable on a quarter-to-quarter basis. In fact, on a distributional basis using the 120 quarters from 1961 to 1990, there is a 7-1/2 percent chance of velocity being more than 3 and an 18.3 percent chance of velocity being more than 2. And if you use lagged velocity, I have a distributed lag function where the odds are even greater than that: 29.2 percent for having a velocity shock of more than 2 percent. So, I think what we're seeing now is very much in line with historical averages on the up side. One need only to think back to the early 1980s. I wasn't here, but I've looked at the numbers; there was a very strong negative velocity shock on the order of perhaps 2-1/2 or 3 percent a year. So, I don't know if we really want to abandon velocity just because it's unstable on a quarter-to-quarter basis. I agree with President Melzer's comment in fact that it's over long periods of time that M2 and the M2 velocity relationship are stable. Of course, that means that if we're going to have 4-1/2 percent nominal GDP growth and we have a year and a half of 2-1/2 percent M2 growth, that we should be equally comfortable with a year and a half of 6-1/2 percent M2 growth. If one is willing to let [M2 growth] go to 2 or 1-1/2 or 1 percent, one should also be willing to let it go to 7 or 7-1/2 or 8 percent for an equally long period of time on the other side. So, the real question is whether or not we want to use money as a policy variable in constraining [the economy]. The point is that velocity is stable over the long run, so we're going to have a bounceback. Indeed, all the explanations we've heard this morning suggest that that's the case. Don Kohn yesterday mentioned that if we include the yield curve we can explain perhaps a 1-1/2 point velocity shock. I don't think anyone thinks the yield curve is going to remain as steep as it is now. It's going to bounce back and so will velocity. How about the flight from CDs? Well, certainly, it isn't going to go on forever; eventually CDs would go down to zero and then [the decline] would have to stop. My suspicion is that CDs probably will catch on at some point in the future and money will flow back into CDs. So, again, we have to think about the fact that in the long term we have a stable relationship here. M2 growth of 2-1/2 percent is not a long-term sustainable rate of growth. How long we want to tolerate it in the short run is something we might want to debate. But no one says that it's a short-term parameter. That's the math lesson.

The history lesson is one that I was debating about, but my contrariness juices really got flowing. I heard a wholesale abandonment of money here this morning and that takes three [forms]: (1) money doesn't matter; (2) banking weakness is also not a monetary phenomenon; and (3) that one [assesses] monetary ease by looking at interest rates and not money growth. I happen to have these quotes from history; we've been here before. As to the first that money

doesn't matter: These events "shattered the long-held belief, which had been strengthened during the 1920s, that monetary forces were important elements in the cyclical process and that monetary policy was a potent instrument for promoting economic stability. Opinion shifted almost to the opposite extreme, that 'money doesn't matter' that it's a passive factor which chiefly reflects the effects of other forces." That was Friedman and Schwartz. They went on to say that there was a tendency--this is again in the early '30s--to regard bank failures and contraction of deposits "as regrettable consequences of bad management and bad banking practices or as inevitable reactions to prior speculative excesses,"--Where have I heard that before--"or as a consequence but hardly a cause of the financial and economic collapse" of the time. And finally, regarding nominal interest rates, a gentleman named Sprague who was a consultant to the Fed--and this was in February 1931--wrote that the Fed concluded that an aggressive easy money policy was practically out of the question in the United States "for there is no general acceptance of view in this country that additional good loans and additional good investments are available at a lower rate of interest." And continuing on the line that short-term nominal rates are a measure of policy, the Annual Report of the Fed in 1930 said: "The Federal Reserve pursued a policy of monetary ease" in the last year. In 1931 it said: "The credit policy of the Federal Reserve System in the first nine months was directed toward the furtherance of easy credit conditions, as indicated by further reductions in rates on discounts and acceptances." And finally in 1932--this is over a period in which money shrank by a third--"Conditions in the open market for short-term money were relatively easy throughout the year and in the latter part money rates declined to exceptionally low levels." We've been there before. My suspicion is, and my fear is, that we might be there again. I certainly hope not. And finally, this is from the FOMC statement of October 1935 and suggests that inflation is always a fear we have: "The Committee cannot fail to recognize that the rapid growth of bank deposits and bank reserves in the past year and a half is building up a credit base which may be very difficult to control if undue credit expansion should become evident." They were worried about it in 1935.

With regard to existing conditions, clearly we're on a good path. I'm not sure that an easing at this time is the right thing to do, but whenever I see the kind of wholesale abandonment of monetary aggregates that I heard this morning I get nervous. So, I'd rather have the gun loaded, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Phillips.

MS..PHILLIPS. Thank you. I think I'm bringing up the tail end again and I'll keep my comments short. It seems that since I've been here we've been on the cusp of a recovery, trying to get a recovery going. Certainly the signs on the real side are more positive this time; certainly that's what we've heard this morning. I find myself being concerned about and questioning its strength and its sustainability. Some of the sources of strength that we've been pointing to the last couple of months--housing and exports--seem to be fading a bit. And I think it's interesting that no one has really talked today about some of the problems in the economy that we seem to have forgotten about. The first one that I'd point to is the federal deficit, which I think is a continuing drag on the economy. We have talked about the state and local government shortfalls, and I've seen

a few tax increases coming out of some states but not a lot. So, I think we're going to continue to see that as a drag on the economy.

The major area of concern that I would point to--and I would magnify perhaps Dick Syron's [remark] with respect to its potential-- is consumer confidence, which seems to me to be very much tied into the labor market situation. I think the 7.2 percent unemployment rate perhaps understates some of the weakness in the labor market because of the pervasiveness of unemployment through a variety of occupations and the restructuring that is going on in industry. This whole concept of underemployment and downward mobility is continuing to lengthen the period of time it's going to take us to get a real recovery going. Certainly, on the money and credit aggregates, which we've talked about so I won't go into it, I'd agree with Larry: I don't think we ought to abandon M2; we ought to look to see what it's saying at least in part. On inflation, I am concerned that we're still seeing a bit higher inflation than we'd like. I would have to say, however, that we need to expand our research on what zero inflation is. I'm beginning to wonder if we're not getting closer to it than the traditional CPI measure or even the deflator would imply. On balance and in sum, I'm pleased that we're making some progress but the risk of another stall is certainly in the realm of possibilities. So, I think we should be alert to weakness on the real side.

VICE CHAIRMAN CORRIGAN. Thank you, governor.

MR. MELZER. Jerry, I might interject for those who worry about money that from the third quarter of 1987 to the first quarter of 1992, M2 grew at a 4.2 percent annual rate even with all the weakness we've had recently.

MR. MULLINS. So, with 4 percent inflation we're looking at zero real M2 growth?

MR. MELZER. Yes.

MR. LINDSEY. Do you have our average target for that period?

MR. MELZER. No, I don't.

MR. ANGELL. The average target would be more like 4-1/2 to 5 percent.

[Coffee break]

CHAIRMAN GREENSPAN. Not only did that note about the coffee say that the note was an hour and a half late, but I think the coffee probably arrived an hour and a half before the note!

SPEAKER(?). You're right!

CHAIRMAN GREENSPAN. With that, I would like to call upon Mr. Kohn.

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

CHAIRMAN GREENSPAN. Any questions for Mr. Kohn?

MR. FORRESTAL. Mr. Chairman, this is in a sense a procedural question: As I read the Bluebook and the projections for the monetary aggregates, particularly the alternatives, the time frame is from March and April to June. I wonder if we wouldn't be better served in the policymaking decision to have a longer time frame extending beyond June for those projections. We're practically at June now. I assume you have those [longer-term] projections, and it seems to me that it would be better to have a projection out perhaps to the fourth quarter.

MR. KOHN. President Forrestal, if you look at paragraph 15 in the Bluebook, it gives a sense of where the aggregates might come out for the year--1/2 point more or less than for Alternative B with the selection of "A" or "C." We have been going for many, many years with this [procedure], but I agree with you. The reason that paragraph 15 is in the Bluebook is that the effect of anything done in the middle of May probably would be greater in July and August than it would be in May and June, so you do need to be thinking about that.

MR. FORRESTAL. Yes, I realize this is the way it has been done for a long time.

CHAIRMAN GREENSPAN. I think there is another problem with that in the sense that if we introduce a longer-term time frame for money supply where it tends to override the targets that we came out with at the beginning of the year, what we're in danger of doing is having two forecasts. It's essentially the targets on the one hand and a specific one on the other. In general that might be fine if the second forecast is close to the middle of [the target range]; but if it is not, we're raising an interesting question about what it is we're trying to do. It's almost as though we're trying to find a degree of accuracy that I think isn't even remotely possible. I would be more inclined to the argument that we drop that forecast than extend it too far because our ability to forecast is awful.

MR. SYRON. You raise an interesting question--maybe not facetiously--about dropping it.

CHAIRMAN GREENSPAN. I would prefer to drop it. I have not given it any thought until this minute, but I ask: What does it do for us? What would happen if we were to drop it?

MR. KOHN. Well, I think the issue would be how it feeds in. Perhaps it's an issue that really should be discussed in July because it's a question of having annual ranges and where the aggregates are [currently] relative to those ranges or whether you care where they are relative to the ranges. If you were to drop the--

CHAIRMAN GREENSPAN. Could you draft us a memorandum? Could you circulate to the Committee the pros and the cons?

MR. KOHN. Sure.

CHAIRMAN GREENSPAN. Include President Forrestal's recommendation. That ought to be addressed.

MR. KOHN. Certainly.

CHAIRMAN GREENSPAN. There are a lot of anachronisms sitting in our directive. Every time I read it I'm waiting for somebody somewhere to write a fun piece in some newspaper about the Federal Reserve directive! I hope Bill Saffire of The New York Times doesn't get hold of that!

MR. KELLEY. How about Art Buchwald?

CHAIRMAN GREENSPAN. Either one of them!

MR. ANGELL. You know, it's written as it would be written if we were going to publish it the next day.

MR. SYRON. And as if we [know] all of the structural shifts in these relationships and how tight they are.

CHAIRMAN GREENSPAN. Yes.

MR. MULLINS. He might also compile our estimating accuracy over the past few years!

CHAIRMAN GREENSPAN. That's a mean thing to say!

MR. KOHN. We do actually do that as an internal matter from time to time.

MR. LINDSEY. Very internal!

CHAIRMAN GREENSPAN. Any other questions for Don?

MR. SYRON. Just a quick technical question. Don, you mentioned that the lags had to do with the tax payments and some of the other things that we think have distorted these [numbers]. Could you quantify the lags from the inside to the outside of the deposits?

MR. KOHN. Well, on the taxes, I certainly expected the sort of snapback we saw. [Our analysis suggested that] those checks would be clearing in late April and the first half of May--

MR. SYRON. Right.

MR. KOHN. --and that's when one would expect to see a snapback [in money growth]. So, the fact that we had a \$9 billion increase, or whatever it was, in M2 last week and that we have another increase in the \$4 to \$5 billion range coming for the week of May 11th is not surprising. And it's heavily in the M1 component, which is where the transactions money is, where you'd expect most though not all of the tax payments to be made. So, I'd expect the tax [effect] to play out pretty much by the second half of May. The other [factors] I think are much harder to explain. The [effect of] RTC activity is a bit contrary to common sense. We have always found, though, that there were some lags in that. That is, RTC activity one and two months ago was having an effect on M2 growth this month. Now, I think that's partly because it does take a while: peoples' depository relationships are disrupted; they get notices that their rates are reduced or a new bank has taken over and it takes them a while to react to that and to reconsider their portfolios. So, perhaps it's not that contrary to common sense, but there is a little

lag there. So, given the lack of RTC activity after about the second week of April or so, we probably will begin to feel that more in June and moving into the third quarter. And on the other one, the interest rate [effects], the lags are of course even longer so that they can play out over a longer period of time. We have by the way, President Forrestal, about 3-3/4 percent growth on a quarterly average basis projected under "B" for the third quarter and then 4-1/2 percent for the fourth quarter. So, we would have a strengthening in the third quarter, presumably.

MR. SYRON. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. To catch up a bit with you on where you are compared to where you thought you were: I don't know what you were looking at in terms of alternatives in your midyear review last year but you mentioned an easing in policy since last summer. If at that time you had run your model contemplating a drop of 200 basis points in the funds rate over the next nine months, what would you have been projecting for the Committee in terms of monetary growth?

MR. KOHN. I'm sure I would have been projecting several percentage points more than we had, but at the same time we did embody in the projections to the Committee last year and in February of this year an expectation of downward shifts in money demand. So, I don't think we would have been as far off as you might imagine just from feeding that [funds rate decline] through because we were aware at the time that things were out of kilter relative to the standard models. We allowed for that; last February we were predicting only 3-1/2 or 4 percent [M2] growth for 1992. So, we had allowed all along for some slippage there. But I'm sure we would have been predicting probably about 2 percentage points more--maybe instead of 3-1/2 percent more like 5-1/2 percent for 1992--if you had told me in July that we were going to have 2 percentage points lower interest rates.

MR. JORDAN. With your past experience with the model, what is the probability you would assign of an offsetting error going forward? Is that a tendency you have any confidence in?

MR. KOHN. Well, there used to be, but I don't have much confidence in that right now given that we've had a string of about eight shortfalls in a row counting the second quarter of this year. A couple of years ago I would have said that I'd expect some offsetting errors and come out about right. But I don't expect that now. We are not projecting an offsetting error in our projections of 3-1/2 percent for 1992 and 4 percent for 1993 for M2 growth consistent with the Greenbook GNP; we do not have offsetting errors built in. We have continued increases in velocity. We do have a fading out of some of the shift that's occurring; instead of continued downward shifts we have it fading out gradually.

MR. JORDAN. Okay, that answer suggests a one-time level adjustment on M2, a mirror image of what happened in 1983 when MMDAs were introduced.

MR. KOHN. Right.

MR. JORDAN. We got double-digit growth of M2 for about a year. We all recognized it as a shift of the level and then resumed [with] what a model [would predict] afterwards.

MR. KOHN. Right.

MR. JORDAN. Is that the way you would characterize this period?

MR. KOHN. Well, no, in the sense that in 1982 one could identify a specific deregulation event. We knew the MMDAs were coming. We actually surveyed people to find out what they were shifting into NOW accounts and whatnot. In one sense you're right: If the shifting stopped and it was just a level adjustment, that would be fine. I'd have more confidence in that if I saw the shifting stop. But in an underlying economic sense, I think a very different kind of thing is going on. One can't identify it so strongly with an external deregulation or technology change as we had with M1 in the mid-1970s. It's something much deeper in the intermediation process and I think harder to analyze.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. What's the sample period, Don, over which you estimate your standard model?

MR. KOHN. I think it's about 1963 to 1986. Is that right, Dave?

MR. D. LINDSEY. I think it goes up to 1988 now.

MR. KOHN. It's the same model, however, that we used in the conference we had in 1987 on money demand.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Don, in your comments about the structure of interest rates and the yield curve, I don't think I heard you say anything about the supply factor and the impact that has on rates. Is that in your mind not an issue?

MR. KOHN. Well, I think it's a smaller issue than expected in increases in real interest rates because of where we've driven short-term real rates and perhaps inflation as well. I tend to discount it to a certain extent. On the supply, one thinks of not only government but even more particularly corporations and households shifting way out on the yield curve. On the other hand, we have had the households supplying the funds in some sense through shifts into bonds and mutual funds. It probably had some effect but a small one relative to the other [factors], in my judgment.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Could I follow up on Jerry Jordan's question? At what point do you predict that the leveling off of velocity will occur?

MR. KOHN. Well, in terms of our models we actually have the demand shift pretty well dying out by next year. We do have an increase in velocity next year on the order of 1 percent. We would view that partly as still a working down of some things like savings accounts and NOW accounts, in our models anyhow. And I think that will probably be true in real life as well. Rates on some of these types of accounts, like NOW accounts and savings accounts, will continue to drop very slowly over an extended period of time in response to the lower rates. So, we will have an increase in velocity next year but not really a money demand shift.

MR. LINDSEY. Could we call that a continuing response to the steepness of the yield curve?

MR. KOHN. No, that [effect] sort of dies out. The way the yield curve plays out in our model is that it is affecting [M2 growth] this year and is rather neutral for 1993. It's not affecting it much one way or another.

MR. LINDSEY. What happens when the yield curve starts to level out?

MR. KOHN. Well, assuming that the CD rates then come into closer alignment with market rates and market rates level out, then I'd expect some reflows into M2.

CHAIRMAN GREENSPAN. Any other questions for Don?

MR. MCTEER. On the question of resumed bank lending, have you taken much account of the risk-based deposit insurance as well as the risk-based capital coming into view?

MR. KOHN. Only a little, I think. We implicitly had a sense that banks would not be actively pursuing deposits in order to make loans in part because the cost of making loans is going to be higher. We have not specifically factored in the risk-based premium. We had, I believe, a notion that premiums would be higher; whether they would be risk-based or not is another issue. That may be more an issue of distribution of loans throughout the banking system rather than the total.

CHAIRMAN GREENSPAN. Further questions? If not, why don't I get started. Listening to this general conversation, it creates a somewhat better outlook than I was perceiving as I walked into the room--not a great deal better, but enough to be somewhat noticeable. The general consensus around here, which is clearly supported by the data, is that the economy is moving forward on a fairly broad front but that nothing seems to be moving very quickly. There doesn't seem to be significant, outsized momentum in any sector, but it does seem to be gradual and pervasive across a fairly broad [spectrum].

The crucial question, however, is how fast [the expansion in the economy] really is. I think the issue that Mike Prell raised with respect to the first-quarter GNP problems is a clear indication that there is something peculiar in our data system. There may be something to the argument that the payroll series could be more deficient this time than usual. The general argument that we all can make with respect to month-by-month changes in employment is that the



standard error of the employment change in the household series is very high. It isn't all that high if you take a time frame of four, five, six, or seven months, average two or three months on one end and two or three months on the other, and calculate the standard error of that change; it's obviously very substantially lower. So, it's hard to believe that with a sample of 60,000 [in the household series], with some historical parallelism to the payroll series, that the argument has to be that the payroll series is really being representative and that the man-hour data that are implicit in it are the best indicator for industrial production because, remember, industrial production is weaker than the GDP. Obviously, if we decided that the household payroll series was accurate and built up the gross domestic product side with those data, then the statistical discrepancy, which is the problem with the first quarter, would narrow very considerably. And, obviously, what you would get is a significant rise in the saving rate in the first quarter which, of course, is where the discrepancy change gets offset in the accounts. When you look at that, you ask if it is possible that the economy is really growing at 3-1/2 to 4 percent [and] that we have a saving rate which suggests that there is actually room for consumption to move faster than income; that is sort of a scenario that suggests there is more buoyancy in this outlook than the first-quarter data show. The truth of the matter is that I'm not sure anyone can judge that. The anecdotal evidence raises questions as to whether the economy has anywhere near that type of momentum. Even though the orders data in manufacturing look somewhat better, they are not consistent with the type of significant rise in employment in manufacturing that one must presume would be part of the acceleration in household employment of the size or order of magnitude that we've been seeing in recent months. I conclude that we're probably doing somewhat better in employment than the payroll series [indicates] but far short of the household series [increase] in that the economy in the first quarter was fairly good.

The only question I would have with it is whether it is too much too soon in the sense that rather than going into the second quarter with inventory liquidation, we're going in with very modest liquidation and with upside momentum. If one looks at the data as they are materializing with respect to auto sales, starts, and the like, they don't suggest a really robust second quarter.

It also looks as though we are financing this recovery very heavily internally. If you look at the household sector, for example, there's very little borrowing. That essentially means that both gross asset expansion and gross liability expansion are very significantly below normal. That is another way of saying that M2, which is on the household asset side, is exceptionally slow and that the slow borrowing, with everyone financing internally, is an element of risk aversion. Clearly, that has also been the case, although I suspect to an increasingly lesser extent in the corporate sector where one must presume, if these numbers are correct, that a very significant increase in cash flow is going on and that even though we have some fairly heavy borrowing externally a very large amount of financing with internal funds is going on pretty much as usual.

So, this is in a way an odd sort of recovery, one that we've discussed at length in connection with the question of balance sheet repair, which is another way of saying that a significant amount of

cash flow is going to pay off debt rather than going to the consumption of goods and services or investment. The outlook does not seem to have changed significantly from the last time we were here when there appeared to be some form of financial ceiling on the economy basically represented by the balance sheet pressures and essentially reflected in the fact that every time the economy seems to pick up, long-term interest rates seem to go up. What we have learned apparently is that that is having an effect on a number of areas, very specifically on the housing area, which leads me to conclude--pretty much as I have been concluding since the beginning of the year--that the crucial statistic in the outlook is nominal long-term interest rates. To the extent that they have a significant effect in the housing market and the turnover of mortgages, refinancing, they have been a critical factor in the general forward thrust of the economy.

I think we're also learning that the inclination at the long end of the market for rates to move lower with lower federal funds rates is increasingly dubious. While I must say that I can't give a persuasive analytical argument at this particular stage, I nonetheless would be willing to put money on the table that moving the fed funds rate lower right now would not bring a lower long-term bond yield. However, that may not continue to be the case. As a consequence of that, I would be disinclined to try to move the funds rate lower now, but if it turns out that at some point it begins to look as though we might be able to prod the long-term rate lower were we to move the funds rate, I personally would be more inclined in that direction. Frankly, my overall view is that we are probably more likely as a Committee to be moving to lower rates than to higher rates in the next several months. The next move is more likely to be down than up, but I don't think the odds are skewed enough in that direction to argue in favor of an asymmetric directive. I must admit that I don't have any strong feelings personally either way. I would be somewhat inclined toward symmetry if for no other reason than that in listening to the tone of the individual District discussions, things are somewhat better than I would have suspected; but I could live with an asymmetric directive. In either case, I would argue that we should adopt alternative B. I would prefer symmetric but could very easily go with asymmetric if that's what the Committee wants. President Parry.

MR. PARRY. Mr. Chairman, I would strongly support your recommendation. It seems to me quite likely that the economy could be growing at a rate of 3 percent over the next six quarters. At the same time, all of our forecasts are showing that inflation is not going to show significant improvement. In that kind of environment and with those kinds of prospects, I think it would be very desirable not to change policy and also to have a symmetrical directive. I might also point out that if we get a very significant upward revision of those first-quarter data and the next thing that hits the financial market is the fact that we had an asymmetric toward ease directive, I don't think that would be received very favorably in the financial markets at all. So, I believe the case for a symmetric directive is quite strong. Thank you.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Mr. Chairman, I could support an asymmetric directive if it were toward tightness and I could accommodate myself

to a symmetric directive as you have suggested. It seems to me that we do encounter some likelihood over the coming period that the fed funds rate might need to be closer to 5 percent than to 3-3/4 percent; and money growth, M2, right now doesn't give us any leeway to make that move at this point in time. So, symmetric will work for me. But I just wanted you to know my leanings and also my inability to support the asymmetric direction.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. I would support alternative B with a symmetric directive.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. I support alternative B with a symmetric directive.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, I understand from your logic that we should keep our options open. That is a very compelling case. One of the first things I learned at my first [Committee] meeting was that the "would/mights" were not an insect but in fact inhabit our monetary halls. This sounds to me as not a "would/might" situation but a "would/would" situation. I think we want a symmetric directive but want to keep our options open to indicate that we [are prepared] to respond to economic data. So, in stating my opinion, perhaps I'm asking a question: Does your suggestion for symmetry mean a "would/would" directive or a "might/might" directive?

CHAIRMAN GREENSPAN. I don't have a clue!

MR. LINDSEY. Then I would recommend the "would/would" as an approach if we want symmetry.

CHAIRMAN GREENSPAN. Let me say this: I will be disinclined, frankly, to support moving lower unless we see some real signs that this [recovery] is starting to stall out. And I'd need a little more than just a vague notion; I'd need a set of data suggesting a cumulative process that in my judgment probably would incline this Committee toward moving lower even from a symmetric directive. But I would be a little cautious if we kept seeing a steady economic recovery and M2 looked awfully weak. I would conclude from that that we have more of a problem with M2 than we have with the economy. But if we saw both beginning to look rather shabby, then I think it would be incumbent on us to move lower. I would also say that should we get a change in the economic environment, it would be appropriate for us to have a telephone conference and discuss it because, if there is a real change in the economic environment, the group around this table collectively would have a good sense of that. If there seemed to be some evidence that this recovery was faltering and it were not confirmed in the individual Districts, I would question the data. So, even though I'm saying we should keep our options open, I do think we ought to be cautious about moving too quickly unless the evidence really begins to mount. This is a very unusual set of circumstances and a type of period where we could make the kind of mistakes that

monetary policy often makes at the bottom of the cycle. I don't know whether that's "would/would" or "might/might."

MR. KOHN. The Secretary's view is that "might" captures that thought better than "would."

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Well, following on your last comment, Mr. Chairman, I too favor "B," symmetric. In part, I think we have to be careful not to respond to what we already know--the sense that we continue to look at a modest recovery by historic standards. Presumably, that's what we expect. We continue to expect for the next six weeks anyway to look at pretty sluggish M2 expansion; that's what the Bluebook expects at least. If that isn't acceptable, we ought to want to change policy. With regard to M2, since I didn't weigh in earlier, I might try to muddy the waters a little further right now. Governor Lindsey's point about the volatility of M2 velocity in the short run is undoubtedly correct. I recall that we ran some simulations several years ago that said that if we really wanted to apply fairly rigorous confidence intervals to the annual M2 targets, then the ranges shouldn't be 3 or 4 percentage points wide; they really had to be 6 to 8 percentage points wide if we wanted to be reasonably confident of achieving them. That tells you that there's a lot of short-run volatility in velocity. As to whether M2 is going to or has to bounce back at some point, I must admit I'm getting increasingly skeptical. I think we may need to devote a little more time to that question and the role of that aggregate. If I think about what has transpired recently and what is different, it seems to me that customers of depository institutions today--customers broadly defined--clearly face a wider range of choices than they did certainly 10 or 20 years ago, the time encompassed in the estimation period of these models. Clearly, banks and other institutions face a much wider range of choices when it comes to pricing and other policies than they did 10 or 20 years ago. And we're also operating for the most part in a lower interest rate environment than we have over a sustained period of time. Maybe we have to go back to the '60s to find something like this, at least for short rates. So, as I think about all that, it's not clear to me that there's going to be some automatic correction in M2 or indeed that a correction in M2 is desirable in these circumstances. A lot has changed.

CHAIRMAN GREENSPAN. Banks have disappeared; depository institutions have disappeared. The way we measure some or most of M2 almost surely--

MR. STERN. Right.

CHAIRMAN GREENSPAN. It's an interesting question: When does this long-term trend we are all forecasting begin to affect the M2 data?

MR. LAWARE. Congress is working on it! [Laughter]

CHAIRMAN GREENSPAN. Since you have the floor, Governor LaWare, why don't you stay with it.

MR. LAWARE. Well, for all the reasons cited in my earlier sermon, I support your recommendation of "B" symmetric although I would like to identify myself with Governor Angell's preference for asymmetric toward restraint.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I always have to translate what I think it really means when people talk in terms of raising and lowering the funds rate in the sense of tightening and easing policy. I've come to understand that easing in the sense of the funds rate doesn't mean we are more stimulative necessarily and raising the funds rate doesn't mean we are more restrictive. We have difficulties [not only] in communicating [that] outside this room, but translating it inside.

I was pleased that Governor Lindsey mentioned the 1930s in that context of easing and tightening because otherwise I would have been shy about mentioning something that relates to 60 years ago. I read that period a little differently in that, first of all, asset prices historically have always risen in advance of output prices and the reverse, taking the stock market as the measure of asset prices. And, of course, in that earlier period asset prices were falling very sharply; and it turned out to be a good indicator of what was going to be happening to output prices, deflation. Governor Lindsey mentioned how money shrank by one-third in that period as interest rates fell, so was policy tighter or easier? I think it was tight. The money measure, though, was a very narrow measure, even narrower than today's published M1. And today the very narrow measures, i.e., reserves, M1, [unintelligible] are growing extraordinarily rapidly. And I think we interpret those as biasing our actions in the direction of stimulus to the point that, if credit demand grows and short-term rates are under upward pressure, a higher funds rate would be interpreted as a tighter policy. I would view it as stimulative if we were lagging behind the market. I think there is a risk going forward as the economy gains momentum that we could lag behind the market and our actions would be stimulative while raising the funds rate would have the label "tight" on it. If we should get a good rally in the bond market--something I hope very, very much for--and a flattening [of the yield curve] from the long end, and if that should carry with it downward pressure on the bill rate on a full-coupon equivalent basis toward a level well below the funds rate, then I think it would be appropriate to lower the funds rate and not hold it up artificially. If the bill rate were rallying down we would have to drain reserves and contract monetary growth, and I wouldn't like to see that. So, I come down on the side of symmetric with a bias in the direction of up, especially promptly up, if credit demands so warrant.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, I was right with you absolutely all the way as you went through your analysis right up until the end. I must say that although the general tone of the comments seems more positive now than it was the last time, I do think there are some unusual factors here. And I continue to think that the risks on economic growth are on the down side. You said, and I certainly agree, that in the near term we are more likely to ease than we are to tighten. Therefore, it seems to me that the directive ought to

reflect those possibilities. As a consequence, I'd be in favor of "B," but I'd continue with asymmetric language.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I'd favor "B" asymmetric toward tightening. I think we've had a stimulative policy in place, no matter how you look at it, for a long period of time. And, at a minimum, that's consistent with recovery and expansion. Consistent with what Jerry was saying, I also think there's a risk as this expansion progresses that our policy, in terms of interest rates, is likely to be inconsistent with progress toward price stability. We ought to be mindful of that. I was quite comfortable with what you said in responding to Governor Lindsey, Alan. Your earlier comments about perhaps seeing an opportunity to coax long rates lower worried me a little. That may be possible at points in time, but I think it's very risky business at the level of short-term real rates we have right now and could well backfire, for what that's worth. Finally, I could live with your prescription of "B" symmetrical but I'd prefer "B" asymmetrical toward tightening.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I think your proposition is reasonable and I support it. I must say that it's hard for me to imagine a set of circumstances that would be convincing to tighten policy in the next five or six weeks, given where the economy has been and where it is likely to go and all the uncertainties about the money supply. Maybe [that view] reflects the fact that Philadelphia is in the northeast part of the country.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I would support your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. "B" symmetric, Mr. Chairman, with your clarification about your reluctance to move in either direction unless we had some confirmation in the real economy as well as the aggregates. I think you're dead right on that and I was going to throw that [comment] out had you not done it ahead of me. Another thing we need to address is this alternative sentence proposed for the directive. That sentence indicates we are expecting at least a moderate resumption of expansion in the aggregates, and I'd like to see that in there rather than the old sentence that we had.

CHAIRMAN GREENSPAN. The reason for it, obviously, is that the original procedure would have given us an odd statement.  
President Syron.

MR. SYRON. I support "B" symmetric. I hope we need to tighten before the next meeting; I doubt it. Coming back to language, on this whole issue of symmetry I remember long debates about "would/coulds" and "could/woulds," and I find it very hard to get excited one way or the other about a consonant. So, in that regard, I would go along with what you suggested.

CHAIRMAN GREENSPAN. Governor Mullins.

MR. MULLINS. Well, using Jerry Jordan's model, I would have to prefer asymmetric toward ease with the T-bill rate well below the fed funds rate. With that model I wonder a bit how we get a clear view of what the Treasury bill rate really is other than a prediction of what we're likely to do next. And I do agree in general with the notion that we are going to have to think very carefully about real rates as we go through this process. However, I simply don't see the loan demand picking up again. And I don't think it's just M2; it's total debt, as the Chairman mentioned, as well. So, I would prefer asymmetric toward ease in this environment but I would support symmetric along with the stance of monitoring developments as we roar through this 2 percent quarter! [Laughter]

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I certainly would support "B." As far as symmetric or asymmetric, my preference would be toward asymmetric. I may have heard some good things about the real economy, but I don't consider it all that much stronger than where we were some months ago when we were talking about being willing to live with money growth above the midpoint. And now suddenly we're very satisfied with it being at the bottom [of the range] and are satisfied that [it will be sufficient] to carry us forward. We're now relying on an accelerating velocity that we really can't predict. I don't see that there is all that much strength going forward. But I certainly can live with symmetric language given that we would have a consultation if there's other news coming forward.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. "B" symmetric is fine with me. And just a quick footnote: I don't know when we'll have to tighten; it could be soon; it could be later. But I'll tell you this: If that judgment is reached in a context in which M2 is still on the floor, it's going to present a mighty tricky issue in terms of formulating the logic and the public relations to go with it. And it's quite possible that that could happen.

CHAIRMAN GREENSPAN. I know what the solution to that is. Give the job to Don Kohn to get a new set of Ms! Although I will say this: Unless it's very close by, that would certainly indicate that M2 is really very far off target. I was quite sympathetic with President Hoenig's remarks about how we were talking about M2 earlier.

VICE CHAIRMAN CORRIGAN. Right.

CHAIRMAN GREENSPAN. In the last six weeks to two months I have been somewhat dismayed by what has been happening to M2 on the grounds that it has been a very useful indicator for us. And I am increasingly coming to the conclusion that something is wrong with the measure. As I indicated before, whenever you get a measure [that previously] explained several different things like the P\*/price relationship, the income/velocity relationship, the relationship of balance sheets, and all those things [the issue is whether] you could just draw a new line and everything would fall back into place. It

really raises a question as to whether it's the single [measure] that's out of line with everything else.

MR. KOHN. Mr. Chairman, there is active staff work not only here but at the Reserve Banks looking at different measures, and it will be a topic on the agenda at the Financial Analysis Committee meeting in St. Louis in June; there is at least one paper on that.

CHAIRMAN GREENSPAN. Finally, Governor Phillips.

MS. PHILLIPS. I would prefer "B" asymmetric toward ease, but I'll support symmetric recognizing that we may have to talk again in the intermeeting period.

MR. LINDSEY. I'm sorry, Mr. Chairman, I asked a question but I never stated my view. I'd just like to indicate my preference for the record, especially since I see that my colleague to my left has me down as favoring symmetric. My preference would be for asymmetric.

CHAIRMAN GREENSPAN. I had put down that your preference is asymmetric.

MR. LINDSEY. Okay.

MR. ANGELL. Asymmetric in which direction? [Laughter]

MR. MULLINS. He's asymmetric to you!

CHAIRMAN GREENSPAN. I tried to get a view of the Committee, and it's very clearly heavily asymmetric toward symmetric. [Laughter] Let me say this. I think that Don's recommendation with respect to the alternate sentence really makes a good deal of sense. Unless I hear an objection--

MR. LINDSEY. Could you tell us where to turn to read that sentence, please?

MR. BERNARD. At the bottom of page 15 in the Bluebook.

MR. LINDSEY. I'm sorry, Chairman Greenspan: "Contemplated reserves conditions..."

CHAIRMAN GREENSPAN. The very bottom of page 15.

MR. KOHN. I would write in there 2-1/2 and 1-1/2 percent; I don't like writing 1/4 percent on growth targets.

CHAIRMAN GREENSPAN. Does anybody have any objections to the insertion of Don's recommended language?

MR. ANGELL. I understand the "might" but do you want "somewhat" on both sides?

CHAIRMAN GREENSPAN. We have not gotten there yet. We're on the very last sentence, the bracketed sentence.

MR. LINDSEY. Mr. Chairman, if the numbers are 2-1/2 and



1-1/2 percent, I'd question the word "resumption." Are we talking about a resumption to 2-1/2?

CHAIRMAN GREENSPAN. Well, that's a good point.

MR. SYRON. No. You're right.

MR. LINDSEY. This doesn't make a lot of sense.

MR. SYRON. With a resumption of growth in M2--

MR. MULLINS. It shows our problem.

MR. LINDSEY. We don't have growth in M2, so I suppose we are open for a resumption.

MR. ANGELL. We might take out the words "a resumption of."

MR. LINDSEY. So the phrasing would be?

MR. ANGELL. "With growth of..."

SPEAKER(?). That's better.

CHAIRMAN GREENSPAN. Agreed without objection. Will the Secretary read the language?

MR. BERNARD. "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, slightly greater reserve restraint or slightly lesser restraint might 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 April to June at annual rates of about 2-1/2 and 1-1/2 percent, respectively."

CHAIRMAN GREENSPAN. Would you call the roll?

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Hoenig	Yes
President Jordan	Yes
Governor Kelley	Yes
Governor LaWare	Yes
Governor Lindsey	Yes
President Melzer	Yes
Governor Mullins	Yes
Governor Phillips	Yes
President Syron	Yes

CHAIRMAN GREENSPAN. Thank you very much. Our next meeting will be a two-day meeting, June 30th and July 1.

END OF MEETING