Meeting of the Federal Open Market Committee
August 20, 1996

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 20, 1996 beginning at 9:00 a.m.

PRESENT:
Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Jordan
Mr. Kelley
Mr. Lindsey
Mr. McTeer
Ms. Phillips
Ms. Rivlin
Mr. Stern
Ms. Yellen

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Messrs. Hoenig, Melzer, and Ms. Minehan, Presidents of the Federal Reserve Banks of Kansas City, St. Louis, and Boston respectively

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

Messrs. Lang, Lindsey, Mishkin, Promisel, Rolnick, Rosenblum, Siegman, Simpson, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

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

Mr. Connolly, First Vice President, Federal Reserve Bank of Boston
Mr. Beebe, Ms. Browne, Messrs. Davis, Dewald, Eisenbeis, and Goodfriend, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Boston, Kansas City, St. Louis, Atlanta, and Richmond respectively
Ms. Krieger, Vice President, Federal Reserve Bank of New York
Mr. Sullivan, Assistant Vice President, Federal Reserve Bank of Chicago
Mr. Bryan, Consultant, Federal Reserve Bank of Cleveland

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CHAIRMAN GREENSPAN. The first item on the agenda is approval of the minutes of the July 2-3 meeting. Would somebody like to move them?

VICE CHAIRMAN MCDONOUGH. Move approval.

CHAIRMAN GREENSPAN. Without objection. Peter Fisher, you are on.

MR. FISHER. Thank you, Mr. Chairman. I will be referring to the two pages of color charts distributed this morning. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Peter, I think we have all been aware of a tendency that seems to go against our theoretical preconceptions. I am referring to occasions when we have seen a significant rise in long-term interest rates, which one would presume would have a firming effect on the dollar. Yet, what obviously was happening on some days was that heavy sales of dollar-denominated securities were made in part against purchases of foreign currencies, and the dollar weakened as a result. Have you been able to segregate those episodes in which the rise in U.S. interest rates dominated what happened to the dollar in the foreign exchange market or alternatively the sale of securities denominated in U.S. dollars to purchase other currencies was the dominant force in determining the exchange rate for the dollar?

MR. FISHER. We have not tried systematically to segregate those episodes. We have observed the phenomenon that you referred to, and that is something we could try to do, although it is quite tricky. I think the causation tends to run in both directions at times such as those you are referring to. So I am not sure--

CHAIRMAN GREENSPAN. What is required here is that sales of securities denominated in U.S. dollars occur against purchases of foreign currencies. The mere sale of U.S. securities does not in and of itself have any impact on the dollar. Is there any additional evidence related to those episodes that could conceivably give us some insight into which way the pressures on the dollar would emerge or do we face a hopeless task if we try to disentangle those market episodes?

MR. FISHER. I do not want to be quoted as saying it is hopeless, [laughter] but it may be akin to looking for a needle in a haystack.

CHAIRMAN GREENSPAN. You will look nevertheless. [Laughter]

MR. FISHER. It will be quite a challenge. Let me think about that, and maybe Don Kohn and I can come up with ways to sort it out. It really is tough to do much better than to talk to as many of the major market participants as one can and get a sense of what they were seeing major accounts doing. Sometimes those accounts are liquidating bonds and moving out of the dollar at the same time, and sometimes they are not doing it coincidentally, but the effect may be the same if they are doing it over a period of time.

I strongly share the impression that bond markets are traded more and more each year as we think foreign exchange markets are traded, that is, as a collection of currencies. Traders are consistently thinking that if they move out of one currency or government bond maturity, they will move to some other currency or maturity automatically. It is not automatic in the sense of being by rote because traders do make a conscious decision as to what to move into. So, we think people are trading bond markets as if they were currencies but it is very hard to pin that down.

CHAIRMAN GREENSPAN. Could we at least look at the Desk's records to identify these episodes and see what proportion were associated with a weakened dollar and what proportion with a strengthened dollar?

MR. FISHER. Yes, we will.

CHAIRMAN GREENSPAN. That might be helpful just to see what the trends are.

MR. KOHN. We can certainly look at the daily correlations, Mr. Chairman, to see how the bond and the exchange markets were moving. I think it is still true, though Charles Siegman may want to comment on this, that over time the dollar and interest rates tend to move together. But there is a lot of ceteris paribus behind that tendency, and it certainly does not happen all the time and every day. Certainly, real interest rate differentials might be the relevant issue.

CHAIRMAN GREENSPAN. On the famous Fridays once a month, we get a lot of evidence of spikes in both directions, and that might be a useful laboratory to see what happens.

MR. SIEGMAN. Don's comment about real interest rates is obviously important. If other news in the market is interpreted in a way that leads to rising inflationary expectations, then long-term interest rate movements need not necessarily affect the dollar.

CHAIRMAN GREENSPAN. You are really confirming what Peter Fisher said. Jerry.

MR. JORDAN. I want to turn to domestic operations, Peter. Looking at the daily information you reported and your problems over this intermeeting period, it seemed to me that there were at least three significant parts of the story that were not mutually independent. But I could not tell from your reports which was the most important part of the story from the standpoint of this Committee. A part of the story simply seems to be what is going on with sweep accounts and reserves, which created one type of problem. We now have a survey to help us figure out the implications of the low level of bank balances in reserve accounts. But I don't know what to make of the other two parts of the story. One of them is the reference to foreign currency outflows, possibly Russian demand for U.S. currency, which reduced the supply of bank reserves. But it also seemed at times that there was something going on in the domestic economy such that the derived demand for bank reserves associated with the growth of bank credit was coming out differently than you expected. That is quite a different matter. If we failed to interpret correctly the demand for bank reserves coming from the expansion of bank credit, then we would make the kind of mistake that was made back in the 1970s of misreading underlying forces. That is exactly the opposite of a reduced supply of bank reserves coming from foreign demand for our currency. If we failed to accommodate that, that would be the opposite type of mistake. Do you have a sense or feeling of the relative importance of those?

MR. FISHER. Let me try to answer that, and I invite Don to jump in after I have made the first stab. Your three factors were sweep accounts, demand for currencies from overseas, and then just general demand for reserves.

MR. JORDAN. Derived from bank credit growth.

MR. FISHER. Right. The nexus that we have been looking at is really the first and third together. As sweep accounts continue to "sweep" the nation, the level of vault cash that is applied to bank reserves becomes much more important. What we are observing here is a weekly, moving phenomenon, with Friday flows in and out for weekends, and we are experiencing some difficulty in tracking total required reserves as vault cash becomes a larger and larger, and in some cases a dominant, share of the reserves of major banks. So, I would link your first and third points. I do not know if we have any sense--I look to both Sandy Krieger and Don Kohn--that there are other sources of demand for reserves that are giving us a problem of interpretation. We are certainly focusing on this one. Don, maybe you want to comment.

MR. KOHN. President Jordan, with respect to the third factor, I think the evidence for unexpected demands for money and credit or intermediation services through the banks is not strong in this period. If anything, money growth in July came in weaker than we were expecting. While it strengthened in August, it is still growing along a very moderate track. So I do not think we are seeing a situation in which we are having trouble assessing developments, other than the problems that Peter mentioned of the week-to-week and day-to-day demands for excess and required reserves. I do not think we see a situation in which we are persistently underestimating the demands for reserves because money supplies are coming in stronger and it looks as if we are accommodating a perhaps inflationary increase in liquidity. That is not a situation that we have seen, if that is what you meant by your third point.

MR. FISHER. This week-to-week, day-to-day problem is clearly something we are spending a great deal of time focusing on. I think this episode reflected a unique confluence of events; everything conspired against us at the same time. But we are still focusing nonetheless on how to track the week-to-week changes.

CHAIRMAN GREENSPAN. Any further questions for Peter? If not, would somebody like to move to ratify the operations of the Domestic Desk?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection. You may remember that at our last meeting, Bill McDonough and I were sent on a mission to the BIS to discuss the issue of swap arrangements

I thought I would bring the Committee up to date on our discussions and suggest where I think this leaves us in terms of moving forward on the range of issues we discussed at our last meeting. I assume that Bill will want to make some remarks of his own shortly.

Based on these conversations, it is my view that we should set aside the issue of the discontinuation of the swap network for the moment. We should return to this matter when a better opportunity presents itself, such as when the European Central Bank is established and we have to decide what to do with our swap lines with the participating national central banks whose currency will soon be the euro. On the current timetable, a decision on stage three of EMU would be taken no later than the spring of 1998. If it were positive, the European Central Bank would come into existence soon thereafter, although it would not start operating until January 1999. Thus, we would return to this issue in the spring or summer of 1998.

On the matter of authorizing the Desk to do reverse RPs with foreign central banks, our discussion last month revealed that there are a number of aspects of this issue that the Committee would like to see addressed in the context of a concrete proposal. Those aspects include: (1) the principles that should guide the Desk in using such authority; (2) procedures that would be followed in activating the authority; and (3) whether there should be a pre-established list of countries with which the Desk would stand ready to operate. My suggestion is that the staff should develop a concrete proposal, perhaps with some options or alternatives, that would address these issues and others that were raised in our discussion at the FOMC meeting in July. My expectation is that the Committee would be able to consider the proposal at our September meeting or at the latest in November. Bill, would you like to add anything to this?

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I share the view that, since the swap lines are essentially anachronistic, it would have been better if we had had a more receptive response

But certainly your report on our meetings with them is absolutely accurate both in content and tone. Since those conversations took place in July, the atmosphere of the European foreign exchange markets and the future of EMU have become a little more troubled and troubling. I think that if we were seen to be trying to dismantle the swap network at this rather delicate time, if that house of stone or house of cards should fall, we could be deemed responsible, which would not be in our best interest. So, I believe that maintaining silence and assuming that the swap lines are harmless even in the worst of cases is very much in our interest. Whereas I was rather hopeful at our last meeting that we could get rid of the swap lines, what has happened in the meantime in addition to our conversations indicates that this is not the right time to dismantle them.

CHAIRMAN GREENSPAN. We have to be careful not to allow what are essentially financial anachronisms to continue to embody themselves in our financial system. Were these swap arrangements a potentially dangerous or malignant problem, one could trade off the concerns of against other considerations. But that does not seem to be the problem. So long as we pledge ourselves to review these arrangements and hopefully to dismantle them in an appropriate timeframe, we probably will have done about as much on this question as I think we can at this time.

VICE CHAIRMAN MCDONOUGH. I very much agree with that. I would hope that the staff could do their work so that we would be in a position to discuss the reverse repos in September. As I mentioned at the last meeting, I think the likelihood of our using a reverse repo capability would be very, very low, and we would make sure that there were all kinds of protections against ill-advised use of it. But the fact that the Desk is not authorized to use that financing instrument with foreign central banks has taken on a life of its own that I think is a bit of a problem for our relations with some countries, especially in Asia. Therefore, our having the power even if we did not plan to use it, I think, would serve our interests better than our swap lines which are an anachronism. The fact is that 20 years ago when the Committee considered the use of RPs with foreign official accounts, nobody thought we would need reverse repos, and that is why the Desk does not have the authority to use them. It is not because anybody went through a thoughtful exercise and said, "this is an inappropriate power for the Desk to have."

CHAIRMAN GREENSPAN. There are, however, foreign policy considerations involved here.

VICE CHAIRMAN MCDONOUGH. Exactly, yes.

CHAIRMAN GREENSPAN. Which I think the staff will address. Governor Lindsey.

MR. LINDSEY. Mr. Chairman, I agree that this is not the time to dismantle the swap lines, but I have a question as to whether there really is ever going to be a good time. The establishment of the European Central Bank is not a foregone conclusion, although the odds may favor it. It is also unclear who is in and who is out. Even if all of Europe is included, that does not do anything for our Japanese swap line. So, I am not sure that we have identified an appropriate time as a target date to get rid of these arrangements. While this may not be the moment, it would be nice to have a little more comfort that there is a time when we think it definitely will be appropriate to revisit the issue.

CHAIRMAN GREENSPAN. I think we will revisit this issue during the spring of 1998. At that point, we may conclude that the EMU is active, alive, and the ECB is about to happen. Because so many of our swap lines are with those EMU countries, we will have a window to reshuffle all our central bank financing arrangements. If it does not happen that way, we will have to address this issue anyway, and I would suspect we may just decide to drop the whole swap line network at that time.

MR. LINDSEY. Let us think about what the ECB is going to look like in 1998. I do not have the complete list of countries that we have swaps with, but I would wager that some will be in and some will be out.

CHAIRMAN GREENSPAN. That may be, but the ones that will be in will provide an opportunity for us to readdress the issue. We can use that as the vehicle.

MR. LINDSEY. Would it not be even more disruptive if we started to talk about getting rid of the swap lines at a time when, say, there was a great debate as to whether France or Britain met the criteria--I am just using that as an example--and we had some of Europe in and some of Europe out when the decision was made to go ahead with the ECB? We would encounter all the delicacies and ramifications of European politics if we raised this issue then. I would think that, if anything, that would be an even more sensitive time than the present.

CHAIRMAN GREENSPAN. It is conceivable that you may be right. I doubt it myself, but I think our conversations with

MR. LINDSEY. That is, not now?

CHAIRMAN GREENSPAN. Not now.

It may well be that when we review that again in the spring of 1998, if that is our plan, we will at that point conclude that we face such a mess that we will bite our tongue, so to speak, and say nothing about the issue. My guess at this stage is that the probabilities of the swap network disappearing by mid-1998 are well in excess of 50 percent. If I have my way--I have a vote, you have a vote--it will be gone. But there is obviously more here than merely the question of financial arrangements. Indeed, the financial arrangements would no longer be relevant if the issue inadvertently turned into a diplomatic hassle. Yes, President Jordan.

MR. JORDAN. I have a question and a suggestion also. In your recommendation that we put this aside for two years, could you elaborate for us on Mexico and maybe Canada too with regard to the arrangements that we have with them?

CHAIRMAN GREENSPAN. I think the NAFTA arrangements are essentially independent of this issue, and because they involve a different issue we will evaluate them completely separately from the other swap lines.

MR. JORDAN. Okay. Then, concerning what happens two years from now, I know this Committee cannot bind the Committee two years from now, but in the past we have been in the situation where the presumption was, it seems to me at least, that we would continue such arrangements unless somebody bore the burden of persuading the Committee that it was the time to end them. At this point, I would like to have at least a presumption of a soft sunset provision that says the swap arrangements will be terminated two years or so from now unless somebody makes a compelling argument that they should be continued. Such an understanding would reverse what I sense is the environment that we are in now. I know it would not be binding two years from now, but it would help my comfort level a great deal if the general view of this Committee was that we should not renew the swap lines after two years.

CHAIRMAN GREENSPAN. I certainly do not want to take a vote on this question. But if you are asking me personally, I agree with you.

MR. JORDAN. Good.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. I was going to make basically the same point that Jerry Jordan did, Mr. Chairman. I understand the timing problem currently, but I think Larry Lindsey is right. It is very difficult to find a convenient time to do this. I am concerned that we are going to continue to drift with this issue, and I was happy to hear your response to Jerry's question. Two years is a long time down the road. Maybe we can take an opportunistic approach to this issue as well. [Laughter] If there is an opportunity and circumstances change or it looks as if we might be able to make progress sooner, I would not hesitate to do that.

CHAIRMAN GREENSPAN. It is conceivable that something may happen. The EMU may break down. Events may differ from what we expect. We all know the types of changes that can occur in the international financial system, both planned and otherwise, and circumstances could alter that system. All I am saying is that this issue will be back on our agenda no later than the spring of 1998. Any further comments on this issue? If not, let us move on to Mike Prell.

MR. PRELL. Charles Siegman will start us off this morning, Mr. Chairman.

MR. SIEGMAN. Thank you. [Statement--see Appendix.]

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

CHAIRMAN GREENSPAN. It had been the conventional wisdom in the business community that a strike tends to be inflationary in the sense that it creates an artificial degree of pent-up demand. That demand gets unleashed when the strike terminates and potentially induces some acceleration of economic activity that would not have occurred without the strike. Are you aware of any systematic analysis of that hypothesis?

MR. PRELL. I am not aware of any. Certainly, in this particular set of circumstances, were there not to be a major damping of underlying demand trends--and I do not see why that would necessarily occur from a strike of plausible duration--the attempt to make up the lost production to meet the pent-up demand for autos would press pretty hard on capacity. The GM strike in March, as we have seen, created some turbulence in the data, and GM had to press production pretty hard after the strike. In that recent period, we did not see major price increases in the auto industry. So, the bottleneck there does not seem to have resulted in a lot of inflationary pressure.

CHAIRMAN GREENSPAN. What is the earliest date that a strike can occur?

MR. PRELL. Our understanding is it would not occur before the expiration of the contract, which I believe is September 14. So, we presumably will have some information around the time of the next meeting. The strike target is, as I gather, to be announced on August 22.

SPEAKER(?). August 22.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. My memory on the subject of strikes is short because I have not been coming to these meetings for very long, but I was struck by the number of times the notion of a "strike" appeared as a factor underlying the analysis in the Greenbook, particularly in Part II. There were references to strikes that had just ended and to the potential for a strike in the auto industry. I am wondering whether the principal effect of strikes is not so much their near-term impact on economic activity or inflation but rather their longer-term impact on people's perceptions of the relative power of labor unions versus management despite the decline of membership in labor unions in this country. It's an impact that is occurring in an environment in which there seems to be a great deal of concern about whether Wall Street, shareholders, and management are enriching themselves at the expense of workers' standards of living. So, I am wondering whether, even if a strike does not have an immediate inflationary impact, its potential to affect even nonunion relationships between labor and management may be significant going forward.

CHAIRMAN GREENSPAN. That would depend on how the strike came out, whether, for example, it was a significant management victory.

MS. MINEHAN. Yes. But just the fact that a strike occurred, I think, is something that is--

CHAIRMAN GREENSPAN. Well, I wonder. That is not so clear to me. There have been significant strikes in the past where evident union defeats had a very damping effect on labor unions. For example, the flight controllers' strike, which was quashed, did more to suppress union power than almost anything else in the 20th century.

MS. MINEHAN. Yes, but I think that was in an environment in which people generally felt that unions were detrimental to the overall competitiveness of U.S. industry. They may still feel that way, but I think there is much more of a feeling now that the wage earner is the one who is bearing the brunt of efforts to improve U.S. competitiveness.

MR. PRELL. I would just note that in this auto industry situation there also are peculiarities that people will be focusing on in terms of whether the union is able effectively to set a pattern after they have negotiated an agreement with one of the auto makers. I think there are major questions about the mechanics of this negotiation process with the three auto makers. So, there will be a lot of grist for the analytical mills that look at how labor relations work.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I want to ask Mike Prell two questions. But first let me comment on what we have heard on the strike issue from auto supply companies and competing firms in our area. Maybe you have been hearing some similar or perhaps different things, Mike. Our contacts tell us that for General Motors, if they decide to take a strike, it will be a "no lose" situation in the sense that they must be victorious or they will have to break up the company. There is a very strongly held view among some of the firms in the industry that for General Motors this is a life-and-death situation because their costs are so much higher than Eaton's and TRW's and some of the auto supply parts companies that they absolutely must get concessions. It really does not matter to them what Chrysler and Ford get. GM needs significant concessions to survive in this view.

I have two questions, Mike, and I think they are unrelated. The first has to do with what Charles Siegman had to say about the second-quarter numbers. Typically when we get surprises and revisions of numbers there is one of these two responses: Either they carry forward in the same direction or they produce mirror image offsets in the subsequent period. What is your tentative judgment about the implications for the third quarter and the second half based on the firmer numbers you now have for the second quarter, which are different in some respects from what you thought they were going to be at the time of the May Greenbook? If you want me to, I will let you respond to that before I ask the second question.

MR. PRELL. There is little I can say at this point because I do not really know the details of these revised data. One obvious implication is that, if our estimates are correct, we will have stronger final sales and stronger output. We also will get the same kind of inventory level that we estimated before, which suggests that inventory positions may be even leaner relative to sales than we had anticipated. Obviously, that might have some favorable implications going forward. Now, we are not talking about night and day differences, but we would lean in that direction. We also want to look for whatever evidence of export trends there may be in these data, and we shall have to make a careful assessment of that. Charles, maybe you know more.

MR. SIEGMAN. Again, we have few details. For example, with respect to the composition of the decline of more than $2 billion in imports, about one fourth is accounted for by automobiles, and automobile exports went up a little. Inventory movements play a role in this sector. We just do not know how that will work out. Imports of industrial supplies also declined $700 million. This is not a sign of economic strength. Again, we are looking at very preliminary information, but eyeballing the monthly trade data from the beginning of the year, it now looks as if the large May import number may have been the outlier because it was relatively high. The number we have right now for June is similar to that for most of the other months of the year, but that again is the first impression.

MR. JORDAN. The other question, Mike, has to do with Greenbook projections for the period. I was struck by the increase in nominal GDP of about .3 percentage point from the last half of this year to the end of 1997 with the same assumed federal funds rate. I noticed that starting with the fourth quarter of 1994, your four- to six-quarter projections for nominal spending associated with an unchanged funds rate were remarkably stable. This is the first instance where you raised nominal spending growth with a given funds rate. I tried to find in the Greenbook or in your briefing this morning why you now expect, given an unchanged funds rate, spending growth to be more rapid for the next year and a half.

MR. PRELL. This nominal GDP change is so small that it is going to be very hard to pin down all the factors that go into it from different directions. I don't think there is a major story here because, as I have said before, we do not approach the forecast in terms of taking interest rate assumptions and from that drawing directly a forecast of nominal GDP. It is a complex process. There has been a reassessment of some of the price series and relationships that have crept into the analysis. We do have a situation where we have a bit more inflationary pressure because of (1) a lower starting point for the unemployment rate, (2) the minimum wage hike, and (3) we are impressed by the wage data in the first half of the year that are tending to push us to a forecast that has a little more of an inflationary cast. Given the nominal funds rate, we have a little more inflation and a monetary policy that is a little more accommodative as measured by real interest rates. If you put these things together, they end up producing a nominal GDP path that is a little higher even with essentially the same real path.

MR. JORDAN. I have thought about that linkage, but the problem with that response is that I cannot convince myself that it is not circular. If you assume that we have had an inflation surprise, for whatever reasons, and you now think inflation could be higher than you previously thought--and as a result real interest rates would be lower than you previously thought--that does not necessarily lead to higher nominal spending growth. In my framework, that means we could have higher velocity growth, and I do not see that happening from this dynamic of higher inflation and lower real interest rates.

MR. PRELL. We have a monetary accommodation implicit in our forecast.

MR. JORDAN. Then you are saying faster money growth.

MR. PRELL. We let the money stock be whatever it will be. Whether it actually comes out faster in our forecast is also a function of how the recent developments have influenced our views of the money demand relationship. We do not have faster money stock growth in this forecast.

MR. KOHN. That is based primarily on the observation that the incoming money growth data are a little weaker than we had anticipated.

MR. JORDAN. You have to have a budget constraint and central bank money in your framework, so you are telling me that velocity growth is going to be higher. I don't see how that follows from this linkage.

MR. PRELL. What we assume is that monetary growth will accommodate the maintenance of a nominal funds rate in the face of the growth of aggregate demand.

MR. KOHN. The way we go about this is entirely endogenous. As you know, a nominal interest rate, particularly one that is the Committee's target, is not a nominal anchor. I think that the process that Mike described is exactly what went on.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mike, revisions in the Greenbook forecasts prepared for recent meetings have been quite small. But I think they have been in the direction of raising the rate of inflation and to some extent, I guess, the level of real GDP. In light of that, could you comment on the likelihood that the slowdown during the forecast period will be enough to relieve inflationary pressures?

MR. PRELL. We do not think there is enough of a slowdown in our forecast to relieve inflationary pressures. Basically, what we see is that the evidence on wage behavior in the first half of this year supports the view that we are operating at a level of resource utilization that is incompatible with maintenance of a steady rate of inflation in the economy. We are not in such tight conditions, particularly looking at the capacity utilization side of the picture as well as the labor market side, that we would anticipate, absent external shocks, a very rapid pickup in inflation. But we would expect some gradual updrift.

MR. PARRY. The change in the forecast in the last couple of meetings and some of the comments in Part I of the Greenbook, which I must admit I found striking, seem to suggest that you see the prospects of a more favorable outcome as probably lower now than you did at the time of the previous meeting or the meeting before that.

MR. PRELL. I think our confidence in our assessment of the implications of this level of resource utilization has grown with the latest wage figures.

MR. PARRY. I see. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Just getting back to the potential for a strike, someone in the auto industry described this period to me as the calm before the storm since nothing really happens until later this week when a target is selected. The key issue, of course, is outsourcing for General Motors. They manufacture a lot more parts themselves, as we all know, and they need to get more flexibility in outsourcing these parts. Of course, the selection of the target is important because if GM is not selected, Chrysler will be. Chrysler could agree to some provisions that would not hurt Chrysler but would hurt GM in terms of this outsourcing issue because Chrysler does so much outsourcing. Compensation increases do not appear to be an issue here. The unions already have a cost-of-living escalator in their agreements; no one is really talking about changing that. They have profit sharing already. The profit sharing agreement for Chrysler workers has paid them very high benefits recently. Of course, the last time they negotiated, they won a lump sum payment and there is a high probability they will get that again. But that does not go into the base of the compensation.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Mike, I agree with your characterization of the productivity data, but I think the business community would take sharp exception to it. Everywhere I go they talk about the tremendous productivity improvements that they are achieving. I must say that I am increasingly uncomfortable about our ability to reconcile the two sources of information. I wonder if you have given that some further thought and have any new information?

MR. PRELL. I've observed what you well know, that the data certainly are supportive of the notion that there has been in the past couple of years a continued quite rapid improvement in productivity in manufacturing. We get reports from business executives that they can produce as many widgets now as they did a few years ago with twice as many workers then. I think the data are not completely inconsistent with the reports we get anecdotally from the manufacturing sector. In some of the nonmanufacturing sectors, we get into the difficult problem of measuring the output, and it is conceivable that output growth is being underestimated. The only caveat in this regard is that, when we look on an aggregate level at what has been happening to output and what has been happening to unemployment, the relationship has held up reasonably well. We had some veering off seemingly in 1995, but we now seem to be pretty much back on track with that basic Okun's law relation. Ultimately, we think that is of critical importance because it tells us where resource utilization levels are headed for given measured levels of output growth.

MR. STERN. Thank you.

CHAIRMAN GREENSPAN. Are there any further questions for Mike? If not, would somebody like to start the Committee discussion? President Hoenig.

MR. HOENIG. Mr. Chairman, the economy in the Kansas City District, like other parts of the nation, has slowed, in our case from a very strong to a still strong rate of growth; it just is not as strong as it was a few months ago. Our directors confirm the positive tone in the region's economy, with many reporting healthy gains in businesses throughout the District. The rail transportation industry, for instance, is reporting solid gains in rail traffic, and operations are at full capacity right now. The signs that regional growth has slowed through the summer include indications in our latest manufacturing survey of slower growth in output than in our previous survey last spring. Construction contracts and housing permits, consistent with data for other parts of the country, also have shown some easing, but it has to be emphasized that the easing has been from very high rates. On the agricultural side, grain producers continue to do very well at currently high prices while the cattle industry is still suffering somewhat. Our labor markets continue to be tight. Reports of wage pressures, while still sporadic, are becoming more frequent now, and we are seeing some efforts to address those pressures through improved benefits. So, I think inflation prospects are worsening somewhat in our regional economy.

On the national economy, we continue to see an outlook for growth along the lines reported in the Greenbook. I do not see a lot of differences in our projections and those in the Greenbook. We agree with the Greenbook that, even if the expansion slows somewhat, the rate of inflation will register a very modest 1/4 point increase this year and maybe another 1/4 point next year, all other things held constant. I think that is the outlook we have to deal with here today or in the next few meetings. Thank you.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Thank you, Mr. Chairman. The Beigebook summary this time starts off with a statement that the national economy continued to expand in June and July, but it points out that there was some slowing in some areas and in some sectors. I think that characterization describes reasonably well what is going on in our region. There are signs of slower growth in some sectors over the last month or so. For example, the growth of consumer outlays for durable goods other than automobiles appears to have decelerated a bit, and there is some evidence from one of our regular monthly surveys that the pace of manufacturing activity is a little softer than it was earlier. But I would emphasize that this moderation in growth is still a pretty tentative development at this point. At least in our region, it may reflect in part the unusually wet summer we have had. At this point, it is not at all clear how long this trend will persist, if it persists at all. Moreover, I would make the point that it is a moderation from a very robust rate of expansion in the second quarter, as I know was the case in many other regions of the country. Overall, most of the comments we hear from our directors and other business contacts are still mainly upbeat. They suggest that District business activity has settled into a groove at a very high level of activity even if there has been some deceleration in the rate of growth recently. There are still pockets of very robust activity in certain parts and sectors of the District. For example, on the commercial real estate side, the market for Class A office space is very tight here in the Washington metropolitan area. Whatever may be happening to housing nationally, residential construction is really booming in West Virginia and there are a couple of very large resort and hotel projects under way in that state. Again, the bottom line is some moderation in the rate of growth in the District, but the level of activity is still very high.

I emphasize this point about the level of District activity because that, it seems to me, is where our focus ought to be in looking at the national picture this morning. Given the greater-than-expected growth of the economy in the first half, it seems to me that the level of activity nationally is really quite high. It is reflected in a number of ways, of course, but it is especially apparent in the tightness of labor markets and the recent behavior of wages. Consequently, even if the growth of aggregate demand decelerates in the period ahead, as the staff points out in the very first paragraph of the Greenbook and Mike Prell has repeated again this morning, the pressure on resources is still likely to push the trend rate of inflation up a bit, perhaps to above 3 percent over the projection period.

To me, that is the central feature in the economic outlook that we really need to focus on most closely at this juncture. If we get an outcome like that, it will be inconsistent with our public commitment to hold the line on inflation. Moreover, as I understood the discussion that we had at the last meeting about our longer-term price objective, while there was some disagreement around the table as to whether we should try to push the trend inflation rate below 2 percent, there was general agreement that we ought to move in that direction, and this projection is saying that inflation is going to be moving in the opposite direction. It is true, of course, that the latest incoming data suggest that the economy may be slowing somewhat from the second-quarter pace. In particular, as we all know, employment grew more slowly in July, but as was mentioned this morning, there certainly are signs of strength in some of the data. Initial claims are at a very low level in recent weeks, as Mike pointed out. The Greenbook is projecting a third-quarter gain in aggregate hours at a 2 percent rate. That's lower than the second-quarter pace but it's still above trend, which means that labor markets are likely to tighten a bit further. Tighter labor markets in turn could foster greater job security, and that raises some questions about the extent and duration of the current softening in consumer spending. But whatever the outlook may be and whatever the debate may be about that outlook, the main point seems to me to be that even if we do get a fairly sustained and marked deceleration in growth, we still have an inflation risk that we need to be aware of and come to grips with.

One final comment about wages: I think we ought to be quite concerned about the first-half pickup in the ECI. One can interpret that pickup in several ways. I am inclined to interpret it as a fairly straightforward bit of additional evidence that underlying inflation pressures may be increasing at least to some extent. Obviously, an increase in wages is not inflationary if productivity is rising. Like Gary Stern, I hear a lot of anecdotal comments that suggest productivity may be rising, but it seems to me that we do not yet have any really compelling evidence that the trend rate of productivity is rising. I guess it is also possible, along the lines of the argument in Governor Yellen's paper that was distributed at the last meeting, that the increase in the ECI reflects a corresponding increase in the equilibrium real wage, perhaps because workers are more secure in their jobs now than they were before. If that is happening, then obviously that would not be inflationary in and of itself. But in my view it would still constitute an inflation risk since firms will try at some point to push those wage increases through to higher prices if they can get away with it. They will refrain from doing so only if they are forced ultimately to absorb the increases. For my money, that is where the Fed and its credibility come in. I think we need to insure that our policy stance will maintain a pricing environment that is hostile to such pass-throughs. I think we need to send the same message that a famous resident in Bob Parry's District, Clint Eastwood, used to send, "don't even think about it." [Laughter] Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. That is a hard act to follow! [Laughter] The Seventh District economy is still operating at very high levels, but it is expanding at a slower pace than in the first half of the year. Housing starts and permits increased rather sharply in the Midwest in July and partly made up for weather-related delays that we experienced in June. Manufacturing activity in the District continues to be strong and light vehicle production reached an expansion high in July. Growth in consumer spending slowed considerably in July, but information from retailers points to some pickup in early August. One of our directors said the Olympics had a very real retarding effect on retail sales, especially during the first week. He indicated that sales have picked up since the Olympics ended, though the tempo is down from earlier this year. While reports were mixed, other retailers generally noted some sales improvement since July. Reported auto and light truck sales for July were down sharply from June, but July's 14.2 million pace exaggerates the degree of slowing in demand for light vehicles for reasons that were discussed in the Greenbook. So far in August, our reports suggest that sales have moved up to the 14.8 to 15 million unit range, assuming no special factors will distort the numbers this month. This is consistent with the modest slowing in sales that we have been expecting for the second half of 1996.

On employment conditions more generally, the news is the same. Labor markets remain tight in the Seventh District and we continue to experience unemployment rates below the national average. Future hiring plans seem robust. We have an advance copy of Manpower's latest national survey, which will not be publicly released until next Monday, August 26, that shows stronger fourth-quarter hiring plans relative to a year ago. The strength is fairly widespread across industries and across regions of the nation. The survey indicates the best holiday job gains seen in 13 years for wholesale and retail employment. Recent reports from our contacts continue to show an uptick in wage rates. Wages in the paper industry are up 2-1/2 to 3 percent this year compared to 2 to 2-1/2 percent last year. Wage settlements in the steel industry are under 3 percent, but these replace contracts with no wage increases at all. As discussed in the Greenbook, the upcoming increase in the minimum wage will affect entry-level and near entry-level wages. The Greenbook analysis assumes that hourly workers earning over $6 an hour will not be affected. However, one major retailer indicated that their employees with wages of $8.50 an hour would be receiving wage increases as a result of the minimum wage hike. So I think the Greenbook is understating the impact for those employees earning over $6 an hour.

More generally, on the price front most reports still indicate that inflationary pressures are contained, but we have had some scattered reports of more rapidly rising prices. In agriculture, this year's harvest may not significantly ease the tight supplies in grain markets, but very high grain prices are cutting demand from abroad and from domestic users. The related cuts in livestock, milk, and poultry production will extend the recent upward pressure on retail food prices well into next year.

Turning to the national outlook, our assessment is similar to the Greenbook's with economic growth over the next year and a half returning to a pace near the growth in potential output. We expect real GDP growth in the second half of 1996 to be in the range of 2-1/4 to 2-1/2 percent. But even this moderation in growth will likely leave the economy's resource utilization at a rate high enough to increase inflation, as Mike Prell and Al Broaddus mentioned in the discussion. In other words, aggregate demand will exceed potential output. We are already beginning to see some of these resource strains reflected in recent compensation data. In addition to the anecdotal reports that I mentioned, second-quarter ECI data suggest rising wage and cost pressures, and I am concerned that the recently favorable trends in benefit costs will not be sustained and that growth in total compensation will increase even further. As we discussed last time, the risks to inflation are on the up side. I think the information that has become available since our last meeting suggests that these risks remain on the up side and may even be slightly higher than they were six weeks ago.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, economic growth is strong in the Twelfth District. In California, job growth picked up noticeably in the second quarter, and the unemployment rate fell about 1/2 percentage point. In July, the California unemployment rate edged down further, and payroll jobs continued to expand at about the second-quarter pace. Economic activity in the State of Washington also is picking up as aircraft production rebounds and the software business continues to be good. Job growth has continued to be strongest in Nevada, Utah, and Idaho. In the second quarter, employment growth in these three states was about 7 percent at an annual rate, twice as fast as the accelerated 3-1/2 percent second-quarter pace for the nation. Employment growth in Oregon and Arizona has continued in the 3 to 4 percent range, and we even have seen some improvement in our laggard state, Hawaii, where economic conditions were deteriorating until recently.

For the national economy, the recent news is consistent with our forecast of a moderate slowdown in real output and employment during the second half of this year. Thereafter, we expect real growth to stabilize at around 2 percent in 1997, although our projection is predicated on a slight tightening of policy over the forecast horizon. However, the recent news is also consistent with our general assessment that the economy faces an acceleration of wage and price pressures. We have reached levels of labor and capacity utilization that are inconsistent with steady inflation. Indeed, we anticipate an acceleration of inflation in 1997 on the order of 1/4 to 1/2 percentage point in a wide variety of price and compensation measures. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, while the economy may be slowing somewhat nationally, that is a bit hard to see in New England right now. Job growth is steady, unemployment rates in the region are low--a full percentage point below the nation--and pressures in the job markets are growing as employers find it hard to hire skilled and in some cases even clerical workers. Wage increases are picking up, with increases of at least 3 percent the norm, and reports of up to 5 percent are not uncommon. However, inflation concerns remain low with the expectation that wage increases will be offset by productivity increases. Manufacturing conditions have improved. While jobs in this sector continue to decline, New England's rate of decline is now marginally less than that for the country as a whole. By some estimates, the manufacturing job picture is better now than it has been since the late 1980s. Our contacts in the manufacturing sector are upbeat overall, with areas of particular strength noted in medical supplies, furniture, and construction-related products. Construction jobs also have grown at a good clip, in part reflecting an increased pace of activity in the construction of Boston's Central Artery project, which in nominal dollars is the most expensive highway project ever undertaken in this country. Residential construction has picked up as well. At least in the western suburbs of Boston, much of this construction involves very high-end, high-priced single-family homes. The commercial real estate markets are vibrant in many areas. There has been virtually no new construction, and with growing economic activity, conditions are markedly improved, especially in Boston. This is true also in Portland, Maine and in suburban Rhode Island as well as in a number of other suburban locations around the District. Retailing remains highly competitive with disappointing results for many. Tourism has been very strong, with a major influx of foreign visitors.

District loan growth, as reflected in the data that we get from five large banks that report monthly, continues to decline as it has throughout 1996. However, this trend largely reflects the balance sheet restructuring that has been going on at Fleet since the Shawmut and the Nat West mergers. Officials at Fleet have indicated that their balance sheet adjustments are over. Loan data for the District as a whole, which tends to be heavily dominated by three or four institutions, may soon start to reflect trends associated with economic rather than acquisition activity.

Turning to the national scene, we agree with the Greenbook's assessment that the expansion will slow, possibly to potential, through the rest of the year. We also agree that the sources of the slowdown lie in domestic demand, especially in the interest-sensitive sectors of residential construction, consumer durables, and business fixed investment. We are not quite as optimistic as we usually are about the sources of foreign growth that are shown in the Greenbook. We wonder, however, whether there isn't a certain amount of risk, and I think Mike addressed this, that GDP growth will be stronger than is reflected in the Greenbook in light of the recent declines in long-term interest rates, manageable levels of business debt, recent moderation in the growth of consumer debt, the unknowable effects of an inventory bounceback that may be even larger than is anticipated in the Greenbook, and the continuation of rather buoyant equity markets. Moreover, the risks that wage cost increases will push overall inflation higher seem even greater than the risks that GDP growth will be greater than we expect. Given the overall credibility of the Greenbook forecast, we find possible and certainly credible the assumption that price increases will be moderated by productivity improvements at this point in the business cycle or by shrinking profit margins, but we wonder whether there isn't a good deal of risk in this area. Thus, we believe the inflation situation as measured by the core CPI is likely to be marginally worse than is forecast in the Greenbook if no adjustments are made to policy.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The economy in the Philadelphia District appears to be on a modest uptrend that has tilted down from a somewhat faster pace earlier in the year. Manufacturing is growing but at a somewhat slower pace. Delivery times, while lengthening in the spring, have shortened more recently. Retail sales growth, quite healthy in the spring, has eased during the summer months. Nonresidential construction is flat and the pickup in residential construction appears to be decelerating. Employment growth is improving slightly and some labor markets are tight while others still have slack. Price and wage pressures on the whole still seem to be reasonably contained in the District.

Turning to the nation, at the last meeting in early July we hoped that more information would help settle two questions--whether growth would moderate to a more sustainable pace and whether wage inflation indeed is beginning to accelerate. On the sustainable growth question, I think the bottom line is that the weight of the data suggests a moderating growth trend but how much moderation is far from clear. On the wage question, the larger first-quarter gain was repeated in the second. Once again, however, sizable wage gains were offset by a small rise in benefit costs so that total compensation has been rising at essentially the same rate in 1996 as in 1995. On the whole, price pressures remain remarkably subdued for this stage of an expansion. Reasonable people can easily come to different conclusions about the outlook at this point. My hunch is that we may see appreciable slowing in growth because of subdued personal consumption, more modest growth in business fixed investment, and some slackening in residential construction. At the same time, upward wage pressures will not likely bubble up into upward price pressures as much as one might think because of continuing offsetting smaller benefit costs and strong competition for products and services. Nonetheless, in this environment I think we need to continue to monitor demand and price pressures very closely.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. The economy of the Atlanta District remains moderately strong. The big news over the last six weeks, to no one's surprise I'm sure, has been the impact of the Olympics. Some businesses in Atlanta and other Southeastern cities were somewhat disappointed by the spillover effects. In general, the level of spending during the Olympics was in line with expectations of about $4 to $6 billion spread over six years. While that spending was a nice bonus for our region and it left behind some really desirable infrastructure that will be lasting in its impact, it was really small potatoes when compared with just the Georgia economy which generates over $160 billion in income per year.

District residential real estate markets generally can be characterized as healthy though activity is now slowing after a one-year growth spurt. Multifamily and commercial real estate markets remain strong. I mention that because continuing growth in each of these markets at both the regional and national levels bodes well for the Southeast manufacturing sector, where the production of construction materials and durables is significant. While the forecast for durables production remains fairly good, our region's important apparel industry continues to hemorrhage. In the second quarter, year-over-year job losses totaled 42,000 for the combined apparel and textile industries. While the goods-producing sectors are expected to produce some new jobs over the last half of 1996, as will be the case nationally, the majority of the new employment positions will likely come from retail trade and services. The pockets of labor shortages and related wage pressures that have continued to be reported in parts of Georgia and Tennessee should be alleviated somewhat by the tens of thousands of individuals previously committed to Olympics-related construction and services. As those people seek alternative employment opportunities, which clearly exist in the District, we think we should have a smooth and rapid transition into the post-Olympics period.

My outlook for the national economy has not changed materially since our last meeting. While the economy seems to be running with little slack in the labor markets, as evidenced by the low unemployment rate and relatively high participation rate, productivity seems to be high when we take account of anecdotal information. Hence, any wage pressures can reasonably be viewed as reflecting those productivity gains rather than an inflationary threat that necessarily will be passed on to prices. At the same time there are signs of the deceleration in activity that we have been forecasting, although they may be preliminary at best. Many fundamentals point to slowing investment and there are signs that the predicted slowdown in housing is finally being realized. The earlier buoyancy in consumer spending seems to be moderating and the saving rate is edging up, at least marginally. I have to admit that inventories are lean and consequently to the extent my expectations for slowing in demand growth are disappointed, we will likely see an immediate impact on domestic production. All things considered, I still think we are in an enviable position with no major imbalances. Real GDP growth will, I expect, average a little over 2 percent this year and probably under 2-1/2 percent next year, and this is with the broader-based measures of inflation continuing in my view under 3 percent. As at our last discussion, I'm unconvinced that our policy stance currently is tending to make inflation worse. So, the favorable news on employment and output is less worrisome to me than it might be otherwise. My inflation forecast continues to show no acceleration for 1996 once we take account of the effect of earlier oil price increases, which seem to be playing out as we had expected. Unlike the Greenbook, when we examine the likely effects of the minimum wage legislation, we see no serious impact on inflation expectations when we take account of recent evidence of the substitution of capital for labor, productivity gains, competition, and job restructuring. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. The economy in the Eleventh District has remained on a firm uptrend throughout the summer. Conversations with our directors and other contacts suggest continuation of more of the same, with some minor slowing during the remainder of the year. There are two and possibly three areas of weakness in the District economy. First, the drought is still a factor, but overall it's not exerting a material impact on the regional economy. The semiconductor industry has continued to weaken since the last FOMC meeting; unit orders for semiconductors continue to fall. Some types like microprocessors and digital signal processors have been in strong demand, but this has not been sufficient to overcome the weak demand for memory chips. Several Texas semiconductor firms have announced layoffs or hiring freezes, with the result that employment at firms manufacturing electronic equipment fell at a 6 percent annual rate in June. This industry represents about 12 percent of Texas manufacturing employment and 1-1/2 percent of Texas nonagricultural employment. Construction of single-family housing is still strong but most builders and real estate contacts expect a noticeable slowing in the coming months as the impact of higher mortgage rates begins to take hold.

Several sectors of the District economy have continued to improve. Improvements in the Mexican economy have spurred retail sales gains along the border, and we hear that affluent Mexican shoppers are back in large numbers in the Houston Galleria area. The energy sector continues to expand, with every available rig in the Gulf of Mexico reported to be under contract. The anticipated softening of housing construction may be a good thing because it will free up badly needed resources for the construction of industrial warehouse space, commercial real estate, and maybe a year from now a rebirth of office building construction, which has been almost dormant in our area for a decade. Vacancy rates in suburban markets have fallen considerably in the last year or so, and office rents are beginning to reflect the shortages of available space. A similar churning in resource allocation is occurring in electronics manufacturing. Falling chip prices have helped Texas computing manufacturers. Advances in technology are beginning to reduce the demand for paging devices and to boost that for personal communications services devices. This has shifted the demand for a wide range of workers to businesses located only a few miles away.

Overall, the national economy seems to be performing quite well. I agree with the broad outlines of the Greenbook forecast. The rate of economic growth will likely slow somewhat in the months ahead, but inflationary pressures could begin to accelerate, although I don't think that is guaranteed.

On the question of the inflation outlook, it is somewhat surprising to me to see all the emphasis that people in this room place on wage-push inflation, which I recall learning in school was dependent on an accommodative monetary policy. The first line of defense is productivity improvements and the second is Clint Eastwood's "don't even think about it" monetary restraint.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. Tight labor markets continue to be the rule in the Eighth District. The District unemployment rate was less than 5 percent in both the first and second quarters, the lowest since the 1970s. The strike of 6,700 McDonnell Douglas machinists that began June 5 remains unsettled. The company has maintained output so far with replacement workers. Anecdotal evidence in a survey of more than 200 District enterprises indicates quite persistent wage pressures. About one-fifth of the firms surveyed are planning to increase prices in the third quarter and few are planning cuts. District automotive output is expected to jump appreciably in the fourth quarter, although much of this increase reflects the boost that is normally associated with the introduction of new models. Because of strong demand for models produced in the Eighth District and increased capacity this year, the number of cars and light trucks built in the District by Ford and Chrysler is expected to be 22 percent higher this year than last year.

Although the District economy is operating at a high level, a variety of indicators suggests that growth is moderating, which is a picture that we have heard described by a number of people around the table. For example, year-to-date growth in District payroll employment lags behind last year's pace. An exception is residential construction where employment continues to grow at a vigorous rate and permits are well above year-earlier levels. Loan growth at District banks has decelerated from the high rates observed last year, matching the national pattern. The most recent Senior Loan Officer Survey suggests that the slowdown may be partly due to a tightening of lending standards. On the ag side, crops are in fairly good condition across the District. The rice crop is down from a year earlier because land has been diverted to other crops. Overall, harvests are expected to be larger than last year, though down from the records of two years ago. Nonetheless, District farm income should increase substantially this year because low inventories are holding up prices and federal outlays for farm income and price support programs will be higher over the next few years under the new farm bill.

At the beginning of the year, the Committee took out an insurance policy against the risk of a slowing economy. As events have unfolded, the outlook is much better today than it was then. Most forecasters see real growth holding close to the long-term trend through 1997. In July, the Committee's central tendency forecast for real GDP was a full half-percentage point above the estimates that we presented in January. Because real growth in the second quarter was above trend, forecasters naturally expect some slowing. Earlier figures on retail sales and factory orders for July confirm that view. There also was a decline in job growth in July and a decline in the index of hours worked. It is worth noting, however, that 193,000 new jobs in July, though down from the figures for earlier months, are still well above the growth of the working age population of about 110,000 to 120,000 a month. All said, the real economy seems to be in good shape entering the sixth year of the expansion.

Whatever the outlook may be for the real economy, we must be concerned about the rising inflation trend. This rising trend can be seen in the staff's projections. CPI inflation touched its low for the current expansion in 1994, accelerated a little in 1995, and according to the Greenbook, will accelerate a little more in 1996 and yet a little more in 1997. CPI inflation was 3-1/2 percent at an annual rate in the first seven months of 1996, up from 2-1/2 percent over the 12 months of 1995. Last year, we could see signs of falling inflation in August that showed up in the data in the second half. This year all of the signs--tight labor markets, the prospect for further increases in food prices, the pending labor negotiations, inflation-jittery financial markets, fairly rapid growth in M2 and in sweep adjusted M1, and high levels of long-term interest rates relative to current inflation--suggest that inflation pressures are building. We have taken a risk this year by failing to respond to the unexpected growth in both output and prices. We should not want increasing inflationary pressures to get built into expectations as happened in the late 1970s and again in the late 1980s. Absent the kind of inflation credibility that announcement of a firm commitment to price stability would give us, we need a strong response to signs of incipient inflation pressures. As I read the Greenbook, these signs are becoming increasingly clear. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. The District economy remains healthy. I have been impressed most recently by strength in many of the natural resource industries. Labor markets continue to be tight and if anything they have tightened a bit further. They are so tight in fact that my kids have found jobs! [Laughter]

As far as the national economy is concerned, I read the situation much like the Greenbook. Wage increases clearly are more rapid. They are not offset currently by improvements in productivity, and I think increased price pressures are likely to result.

I would like to comment briefly on an issue that has intrigued me recently, though I must admit it is something that is hard to quantify. It is the use of personal credit cards by small businesses, by entrepreneurs, for business purposes. There is no question that this is going on, and I strongly suspect that it is increasing in volume and breadth. I say that because of the anecdotes that I have been hearing; one just has to raise the subject to hear from almost anybody in the small-business arena how they use their credit cards for business purposes. It is not surprising given the teaser rates that are available and the ease of credit card applications as opposed to applications for small-business loans at banks. I think the consumer credit data are being affected by this phenomenon because the small-business people I talk to do not tend to pay this borrowing down; they tend to roll it over from one teaser rate to another and indeed to build up an increasing volume over time. It does not mean that we ought to be sanguine about credit-quality issues. Of course, that depends on whether we believe small businesses are more likely to repay this type of borrowing than consumers. I do not have any convictions about that. But I think it does mean that when we look at consumer credit data relative to something like disposable income, we may be getting a misreading of credit exposure because the denominator is not quite right. What we want to include in the latter is business revenues, business income, or cash flow, or something like that. I have discussed this with Don Kohn and I do not think we have much data on it, but it is something that we may want to bear in mind as we think about some of these credit versus income issues.

CHAIRMAN GREENSPAN. Do you have any idea what the order of magnitude might be?

MR. STERN. No. I really do not.

CHAIRMAN GREENSPAN. These involve 15 or 16 percent interest rates?

MR. STERN. No, not on the teaser rates. These are 5.9, 6.9, 8 percent rates, and they are available without any effort. Applications just show up in the mail.

MS. MINEHAN. By using these cards, small companies can offset considerable expenses that they otherwise may have. For example, a small business may previously have had credit cards that were being charged to the company's account and may have incurred sizable clerical costs to reconcile the charges and various business expenses. Diners Club, for example, will now give all of a small firm's employees a credit card against the employees' own credit. The firm avoids the need to reconcile charges. And if there are enough employee names on the list, the firm does not have to pay the first year's billing costs, and it can switch to another card and do that fairly easily.

CHAIRMAN GREENSPAN. It sounds like a decisively sound business practice! Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. At the last meeting I reported that the Second District economy had been expanding rather rapidly. It has continued to expand but at a somewhat slower pace in recent weeks. From May to June, the growth of payroll employment decelerated from 2.1 to 1.4 percent in New Jersey and from 2.1 to 0.1 percent in New York State. June unemployment rates were essentially unchanged at 6.3 percent in New York and 6.1 percent in New Jersey. Our retail trade contacts reported disappointing sales in June and July after a very strong spurt in May.

Growth in permits for the construction of new homes slowed in June, and realtors reported similar softness in existing home sales for the July and early August period after a robust second quarter. In contrast, the commercial office market continued to improve. Growing demand for office space in the absence of new construction pushed June vacancy rates lower throughout the greater New York metropolitan area.

Regional price pressures have remained subdued. The 12-month gain in the New York-northeastern New Jersey CPI was just 2.7 percent in July compared with a 3 percent rise in the national index. That continued a 3-year trend of relatively lower regional price inflation.

Going forward, we believe that expansion will continue in the District. The government restructuring in our District states is slowing this year. The drag on job growth from manufacturing continues, but it is less than it was in the past. Modest overall job growth continues, and as we look ahead to next year, we think that the government restructuring will slow even further, manufacturing declines will moderate, and we will continue to have strength in business and consumer services. So, the District economy looks as if it is beginning to behave better than it has since the 1990-91 recession.

We have, however, what may wind up being a rather difficult problem for New York State coming from the welfare reform bill to be signed this week. The New York constitution is unique among state constitutions in that it requires that the state provide and I quote, "aid, care, and support of the needy." So, it looks as if some of the effects of the welfare reform bill simply cannot take place in New York State. The state is at least as litigious as any other part of the country, and therefore it is almost certain that because the state constitution says the needy have to be taken care of, lawsuits will seek to prevent the state and the cities from making any changes. The level of welfare is already higher than that for the nation. In New York State, 17 percent of all children receive AFDC. That compares to about 14 percent at the national level. The maximum benefit in New York City is $577 a month for a family of one adult and two children. That compares to $367 as a national average. So, we could have a situation in which the already fairly severe fiscal problems of New York State and New York City could be aggravated. What one does not know is whether there will be migration caused by changes in welfare. The scholarship on the subject says that people do not in fact migrate because of differentials in welfare payments, but we could get into a situation that does not involve a differential as such but rather migration from a state with no welfare payments for a family to New York State, which would be constitutionally required to provide welfare support. We do not know exactly what this is going to do to the state's economy. As of now, the political leaders of the state seem to be rather quiet on the subject.

Turning to the national economy, our forecast is somewhat different from that of the Greenbook on both growth next year and not surprisingly, therefore, the effect on the CPI. We have fourth-quarter-to-fourth-quarter real growth slowing to 1.7 percent in 1997 as compared to the Greenbook's 2.1 percent. We have the overall CPI at 3.1 percent; the Greenbook has it at 3.3 percent; and we have core CPI creeping up and touching, although not passing, the 3 percent level in the fourth quarter of 1997. Our forecast is based on an assumption that, looking at the employment cost index, there will be a gradual upcreep in wage inflation and that the sharp reduction in the growth of benefits that the economy has been enjoying will at least slow down. We have the growth in benefits plateauing, and I think that any model used for a forecast should include such assumptions rather than ones that are more optimistic.

The board of directors at the New York Fed, which is a particularly interesting board that includes a very good cross section of strong-minded, bright people, is of the very strongly held view that the forecasting models are missing what they think are two changes affecting the performance of the economy. First, with regard to benefits, their very firmly held view is that the rise in benefit costs will continue to drop. At most in their view, we will have a respite in which there may be a bit of a slowdown in the reduction of benefit cost increases. But they hold very strongly to the view that the managements of firms will have to continue to reduce benefit costs. They will do it by pushing those employees who are not yet under managed care onto that health care system and then forcing the providers to rationalize further. The net result will be to keep benefit costs dropping. Again, we have not assumed that in our forecast, but it is a very firmly held conviction by my board members and one that I have difficulty not sharing.

The other thing that they think we are missing relates to the view that if there is some increase in wage costs, at this stage of the business cycle it would not be wise to assume that we would be rescued from its effect by high productivity growth. They are very strongly convinced that business simply is not being run in a way that assumes business managers will pass on rising costs by increasing their prices. Quite to the contrary, the people running businesses are aware that the only shock absorber is a reduction in profitability. Since business executives are not hired by their stockholders to have their firms' profitability squeezed, they are going to work even harder, as in the benefits area, to make sure that their businesses continue to be rationalized. Therefore, cost pressures will simply not occur and will not be passed on in inflation. If you were to listen to these wise people, you would say that the trend in the inflation rate will in fact continue to be down. I do not know if that is likely to be the case. I don't think it is certain enough by any means that one should put it into any kind of official forecast. But since in our view the present stance of monetary policy is not creating an inflation problem, one would not have to believe any portion of what my board members believe to conclude that rising inflation is not a problem. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. I had been thinking fairly positively, feeling pretty good, about things since our last meeting in early July. Then, over the weekend, I got a call from my tenant in Los Angeles who said he had lost his job and was breaking his lease and moving to New Jersey. Then I read the Greenbook and that depressed me further. So, I am not quite sure whether the change in my mood since July is affecting my view as to what is the right thing to do at this point.

In agriculture in our region, this will be a down year for farm income. There was a fair amount of crop substitution. Farmers were able to plant more crops than they earlier thought they would be able to, but the yields are going to be down and the price effect is not going to compensate. So farm income is expected to be down, and the banks in the farm areas expect some pressures to come from that.

One of the issues that we kept hearing about through the spring and into the early summer, even at the last meeting of our board of directors, was concern about speculative excesses, especially in the high-tech sector. But with the sharp overall adjustment in the prices of high-tech stocks on the Nasdaq earlier this summer, that concern has pretty much vanished from the reports we are hearing. We deliberately went out to see if we could find stories of other forms of speculation that might be symptoms of inflationary excesses in the real estate sector, whether with respect to construction or bidding up land prices, and we simply did not find evidence of that in our region. We likewise have focused a fair amount of attention on the auto situation because of the very widely held view that GM is building inventory, that it wants a strike, and that it plans to take a strike to get some very significant changes in work rules. But we also are hearing about a fair amount of militancy on the labor side as well. I am not sure how all that will net out. We asked people what was being done by businesses or by anybody in their communities in response to the possibility that there will be a GM strike. A lot of our communities are very heavily influenced by General Motors. The responses were that nothing was being done. So, I am not sure what the effects of a strike would be if that assessment is correct.

The steel industry says that its orders are flat. Orders for steel-producing equipment to renovate and expand domestic facilities are down very significantly and are expected to decline further in 1997 because of what is characterized as looming overcapacity in the domestic flat-rolled steel sector of that industry. However, exports of steel-making equipment are very good. Our contacts also believe that the recent increase in steel imports will fall off so that domestic demand will be relatively flat going into next year.

District employment is mostly expected to be flat at very low levels of unemployment, and there is little talk of wage pressures in spite of continuous reports of tight labor markets in large and small communities. We have heard some interestingly mixed views about the minimum wage increase. One surprising response from two different sources was that the perceived adverse effect on retail and fast-food companies, which would expand less or possibly contract in some cases, would be offset by increased applications for employment at other firms. Contacts at investment and bank branching companies said they were looking forward to the minimum wage hike because it would mean that more people would be applying for their job openings. In construction, a labor leader said that union halls were empty but that was not leading to wage pressures. He said the response of workers to this situation is not to look for higher compensation.

When we asked what was happening around the region as a result of tight labor markets--and we confirmed the responses in other ways--we were told that business firms simply were postponing projects throughout Ohio in particular and also in central Kentucky and to a lesser extent in parts of eastern Kentucky. Businesses mainly are saying at this point that they are not going to get the projects finished anyway before bad weather sets in, so they are just planning ahead for next spring. Their expectations now are that in 1997 construction will continue to be very good in our part of the country.

In banking there are consistent reports throughout the region that loan growth is slowing, including housing and auto loans. I don't know to what extent the auto loans may reflect the decline in auto sales that we saw in July--these reports may be lagged--but the reports provide consistent indications that bank lending has softened. There also has been some deterioration of credit quality. Both the bankers on our three boards of directors and our community bank advisory council have told us a lot of stories about poor credit quality. Some banks were doing spot checks on credit ratings. A consulting firm that is now offering this service went back and rescored all the consumer credit files of a bank and found a very sharp drop in the scores of the same individuals compared to two years ago. The main reason for the drop was the credit card debt that these consumers had incurred in the interim. All the bankers reported slower payments, higher delinquencies, increased bankruptcy filings, and larger allowances for chargeoffs as they finish out the year. The thinking about 1997 is that the volume of credit extensions will be down, the quality of accounts will worsen, and bank profitability will decline. So, they are in a negative mood about that. It's the sort of thing that Governors Lindsey and Kelley cited as a potential development earlier in the year. It seems to me from what we are hearing that such concerns are now becoming more common.

Let me turn to some remarks about the national economy. We have heard this morning about the hope that real growth will slow. In one sense, I hope that real growth does not slow down. If it turns out that the investment boom that we have had for some 3 to 4 years has strengthened productivity more than is being assumed, then we could enjoy more output growth without the concerns that we all feel about inflation. But if we are going to experience slower output growth over the balance of this year and into 1997, then of course we need slower growth in the demand for that output. The arithmetic of the Greenbook is that inflation is going to increase and that is why I was disturbed by the upward revision in nominal GDP. Even though it is only .3 percentage point, the higher nominal spending growth continues for the next six quarters. If we are right in assuming that output growth is going to slow because of capacity constraints and if the assumption is right that nominal spending growth is going to increase for whatever reason, then we have baked rising inflation into the cake and that is unacceptable.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. In the fourth quarter of 1994 the unemployment rate dropped rather precipitously from 6 percent and above, where it had been for some time previously, down into the 5-1/2 percent range where it has been ever since. It also was right around that time that capacity utilization in manufacturing began to drop from its peak of around 84.3 down into the low 82s. For the past eight quarters, including this one, we have been pretty close to living in an economic nirvana. GDP growth has been right on trend: 4 quarters over 2 percent, 1 quarter at 2 percent, 3 quarters under 1 percent. The economy has been operating either at or very close to capacity with very little, if any, gap between potential and actual output. Unemployment has been steady at around 5.5 percent, capacity utilization as I noted has been declining slowly, inflation is flat to down, core CPI has averaged 2.85 percent. If it turns out that the core CPI has been overstated by a percentage point or so, that means that we have been even closer to an economic nirvana. Other measures such as the deflator and the chain indexes have been lower in absolute levels but the trend has looked the same. The expectation going forward in the Greenbook is for more of almost the same through 1997: capacity utilization steady at 82 percent, unemployment steady at 5.4 percent, and GDP growth right on trend at 2.1 percent. At least that is close enough to trend for government work. Government work, you know, is defined as measuring with a micrometer, marking with chalk, and then cutting with an axe. [Laughter] But there is one big difference in the forecast that we have been discussing. That is that inflation will start to rise, and that is projected to start to happen right about now. The Greenbook shows the core CPI moving up to 3 percent this quarter and to 3.2 percent next year. That would represent a half percentage point jump in a year's time, and I presume that if the forecast were extended, the trend would continue to be up from there, ceteris paribus. Now, that certainly would not be acceptable to me or probably to anyone else in this room. And I am afraid that the .3 percent increase that we got in the CPI in July could be a harbinger of things to come.

If we are going to get this rise in inflation, how would it happen? We have been discussing all morning that it would be through rising compensation costs that would get passed upstream into prices. If that is going to happen, several things in some combination have to occur. First, the rising wages obviously have to drive unit production costs up materially. We do see that beginning to happen, possibly through the ECI and certainly the new minimum wage law. But the increase in production costs will have to be high enough to overcome productivity growth, which I continue to believe is under measured, and the flatter benefit costs that the Vice Chairman spoke about a few minutes ago. That certainly could occur. There is no doubt about that. But the other question is whether some pricing power will begin to re-emerge in the economy. We still have a world with a lot of slack in almost every economic sector. There still seems to be fierce competition everywhere in the domestic economy. I have not heard of any easing in the consumer's fierce resistance to price increases. Also for this to happen, it would have to imply that business would be able to refuse to compromise their very strong profit margins. Historically, of course, they have compromised them when they needed to. I suppose that it would also imply the likelihood or need for a lower dollar. These conditions for pricing power to re-emerge are not in view insofar as I can see.

Nevertheless, could all of this come together and perhaps result in an inflationary surge? Yes, indeed; I do not think there is any doubt about that. But can we be confident that is what will happen, especially very soon or starting now? On the basis of the long-term historical record, I think we probably would be persuaded that that is in fact extremely likely. But on the basis of developments over the past two years, it is a little more difficult to be convinced. It is quite possible that we could roll on along like we are for some time. I do not know how long, certainly. What happens then is virtually anyone's guess in such a period. Admittedly, that is a very sanguine outlook, and frankly I am not a bit comfortable with it. It is dependent almost entirely on an early and substantial slowdown in the expansion, and I have a special concern in that regard given the possibility of a new inventory surge. But the slowdown has to happen if that happy outlook is to ensue. It seems to me that the risks are distinctly on the up side, but for the moment I would say let us continue to give it a chance.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you. We clearly are still struggling with the same two questions that occupied us at the last meeting. First, is the economy slowing or likely to slow quickly enough to trend to at least stabilize the unemployment rate at the current level? Secondly, is the current level of the unemployment rate definitively below NAIRU so that it ensures a trend toward higher inflation? The Greenbook gives us an optimistic answer to the first question and a pessimistic answer to the second. The data available since the last meeting gave me a little more confidence in my answer to the first question but still left me with uncertainty about the second.

There has been a lot of mention around the table already of the risks of higher inflation as a result of that uncertainty. But I hope that we won't ignore the fact that the slowdown has the potential to allow the economy to sustain trend growth at the current level of unemployment with modest, stable inflation at least for some period. While the persistence of the slowdown is hardly assured, the data that have become available since the last meeting provide evidence of slowing that we could only anticipate then. This certainly reinforces my confidence in the slowdown projected by the staff, and that is also very consistent with the consensus of private sector forecasters. So, I think a provisional "yes" is in order for the slowdown scenario. Of course, what we are talking about here is really a knife edge--slowing just to trend. So we obviously are going to have to revisit this issue and adjust as necessary.

The real key is the second question; that is the heart of our problem. The staff forecast answer to the second question is as follows: The unemployment rate is already below NAIRU and will remain so after the projected slowdown, resulting in a gradual, persistent deterioration in inflation. The minimum wage increase is an ingredient in the staff forecast of higher inflation, but it is a spice not the substance. The fundamental source is the conviction that the current unemployment rate is incompatible with stable inflation. The problem we face in acting on this forecast is that the pattern of rising inflation that it projects going forward should have been under way for some time and in fact is not yet evident. The data available since the last meeting, while somewhat mixed, did not alter this interpretation. The staff views the benign inflation environment in recent quarters as a temporary aberration relative to longer-standing regularities. Technically, the excellent inflation performance is a mirror image of poor model performance. The forecast of higher inflation going forward simply reflects confidence that this model error will diminish or disappear. But it is very hard to dismiss the fact that the extraordinary performance of inflation in recent quarters raises serious doubts about the estimate of NAIRU compared to what it was in earlier periods. As a result, my answer to the question of whether or not the current unemployment rate is below NAIRU has taken into account not only the estimate of NAIRU based on a longer period, but also the details of the inflation performance over the last couple of years. Indeed, estimation techniques that weigh the more recent data more heavily suggest that NAIRU has declined recently and may be close to 5-1/2 percent today.

The inflation picture is even more impressive than many acknowledge. More broad measures of inflation have declined than have appreciated; they show no signs of broad-based acceleration and in many cases even hint of ongoing disinflation. Consider particularly the recent patterns in the chain measures of the GDP price index, the gross domestic purchases price index, and the PCE price index. The inflation rate in each case is about 2 percent over the past year and below 2 percent if it is measured net of food and energy components when that breakdown is available. Each of these measures posted a lower inflation rate over the year ended in the second quarter than over the preceding year. At least for the available core measures, each of these inflation measures was near its recent low in the second quarter. The CPI in contrast is closer to 3 percent than 2 percent, and there is less evidence of ongoing deceleration. But even for the CPI, both overall and core inflation rates were lower over the four quarters ended in the second quarter than over the previous year. The ECI data do challenge us, and we are seeing some signs of higher wages. I think we ought to take into account that, given the slowdown in the rise in benefit costs, some increase in wage pressures should be passing forward the benefits that firms have received from those lower benefit costs. So, we want to focus on total compensation, not just on wages. There has been some edging up in compensation; it is fairly small so far, and given the projection of some compression in profit margins, it is also quite compatible with stable inflation at least for some time.

In case all this may seem too optimistic, let me end with a cautionary note. There has been some discussion around the table of the potential, or even the reality, that we are already facing fast productivity growth or that we might see some in the future or that faster productivity growth might offset any increase in compensation. My reading of the data leaves me somewhat concerned about that interpretation. Productivity growth over the last three years has been very low, below 1 percent. If we look at the productivity trend over that three-year period--when, after all, the economy has been growing at a rate averaging close to what we thought was trend over that period--one would think that productivity growth during that period also would be close to trend. In that case, we might reach the judgment that the productivity growth trend is a half percent rather than a percentage point. I think we need to monitor this path very closely. But if the trend rate of productivity growth has in fact downshifted, then the growth of potential will turn out to be much slower than the Greenbook projects. The slowing in growth that will be required to reach trend will need to be more aggressive and less certain, and the price inflation that we should expect from the current trend in nominal compensation will be greater. But for now, steady as she goes.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. At the last meeting I thought we would have more information by now. We certainly have more data, but it is not clear to me that we have much more real information. We are into the sixth year of this expansion and, depending on how we measure them, we have had either two or three soft landings. We are now coming off a strong second quarter. People around the table have discussed whether we are either in for another soft landing or a continuation of relatively strong growth. I must say that I am quite impressed by the unanimity around the table in terms of the outlook, which seems to be settling on the notion of moderating growth. Clearly, the factors pointing to further growth that we have been citing over the last couple of meetings are still in place. In fact, I think some of those factors have solidified. Financial markets generally continue to support growth. With the decline in long-term rates, the yield curve has come into a flatter and more normal alignment. We have had some excitement in the equity markets during the intermeeting period, but much of the correction, particularly in the blue chips, has reversed itself and there has been substantial recovery. If we were to have additional correction or a sideways movement, that probably would be a healthy development in that it would allow earnings to catch up. So, I think the equity markets remain a quite reasonable source of capital. Banks generally appear to be providing ample credit and they seem to be adjusting their credit terms to changing circumstances. Inventories are in reasonably good shape. Growth in business investment is down from 1994 and 1995, but this sector of the economy is still a contributor to the expansion. As long as people are working, I do not think that we will see a big pullback in consumption expenditures.

On the inflation front, a lot of people have commented on the surprisingly good inflation numbers, and I think that performance is particularly notable in view of the length of the current expansion. We have had an uptick in some of the indexes, although it can be said that food and energy largely explain the increases in the CPI, the PPI, and the prices of crude materials. The core indexes all show improvement in the last twelve months over the previous twelve months. We do not get as many readings on the deflators, which are broader-based indexes, but they also show improvement over the last twelve months.

Where do we go from here with respect to inflation? The outlook for energy prices is considerably improved. I think that food prices remain a risk. Labor cost pressures are firming and are likely to remain a risk. With regard to the recent ECI data, it is hard for me to believe that aggregate compensation costs can be held down forever by improvements on the benefits side. I hope the members of President McDonough's board of directors are right and that we are on an ever downward trending slope in the benefits area, but I have to tell you that I am skeptical. I can certainly understand why some of the benefit costs may go down. State unemployment insurance costs surely could go down, but improvements in other components seem unlikely to be sustainable. Assuming that at some point we do not get further improvement in benefit costs, total ECI is going to be exerting more pressure than we currently are seeing. The question will be whether business is going to absorb these cost pressures either through the traditional squeeze on profit margins or through improved productivity. I am sure that I do not want to wade into the productivity measurement morass. The recent performance of inflation leads me to believe that the economics profession does not have a good handle on productivity measurement. I am sensitive to the comments by manufacturers that we must be doing better than the estimated 1 percent trend in productivity improvement. But in case the statistics are right, we still have the profit-margins safety valve. As much as business managers do not want to report declining profits to their boards of directors, they have had to do so on occasion. So profit margins remain a safety valve.

In sum, we have had additional confirmation of an economy that is on a sustainable growth path or even better. There has not been any significantly bad inflation news since our last meeting, but I have to say that the risks remain on the up side.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. I think Governor Phillips said it well when she said we have more data but not more information, and maybe that is good. I have two observations. The first is on the business use of credit cards, which I think is certainly happening. In fact, small businesses have always used credit cards as a means of finance, and that use has expanded. It has expanded in part because a lot of the small businesses that are created now involve people who had lost their previous jobs through downsizings or are now in a relationship with their employers that involves consulting. As a result, it is natural for these people to go to credit card financing. However, that is not necessarily a basis for optimism.

First, if the entrepreneur is not careful, the apparent 6.9 percent or other low rate of interest is in fact quite expensive financing because, if the entrepreneur is mingling private consumption debt with business debt, the IRS will quickly disallow the deduction of the interest. For example, for a middle class entrepreneur, a 6.9 percent credit card debt is like a 10.8 percent business loan. That tax consequence has not been featured in Money Magazine or on the front page of the business column of the Wall Street Journal, but I think entrepreneurs will be finding out about it soon if in fact that is what they are doing.

Second, with regard to the riskiness of credit card debt, it is important to recall that the proprietary type of income is in the personal income numbers. There is no real capital behind what these people are doing. They are basically in the service sector. There may be a computer in the business; but we all know what the resale market for computers looks like, so there is no significant amount of capital behind what they are doing. In a sense, they are giving themselves a consumption loan, but they call it a business loan, and they pay themselves higher salaries than otherwise with the difference in interest. The result is no different from anyone else running up a credit card debt to buy, say, a vacation. So, I think Gary Stern's point is well taken, and if anything I think we should be a little more concerned about small-business-based financing than we are about general financing with credit cards.

As far as the economic data are concerned, we are going to get more data and we may or may not get more information in the intermeeting period. Where I would think that we have a risk, however, is not in the U.S. economy. I think our risk will stem from the activities of our good friends located not far from the Federal Reserve Bank of New York in the Second District and our compatriots around the world returning from the beach and looking for a source of money to be made. In fact, there is a great deal of money to be made in speculating on the European Monetary Union or nonunion or whatever. In that regard, there are two obvious events and probably a lot more that are not obvious. One is the French budget, which will be a fake and everyone knows it. The question is, how much of a fake? That should cause a little instability with regard to the franc/mark convergence. The other event--to call it an event really is not fair --is the Italian government, which provides an ongoing spectacle. France and Italy both are risky. I think there will be lots of bets on both the franc and the lira and maybe on the Spanish peseta that will tend to push money into marks. For some reason that I am not fully comprehending, the consequence is not just a mark/franc gain or mark/lira gain. The dollar tends to lose when the mark appreciates. I think this situation is risky for us for two reasons. The first is a long-run fundamental reason and that is that a weaker dollar will result in a net stimulus to the U.S. economy at a time when we really do not need any extra stimulus. The greater risk is that it will tempt policymakers to intervene. I think that would be a serious mistake. We should be ever vigilant in watching the data come in, but I see that as the key piece of information that actually poses a policy risk for a potential intermeeting move.

CHAIRMAN GREENSPAN. Governor Yellen.

GOVERNOR YELLEN. I had naively hoped that with the long intermeeting interval and so many key data releases that the fog of uncertainty hovering above the forecast might lift by the time of this meeting. Unfortunately, as many of you noted, the body of incoming data has provided only modest illumination with respect to the two fundamental issues that cloud the outlook. Those are, as many of you have indicated, whether aggregate demand is poised to slow toward trend and whether core inflation is in the process of accelerating. My answers to these questions really are identical to those of Governor Meyer.

On the first issue, I agree with him and many of you and with the analysis of the Greenbook. It seems to me that most labor market and demand-side indicators along with the Beigebook and other anecdotal reports do offer tentative evidence pointing to a slowdown in demand growth beginning this quarter. But, unfortunately, the extent and timing of the moderation in demand remain highly uncertain and significant risks remain. I would enumerate two. With inventory-sales ratios at relatively low levels, a surge of inventory investment with attendant multiplier-accelerator feedbacks seems to me to be a definite upside risk. Another risk is from the stock market. Present market valuations appear to be based on earnings expectations that are highly optimistic. Market participants could easily be disappointed, particularly if productivity performance is disappointing and wage pressures intensify, thereby setting the stage for a very significant correction.

With respect to the inflation outlook, my opinion is little changed from last time. Labor markets clearly remain tight, but unemployment has not decisively broken out of its recent range. And, as Governor Meyer emphasized, broad measures of price inflation are still declining. If one smoothes through the noise, it seems to me that the trend toward a more rapid pace of wage and salary growth is quite firmly established. At the same time, growth in benefit costs remains well contained, at least thus far, and I also found the Vice Chairman's comments about the prospects here a hopeful sign. The bottom line is that we have a very mild acceleration in the pace of nominal compensation growth, which is of course what matters to unit labor costs. In spite of this uptick, though, nominal compensation growth still remains well below the pace that historical econometric relations would be predicting, and the uptick may thus simply reflect a rebound toward a more normal level. So, assuming that productivity growth recovers somewhat toward its past trend of roughly 1 percent--and I agree that is a significant assumption--or that profit margins erode somewhat, I think that the present pace of compensation growth should be consistent with stable inflation rates in broad measures of product prices.

Now, suppose someone, and that someone is not I, firmly adheres to the view that the economy is currently operating at NAIRU and not below it. Can one point to anything in the recent pattern of wage and price behavior that would provide strong evidence against that view? Here I would agree with Governor Meyer; I think the answer is no. On the other hand, historical evidence strongly suggests that NAIRU is higher than 5.4 percent, so it would be both dangerous and foolish to discount the possibility that the modest uptick in compensation that we are now seeing is the beginning of a process that, if left unchecked, will lead to gradually accelerating inflation. I think the minimum wage increase does compound the risks. When I reviewed the transcript of our last meeting, I found myself in strong agreement with the way Governor Kelley summarized the situation and, of course, with what he said today. Last time, he noted that "it is very correct to be suspicious of the notion that this time things have changed because assuming that is a classic trap and frequently a loser's cry." I completely agree. He then went on to reason, as he did today, that there are actually very strong indications that things have indeed changed. I also agree. [Laughter] In other words, I am "conflicted." I consider the Greenbook inflation forecast pessimistic simply because it assigns virtually no weight to the possibility that things have changed.

CHAIRMAN GREENSPAN. Governor Rivlin, top that.

MS. RIVLIN. Let me put a slightly more positive cast on the same facts. It seems to me that we are being a little hard on ourselves. Actually, we should be fairly pleased not only with the way the economy is performing, but with our general understanding of it as expressed at the last meeting. There may have been no definitive data during the intermeeting period, but at least there have been no surprises. Everything that has come in has been pretty consistent with what we thought. In July, we knew that the economy clearly was growing above its potential, that labor markets were very tight, that there was beginning to be some indication of wage acceleration but offset by the behavior of benefit costs, and that there was little or no evidence of accelerating price inflation. We were all a little queasy about the forecast of a slowdown because we could not see the slowdown anywhere in the available data. It was not happening yet, and there were two big questions. One was, would the slowdown in fact occur and begin to be evident? And the more fundamental question was, could we continue to run labor markets this tight without incurring accelerating inflation? To put it more technically, was there a NAIRU and where was it? Was it indeed lower than we had thought? The inflation risk was clearly there. It seems to me that by August most of the statistics have come in on the track that we thought they would. The evidence of a slowdown also seems to be supported by the anecdotal or regional information that we have heard around the table. Labor markets are still tight, and we have had a little more evidence of wage pressures but no evidence yet of price pressures. The minimum wage is a new law as of today when the President signs it, but it really is not new information. We knew about the minimum wage when we were here last time, indeed since spring. If it was not built into the actual Fed forecast, it certainly should have been on our minds when we were talking about what to do because we knew the minimum wage legislation was going to happen. So, it does seem to me that we structured the problem about right. We see an economy probably growing at about what we think is potential. We still do not know whether we can sustain the currently low level of unemployment for very long without escalating wage pressures.

I was struck by the fact that President McDonough was the only one who mentioned the other big bill being signed by the President this week, namely, welfare reform. That legislation not only threatens to put a good deal of pressure on state governments, and not just in New York, but it also puts in strong relief the problem of how tight labor markets can be. If we are going to be successful in integrating some of the welfare population into the labor force, it is important that we keep labor markets pretty tight. So, erring on the side of not precipitating a recession, without taking on a serious risk of inflation, still seems particularly important for that reason, not just right now but over the next several years. My reading is that we still have the big question, given that the expansion is slowing, as to whether labor markets are too tight. The wage information is inconclusive, and I see no reason for losing our nerve when we see things coming in about on the track that we expected.

CHAIRMAN GREENSPAN. Thank you. Do we have coffee? Shall we go into recess?

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

MR. KOHN. Thank you, Mr. Chairman. There must be something in the water here! I began my briefing exactly as Governor Meyer began his and Governor Yellen began hers, but it diverges thereafter. I will cut through the first part of my prepared text a little. [Statement--see Appendix.] Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Questions for Don? If not, let me see if I can summarize and review where we are. I think we are in general agreement that there is some evidence, at least at the margin, of a slowing in the expansion from the frenetic pace of earlier in the spring. Homebuilding is beginning to soften, but I think the softening is modest at best at this moment. Certainly, the permits and backlog data that came out with the starts figures for July suggest that further significant erosion in starts does not appear likely in August. Motor vehicle sales clearly were lower in July, as was pointed out by Mike Moskow and in the Greenbook. A very significant part of the decline in July was the result of the unilateral action on the part of General Motors to curtail very significantly its fleet sales. General Motors has been concerned since the strike earlier this year that its inventory structure was inadequate to supply both its fleet sales markets and its retail markets. For obvious reasons, it chose to support its retail markets. Nonetheless, motor vehicle sales this summer clearly are a tad softer; and a not insignificant weakening in used car prices, especially the ratio of used car prices to new car prices, is suggestive of a softening market. So, I think a judgment that light motor vehicle sales will be coming back in August, seasonally adjusted, is the correct view, but it clearly is not one that implies a surge.

As a consequence of the weakness in sales and especially in fleet sales, inventories of motor vehicles were built up at a fairly significant pace in July. There also is evidence of some buildup of inventories in the non-motor vehicle, nonfarm area. One can pick up some evidence of this in anecdotal and state-level data and also from models using C&I loans and commercial paper to address the question of inventory investment. The evidence is still very marginal and most of the inventory data that we have for the third quarter clearly relates to motor vehicles, but I think there is no reason to disbelieve the projection of a significant uptick in inventory investment that shows up in the Greenbook for the third quarter. One potential explanation of the low initial claims and insured unemployment figures may well be that we are getting some production for inventories in the third quarter. We are not, however, seeing any of the elements that indicate a rush to build because we are not getting the usual signs of delivery tightness, stretching out of lead times, and shortages of various goods that tend to be associated with that phenomenon. Those are the types of problems that would induce a significant increase in safety stocks and bring on the kind of accelerated inventory investment that creates the major problems we have seen in the past. What seems to be involved here is not an increase in safety stocks, but an inadvertent drawing down of inventories to levels that are excessively lean at any existing safety stock level. Therefore, I think stocks are being built up at this stage, and that could suggest a somewhat higher GDP than one would normally expect. Indeed, it is probably one of the reasons why there has been an upward revision in the Greenbook's third-quarter GDP estimate.

Consistent with a basic slowing of the expansion, though without any evidence of weakness or cumulative erosion, is the fact that domestic operating profit margins finally appear to be flattening. But the data do, nonetheless, suggest that those margins remain high. If you were to believe the individual "bottom-up" earnings forecasts of the securities markets, you would find that difficult to believe. However, I think there is some merit to Governor Yellen's suggestion that earnings forecasts are very likely to be discouraging because all the people who do the buildup from individual estimates are getting higher domestic operating profit earnings than those who are doing it from the top down.

I think the reason for this is that we are getting mixed evidence with respect to productivity gains. This is crucial because if we disaggregate the total GDP data and separate manufacturing from all other sectors, we end up with the very interesting issue that we were discussing at the break. In the non-industrial area of the GDP, we are simultaneously getting a very significant increase in unit labor costs--in the 4 percent area--and a very dramatic rise in operating profit margins. I suggest to you that while those are reconcilable arithmetically, and indeed the data will reconcile, we do not get the sense that everything will be coming out exactly the way that the markets presume. We are getting anecdotal reports of productivity improvements in the manufacturing and industrial area even when we move a lot of the temporary worker hours from the services area into the manufacturing area, which is where they should be. So, manufacturing productivity is strong; it squares with the anecdotal information. Profit margins are rising in manufacturing but less so than in nonmanufacturing. Something has to change in this data system, and I am frankly curious to see how it ultimately will come out at the end of the day.

The flattening of profit margins on the presumption that that is indeed happening is consistent with the expectation that the expansion in the capital goods market will gradually slow down. Yet, there is no doubt in my view that it is premature to assume that the economy is backing off its unsustainable rate of expansion. Product markets do not exhibit much pressure; that is, we are not getting any pronounced upside pressure in industrial commodity prices, lead times are dull, and inventory shortages do not appear to exist. Nonetheless, there exists a tautness in labor markets that has been there all year long, and I think, as has been discussed at length around this table, the crucial inflation question that we confront is on the labor side. Our difficulties lie with the issue of tight labor markets leading to increased wage pressures not offset by productivity improvements. The issue that the Vice Chairman raised with respect to benefits is one that I, too, hear out on the hustings. That is, while everyone acknowledges that the sharp deceleration in the cost of health insurance benefits largely reflects the dramatic shift from fee-for-service to managed care, it is apparently not correct to presume that the end of the adjustment will occur when we reach the point where 98 percent of workers are in managed care. There has been dramatic pressure from the business community to move from fee-for-service to managed care. When that is completed, they are going to go straight at the managed-care providers the way the Vice Chairman suggests. Whether they are successful or not remains to be seen, as Governor Phillips quite appropriately suggests, but I do not think the automatic elimination of further containment of benefit costs is necessarily an obvious forecast.

Nonetheless, with the U.S. economy operating at high levels and very little evidence of cumulative weakness in recent data, the risks are and remain unquestionably on the high side. It would not take much to induce strong final demand that would require an accelerated inventory buildup coming from safety stock concerns. This is the type of development that occurred in 1994 but is not as yet showing any signs of emerging. Consumer confidence unquestionably is high, and the balance sheets of households, with the obvious exception of the debt problems in some of the middle-to-lower income households, are in very good shape.

While there appears little upside margin, alternatively it would not take much softening to reduce pressure on markets and even labor markets with a lag. As I indicated in my Humphrey-Hawkins testimony, I believe we are at a key juncture where small changes in macro demand can tilt the economy in wholly different directions with different outlooks. Current forecast error ranges easily encompass either scenario. The economy has eased since the Humphrey-Hawkins testimony but only marginally, and it would not take much to put us back in a tightening situation. Certainly, the declines in initial claims and unemployment insurance are not encouraging in this regard, though that may be, as I indicated earlier, a reflection of temporarily higher production in order to replenish perceived depleted inventory levels. I would suggest that is more likely the case if indeed it is showing up in the aggregate numbers rather than any evident upsurge in final demand. Of course, while it is true at least in the retail area that we are getting somewhat better chain store numbers for August, the sales figures for the week ended August 17th that came out this morning tilt down again. The chain store numbers do appear to be modestly better seasonally adjusted for August than for July, but it does not appear to me to be a big deal, and the improvement does not fully reverse the weaknesses that were apparent in both June and July retail sales data.

As far as policy is concerned, if the economy is in the process of growing at an unsustainable pace or moving in that direction, raising the federal funds rate only 25 basis points is not going to help much at this stage. Fifty to seventy-five basis points would more likely be required. Although the real funds rate is only a shade off its peak for this cycle, a much larger increase should not be necessary if indeed we have moved toward an unsustainable pace of economic growth. Had we been in a firming mode this year, it would seem prudent to me to tack on an additional 25 basis points at this meeting, as we did under not dissimilar circumstances in early 1995. But any upward move at this point implies a reversal of trend, which the markets will quickly price in, reflecting our increased credibility. They believe we have insights that they do not have; and my suspicion is that is a dubious proposition to say the least. The one scenario that I would very much like to avoid is our reversal of the trend and moving the funds rate upward just as the economy is in the process of measurably slowing down. As I indicated in July, our policy stance is not sufficiently out of line currently to require that we move quickly. I had expected that conditions by now would dictate the reversal of trend, but as a consequence of evidence suggesting some slowing in the economy, the case has become less compelling than I thought it would be. I believe that we can prudently hold off for a while to assess developments to make a determination of whether or not the economy is moving at an accelerated pace or gradually beginning to ratchet down. Nonetheless, if we do choose alternative B, which is the one I would like to propose, I trust we will continue our asymmetric bias.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I support your proposal.

VICE CHAIRMAN MCDONOUGH. Yes, I support the proposal.

CHAIRMAN GREENSPAN. President Boehne.

PRESIDENT BOEHNE. I support your proposal.

CHAIRMAN GREENSPAN. President Broaddus.

PRESIDENT BROADDUS. Mr. Chairman, as I said earlier today, my main focus has been on the second of the two questions we have been looking at. The possibility clearly laid out in the staff forecast is that the trend inflation rate is set to increase even if there is some further slowing in the growth of demand. Given this situation, I still favor some tightening of monetary policy. I think there is already ample evidence that the level of economic activity warrants what I would describe as a moderate mid-course correction to reverse at least part of the easing that was undertaken last winter. I must say that I was impressed by Don Kohn's comments about inertia and the potential cost of waiting to take this action. I recognize that the financial markets are not looking for any tightening action today and that such an action would be a surprise. But it seems to me that such an action could be quite beneficial to the atmosphere of the markets in the weeks ahead. The markets have been, it seems to me, exceptionally edgy over the last intermeeting period. They know there is an inflationary risk, and they are not sure how or when we are going to deal with it, especially given the fact that we have not acted to date. The situation and the atmosphere are almost reminiscent of the early part of 1994, after we made our initial move, when the markets were still waiting for the other shoe to drop. Only this time they are waiting for the first shoe to drop. A 50 basis point move today would essentially drop both shoes. You suggested in essence in your comments that the markets would likely conclude that such a move would be all or nearly all that would be required if in fact the expansion continues to decelerate. So a 50 basis point move would be what I would favor today. Beyond any longer-term settling effect it might have on the markets, a relatively decisive action like this would put everybody on notice that we firmly intend to keep our commitment to hold the line on inflation. It would be a very clear signal for anyone who needs it. Finally, while I still think a 50 basis point move is the better move, in this case a quarter of a loaf is better than none. So if 1/2 point is not acceptable, I would recommend that we consider doing 1/4 point. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I believe that the risks to economic performance are on the high side in the sense that the stage is set for more wage and price inflation than is desirable and perhaps than market participants expect. To be sure, the price data so far this year can be read favorably, but I know I am preaching to the converted in saying that we have to be forward-looking. There has been a lot of discussion of productivity and, of course, productivity is important; it matters for a lot of things. But the productivity performance notwithstanding, whether we have mismeasured it or not, we do know for sure that output growth so far this year is unsustainable because employment growth thus far this year has been roughly twice the sustainable growth of the labor force. Initial claims data suggest that this may be continuing. There are also signs that aggregate demand, in fact, is moderating. But the evidence is preliminary on this score, and it is not at all clear that it will moderate to a degree that will significantly change the labor market conditions I just described. Given the risks as I perceive them, waiting to act might damage our credibility, and more importantly in my view, might well make it more difficult for us to contain inflationary pressures. This could ultimately produce circumstances that would threaten the ongoing expansion of the economy. Moving modestly toward restraint now would seem to entail relatively little risk to economic performance and moreover could start us down the road that over time would not just contain inflationary pressures but could set the stage for some reduction in them. I would think that would be a prudent course of action and favorable for the long-term health of the economy.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, although the pace of economic activity seems to be slowing as expected, my best estimate is that the level of activity will remain somewhat above its long-run potential. The economy's capacity and the effects of worker insecurity on wage pressures, of course, are subject to uncertainty. In my opinion and that of the Greenbook, we face rising inflation. The inflation increases projected by the staffs at our Bank and the Board imply that the current level of short-term rates will cause inflation to accelerate through the forecast horizon and beyond. I am persuaded by this year's pickup in labor costs and the projected increase in all of the inflation indexes in the Greenbook. Therefore, I believe it is prudent to raise the funds rate by at least 25 basis points.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I am persuaded by your explanation of what is going on and the situation we find ourselves in, but I am chastened by Don Kohn's presentation of the risk of an excessively slow reaction to a policy requirement. I support your proposal. I think that a 25 basis point increase in the face of a market expectation of no action would be extremely risky in that it would absolutely assure the market that it would be 25 plus 25 plus God knows when that would end, and this would tank every market that I can think of. When we move, it would seem to me that the move should be 50 basis points and that we would try to explain it as a recalibration of monetary policy. That is fairly risky in that I am not sure that there would be three people outside this room who would believe it. But at least to me it makes more sense than to do 25 and to start what would definitely be interpreted as the installment plan.

I think the economy is at that balance point at which--as you suggested, Mr. Chairman--a move of policy now with the assumption that we know all kinds of things we really do not know, would be very likely to produce an excessive market reaction, which could very well tilt the economy into much slower growth than is either desirable or appropriate. So, recognizing that the risks are on the high side and therefore the directive should be asymmetric, the better judgment now is to maintain the fed funds rate at its present level. Therefore, I support your recommendation.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I agree with your characterization of the situation and the kind of decision that we are faced with, Mr. Chairman, and I agree with the remarks that the Vice Chairman just made. I thought we were correct in our use of the installment plan to lower the funds rate the last three times we did so after it had peaked at 6 percent. I do not think that we would be correct in starting off on an installment plan now because we would be saying that we misjudged the economy and the inflationary pressures--that we should not have been cutting the funds rate in the first place, and we have to roll it all the way back up to 6 percent. That would be a very, very strong message.

I want to explain to the staff of this Committee what it would take to persuade me that they are right about the outlook. I will put it in the form of a challenge. I will not blame you if you do not like the way I am going to characterize this, [laughter] but what you have said to me is that the minimum wage increase is expansionary for the economy. You have said that raising the minimum wage and other wages carries through to higher prices, lowers real interest rates, and therefore expands the economy at a faster pace. Thus, if we raise the minimum wage to $10, we will have a roaring boom. This just defies credibility to me. So, I have to judge my policy decision on the basis of a disbelief in the Greenbook forecast for nominal spending. I do not even believe the real part, but the nominal part bothers me more because of its direction. I cannot get away from the idea that the purchasing power of the dollar has something to do with the dollar and the supply and demand for it, and that what we are trying to do is to stabilize the value of the dollar. I would like to have a definite time horizon for when we are going to stabilize the purchasing power of the dollar and keep it there. When I see your recent numbers and the projection of central bank money growth accelerating, I have to be concerned. But I have a great deal of trouble separating out what is going on in the demand for foreign uses of our currency, that component of central bank money, and the contraction in the reserve balance component of it. I would have to assume that the demand for reserves is contracting even faster than the supply of reserves in order to conclude that we are seeing greater inflationary pressure. I think there is no evidence for that. If you have evidence and you can convince me, then I would change my mind.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I ask myself, what are we doing here? [Laughter]

SPEAKER(?). That's a pretty good question. Do you have an answer?

MS. MINEHAN. Yes, I have an answer to that. We are trying to keep the economy on track. We are trying to keep inflation low so as to provide the best atmosphere for economic growth. This is not easy to do, and we have not always been very successful at it. But we have been more successful over the last 10 years and particularly over the last 5 years than we had been in earlier years. Part of that is because we have tried to put an emphasis on being forward-looking. Looking back over the long run, it seems to me that most of the times when we could with 20/20 hindsight characterize the Fed as having made an error, it was mostly on the side of waiting too long, as Don Kohn has mentioned, and then having to move harder than we would have had to otherwise, clamping down and feeding into the business cycle. I probably have the name of this philosopher wrong but I think it was

Santayana who said that "those who ignore the lessons of history are doomed to repeat it."

CHAIRMAN GREENSPAN. You are correct.

MS. MINEHAN. Good, I am glad.

CHAIRMAN GREENSPAN. The last time I spoke to him, he said that. [Laughter]

MS. MINEHAN. You are older and wiser than I am, Mr. Chairman! Now, it may be that the experience of the last 8 to 10 quarters is a signal that the economy is changing. But we are starting to see wage pressures and we are starting to see a flattening out, if not an upturn, in most of the broad measures of inflation. In this environment, I do not think we can be quite as sanguine as many have suggested. I think we need to be very humble about our forecasts of the GDP slowdown being enough to guide this rather large and cumbersome plane totally on instruments without human intervention, at least at this point in time. I think we need a course correction. I think we need to step in and start steering this economy a little bit. Now, it seems to me that if, in the expectation that the expansion would be slower, we adjusted policy in 25 basis point increments, then we could start to steer it against an upside threat in small increments as well. It might be that the markets will overreact, but I think that overreaction would be short-lived. I do not necessarily believe that they would think we are all knowing because many of them have seen the same trends that we see in some of the data. I am conscious of the fact that a lot of what we are getting from the markets has more to do with how they think we are going to react rather than how they think we should react. If some uptick in the markets, particularly to the extent that it increases costs, takes them back up to perhaps where they were earlier in the year, that might be helpful in restraining some of the possible sources of overshooting that might be in the GDP forecast.

So, I would agree with those who recommended a course correction at this point. I could go with 25 basis points.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I support your recommendation. Although it is difficult to judge the stance of policy with any great precision, it is still my sense that with our current policy and the slowing of economic activity that we are beginning to see, we likely will be able to sustain a pace of moderate growth without a pickup in the broader-based measures of inflation. Consequently, I would have a preference for keeping the current funds rate of 5-1/4 percent in place and giving things a chance to play out a bit more. I am certainly comfortable with the asymmetrical directive.

Having said that, I again would like to join those who continue to urge us to do additional study and debate, both inside and outside the System, on the costs and benefits of a policy aimed at moving inflation rates still lower. Current circumstances and those likely to be immediately ahead may in fact provide us an excellent opportunity to pursue such a policy.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I believe that we should increase the federal funds rate now at least 1/4 percent. As I read the evidence, inflation is not slowing. I think that is a fact and that the indications are that it will rise. I would also argue that even small but persistent increases in inflation over time can have a fairly dramatic effect on the purchasing power of the dollar when compounded. Also, in the context of our currently strong economy and the objective of sustaining growth over the long term--and I recognize that policy involves balancing risks--I believe that a small increase now would bring more benefits in terms of moderating the inflationary pressures that are facing us than the risks it would incur of accelerating the economic slowdown that is worrying us to some degree. I think it would be prudent for us to take this action now. The economy can afford this action, and I think the long-term benefits would be greater for us.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. I support your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. I support your recommendation, Mr. Chairman. It seems to me that to move up now, when we did not in July and when we have seen evidence of the slowing of the economy, would be a very hard thing to explain and would risk a different kind of credibility. You said in your Humphrey-Hawkins testimony that we expected the economy to slow. Now we are seeing that it is, and suddenly we would be moving in a direction not suggested by that slowing. Clearly the risks of inflation are there. We have to remain vigilant. I still believe it is possible that we will not have to move; I do not think that is the general view around this table. The general view seems to be that it is a question of when rather than whether. We will know more as time goes on. It is more likely that we will have to move at some time if this economy does not slow more than predicted by the Greenbook, but I believe we have time to make that decision.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. With respect to the stance of policy, I would say with some conviction that I do not think it is restrictive and quite likely it is accommodative, whether we look at the growth rates of monetary aggregates or a funds rate that has not moved in the face of rising market interest rates. I think the risk is that inflation will move higher and perhaps more importantly, it will move higher from a level that I think is already unacceptable. We ought to be moving closer to price stability, not moving away from it. As a result, I would favor an increase in the funds rate today and, for reasons that have been stated by others, an increase of 50 basis points.

Let me just make a couple of other comments quickly. I think we are suffering from the fact that we do not have a nominal anchor for monetary policy. We do not seem to have a way to make a judgment about what the stance of policy is and relate that to a longer-run inflation outlook. As a result, I think we have become excessively focused on what is happening with respect to growth as opposed to looking at inflation. I think our actions have in fact been asymmetric. We have tended to show in our actions in recent months more concern about the prospect of slowing growth than we have about rising inflation, let alone getting inflation lower. I think we have gotten away with it so far because a good bit of credibility has been built up over the last 5 or 10 years, and for good reason. But if our indicator of the time to move is seeing the whites of inflation's eyes--I have not heard anybody explicitly say that, but I worry about that sometimes--when we get to that point, we will have lost a good bit of credibility and will probably be looking at a very ugly end to this expansion just to contain inflation, as others have said.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I support your recommendation.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Mr. Chairman, I also support "B" asymmetric. My suspicion is that at some point we are going to need to tighten, but to me the timing is not clear. If the expansion continues at an above-trend pace, the inflationary pressures are bound to prevail. On the other hand, if productivity is better than the historical levels, the move could be deferred. So it seems to me for now that "B" asymmetric is the right move.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Mr. Chairman, I support your recommendation. I continue to consider the inflationary risks biased to the up side. I believe we have agreed that regardless of whether we prefer opportunistic or deliberate strategies, we should resist any sustained uptick in inflation. I support that policy. I also think Don Kohn has properly warned us that if we are actually below NAIRU and fail to act, all we will end up doing is buying more output and more jobs now at the expense of less output and fewer jobs later, in effect adding to cyclical fluctuations rather than mitigating them. Ordinarily, I would prefer a preemptive approach to controlling inflation rather than, as Tom Melzer put it, simply waiting to shoot until we have seen the whites of its eyes.

Nevertheless, I think the current situation is unusual. In spite of the apparent inflation risk, which has been present now for a considerable time, inflation has been declining, not increasing, and now demand finally appears to be moderating. So, the level of uncertainty about the future course of inflation under current policy settings is extremely high. And particularly because a move today would constitute a change of direction and a surprise to the public and to financial markets, I would prefer to have a slightly higher degree of confidence that a policy change is actually needed before making one. In situations where forecast uncertainly is extremely high, I, at least, find it appealing to look for some guidance from the recommendations of sensible feedback rules, so I would simply reiterate what Don Kohn pointed out, which is that the funds rate judged by Taylor's Rule or other simple benchmarks is now at quite a reasonable level given current levels of unemployment and inflation. On the other hand, the rule definitely calls for a policy adjustment if either of two things occurs: first, if the degree of labor market slack declines appreciably, presumably because demand fails to slow as we anticipate; or second, if broad inflation measures rise. Under those conditions, I would certainly support a tightening of policy.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Mr. Chairman, I also support your recommendation that we make no change in policy at this meeting and retain an asymmetric directive. This position reflects my willingness to support trend growth at full employment with stable modest inflation in the near term, patiently awaiting opportunity down the road for renewed progress toward price stability. I simply am not persuaded at this point that the current policy setting is inconsistent with stable inflation. Given the lags in response to monetary policy, particularly when it comes to inflation, it is often prudent to move to change policy on the basis of forecasts, and that is the challenge that the staff forecast presents to us today. But my willingness to move preemptively in this case has to be conditioned by what seems to me the inconsistency in the story that the current unemployment rate is too low to sustain stable inflation, given that we have seen stable inflation for the last two years. So at this point, I think it would be prudent to hold the line and wait for additional data. Nevertheless, I think there are risks of higher growth and there are undoubtedly risks that inflation at the current unemployment rate might move up. Therefore, I think the asymmetric directive is very reasonable. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I support your recommendation for a "B" asymmetric directive, but as I mentioned in my comments, I am concerned about the labor cost pressures exceeding productivity. I also am concerned about the potential for allowing some upcreep in inflation to be built into the economy late this year and in 1997. Of course, waiting makes the September and the November meetings very crucial decision points.

CHAIRMAN GREENSPAN. Would you, Mr. Secretary, read "B" asymmetric.

MR. BERNARD. The wording is on page 13 of the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Boehne	Yes

President Jordan	Yes
Governor Kelley	Yes
Governor Lindsey	Yes
President McTeer	Yes
Governor Meyer	Yes
Governor Phillips	Yes
Governor Rivlin	Yes
President Stern	No
Governor Yellen	Yes

CHAIRMAN GREENSPAN. Thank you. The next meeting is Tuesday, September 24th.

VICE CHAIRMAN MCDONOUGH. Can I make one correction? Earlier in our discussion, I asked Don Kohn and Peter Fisher to come forward with the reverse repo recommendation in September. Actually, it makes more sense to do it in November.

CHAIRMAN GREENSPAN. So be it. We adjourn for lunch.

END OF MEETING