Meeting of the Federal Open Market Committee
November 12, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, November 12, 1997, at 9:00 a.m.

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

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

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

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist
Messrs. Cecchetti, Goodfriend, Eisenbeis, Lindsey, Promisel, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

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

Messrs. Alexander and Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

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

Ms. Pianalto and Mr. Rives, First Vice Presidents, Federal Reserve Banks of Cleveland and St. Louis respectively

Messrs. Dewald, Hakkio, Rolnick, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, Minneapolis, and Cleveland respectively

Messrs. Bentley, Meyer, and Rosengren, Vice Presidents, Federal Reserve Banks of New York, Philadelphia, and Boston respectively

Ms. Gonczy and Mr. Koenig, Assistant Vice Presidents, Federal Reserve Banks of Chicago and Dallas respectively

Mr. Trehan, Research Officer, Federal Reserve Bank of San Francisco

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CHAIRMAN GREENSPAN. I would like to welcome Governors Ferguson and Gramlich to their first meeting and offer a preliminary farewell to President Melzer. We will do the farewell more officially at the next meeting.

MR. MELZER. Thanks, Alan.

CHAIRMAN GREENSPAN. Why don't we get started. I request that someone move to approve the minutes.

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection. Peter Fisher.

MR. FISHER. Thank you, Mr. Chairman. I will be referring to the package of charts that should be in front of you.[1] It has a Class I cover and begins with a color chart showing 3-month deposit rates. Today I will be going over four distinct subjects. To give you a roadmap: First, I will discuss market developments in general, focusing particularly on some of the causes of events in Hong Kong. Second, I will discuss recent open market operations. Third, I would like to take a few minutes to bring the Committee up-to-date on the performance of primary dealers. I think it is important for me to give you a sense of what I have been doing with the dealer community. After that, I will be seeking two votes. One is the normal vote to ratify the open market operations since the September meeting. I also will be asking for an increase in the intermeeting leeway. After that, I will come back and comment on the swap line renewals, which are a separate agenda item. I will seek a vote to renew the swap agreements for another year.

Focusing on market developments, the first page of charts shows 3-month deposit rates, including the current rate, 3-month forward, 6-month forward, and 9-month forward for the United States, Germany, and Japan. In the first panel, you can see that interest rate expectations began to back up here in the United States following the Chairman's testimony before the Budget Committee on October 8. The next day, the Bundesbank hiked their repo rate by 30 basis points, as you can see in the middle panel. To many people in financial markets around the world, this indicated, perhaps inaccurately, a concerted effort by the industrial nations to raise interest rates globally. Many

1 Copies of the charts used by Mr. Fisher are appended to this transcript.

people talked very seriously about how the tide had turned and interest rates could be expected to go higher in the industrial world. Both in Germany and the United States, rates continued to back up for several days until the events beginning on October 23, a date I will come back to in a minute. That was the day when financial pressures first emerged most acutely in Hong Kong. You can see that interest rate expectations in both the United States and Germany came off rather sharply beginning that Thursday, October 23, and bottomed out on the day of the sharpest U.S. equity market decline the following Monday, October 27. Forward rate markets were already stabilizing to some extent, at least here, by the time of the Chairman's testimony before the Joint Economic Committee on October 29.

I would like to note that U.S. interest rate expectations, as measured by the forward rate agreements, did not subsequently back up. They stabilized more or less at levels slightly above the lows reached before the Chairman's October 8 testimony, whereas German interest rate expectations, reflecting a rise that occurred in market rates, are still quite a bit higher. I think this goes a long way toward explaining the relative movements in the dollar and the mark. One does not need to look anywhere else even though many financial market analysts are looking under every rock and in every nook and cranny. You can see in the bottom panel that Japanese interest rates, as measured by forward rate agreements, are still quite flat. I will come back in a moment to some events leading up to this morning's developments in Tokyo.

Turning to the charts on page 2, I will focus on the causation of the events in Hong Kong, or as the Chairman sometimes puts it, a discussion of who sneezed last. This discussion is not necessarily to point a finger at anyone but to delineate the series of events that led up to the financial pressures. The first panel shows the percent changes in the foreign exchange value of the Taiwan dollar, the South Korean won, and the Hong Kong dollar since September 30. The middle panel shows 1-month interbank rates for Taiwan, South Korea, and Hong Kong, and the bottom panel shows percent changes in key equity indices for those countries and for the United States, Japan, and Brazil.

Working across the top panel--the Hong Kong government announced in early October that they would hold another land auction. This is a more or less routine event for them, but the announcement did indicate they were coming back to the market and would be putting some pressure on land prices. They held the auction several days later, on October 15, and found a bogus bid for one of the largest parcels of land that were up for sale. The bid was made by a woman in the name of a major firm and she certainly did not have the billions of dollars necessary to purchase the real estate. The

Hong Kong authorities are reviewing their practices for accepting bids, but it was rather shocking to think that an auction for this kind of real estate could involve someone who was a mental patient, quite literally.

Several days later, Taiwan ceased intervening in the exchange market and allowed its currency to depreciate significantly. This posed a question in the minds of many foreign exchange market participants the world over--a profound question. If a country with such a high level of foreign exchange reserves was not prepared to defend its currency, who would? The Taiwan government certainly had the capacity to defend their exchange rate, but it turned out they did not have the will. The question in everyone's mind after Taiwan's decision was whether the People's Republic of China, and not so much Hong Kong, would need to devalue. For many people the answer to that question appeared to come when, on October 23 or late in the evening of October 22, the People's Bank of China announced a reduction in interest rates. They reduced their lending rate by 150 basis points and their savings rate by a little more than 100 basis points. This appeared to answer the question for many people by showing that China was worried about their competitiveness. The markets very quickly tried to price that in, but they could not price it into the yuan. The only place it can be priced is in a proxy for the yuan, the Hong Kong dollar. So, the pressures began to build and you can see in the middle column that the Hong Kong monetary authorities squeezed their money market rather tightly. I don't think they expected overnight interest rates to go to 300 percent. They expected the rise to be considerably less than that, but there were a number of players who held onto long positions hoping to make money in subsequent days. In the bottom panel, you can see them play through to the equity markets, with whose performance you are familiar.

Turning to the third page of charts, I want to draw your attention to the impact of these developments in credit markets. While equity markets had some sharp losses, the real fear and adjustment that took place in financial markets seemed to be, as I heard it, in the credit markets. In the first panel, you can see that absolute spreads of Asian Yankee and stripped Brady Bonds over U.S. Treasuries backed up rather considerably. These are measured in hundreds of basis points. The backup was more or less triggered by the pressures on October 23 and thereafter, obviously with many contributing events. In the middle panel, in order to get the scaling right, I simply have the basis point changes in two Merrill Lynch corporate bond indices, one for high yield and one for investment grade, over Treasuries since September 30. Clearly, there has been some widening of spreads over Treasuries. What is worth noting is that the corporate yields have not moved at all; it is the Treasuries that have moved. As shown in the bottom panel, 10- and 30-year rates were down 20 basis points over this period, and that was the full extent of the backup, the widening of the spread if you will, both to junk and investment grade paper. It was very hard to chart in the bottom panel how odd the bond market has felt over the last few days because there has been a tortuous back and forth between those who want to trade on fundamentals and the flight to quality that seems to be taking place. I cannot show you last Friday's developments in a chart because the adjustments happened so quickly. Following the release of the employment data last Friday, bond market and fed funds futures backed up and then, after about 90 seconds, came right back down as the market returned to its flight-to-credit posture.

The fourth page displays three charts to make a very simple point. Each panel shows the percent changes in one of the G3 currencies against the other two G3 currencies. In the first panel, you can see that the mark has appreciated against both the dollar and the yen since September 1. In the middle panel, you can see that the yen has depreciated against both the dollar and the mark. And in the bottom panel, you can see that the dollar is being pulled somewhat in two directions. That is, it is considerably weaker against the mark but a little stronger against the yen, the dollar having been stable for most of this period.

I want to go back to what I referred to earlier, namely, that I think interest rate differentials between the United States and Germany explain most of the movement between the dollar and the mark, although market participants do look eagerly at the question of whether there is a flight out of dollars into marks and whether the mark is something of a safe haven. I think it is reasonable to pause and note that in terms of financial flows, there probably was some movement out of dollars, given how many of the assets that have been under pressure are dollar-denominated. So, when portfolio managers sustained losses on Bradys and Asian Yankees and equities that are more or less dollar-linked, there was going to be some marginal movement out of the dollar. That is a very different question from one about the macroeconomic consequences; this is a financial flows issue. I think Ted Truman will be coming back to the broader macroeconomic question.

Let me pause here to discuss some of the events of the last few days in Tokyo. The yen has weakened overnight; it was below 126 this morning. The Japanese government bond yield is up to 1.70 percent after backing up 10 basis points in just a few days. A week ago, with the announced bankruptcy of Sanyo, a very profound event happened in Japanese financial history: The authorities let a major firm go bankrupt. It is something our colleagues at the Bank of Japan have been working on earnestly for 10 years and are very proud of. Obviously, the timing was another matter. It took the markets a few days to begin to price it in. But the number of financial market participants around the world who have been trading with Japanese counterparties on the assumption that the government stood behind them is very large. By Friday of last week, some Japanese names, the weaker ones, were finding it hard to get quoted in the forward interest rate market in New York. Today, people are talking about Japanese institutions needing to liquidate government bonds. The Nikkei was off 434 points earlier and is now down again. We see a grinding out of some of the worst fears one might have about the Japanese financial sector. That is beginning to show up in forward rate markets. For example, in the Euro deposit market as of the end of October, there was no credit premium in the 3-month rate for Japanese institutions. This morning, it is already 250 basis points as compared to zero at the end of October.

CHAIRMAN GREENSPAN. 250 basis points?

MR. FISHER. Excuse me I should have said 25 basis points. I am very sorry. I'm trying to catch up with everything that happened overnight.

On that note, let me turn to domestic open market operations and try to get my numbers right. On the fifth page, there are two panels illustrating developments in the federal funds market. The top panel shows the behavior of the federal funds rate. The blue lines indicate the daily range of actual trading, the red vertical lines depict one standard deviation of funds rate trading on either side of the effective rate, the horizontal red line is the daily effective rate, and the green dotted line is the Committee's target. In the upper right of the sub panels for each of the three full maintenance periods, you can see the period average effective rate. In the lower panel of the chart, the blue bars show the daily level of free reserves, and the numbers on top of each of the bars indicate our daily projection misses. There is one exception related to a labeling problem that I will come back to in a moment.

The intermeeting interval unfolded more or less as we had expected. In the first biweekly period, September 30, the last day of the quarter, was a difficult day in the market. The market priced up for that statement date, initially producing a high rate, and we came in a little later in the day and added quite a few reserves. That resulted in a very wide standard deviation in the federal funds rate on September 30. On the last day of the middle period, the settlement day, the very tall blue bar, is labeled 9.9; that number does not indicate the size of our miss; it refers to the level of the bar, which was cut off at the top of the chart. Our miss that day was only 0.3. This was a day when we supplied quite a few reserves to the market, but given the skewing up in the rate, we underestimated a bit the demand for excess during this period. Actually, the point I want to make, which we describe in our written report, is that the demand for excess reserves has been growing. We target demand for excess reserves of $1 billion in each reserve maintenance period on a period average basis, but actual demand has been creeping up on us. Independent of the turmoil of the last few weeks, the rising demand for excess reserves is in all likelihood a function of declining operating balances. Bankers appear to be looking for a little more excess reserves, but this is something that we are still looking into.

In the final period, you can see that we did have to deal a little with the effects of the large volume of trading in equities. The largest volume day was on October 28, and with a 3-day settlement, the settlement of that trading fell on October 31. That was a month-end, already a slightly complicated day for us. We more or less had a day that looked like a maintenance period settlement day where we had to add a sizable amount of reserves and the funds market had a quite wide standard deviation.

Stepping back, I would like to ask the Committee for an increase in intermeeting leeway to purchase securities on an outright basis during the intermeeting period between now and the December meeting. The temporary increase would be from $8 billion to $12 billion. We began another sequence of outright coupon purchases last week. We have a significant amount to execute going forward. We estimate that our holdings will need to grow about $15 billion by the maintenance period ending around the time of the Committee's next meeting and that the cumulative need will increase to up to $20 billion in the period immediately following the December meeting. I would like to complete the portion we are planning to do on an outright basis in the market before we get that late in the year. So, by the time of the December meeting, I expect to want to add around $10 or $11 billion through outright operations, principally in coupon securities. However, given that the Treasury issuance of bills seems to be increasing somewhat, I also hope to buy some bills a little later this month or early in December.

Before turning to your questions and your vote, I would like to talk to you for a few minutes about the performance of the primary dealers, as shown on your next page. I will try to go through some of the background on our primary dealer relations.

Criteria for primary dealers were revised in February 1992, as most members of the Committee will recall. At that time, we identified some drawbacks in the existing system. We described as one drawback the public impression that because the Federal Reserve Bank sets standards for selecting and maintaining these relationships, the Fed was in effect the regulator of the primary dealer firms. Another drawback was that the primary dealer designation was viewed as conferring a special status on these firms in that it carried with it elements of franchise value. As a consequence, we dropped the requirement in 1992 that dealers maintain a 1 percent share of total customer activity. We also discontinued our dealer surveillance activities, which had led to the impression that we were supervising the dealers. In 1992, we also reiterated our standards for maintaining dealer status. All primary dealers were told that as in the past they were expected to (1) make reasonably good markets in their trading relationships with the Fed's Trading Desk, (2) participate meaningfully in Treasury auctions, and (3) provide the Trading Desk with market analysis that could be useful to the Federal Reserve in the formulation of monetary policy. Primary dealers that failed to meet these standards in a meaningful way over time would have their designation as primary dealers discontinued by the FRBNY. I think that spells out, as I have been describing to the dealers, essentially six criteria that we look at in judging our trading relations with the dealers. As listed at the bottom of page 6, these include their performance relating to our RP operations, our outright operations, the Treasury's bill and coupon auctions, the Desk's trades on behalf of foreign central banks, and the provision of information to the Desk.

Bluntly put, we have not succeeded in removing the "Good Housekeeping" seal of approval. There are many customers in the market who insist that they will only deal with primary dealers. There are municipalities and other public bodies in this country that have such a requirement in their enabling legislation, and many other customers follow that practice informally. So, we have not been successful there. At the same time, it has been hard to motivate dealers to perform. I frankly face something of a moral hazard because there is no longer a volume requirement. Previously, that was an easy thing for the dealers to measure. They knew that if they maintained their volume, they would be kept on our dealer list and that kept their minds focused.

What I had hoped to do is provide the dealers with report cards that they could take home and share with their management and really understand how we saw them. I then decided that I did not want to read about those in the Wall Street Journal. So, we came up with a formula for sharing their relative performance with them, at least on the first four criteria, without giving them something they could take home. The following four charts give you some sense of the performance of the individual dealer firms, though they will not enable you to master the details.

The first panel shows primary dealer performance in financing Desk transactions. The horizontal axis shows the percent of our volume in repo operations that any one dealer actually does with us, that is, it measures the propositions we accept. The vertical axis measures pricing competitiveness in which zero represents the stop-out rate on our operations, that is, the lowest rate at which we operate. Plus basis points indicate better yields we earn and minus basis points measure poorer yields. The vertical axis reflects all propositions, not just the ones we take. On average, we do not take most propositions. For example, we may accept only $2 billion when we get $10 billion of propositions. So, on average most prices will fall below the stop-out. As a first approximation, poor performance is reflected in the lower left corner; strong performance appears in the upper right corner. However, there is another twist. If a dealer firm is too much of an outlier and too eager to price through the stop-out rate, that may say something about its ability to finance elsewhere and whether there may be something of a credit risk associated with its name. In some sense, if a firm is in the very lowest quadrant, it is hard to know whether it has no business at all to be financed or whether it simply has numerous internal sources of funding that are cheaper than what we provide them. So, that is another element of interpretation on this chart.

The next chart illustrates primary dealer performance in Desk outright transactions. The horizontal axis again shows the percent of volume they actually do with us. The vertical axis is in effect a pricing competitiveness index in which zero in this case is a snapshot of the yield curve before we operate. The prices we then see may give us more yield than the yield curve or they may give us less yield. Again, the lower left in this chart indicates poor performance, and obviously something more toward the upper right indicates a stronger performance from our point of view.

The third and fourth charts show the dealer performance in Treasury auctions for bill and coupon issues respectively. The horizontal axis measures awards in their name as a percent of total tenders accepted by the Treasury, and the vertical axis is a measure of their capital that both we and the SEC use. We call it "liquid capital;" the SEC calls it "tentative net capital." This chart again shows, more or less, that the lower left reflects a weaker performance and the upper right a stronger performance. I chose to show the information to the dealers in this form because it indicates that there is not a very strong positive correlation on capital. That is, some dealers that have relatively low capital can compete rather effectively in underwriting the Treasury's debt. Their ability to do so is not just a matter of capital.

We have shown these charts to dealers in the last few weeks, but with only their own name indicated and 38 black dots depicting the other dealers. The charts provide a rather powerful indication of the absolute and the relative performances of the individual dealers from where we sit. I tried to calibrate my message to the dealers. When I showed them this information, I was able to point to both 12-month data, which are depicted on these charts, and four-quarter data, quarter by quarter, because trends were quite important for some dealers. I told the dealers that my goal was to improve median performance. I wanted better performance on their part. I was rather blunt with eleven dealers in saying that they were not doing much to meet our current business needs. Of that eleven, I told four flat out that they were not meeting our business needs currently. However, I proposed that we work together over the coming six months to enable them to describe to me their intended business strategy for meeting my business needs and to make an effort to do so. I will meet with them again two quarters from now to review fourth-quarter and first-quarter data. I warned them that if they took no initiative to describe to me how they intended to meet my business needs and could show no performance over this period, we would discuss at our next meeting in the spring whether they wished to announce the termination of their dealer relationship with us or whether they wanted me to announce it. As I noted, four of the dealers heard that message. Another seven heard a message that they were near that category. I think they all understood it, and they all thought the process was reasonable. Again, the pictures on these charts are rather stark, and the dealers did not have much to argue about in that sense.

I wanted the Committee to be aware of this process that I am going through. I think it is reasonable but, obviously, I am sharing it with you to solicit your views if you have any. I want to emphasize the sensitivity of these data. I have assured the dealers that I was not going to share it publicly, and I informed them that I did not want them to share it publicly. I did not let them take copies with them, but I did let them take notes. I did not want to read about it in the Wall Street Journal, and I am sure many of them did not want to either.

Mr. Chairman, we have no foreign exchange operations to report for this period. I need the Committee's ratification of our domestic open market transactions. Separately, I would like to seek a vote to increase our intermeeting leeway from $8 billion to $12 billion. I would be happy to answer any questions on my report as well as on my memo about our desire to publish the standard deviation of the federal funds rate for each trading day.

CHAIRMAN GREENSPAN. I must say that your endeavor to inform the primary dealers of your likes or dislikes is creating a franchise value for them whether you like it or not. I think the presumption that they are primary dealers and you are in fact making that an issue makes it quite impossible to maintain simultaneously that there is no franchise value in their being primary dealers.

MR. FISHER. I completely agree with you. It is a dilemma, and I think we are stuck with that dilemma. I personally would rather take a hard look with the Treasury on whether the primary dealer system makes sense in terms of underwriting Treasury debt issuance. The Treasury still feels strongly, as it has for many years, that the existing system is important. So, they wish to retain it. We are going to conduct our operations with someone, and until we can get to the point where we do not publish a list of the firms we deal with, which is what I would be happiest with, I think we are in a dilemma. It is very expensive for us to maintain relations with 38 institutions, some of whom are deadbeats from our perspective. We could create a two-tier system. I would be happy to talk to the Committee about that. It would involve our ignoring a lot of firms that provide no value to us but that might continue to sit on our list. Unfortunately, that does not foster very good performance from anybody. That is the nature of the dilemma. We get poor performance from everybody or a franchise value, which sets up the dilemma.

CHAIRMAN GREENSPAN. You mentioned that the yuan was not an attackable currency, which I have always assumed to be the case largely because it is an essentially illiquid, controlled, and blocked currency. Can you conceive of any scenario whereby there could be an international attack on that currency? I presume that would require a free market and some ability to move funds, and I am not sure how that can be done in the yuan.

MR. FISHER. My colleagues and I have thought about that, and we have not come up with a way that might be done directly. I think there are assets that could be sold--

MR. TRUMAN. My guess is that that is the way it would happen. In fact, a country can always experience the problem of domestic capital flight, of which there is a substantial amount in China--on the order of $10 billion a year. Another way that domestic residents can attack the currency is through classical, if I may call it that, leads and lags. There also are certain foreign investment strategies that could be used. I do not think the yuan can be attacked in a money market or financial market sense but--while it is much more difficult--pressure can certainly be brought on yuan asset values, and in some sense that has been going on.

CHAIRMAN GREENSPAN. I have been out of contact. What happened in the financial markets in Brazil and Argentina yesterday?

MR. TRUMAN. Not much happened in Brazil after they announced their program. Rates were down marginally yesterday; stock markets were flat and are down a little today.

CHAIRMAN GREENSPAN. Was it the same in Argentina?

MR. TRUMAN. Yes, both cases.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Just a question. If all the primary dealers reacted well to your counseling, Peter, what would be the impact on our operations? What benefit would we see as a result of that?

MR. FISHER. We would get better prices. We would earn more for the U.S. taxpayer. We would have more flexibility in our operations the more propositions we received. I very much hope to avoid the situation that we had in April when we had the large miss in forecasting Treasury tax flows and an insufficient volume of propositions forced us to go back into the market to purchase more securities. I want to see a healthier volume of propositions so we can have much more flexibility. That is very important to me. Frankly, we can operate more efficiently overall if we get better information from the dealers and they execute our trades more expeditiously. Our costs should in some sense be covered by the value we produce as a trading operation.

MS. MINEHAN. Looking at your first chart on primary dealer performance in Desk financing transactions, that dotted line for the median is -1.8 basis points. Your desire is to move that up to the stop-out rate?

MR. FISHER. No. In this case, what I would like to see is movement of the median volume line to the right and a cluster of dealer performance around the intersection of the two medians. Where the auction falls vis-à-vis the stop-out rate is really a matter of how much we are doing because we want more propositions than we can use. Forgive me for my analogy, but I would like to see what Pete Rozelle always said he wanted for the NFL, that on any given Sunday, any football team could beat any other football team. I would like this money market operation to be very competitive. We should have every dealer bidding at a reasonable price, and that would give us the greatest flexibility. So, if we succeeded, we might move the median volume line to between 2 and 3 percent or maybe all the way to 4 percent, with every one of 30 or 40 dealers getting a roughly equal share of volume. Maybe it would be a 2-1/2 or 3 percent share, and the pricing could be in a tighter cluster on that chart. That is what I would be looking for, and that is what I told the dealers.

MS. MINEHAN. So, you would like to move that intersection both up and out?

MR. FISHER. Out more than up is what I would expect.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. This question reflects my lack of understanding, but are you creating any legal problems for us here? If a team is dropped from the league, can they sue the commissioner?

MR. FISHER. I referred earlier to the paper that we put out in February 1992 to establish the current ground rules. That paper indicated that the arrangements between us and the dealers were business relationships and that we could terminate an individual arrangement if no business relationship existed. There are a lot of lawyers in the country, and anyone who can find a lawyer can sue. But I think that the dealers are on notice. I don't want to say that any of the dealers were happy with the message I was giving them, but as businessmen they understood it because I was able to document it in black and white. That is what I have been trying to do. I felt there was no way I could come down hard on them unless I could show them something concrete. As businessmen, I think they understood that. I have been taking this degree of care to minimize the risk you are referring to.

MS. RIVLIN. You are a businessman, but they think of you as the government.

MR. FISHER. I have been working very hard for a couple of years in every meeting I have had with the primary dealers to remind them that ours is a business relationship and that we want them to treat us as a valued customer. I gave a speech about this business relationship to the Bond Market Association in Phoenix in which I emphasized that they should treat us as a valued customer, not as a mere regulator.

CHAIRMAN GREENSPAN. Did they sniff at that?

MR. FISHER. A little, but it is a language they understand.

VICE CHAIRMAN MCDONOUGH. I think that, as a practical matter, the dealers who decided they did not want to behave according to Peter's desires would probably decide they did not want to be primary dealers. They would be very unlikely to bring attention to themselves by suing us. That would be saying, "I have been deemed unacceptable, and I want the whole world to know about it."

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Peter, on the domestic bond markets, the yield spread between the regular 10-year Treasury note and the inflation-indexed bond has diminished a little over the intermeeting period. At first glance, that might normally be expected to imply a drop in longer-term inflation expectations. But I am wondering whether in the flight to quality, more funds have been directed to the regular nominal note than to the inflation-indexed bond. Would that be part of what is going on?

MR. FISHER. Yes, I think that is right. I do not want to put too fine a point on it, but I think most people in the market understand that. I don't think people have been making too much of the shift in that spread. I agree with you.

MR. KOHN. It is true that the indexed bond went down several basis points, particularly on the day of the sharp market break. So, I think there was a flight to both of the securities. It had been our interpretation as well, at least for a while, that if investors were going to get into something liquid, they would choose nominal bonds. But as markets settled over the next few days--and they are still skittish and volatilities are still a bit higher than earlier--it struck me that some of that effect would have played out. The fact that this spread may be down 10 basis points on net--and I may be reading this a little too finely--suggests, if anything, that inflation expectations have come down. There is every reason to think that they might have. All the external events were playing in that direction, and certainly the tone of the discussions in the press and in the market was that events were having a disinflationary or even deflationary effect on the U.S. economy.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. Peter, on the issue of publishing the standard deviation data, I have no objection to providing that additional information. I think it is probably a good idea. I guess I would be concerned if I thought the Desk were going to use those data as a measure of its performance and, specifically, if the Desk were to adopt the perspective that a lower standard deviation in the funds rate indicates better performance. I say that because I think we ought to want the market to act as a form of discipline on those banks that have not properly provided for their reserve needs, particularly for settlements. Some degree of volatility is desirable from that perspective.

MR. FISHER. I share your view about that. We have developed this measurement for slightly different purposes. I find it very useful in talking to you about our operations, and I think it may help you to judge what we are doing. That's how I think of the standard deviation. As is illustrated in some of those charts, there will be days when the standard deviation is going to be wide, and we can do nothing about it. It is on days when perhaps we could and should do something about it that I want to focus my attention. The standard deviation does not tell me anything automatically.

For a long time, people in the market have asked us to publish the underlying data that we get on trades in the federal funds market. They want us to give them the actual data on how many trades are done at each rate level. I am very uncomfortable with that, and I think other people in the market also would be uncomfortable if we started doing that. The reason is that the data might help market observers figure out who needed to do what volume. They could then determine at what rates the trades were done even if the names of market participants were not attached to what we published. I think the standard deviation data give the market a very good sense of the volume done at various rates, and that matters to them in their effort to understand trading activity. So, the information on the standard deviation is intended to give the market something that is helpful to them in return for the statistical information that they provide to us. I share your view on market volatility.

MR. KOHN. Both the Desk and the Board staff have been using the standard deviation data for analytical purposes to see whether the character of the market is changing in any way as reserve balances decline. There is no reason why the market cannot have the same data for analytical purposes.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Peter, I have a couple of questions on the primary dealer situation. Is it your impression that the performance of some of the dealers has deteriorated over time? Secondly, what do we know about the profitability of their current operations?

MR. FISHER. I will respond to the second question first. The Desk collected profitability data from the dealers for a long time. When I became Manager, I looked at that and discontinued it. What we were getting was apples and oranges and kumquats. We had no ability to insure that we were getting apples compared to apples from the dealers. The dealers were very unhappy with that decision, but I felt that we should not be putting our name behind something where they had not done the work to develop standard accounting conventions. I viewed that as a very risky and potentially embarrassing situation for us.

MR. STERN. I assume that you get a sense of what is going on by talking to them.

MR. FISHER. Yes, and I want to distinguish two sorts of information that we get from the dealers. From our conversations with the dealers, it is clear that there is some disparity among the firms. There are some firms that are doing rather well and others that are not. What also comes out in our conversations is that the nature of the underwriting process is changing. Many of the dealers understand this. With the Treasury's use of Dutch auctions, they already have been disintermediated in certain sectors and they feel it. I think this is a profound issue that the Treasury has to grapple with, and Don and I have been urging them to grapple with it.

We have looked at individual firms, and we can see dramatic trends. The quarter-to-quarter data are very helpful for that. There are some firms with very fine names globally but whose performance as dealers has deteriorated markedly over the last 12 months because of business decisions they have made. These firms are profitable as global entities. As I have explained to all the dealers, we ask them to compete in the thinnest margined, most competitive sector of global fixed-income markets. It is a tough market, but that is the business I am in. I cannot change that.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Peter, we do not have primary regulatory responsibility for the parents of some of the primary dealers. Do we have a dialogue with the primary dealers about century date change compliance and is it an issue?

MR. FISHER. There are numerous efforts. Bill McDonough might be able to say more about his contacts in New York with the Securities Industry Association. The Federal Reserve has been talking about those issues in many ways with the securities industry generally. I have not singled out the dealer community because there are so many initiatives going on in securities markets.

MR. PARRY. Also, there is the issue of foreign banks, which I think has become more of an issue in recent months.

MR. FISHER. Yes.

VICE CHAIRMAN MCDONOUGH. Within the limits of not in effect becoming their supervisors, which would be inappropriate, we pay as much attention as we can and gather as much knowledge as possible about the activities of the securities firms and perhaps even more so of the foreign banks in our market because we do supervise them.

MR. PARRY. Right.

VICE CHAIRMAN MCDONOUGH. There is a general move at securities firms in the direction of policing their activities better in order to run their businesses more soundly. Needless to say, we have encouraged that effort and applaud it. Some of the time we can get a point across in a speech that shows an interest in how well they are behaving themselves and how well they are managing their businesses.

MR. PARRY. Would it be appropriate to have a discussion with the primary dealers regarding their handling of century date compliance just as we would with banking institutions?

MR. FISHER. On that issue, we are trying to work with the Securities Industry Association and the Bond Market Association. Again, we do not want to become their regulator as primary dealers. As securities firms, we are trying to make sure we are talking to them, but it is a little awkward, qua primary dealer, to discuss the century date change issue with them.

VICE CHAIRMAN MCDONOUGH. On century date change, I meet one-on-one two to three times a year with the heads of insurance companies and securities firms as well as major banks. At those meetings, we go through all the business concerns on their side and our side. For the last year, a piece of that agenda has always been century date change. My impression of the securities firms is that they are very much on top of it. I think in the case of the foreign banks, it varies considerably. The Asian banks seem to be less on top of the problem than the European banks, who are probably six to nine months behind the major U.S. banks. Their attention was gotten a little bit late, but I think we have it now.

MR. PARRY. Okay.

VICE CHAIRMAN MCDONOUGH. You may know that during the annual meetings in Hong Kong, the Institute of International Finance had a very well attended gathering. I was asked to give the primary speech and I dedicated all of it to the century date change issue.

CHAIRMAN GREENSPAN. Any other questions? Would somebody like to move to ratify domestic Desk transactions since the last meeting?

VICE CHAIRMAN MCDONOUGH. So move, Mr. Chairman.

CHAIRMAN GREENSPAN. Without objection. Would somebody like to move to give Peter Fisher some additional intermeeting leeway?

VICE CHAIRMAN MCDONOUGH. Move approval to increase the leeway to $12 billion.

CHAIRMAN GREENSPAN. Without objection. Peter, would you move on to the next item on the swap line renewals?

> MR. FISHER. On the last page of my package, there is a list of our existing swap lines, a note on the Treasury's two swap lines, and the new maturity date if we go ahead with the normal renewal process. This is the time of year I ask you for authority to begin that process, which involves a lot of exchanges of telexes and telephone calls over the next month. I am asking for your approval to renew our existing swap lines, and I would note that that includes both the swap lines listed here and the North American Framework Agreement, which covers the use of our swap lines with Mexico and Canada in certain circumstances. The two swap lines of those countries can be used separately. It is a stand-alone framework in the event of trilateral drawings.
>
> Last year, we had a rather lengthy discussion of our swap line agreements. We discussed the possibility that some of these swap lines might fade into the sunset once European Monetary Union proceeds apace. At that time last year, the members of this Committee agreed that we would begin discussions with our colleagues at the other central banks in the spring of 1998, and we intend to do so. I think that will be an uphill struggle given the relative priority that the ECB and the NCBs will place on this issue vis-à-vis other issues. But your humble servants will begin that effort in the spring before we are back here again a year from now with this issue.

CHAIRMAN GREENSPAN. Servants?

MR. FISHER. Yes, humble!

VICE CHAIRMAN MCDONOUGH. It is also intended to include "and obedient." Move approval of the swap line renewals, Mr. Chairman.

MR. BROADDUS. Mr. Chairman, I think my concerns about foreign exchange operations are well known, and I'm not going to repeat all the arguments I have made earlier. I am uncomfortable with foreign exchange operations for the reasons that I have stated previously, and I see the swap lines as our instrument to implement those operations. Accordingly, I am opposed to their renewal.

CHAIRMAN GREENSPAN. Any further comment? Is there a second to President McDonough's motion?

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. All in favor say "Aye."

SEVERAL. Aye.

CHAIRMAN GREENSPAN. Opposed?

MR. BROADDUS. No.

CHAIRMAN GREENSPAN. Let's move on to the staff economic reports with Messrs. Prell and Truman.

MR. PRELL. Thank you, Mr. Chairman. I want to offer just a few comments before yielding to Ted for his remarks on the recent turbulence in the international economy and its implications for the U.S. outlook.

I think it's pretty obvious that we don't share the view that the United States is going to be sucked into a deflationary whirlpool by the difficulties encountered abroad. Time will tell just how big the contractionary shock will be, but it would have to be a large one to override the momentum of domestic demand in the near term.

All major segments of private spending look strong right now. Consumers as a group are rich and happy, and it seems likely they will continue to buy with abandon. Manufacturers of capital goods report heavy inflows of orders--not just for computers and communications equipment, but for a wide range of other machinery as well. Commercial property prices are rising and should buttress nonresidential building activity. Meanwhile, all indicators of housing demand are giving off positive signals. As for financing, although the recent upheavals have produced some widening of risk premia in the securities markets, conditions are still such that most projects can get funding on what evidently are regarded as attractive terms.

Absent a sizable shock, then, the economy probably will continue to power ahead--perhaps not indefinitely, but for long enough to exacerbate inflationary pressures significantly. In our forecast, the recent developments abroad are a drag on aggregate demand, but not enough alone to bring a halt soon to the above-trend growth we have been experiencing. One possible source of restraint on demand would be a steep decline in the stock market. It's quite possible that the large equity premiums of the past will not be restored; however, we do believe that the current price-earnings multiples incorporate unrealistic expectations about future profits. If we are correct, the market surely will reflect it at some point, but that might not be soon and the adjustment might start from still higher levels.

In our forecast, therefore, we have assumed that you will put a damper on the economic boom by raising the funds rate three-quarters of a point by the middle of next year. That isn't a lot, but we expect that the effects will be magnified by some deflation of the stock market bubble. As you know, we are predicting a drop next year that would take share prices down about 20 percent from Monday's closing level. We make no claim of precision in that forecast--we are dealing not simply with math but also with mind reading. In any event, we expect that once people are shaken out of their complacency about the economic risks, the bond and loan markets will also be affected--with a further widening of yield spreads and some firming of loan standards.

With the resultant financial restraint, demand growth weakens and growth of output falls below potential in our forecast. But this doesn't occur before the labor market has tightened further. In that regard, a few words about Friday's labor market data might be in order. According to that report, the unemployment rate has already traversed some of the distance to our predicted cyclical low of 4.6 percent. The report also showed the labor force participation rate slipping further. This suggests that we might, despite the trimming in our latest forecast, still be on the high side for labor force growth. This could spell more labor scarcity and greater wage pressure. We would recommend waiting for another reading or two before reaching that conclusion, but the data do sound a cautionary note.

The sharp increase in average hourly earnings in October was anticipated in our forecast. Although the recent surge in wages is attributable in part to the effects of the hike in the federal minimum, we do believe that there is an underlying tendency toward acceleration associated with the efforts of businesses to attract and retain workers in a very tight labor market. Real wage gains have turned up noticeably over the past couple of years, and the pressure will remain in that direction. We think, however, that the decline in price inflation and inflation expectations this year has created a circumstance in which nominal wage increases will be damped in the short run--enough to offset a pickup in medical insurance costs that seems to be in the offing.

Our projection shows prices accelerating over the next two years. However, the pickup is even more gradual than in previous forecasts. The recent developments in the external sector suggest that the swing from declining to rising import prices will be of still smaller magnitude than we anticipated earlier. In addition, our reassessment of the trend in labor productivity leads us to think that price inflation will rise more slowly. Our projection of actual productivity growth has not changed much; however, price setting seems to be influenced more by the trends of productivity and unit labor costs than by the short-run variations, and so the change in our trend assumption tends to damp our inflation projection. The end result is a prediction that the rate of price increase will rise only a little over the next two years--especially in the published figures, which will be held down by technical changes to official indexes. But, I would conclude my remarks with the reminder that we believe this rather benign outcome is probably contingent on something happening to create a less accommodative financial environment.

Ted will now say a few words about how we see the external environment.

MR. TRUMAN. I thought it would be useful to say a few words about how we have tried, in preparing the Greenbook forecast, to take account of the recent turbulence in the international economic and financial environment. I would note at the start that our assessment is very much a work in progress; in particular, the assumptions, explicit and implicit, underlying our analysis could be vitiated.

In preparing the Greenbook forecast for the global economy and its impact on our external sector, we tried to take account of three interrelated changes in the international environment since the Committee's previous meeting in September: (1) the evolution of the economic and financial crises in Asia and the limited spread, so far, to other developing economies, particularly in Latin America; (2) changes in our outlook for other industrial economies including the influence on them of Asian and related developments; and (3) the modest further depreciation of the dollar against European currencies. The net impact of these changes on our outlook for real net exports of goods and services has been small; they increase the negative contribution of the external sector to growth of real GDP by about two tenths next year and one tenth in the following year. Although we think that this is a reasonable best estimate, we also believe that the negative risks to our overall forecast associated with developments in the rest of the world have increased. Let me touch on each of the three principal sources of change in our forecast: Asia, the other industrial countries, and the dollar.

We have sliced and diced in a number of different ways the implications of the financial crises in Asia and hints of their spread to developing economies elsewhere, but I think the simplest way to understand the forecast is as follows. In effect, we have taken as a starting point an assumption that in 1998 the current account deficit of the developing economies as a group will have to shift toward surplus by a combined total of $50 billion relative to our baseline in the September Greenbook, which implied a combined 1998 deficit of about $100 billion. Based on historical trade patterns, principally with respect to Asian imports, the U.S. share of such a required external adjustment is about $15 billion, or about two tenths percent of nominal GDP. In this simple framework, it does not matter much for U.S. economic activity or prices whether this adjustment is caused by macroeconomic policies, by collapsing financial systems, or by severely depressed stock markets, nor does it matter much whether the impact on the U.S. economy is felt via exchange-rate, other relative-price, or aggregate-demand channels: as a first approximation, it is the size of the overall adjustment that counts. We are assuming that most of the adjustment occurs quickly, by the end of the first half of 1998, and that little further external adjustment in Asia or elsewhere is required in 1999. Our basic message, as we see it, is that in terms of deflationary effects on the U.S. economy, developments in Asia will be more like a ripple than a wave.

With respect to other industrial economies, in our forecast we took into consideration two influences: the underlying pace of expansion and the effects of the Asian crises. Excluding the effects of the Asian crises, we probably would have left our outlook for Japan unchanged because recent data on the economy have been broadly consistent with what we had expected, pointing toward a resumption of growth at around 2-1/2 percent in the second half of the year and extending into 1998. However, mainly because of Japan's relatively large share of Asian trade and relatively small

GDP (compared with the United States), we have marked down Japanese growth next year by about half a percentage point due to the Asian crises. With respect to Europe, recent information on trends in economic activity have on balance been better than we had anticipated which, other things being equal, would have led us to edge up projected growth. However, these economies also will be affected by the economic adjustments in Asia. Europe's share of Asian imports is essentially the same as ours while its combined GDP is somewhat larger, suggesting that the direct effect of the Asian adjustment on European growth should be marginally smaller than on U.S. growth. The feedback effects on the U.S. economy of lower growth in Japan and Europe are negative, and they are expected to be somewhat more spread out over time than the direct Asian effects.

Turning to dollar exchange rates with the other industrial countries, as Peter Fisher reported, the dollar has appreciated on balance against the yen over the intermeeting period and it has depreciated against the DM and other European currencies, with the latter effect outweighing the former effect in terms of our G-10 average exchange value of the dollar. Broadly speaking, these movements are consistent with relative trends in economic activity in these economies and shifts in the market's view of the outlook for monetary policies: extending the period of easy money in Japan, continuing moves to withdraw monetary stimulus in Europe, and foreseeing no change in policy in the United States. Looking ahead over the forecast period, we have left the dollar unchanged at its recent lower level, on average, in terms of other G-10 currencies. This has the effect of providing a small net stimulus to U.S. net exports that partially offsets the negative effects of Asian developments and their feedback on the U.S. economy through weaker growth in the other industrial countries, Japan in particular.

Returning to our basic message, the combination of these influences and considerations has led us, on balance, to increase by a small amount the negative contribution of the external sector to U.S. growth over the forecast period. The small downward adjustment in prices of imports, other than oil, computers, and semiconductors, in the Greenbook forecast for this meeting is due not to changes in our outlook for the dollar--which on an import-weighted basis in terms of both G-10 and non-G-10 currencies is not projected to change further on average over the forecast period. Rather the lower import prices are due to the small decline in international commodity prices that has occurred over the intermeeting period, a decline that may or may not be attributable to developments in Asia.

The risks to our forecast with respect to the dollar and underlying growth trends in other industrial countries, we believe, are balanced. In terms of the Asian crises in all their ramifications, the probability of further deterioration should be thought of as greater than the risk of a sudden unexpected improvement. However, it would be a mistake to think that there are no upside risks involved in the Asian situation. For example, the news coming out of the deputies' meeting in Manila next week about a new Asia-Pacific cooperative financing arrangement may be perceived as sufficiently positive for the region as a whole that net inflows of private capital will resume and substantially reduce the size of the external adjustments that we now think will be required.

On the downside, the new government in Thailand may not be able or willing to deliver quickly on that country's IMF-supported economic and financial program; the implementation of the Indonesian program also may get bogged down in domestic or family politics; the storm clouds over Korea may darken further; and the spread of contagion to Latin America may intensify. We circulated to the FOMC a note on a so-called "worst case" scenario in which the negative impact on U.S. growth from the Asian crises is roughly double what we incorporated in the Greenbook forecast, largely because of an assumed spread of the turmoil to Latin America. That scenario might better have been called a "worse case," since it is easy to spin out scenarios that are more extreme.

Mr. Chairman, I will stop on that pessimistic note.

CHAIRMAN GREENSPAN. What has been happening in the last couple of years to the statistical discrepancy in the world current account balance?

MR. TRUMAN. It has not moved much. It is still a very big negative or positive depending upon how you want to think about it.

CHAIRMAN GREENSPAN. Is it still $100 billion?

MR. TRUMAN. When we did this calculation, we held that unchanged. We forced the adjustments to go elsewhere rather than into the statistical discrepancy.

CHAIRMAN GREENSPAN. I noticed in the most recent labor force data that the participation rate declined. We usually would expect it to rise in the context of a sharp increase in economic growth. I gather from the underlying data that there has been a significant increase in school enrollments. One would presume that is occurring because of the need to upgrade skills and because parents can afford to let their children stay in school. So, the number of people not in the labor force but in school has been rising very rapidly. This has exactly the opposite effect on the participation rate from what a strong economy would ordinarily impart. When you projected the participation rate to get an unemployment rate of about 4-1/2 percent, did you have any explicit assumptions regarding school enrollment or any other not-in-the-labor-force elements?

MR. PRELL. We have looked at the movements in the labor force in some detail. Basically, in this latest forecast we backed off from our previous expectation of a significant rise partly because the incoming data were not moving that way. What we have seen since the spike in March is a rather broad-based decline involving adult males, adult females, and teenagers. Certainly, a possible factor affecting school enrollments is the wealth or income effect that you have noted. One area where we have seen recent increases in participation is among women who are head of a household, and I think that is consistent with some impact from welfare reform. Basically, all of the rise in labor force participation in our forecast is related to the anticipated effects of welfare reform. The latest data put the participation rate at a lower level than we had anticipated, but there is enough noise in these numbers that we are hesitant to leap to further conclusions. Even so, the data do tend to underscore the risks to the participation outlook in that direction.

CHAIRMAN GREENSPAN. What is the effect on the productivity numbers of the upward BLS revision of payroll employment from the annual survey?

MR. PRELL. All other things equal, it will tend to lower productivity growth over the period in which they wedge in this increase. We are talking about a 0.1 or 0.2 reduction.

CHAIRMAN GREENSPAN. Isn't the BLS revision something like 500,000 workers?

MR. PRELL. I think it was 475,000. If we assess the effect on productivity growth in terms of gauging the trend over a period of time, it would not be quite so large.

CHAIRMAN GREENSPAN. It will affect the historical data, the 1996 numbers, but are you suggesting that it will have little effect on the outlook?

MR. PRELL. They will carry something through as well, but there is also the possibility that by the time we get to the middle of next year other data will have changed too, perhaps on the output side.

CHAIRMAN GREENSPAN. Is there a tendency for that to happen when BEA does its annual revisions?

MR. PRELL. That is a very interesting question for which I do not have an answer. It is something that we ought to look into.

MR. STOCKTON. If it were to show up, it probably would be as an additional increase in the statistical discrepancy. There is no evidence that statistical discrepancies revise back toward zero when the annual revisions are made. So, you could not necessarily use the revision to forecast more GDP, but it certainly is a logical possibility.

CHAIRMAN GREENSPAN. It certainly would make BEA look harder.

MR. STOCKTON. Indeed. I think they will undertake a more careful review of the discrepancy between the income side data and the product side data, and to the extent that they have some discretion, they might emphasize it that way.

MR. PRELL. As I understand it, the only data we are really dealing with are the revised employment numbers. They will feed that through in estimating total hours, but one does need to look at the income data themselves.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mike, I had a question in reading the Greenbook. As you look out beyond this year, you are forecasting a slowing in GDP growth, and even though you have reduced the rate of increase in inflation, the inflation trend is still positive. As the Greenbook explains the surrounding circumstances, it seems that the primary reason for the continuing inflation is the projected decrease in productivity, which raises costs. Are the inflation numbers being driven by labor costs?

MR. PRELL. That is a part of the story. We view resource pressures at this point, particularly in the labor market, as being strong enough to produce some ongoing acceleration in prices. The fact that productivity growth in the industrial sector is as rapid as it is suggests to us that, going forward, we are going to have a reasonably comfortable picture in that sector, but more generally we see ongoing pressures in the labor market. We have the difficult question of judging what the relative influences are of trend productivity and actual productivity growth. It is probable that reality lies in some combination of those two elements. Therefore, as we go forward and the upcreep in compensation is augmented by a decline in productivity growth, we expect to get a noticeable acceleration in unit labor costs that will put some pressure on profit margins. In that case, firms may, in what will still be a reasonably tight market overall, try to extract some price increases along the way.

MR. HOENIG. Even with the GDP numbers coming down markedly?

MR. PRELL. One might think that there will be something of a so-called speed effect as we move into 1999. The other element, though it is a small and uncertain factor, does work in the direction of tending to raise inflation. It has to do with the fact that we have been benefiting significantly over the past couple of years from a decline in import prices. Going forward, we do not anticipate that to continue, so that adds to the acceleration of prices in our forecast.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mike, in the corporate profit area, I wonder if you could elaborate a bit on the basis for the Greenbook's assumption that corporate profit growth slows so significantly by early 1998. The labor costs do not seem to accelerate dramatically in this period, and, of course, if profits come in higher than you anticipate in 1998 and 1999, that could lead to higher spending on business fixed investment.

MR. PRELL. The numbers do conform arithmetically with the behavior of compensation and unit labor costs, but there are other factors that play a role such as movements in interest costs, foreign earnings, and so on. In the short run, we probably will have our greatest hit to foreign earnings from the problems in Asia in particular. So, there are a number of elements that tend to put a damper on profit growth in the near term. The profit share begins to turn down, but the greater damage really occurs as we run through the forecast period. The year 1999 is where we see profits really declining. Indeed, that is one of the reasons we have only the mildest of declines in the stock market through the first part of next year. Year-on-year comparisons of earnings in our forecast will still look quite good. Certainly if there is any continuing inclination for investors to be optimistic, as they clearly have been in recent years, I do not think reduced earnings will be such a rude shock to the markets that they would have devastating effects on share prices in the early part of our forecast period. Cash flow in the nonfinancial corporate sector is not growing as fast as capital expenditure, and we are seeing a widening of the financing gap. As we go out through the forecast period, the financing gap gets to be sizable enough that at least we would not think that firms will be spending simply because money is coming into their coffers and they have to do something with it. It begins to be a less favorable factor as we move out through 1998 and certainly into 1999.

MR. MOSKOW. Thank you.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. In the Greenbook forecast, the funds rate is kept constant through this quarter and then begins to move up, rising 75 basis points by the middle of next year. Was there any thought as to how sensitive the forecast might be to this assumption, in view of recent developments in Asia? In particular, if this path were embarked upon somewhat sooner than is assumed in the Greenbook forecast, would you modify the response of the economy in light of the possibility that it might generate some financial consequences that are not incorporated in the forecast?

MR. PRELL. I will call on Ted to comment regarding how he thinks other markets will respond. This is a question that President Jordan asked at the last meeting, and in retrospect I thought my answer may not have hit on one point that logically would be potentially significant in our thinking about the forecast. That point is that to the extent that you surprised the market early on before you saw any evidence of building price inflation, your credibility would be enhanced. You would not appear to be playing catch-up, and the solidification of low inflation expectations would be greater. Now, in fact, with the kind of acceleration in prices we anticipate, it might be very hard to explain price developments from month to month. So, I do not want to draw this distinction too sharply. Certainly, one of the reasons we have share prices declining is that the markets do not seem to have built in any anticipation of tightening, and an earlier move, as the Bluebook points out, could have fairly sharp effects on domestic financial markets.

MR. TRUMAN. It seems to me that two or three points could be made. One is that there is a sense in which all of this volatility in foreign markets has been associated with some moves toward tighter policies, as Peter has pointed out. We have had the Canadian moves, the British moves, the German moves, and although Japanese moves have been postponed, it is fair to say that the generally benign monetary conditions in the industrial countries have been one factor that has contributed to the acceleration of capital flows to emerging economies. As we have commented before, when that comes to an end, there is some risk of a process of readjustment, some of which may already be under way. I think it is probably a reasonable guess that if the Committee were to surprise the market and move sooner, or move at all at this point, there certainly would be some short-run dynamic effects. And no doubt we all would come under some criticism. That having been said, unless you think that early tightening would set off some great avalanche that would continue regardless of fundamentals, I don't think the timing will make much difference in the medium term. I don't think that in any fundamental sense an earlier policy move will somehow cause political leaders in Southeast Asia to step back from the things that they have said they were going to do. I might even argue that it could accelerate the adjustment process, but there might be a lot more broken crockery in the meantime.

MR. KOHN. I would only add that it is always hard to predict how markets are going to react to a policy move, but if you do something unexpected in a skittish and nervous market, it would seem to me that predicting the outcome is much more difficult in that case. The chances of outlier kinds of responses are somewhat higher.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. This is a version of Tom Hoenig's question. I was quite surprised by the projected falloff in productivity growth in your forecast for 1998. We have had a gratifying improvement now for four years, and you reflect that experience in your estimate of increased trend growth, but then you have a big drop in 1998 to an increase in output of 0.7 percent per hour. Can you say a few words about why you think it will drop that much?

MR. PRELL. The basic thesis here is that we have had a spurt. We think the improvement in trend is an element in that, but we also think that, in part, the acceleration of output has lifted the growth in productivity to substantially above the trend line that we would draw. As the economy decelerates, we would anticipate a movement back toward the trend line. That is the pattern that we have here.

MS. RIVLIN. It's not just a movement toward the trend line; it falls below.

MR. PRELL. No. Think of the productivity trend as a line that is rising and current productivity as moving above the line. The two lines then tend to converge, with actual productivity converging to trend from above. Now, during past business cycles, this has occurred irregularly. Certainly, it has occurred at the end of cyclical expansions. To some extent, that may have reflected a deterioration at the margin in labor quality as new workers were added to the labor force. In some cases, it may have reflected the need to use less efficient equipment, which does not look to be a very significant problem in this instance. It could be simply the deceleration in demand and the cutback in output, which is not followed immediately by a proportionate reduction in hours of labor. It is quite conceivable that not only are we wrong on the trend, we could be wrong on the shorter-run dynamics too, and we could have a more sustained growth of productivity. But we think this is a sensible pattern, one that conforms to experience as we have it embodied in models of productivity behavior.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mike, I may have misread the analysis in the Greenbook, but I got the sense that you placed a great deal more importance on the wealth effect in your current forecast for household consumption. I compared that analysis to your earlier assessment of how much the wealth effect would affect spending as the stock market rose sharply. Is this simply a matter of an asymmetrical response to a market correction downward as opposed to what you thought the wealth effect would be when the market rose sharply? Is there some new work underlying your current analysis or have I, in fact, just misread the importance that you attach to the wealth effect in explaining a falloff in the growth of consumer spending?

MR. PRELL. Perhaps because we did not include verbiage in that part of the Greenbook about a lot of other developments, it may have seemed that there was more focus on the wealth effect. Since the midyear revisions to the national income accounts that showed a decline in the saving rate, I think we have used essentially the same logic in terms of assuming that a good bit of the strength in consumption and decline in the saving rate over the past year is attributable to the increase in stock market wealth. We also anticipate that, as the market turns down in our forecast, we are going to see the wealth effect eroding gradually. "Gradual" is the point that we have tried to stress. Some have suggested that the response is almost instantaneous, but as best we can gauge that response, looking at a variety of econometric models, it takes a significant span of time for the wealth effect to play out. So, in 1998 we would still see for most of the year some impetus on balance to consumer spending relative to income coming from the rise that already has occurred in the stock market. But, by 1999 we have it turning the other way.

I guess one could say that, anecdotally, we hear increasing reports of people feeling rather wealthy and deciding that they are not going to leave all of their gains to their kids or the IRS. They are going to spend some of those gains. Certainly, people in the auto industry believe that one of the reasons the demand for sports utility vehicles, especially the high-end models, has been so strong is that people are spending some of this wealth. I think there is some evidence in the housing market that demand for second homes has firmed in the past year, and people in that industry seem to feel that the improvement could be a reflection of the stock market. So, this factor could be having fairly broad and significant effects, which is the reason we feature it so much in explaining the deceleration in 1998 and 1999.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I want to go back to Ted's comment about whether or not the paper we got on the "worst case" scenario was really "worst" or "worse." I noticed that the paper still foresees some growth in 1998 for Korea, and I must say I am a little concerned that the impact of the Southeast Asian crisis on Japan may be more significant than the paper anticipates. If you have any comments, I would like to hear them because I'm a little concerned that our idea of what is the bottom may not really be the bottom.

MR. TRUMAN. There is always that problem, and that is why I made my last comment. You could always say that if growth is going to be marked down by 5 percentage points, why not mark it down by 6 percentage points? That is at one level. There is always some chance of a cumulative process, reminiscent of a lot of economic history. On the other hand, one also has to think about something from which many tend to abstract, namely, about what might happen to policy along the line. There likely is some policy whose feedback could prevent the cumulative effects. So, what may happen is difficult to say. One point to think about, at least in terms of developing economies, is that many of them are high-growth economies. If they go into recession, say their GDP declines by 2 or 3 percent, we would not think of that as a big recession but for them it would represent a very large adjustment from previous growth rates of 6, 7, 8, or 9 percent. The adjustment in growth would be something close to double digits. We might anticipate that Korean growth would still be 1 or 2 percent, but that would be a decline from 7 or 8 percent, a 6 percentage point change in the trajectory of the Korean economy. Obviously, there is no magic about zero here, and I think what you are saying is that in some real sense these economies will be going into some kind of recession.

Such a development could have further feedback effects, especially in Japan which, I would argue, is hampered principally by their delay in doing something about the problems in their financial system. That has meant, at least in part, that their standard macroeconomic measures may have been somewhat less effective than one might otherwise have thought, and they are to some extent running out of string. I don't think that is true for other industrial countries as a group. The industrial world seems to have the capacity to take policy steps that would cushion some of these effects and in turn avert feedback effects on the developing economies. Things could be much worse.

One part of the world that we have left out of our analysis is Eastern Europe. There, too, some economies have been impacted by at least the financial dimensions of all this turmoil. Although our trade with Eastern Europe is trivial, Western European trade with Eastern Europe is not so trivial. If there were dramatic changes in conditions in Eastern Europe, that presumably would have some impact on Western Europe. While it may be fair to say that Western European nations have scope to use policy to offset the general macroeconomic effects of such a development, it is not unreasonable to question whether they would be able to coordinate their policies to do so. So, I think there is some risk stemming from potential developments in Eastern Europe that we have not taken account of arithmetically. It is one reason why we probably should have called our analysis "a worse" rather than "the worst" case scenario. Absolute zero is difficult to define in this context.

MS. MINEHAN. If you use that "worse" case scenario as a guess, is the impact a one-half percentage point reduction in our GDP growth over the next couple of years?

MR. TRUMAN. It is a little more.

MS. MINEHAN. Spread over 1998 and 1999?

MR. TRUMAN. It is more like adding 0.2 to 0.5 in 1998 and 0.1 to 0.2 or 0.3 in 1999. I think that is the order of magnitude. There is always a question about multipliers in these exercises. Now, in fact, when we run these through, the ex post multipliers tend to be close to 1.0. It is not entirely clear to me whether that is because the true multiplier is close to 1.0 or because either automatic policy responses or discretionary policy responses are such that the multiplier ends up being close to one.

MS. MINEHAN. Apart from that, how does this scenario play out in terms of unemployment and downward impact on inflationary pressures?

MR. TRUMAN. That goes to the question of global deflation. Perhaps Mike Prell and Don Kohn ought to answer this question, but my view is that the fundamental behavior of the U.S. economy has not changed so much in the last half dozen years that we can no longer analyze effects of this size through standard aggregate demand approaches. Obviously, the developments in question would raise our unemployment rate and lower inflation pressures much as one might argue that the collapse in Latin America in the early 1980s may have affected our economy. At that time, our economy was recovering from a recession, but it also was a recovery from a recession with, at least as perceived at the time, remarkably quiescent inflation. Inflation was then in a 4 to 5 percent range, and that rate of inflation may have reflected some influences from abroad in terms of downward pressure on commodity prices and related developments. We are looking at an effect on our macro economy that is marginal rather than large in terms of fundamental behavior.

MR. PRELL. There is a simple rule of thumb. One has to have a full-fledged scenario that indicates the circumstances in which, for example, this extra couple of tenths of GDP restraint might be occurring. If we just had a quarter percentage point more deceleration in GDP growth for two years, we would end up by Okun's Law with about a quarter percentage point higher unemployment rate by the end of the second year. The difference in inflation outcomes would be very small. But if we blend in stories about exchange rate and import price effects and their financial dynamics and so on, one has to step back and think very carefully about what the outcome might be. Just taking that little bit of arithmetic that Ted was mentioning, we need to go to a drastically "worse" case scenario to totally change the outcome.

MR. KOHN. As I looked at this analysis in relation to the scenarios at the end of the Greenbook, it seemed to me that the effects were somewhere between the baseline and the tighter scenario in terms of GDP growth. Remember that the tighter scenario in effect keeps inflation from rising. As I will say in my briefing later, it seems to me the "worst" case scenario still leaves the tightening move an open question.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mike, I was struck by the fact that the projection for the ECI for next year is the same as the number for this year. I would like to get some sense about how comfortable you are with that projection because I believe it was made before we had the October jobs report. Also, we at our Bank get a lot of anecdotal information to the effect that health care costs will begin to rise at a more rapid pace. That information comes from a fairly broad range of contacts. As an example, the head of ,

made a big point of this in a recent meeting. I am wondering whether you are factoring in that sort of information.

MR. PRELL. As I noted briefly, the average hourly earnings report for October did not upset us. We anticipated another large number, and it was in line with our expectations. The forecast of a stable ECI increase in 1998 reflects the expectation that wages will be favorably affected by the very low rates of consumer and overall price inflation that we've seen in the past year and the apparent effect of that price behavior on inflation expectations. That effect has been small on the median of such expectations, for example, in the Michigan Survey, but very striking on the mean. Seemingly, there has been a convergence of expectations to the lower level. We would anticipate this to have a damping effect on wage increases, and in a sense we are not looking for the ongoing effect of the minimum wage hikes that have raised the rate of wage increases in the past year. When we did simulations about a year and a half ago, the simulation of a minimum wage increase involved some follow-through as higher wages raised prices and price expectations. But in fact consumer prices have decelerated, so we see that as a favorable element in the near term.

We have built a significant acceleration of health insurance costs into the ECI forecast. We have reports of increases in insurance premiums beyond those of CALPERS and the federal employee health programs. We are fairly well convinced that those increases will happen this time. They did not happen this year despite some earlier reports, but we feel the evidence is now tangible enough for us to want to build that into our forecast at least in a moderate way.

I guess my final comment would be that there seems to have been some increase recently in the anecdotal reports of step-ups in wage increases. It is very hard to read this information, but I would say that there's a basis for some concern that the increases may be larger than those we have built into the forecast. I have not seen the actual numbers, but just to cite something that I have heard, the survey of smaller businesses by the National Federation of Independent Businesses has evidently shown a noticeable increase in the last few months in the number of firms reporting that they actually have raised wages and a noticeable increase in the number of firms saying they plan to raise wages.

In sum, there clearly are risks. I think we followed the logic of the basic model of how wages are determined, and it just may be that we are going to get increases in this period that turn out to be greater than we forecast.

MR. BROADDUS. Thank you.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I just have a few comments that I'm not sure will be all that helpful and a question. On the balance of payments arithmetic and the worst case not appearing all that bad, I think we should not get too complacent. It seems that we are thinking of the transmission mechanism as being through the trade and the current accounts when it may be that the Asian flu spreads more through the capital account. On the arithmetic, while the net of the two tends to be the same, the gross of the capital account has gotten much larger in recent years than the gross on the current account. So, I think the fact that we have small trading relationships is probably less important than it was before capital became so notable and so large relative to trade. We should be careful about that.

My other comment is on the stock market. I thought, when we had the big stock market decline a couple of weeks ago, that there was a silver lining to it. I thought it would provide at least part of what Mike Prell was expecting for next year so that he would give us some relief in his forecast for stock market adjustments in 1998. But it seems as if it didn't make a dent at all.

MR. PRELL. Before the drop, the market had moved up further. So, as of Monday, I think the average for the quarter was actually higher than we had predicted in the last Greenbook. Now, if the market stays at these lower levels, we will come out pretty much in line.

The decline from the very peak of the market to the low that we forecast, going by the Wilshire 5000, is about 25 percent. We have about 5 percent under our belts.

MR. MCTEER. In line with Mike Moskow's question earlier, I gather the stock market is going to fall because you expect higher interest rates and lower profits. I believe you have profits coming down from a growth rate of 11 percent in the third quarter to only 1 percent in the fourth quarter. That seems rather abrupt.

MR. PRELL. It could be. We have been wrong previously! We certainly have found it more difficult in the past couple of years to track from our output forecast to profits, because the statistical discrepancy has moved substantially. Perhaps that could happen going forward. In our forecast, we do not have that continuing movement in income relative to expenditures that we have experienced over the past year or so.

MR. TRUMAN. On your first comment, I would agree with you and maybe I should have been more clear. It seems to me that in the particular framework that I laid out, which is not the only way we looked at this, it is the capital account that is forcing the current account adjustment. As you say, the order of magnitude of those capital flows certainly is larger than the gross trade flows. But when it comes down to the corrective effect on goods and services--which is what we measure in GDP--we end up wanting to look at that in terms of trade. We always have this question, much like the question on stock market effects on consumption, about how to marry something with financial dimensions to how these things play out in real dimensions, and whether the effects will be cumulative. We have not added that in except, as I think we mentioned in the Greenbook, that there is a side of this that looks at the implications for growth in the developing countries. It is hard to make everything consistent. One sense of why you might find less growth in developing countries would be that the cost of capital has gone up, uncertainty has gone up, and there has been a big drop in investment. It is not only investment that comes from the public sector, which is supported in these economies, but from the private sector as well as we go through this financial turmoil. In that sense, we try to take account of that effect.

MR. MCTEER. I was traveling on the day that the stock market went down over 500 points. I heard about it after it had already happened. I did not get to build up to it gradually. What I heard on the car radio was that it was because of the Hong Kong stock market. So, it was stock market to stock market and had nothing to do with anything rational.

MR. TRUMAN. I was traveling, too. I got trapped in Springfield, Illinois.

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

MR. HOENIG. Mr. Chairman, the Tenth District economy continues to perform very well. I am going to focus my comments on anecdotal information partly because that information, though not different from the statistical evidence, is in some sense at a higher pitch as suggested by various stories coming out of our District. First of all, manufacturing continues to do very well, but there is a very persistent commentary that firms are continuing to do everything they can to substitute capital for labor. The reason is labor shortages, especially in the low-paying, repetitive-type jobs.

Members of our advisory groups corroborate our information that loan growth is moving up. One of our advisory panel members, a CEO, received a call from a major banking firm that asked whether they should put the firm down for a $50 million or a $100 million line of credit next year. The bank did this without knowing what the firm's plans and loan demands might be. This story illustrates a very strong desire by banks in our area to increase their loans to business borrowers. On the other side, there are credit card fish stories that are scarcely believable. I heard one involving, for me, a new high in indebtedness by an individual. In a credit check for a new loan application, one of the banks in our region found that the individual had debts on several credit cards totaling $180,000. The individual was using advances on new cards to keep them all current. Whether that person was trying to support a business endeavor or just consumer purchases was a question in the bank's mind, but they did not consider the application long enough to get into that kind of detail!

With regard to bottlenecks, the Greenbook mentioned some delays in rail transportation and we are finding evidence of that in our region. One firm in Tulsa leased some trucks to go to Memphis to pick up some of its raw materials because the railroad bottlenecks were keeping the firm from getting its supplies on a timely basis.

On the salary issue, we are seeing continued escalation in the high-tech areas. One of our states was losing their programmers because of an average 25 percent increase in programmer wages in their job market. With regard to worker benefits, we are hearing from organizations like PCI in Colorado that they are decreasing the waiting period for their workers to get into 401(k) programs. Other employers are increasing their use of stock grants to entice people to stay or to come on board with them. On medical insurance costs, we are hearing from Kaiser Permanente and Blue Cross/Blue Shield of cost increases of 5 to 10 percent on renewals and 9 to 12 percent on PPOs for next year. Finally, though on the other side, we had some meetings with a couple of labor representatives and, for example, the one from the International

Brotherhood of Boilermakers was talking about wage increases totaling 2-1/2 to 3-1/2 percent. However, the contracts were for 5 to 7 years, and the wage portion was not renewable though the benefits portion was. One of our major companies also indicated that they had now signed a five-year contract. That says something about future inflation expectations.

Briefly on the national level, the only comment I would make is that we have a very strong economy and very strong demand for labor. I do not think the Southeast Asian crisis will necessarily have a contagious effect on our economy. So, we have very strong growth, but in terms of its potential for inflation, I continue to be struck by a number of offsetting factors: how well balanced the economy is at present, a core rate of inflation that continues to decline, the continued absence of pipeline inflation, persisting expectations of stable inflation, and from the standpoint of monetary policy a historically high real fed funds rate. So, the dilemma on the national front continues to puzzle me. Thank you.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, labor markets have remained quite tight in the Twelfth Federal Reserve District in recent months, as employment growth has proceeded at a strong but moderating pace. The District unemployment rate fell about 1/2 percentage point in the first half of the year and remained at this low level through September. With the notable exception of California, unemployment rates in most District states now are at lows not seen in several decades. Although California's unemployment rate is still high relative to those in other states, it has been falling sharply and labor markets in some of the major metropolitan areas are very tight. Unemployment rates have fallen to new lows in San Diego and the San Francisco Bay area. Labor market conditions also have improved noticeably in the Los Angeles area, which until recently had been experiencing a strong out-migration of people who lacked good job opportunities there.

For the District as a whole, although third-quarter employment growth was strong, the rate of increase was about 1 percentage point lower than the very rapid pace in the first half of 1997. This includes California and Washington where the slowdown follows a pickup in growth earlier in the year. Moderation in growth rates in the intermountain states of Arizona, Nevada, and Utah appears to be related to a slowing in population growth. This is partly a result of fewer new residents relocating from California. Job growth has tapered off this year in the population-oriented sectors of the economy such as residential construction and state and local government.

Recent data show that the national economy continues to perform well, with robust output growth accompanied by low inflation. Traditional models still predict that the economy will grow at around a 2 percent rate next year, with the slowing based on factors such as high stocks of real assets, the dollar's appreciation over the last year, and the relatively high level of real interest rates. The latter have been nudged up a little by recent declines in expected inflation. I agree that the turmoil in East Asia may contribute a bit to the growth slowdown, but I think the contribution is unlikely to be large. However, I believe there is plenty of room for skepticism about whether a slowdown as big as that predicted by traditional models will occur, especially when one takes into account the inability of these models to predict the robust performance of the economy over the past year and a half. It is possible that we are experiencing the effects of a positive supply shock, which means that the uncertainty extends to predicting inflation as well. The recent moderation in inflation certainly is consistent with a positive supply shock, and some market-based indicators provide room for optimism. For example, the rate spread between nominal and inflation-indexed bonds has now fallen below 2-1/2 percentage points; we talked about that a little earlier. But I believe recent data provide reason for concern as well. For instance, the unemployment rate has fallen even further below most estimates of the natural rate. This leads me to expect higher inflation, and both ECI and hourly earnings data show that wages are beginning to move up somewhat. In balancing these considerations, I would expect the core CPI to rise about 2-1/2 percent in 1998 compared to about 2-1/4 percent this year. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. In addition to the usual discussions we have had with directors and advisory council members since the last FOMC meeting, we also spent some time visiting communities around southern and western Ohio and central and northern Kentucky. I came away with an impression similar to the one I felt almost 10 years ago when I was still traveling around Southern California, namely that I was in a rare part of the world and everybody else must be suffering because everything was booming where we were. And these are counties that are not accustomed to experiencing such prosperity.

Bankers reported strong loan demand in all categories, with most getting stronger. Of course, there has been a surge in mortgage refinancing that I am sure most people are seeing around the country. In the areas that we visited, people reported that consumer loan demand was still very strong, especially auto-related. The most prominent stories related to real estate lending. Our contacts said it was booming everywhere. One banker in Kentucky indicated that there was more speculative building under construction now than at any time in his memory, and he is certainly older than I am. He commented that in his county if a construction worker were driving through in a pickup and happened to have a breakdown near a vacant field, by the time he got the tools out of the back of the truck at least five bankers would stop and offer to finance the project for him! [Laughter] Just before our visit, one banker saw seven proposals for new speculative building projects. He said three of the ideas were so poorly justified that they did not even have a plan, and all the potential borrowers were significantly undercapitalized. There are a lot of reports that farmland is being acquired for future conversion to either commercial or residential uses or on the chance that somebody might build an interstate interchange on the land, making it more valuable. These are not prospects at all, just hopes. In central Kentucky, we were told that the number of lots developed and ready for construction was triple the number of a year ago. Bankers said that a sharp net in-migration into the region was expected. I asked them from where and they didn't know. Obviously, they thought that people were going to move into their area because the local economies were in such good shape right now. We were hearing the usual reports of farmland prices well above what crop values would justify. We heard more stories of residential mortgages being made by nonbanks with 125 percent loan-to-value ratios. One banker said that one of his nonbank directors indicated that he was strongly opposed to participation in any economic development efforts by the state or by the county because his firm's labor turnover was high and he wanted to slow growth.

On the labor side, we were told that entry-level tellers were being paid around $14 to $15 an hour to start. One reported $20 an hour for a teller trainee. Our contacts said that banks that advertised in newspapers for employees got no applications at all. Instead, the banks were resorting to hiring bounties. They were paying existing employees to bring in a friend or a relative and then paying them part of the bonus, depending on how long the new employee lasted. One new bank said that in their first six months of operations, they had surpassed their initial three-year plan for earning assets. There were more stories about consumer loans going from being current to bankruptcy status without the transitory stages of late payments and delinquencies.

In other reports from directors and advisory council members, like Tom Hoenig we have heard about the bottlenecks in rail transportation and even about the difficulty of booking trucking transportation. The claim is that there is a shortage of truck drivers, and our contacts said that it was common now to pay $40,000 a year or more for truck drivers. We have heard reports of other worker shortages, including nurses, warehouse workers, computer operators and programmers, and machinists. Somebody reported to us that pickers and packers were now getting $14 an hour; I'm not sure exactly what pickers and packers do! One company, a fairly good-sized shop, said that they had a number of machinists whom they had been paying $18 an hour, and a group of them walked out and went to a nonunion shop for $21 an hour. The unionized company cannot find replacements at $18 an hour, and the union will not agree to their hiring new people at higher wages than the existing workers receive. They are demanding that the whole pay structure be raised. So, the company's owners are now looking into the option of simply shutting the plant and moving the whole operation to Mexico. On health care, we heard from one advisory council member that increases in medical costs are now sticking and that we should expect such costs to rise for the next several years--the same kind of thing that Al Broaddus mentioned.

Three years ago I asked the members of my small business advisory council if they could contemplate still being in business in five years if they were not able to increase the prices of their products or services at all over that period. The response was a unanimous "yes," and they explained to us how they could do that. When I asked the same question recently, the responses were almost all "no" or "doubtful." The reasons they give are that labor costs have risen much more than they had expected, the quality of the labor force has fallen more than they had anticipated, and the easy steps to increase productivity have already been taken. Moreover, they now expect more labor militancy, work stoppages, and competition from nonunion operations. Some commented that they thought the unions were going to demand catch-up raises. As the unions view developments, business earnings have been so good because the benefits of increased productivity and efficiency have all gone to owners and not to workers, so now it is the workers' turn.

We heard some general comments to the effect that compensation data understate actual labor costs. It is an interesting phenomenon that nobody thinks that their situation is normal. It will be interesting as we go around the table to see how others view this phenomenon. If all of us are operating above average, it is going to be hard to know what is really going on. No one thinks that the unemployment numbers reflect what they are seeing in their communities and their counties; nobody thinks that the inflation data reflect what they are seeing; no one thinks that the compensation numbers reflect what they are experiencing; nobody thinks that their labor turnover experience is reflected in the statistics. Generally, our directors believe that there is a buildup of inflationary pressures and that the inflation risks are decidedly on the upside. They report that sectors of the regional economy such as construction are operating flat out, constrained only by the availability of financing.

I have a couple of thoughts on the national economy. One relates to the wealth effect that Mike Prell mentioned. Mike referred to high-end SUVs and second homes. We surveyed boat builders and found that luxury boats are doing very well. The recent International Boat Show in Annapolis was said to have been the best in over 10 years. It is the high-end boats, both power and sailboats, that are selling extremely well. As we were driving around in Kentucky, one banker reported that cars with license plates from New York and Massachusetts sometimes pull into a farmhouse driveway and offer to pay cash for the farm.

It appears that we have been in a virtuous phase of the cycle during the last few years, with strong growth in income, output, and employment, good productivity, and falling inflation. It seems to me that the risks are rising that we are going to experience the mirror image of those favorable developments including slower economic growth with possible declines in income, output, and employment, and rising inflation. On the outlook for corporate earnings and the stock market, I was surprised that the Greenbook talks about a decline of only 20 percent in stock prices because it also says that we have seen the peak level of corporate earnings in the third quarter of this year. According to the Greenbook, corporate earnings will be essentially flat from this quarter through the second quarter of next year and will then decline for the subsequent six quarters. By the first quarter of the year 2000, the level of corporate earnings will be below where it is today. I think that if the standard view in the stock analyst community were that the level of corporate earnings early in the next millennium would be below today's level, we would have a more severe correction than the staff is talking about.

The notion that any policy action would be viewed as preemptive is true only from the perspective of the national statistics, such as the consumer price index, but not from the standpoint of Main Street. Wall Street might think so; I do not think Main Street would. I believe that when people on Main Street look at asset prices, not just equities but assets in local communities such as those they are seeing in the housing market and the farmland market, the anecdotal reports would not say that a policy action would be viewed as preemptive. Their reaction would be that it was warranted in current economic circumstances.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, by all accounts, activity in the Fifth District has continued to expand strongly since our September meeting. By now, tight labor markets are obviously old news but, if anything, our sense is that they have tightened even further. Several manufacturers in our region told us over the last several weeks that they had accelerated their purchases of equipment because of the difficulty they are having in finding new workers. In general, the consensus among nearly all our contacts is that just about everybody who is willing and able to work is already working. Anecdotally, I have a little direct personal experience with this. I have two sons. The older one graduated from college back in 1992, and it took him almost a year to get a paying job. The younger one graduated this year, and he already has two jobs. While he was on one of them the other day, someone came up and offered him another, better job.

Elsewhere, and somewhat related to what I just said about labor markets, there is evidence of some precautionary inventory building in our area, especially at the factory level. The delays in rail deliveries are causing some manufacturers to stockpile raw materials because of the difficulty they are having with those deliveries. And some factories are stockpiling finished products since it's hard to find additional workers to raise production when demand increases unexpectedly.

Despite this evidence of strong demand and tight labor markets, the reports we are getting on final prices are still generally mixed. Trucking rates have been rising this year. As I mentioned earlier, it is generally expected that health care costs will rise appreciably over the course of the next 12 months or so, but goods prices at both the wholesale and retail level generally have been flat recently.

Finally, like Jerry Jordan, we are seeing evidence of booming real estate conditions in the District, especially commercial real estate. That is especially true right here in the Washington metropolitan area. And we are beginning to hear comments that developers are now making some of the same kinds of mistakes as were made back in the 1980s. We have a lot of pickup trucks in our District, too!

At the national level, we have a lot of new information since our September meeting. I think the headline of 3-1/2 percent growth in real GDP in the third quarter indicates clearly that the economic momentum we have seen for a year is continuing. Indeed, the growth rate in that quarter, as we all know, would have been even stronger had it not been for a slackening in inventory accumulation. And it appears that the fourth quarter is starting off on a strong note if the job report and the purchasing managers' reports are any indication. We had a big increase in employment in October. The increase was well above the average monthly increase for the first three quarters of the year.

In short, as I see it, the economy currently appears to be growing at a rate well above the staff's estimate of potential longer-term growth of 2-1/2 percent, and we are projecting that such growth will continue roughly through the second quarter of next year. Beyond this, the demand for labor nationally appears to be outstripping the sustainable supply currently by a factor of maybe 2 or 3. That is certainly consistent with what we hear in our District about the difficulty of finding employable people. Factory utilization rates, according to the Greenbook, are currently above past noninflationary levels.

Against this background of quite robust economic activity, the recent stock market volatility, as I see it, is being widely viewed in the markets as precluding any Fed policy tightening for the time being. And what I think is more important is that because the Fed is expected to remain on the sidelines for a while, even very strong economic reports like the third-quarter GDP report and the job report are not getting much reaction in bond markets. They are having little effect on longer-maturity rates. This insensitivity of longer-term rates to the gathering momentum in the economy--and I worry about this--may prevent them from playing their usual role as an automatic stabilizer for the economy. In that sense, one might make the case that the recent market volatility has caused a de facto easing of monetary policy.

Bottom line, I see a number of factors that increase the upside risks in the near-term outlook. These include the accommodation of an economy growing well above potential, labor demand outstripping labor supply, factory utilization rates at high levels, and the short-circuiting of the usual automatic restraining force of increases in longer-term interest rates due to the market expectation that the Fed is on hold. We have heard a lot about downside risks, and they are certainly there, but the developments I noted certainly increase the upside risks. In my view, they also increase the danger that we could get behind the curve, as I think one could argue we did in at least somewhat similar circumstances back in 1988 and 1989.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, the economic conditions in the Seventh District are quite similar to what I have been reporting for several meetings. Our regional economy continues to operate at very high levels, but it is expanding at a slower rate than the nation. Our housing and manufacturing sectors are prime examples of this.

As I have noted before, labor supply constraints seem to be trimming growth in our region. Labor markets remain very tight. The unemployment rate in District states has been below 4 percent since May. One of our directors noted that his firm is paying bonuses to retain computer-related staff, and salary increases of one-third for these skills are not uncommon now. Many retailers express concern about not having enough staffing for the holiday shopping season. Moreover, based on the unpublished results from the latest Manpower employment survey, labor demand continues to be quite robust. Hiring plans are the strongest for any first quarter since 1989, with hiring intentions remaining uniformly high in all geographic regions of the nation. This survey is not going to be made public until Monday, November 24, so this information is confidential until then. For some time, I have reported that wage rates in the Midwest had not risen appreciably faster than in the rest of the nation despite our having the tightest labor markets in the country. However, the latest ECI data show that over the past year, total compensation costs as well as the wage and salary component were up considerably more in the Midwest than in any other region in the country.

In terms of consumer spending trends, retailers report that sales improved over the month of October as the weather got cooler. Reports were mixed concerning whether there has been any impact from the recent stock market volatility. For example, a very large retailer and one of the Big Three automakers reported that sales actually improved in the last week of October. Another of the Big Three showed no noticeable impact. In contrast, the last of the Big Three attributed a sales decline to the stock market. So, on this question, reports of the Big Three clearly are mixed.

Competition in the auto industry is described as brutal, and at least one major automaker, General Motors, will be doing more discounting in the near term. You will recall that GM starting offering end-of-model-year discounts in July this year rather than in the usual October time frame. This, in our view, was the major reason that GM's October sales were weak rather than any serious problems associated with Union Pacific. People we talk to at GM and other companies generally said that while the Union Pacific situation posed some temporary difficulties, it was not having a significant impact on deliveries or sales. The trucking industry is seeing very strong demand, and it is not just a result of the Union Pacific problems, as strength is apparent in areas of the nation not served by the railroad.

The steel industry also faces strong demand, but with new capacity having come on stream, prices for a wide variety of steel products are expected to drop next year. On the other hand, prices for corrugated and paper products have been increasing and further increases are expected in November.

Turning to the national outlook, despite a good deal of financial market uncertainty, the economic situation has not changed greatly since our last meeting. The news on inflation continues to be good, but the long-awaited slowing in aggregate demand seems to be yet further out on the horizon. Even factoring in a larger trade deficit due to the recent events in Southeast Asia, our forecast sees above-potential growth this quarter and out into 1998. The most recent data suggest that labor demand continues to grow more rapidly than the working-age population and that the increase in participation rates has at least temporarily ended. Thus, the tightening in labor markets that occurred early this year may be further intensified. Perhaps the investment boom has increased our productive capacity enough to avoid a buildup in inflationary pressures, but still the resource utilization numbers suggest that the increase in demand may have exceeded the growth in capacity.

On balance, I feel that the risks have increased and are still on the upside. There is one other recent event relevant to our economy that I want to mention. That is the defeat--or I guess more accurately the withdrawal--of the fast track trade legislation several days ago. Short term, that prevents the United States from negotiating free trade agreements with Chile, other Latin American countries, and the APEC nations. Longer term, it will inhibit our nation's progress in expanding trade, which we all know increases our standard of living. My overriding concern is that the United States has been a leader throughout the world in multi and bilateral negotiations to open markets and expand trade, and we are now taking a major step backward. I understand that there is some chance that the fast track legislation will be reintroduced next year, possibly in a more limited form. But 1998 is an election year, which poses another set of difficulties in getting this type of legislation enacted. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, there is not a whole lot that is really new in New England. In a nutshell, our unemployment rates remain well below the national rate. The rate of job growth also remains below the national rate, but it finally has been sufficient to bring the region back to its pre-recession employment levels. This has occurred about a year earlier than most forecasters had been expecting, so it is very good news for the region as a whole. Our state economies are all quite healthy. Their tax revenues in fiscal year 1997 provided all of them with surpluses somewhere between 2 and 5 percent of their spending bases. Inflation remains subdued, as evidenced both by anecdotal reports and the CPI for the Boston area. Increasingly, we hear the lament in a variety of forms that economic conditions are so good they can only get worse.

I want to comment on a couple of developments of a local nature with some national implications. First of all, loan growth at the four large First District banking organizations that are tracked on a weekly basis accelerated to an annual rate of about 18 percent most recently. That increase is well above national trends and well above what it has been locally. This was a result of solid commercial loan growth at the District's two largest banks as well as concerted efforts to expand real estate portfolios, both residential and commercial. Banks in the District, as elsewhere, remain very profitable. They are well capitalized and their stock prices are as high as three to five times book value. However, the CEO of one of our banks in the $10 to $20 billion range--we don't have many of them, but we have one or two--told me last week that his institution, which had been increasing in size basically by acquiring smaller, mostly thrift, depository organizations, was now in a holding mode because he felt the prices of those smaller institutions were getting much too rich for such acquisitions to be sensible investments. He characterized this as a "very dangerous time" when the availability of cash and the outrageous price tags on smaller depository institutions could lead some organizations, his not included, to very poor acquisition decisions.

As everybody knows, we have a large confluence of mutual funds in the First District. Our employment numbers in the finance, insurance, and real estate sectors in Massachusetts have grown almost 4 percent over the last year. The mutual fund industry is seen as one of the main reasons for the tight Boston office market, which is getting tighter every week that goes by, and more generally for the city's currently strong vitality. We have been doing some research over the last year or so in combination with people at the New York and the Cleveland Reserve Banks on what the reaction would be in the mutual fund industry and more broadly to a sizable stock market correction. Lo and behold, about the same size correction that we had been asking our contacts about actually occurred, at least for a day or so. So, we went to all the mutual funds and banks that had been part of our earlier study to see how they felt they had weathered the crisis. In general, the mutual funds believed that they had weathered the experience fairly well. Redemptions were considerably higher than normal on both October 27 and 28, but purchases were also higher, especially on the second day. Outflows were within the volumes that could be financed from cash reserves. Some funds needed to draw on lines of credit, but those that tried to access uncommitted lines of credit found that they probably would be better off paying the extra price to get their lines of credit on a committed basis. Funds reported no major liquidity problems and no significant problems executing payments, but they did experience a degradation in response time to shareholder calls. Banks serving the mutual funds industry also reported no significant delays, and one contact observed that the increased transaction volumes were likely to be highly profitable to the banks in question. So, maybe the next time we go out and talk to the funds, we need to consider asking them about a bigger stock market correction!

Turning to the national forecast, I guess all of us around the table have been impressed, as I know we have been in Boston, by the continuing strength of the economy and the continuing environment of a low and even declining inflation experience as reflected in broad measures of prices. While we have observed this favorable economic performance, we also have found that we are unable with our current forecasting methods to project both the strength of the GDP and the quiescence of inflation.

As a response to our own sense of uncertainty about these developments, we invited a few fairly well known forecasters to talk about inflation and how we might better forecast it. As one can imagine, there was a considerable divergence of opinion as there always is when such people are brought in to talk about something so close to their hearts as the way they forecast inflation. There was, however, a good deal of focus by two or three of these forecasters on the impact of the change in relative prices of computers--something that Bob Parry talked about a little earlier--in creating a positive supply shock with sufficient feedback effects to account for much of our inflation success. Now, they recognize that it is possible that the relative change in the prices of computers and its impact on our overall inflationary trends is temporary, somewhat like health care cost changes or import price changes, but forecasting how temporary it is really presents a conundrum. It would seem that the relative changes in computer prices might be much longer-lived and have a much greater impact on the overall trends in inflation than changes in either health costs or import prices. Maybe this is just the other side of the new paradigm economy, or whatever. There did seem to be a sense among these forecasters of a much less temporary impact and a potential for a much longer-run effect on our inflation numbers.

We talked a little about the uncertainties stemming from the turmoil in Southeast Asia, its impact on Korea and Japan, and the potential for a broadening of that impact. I sense that many of you are much more sanguine about that impact than I am getting to be. I think that this development inserts an element of downside risk that I did not see earlier, or perhaps it generates a greater appreciation of the downside risk than I have had over the course of the last several FOMC meetings. While I don't think we would disagree with the Greenbook's baseline forecast that the economy is very strong--nearly all the incoming data suggest that it is--I do have a little more question about whether we're going to see that transmitted as strongly to the inflation numbers as traditional models would suggest. Also, I think I now have a slightly sharper sense of concern about the situation in Southeast Asia and its impact more generally. So, I guess I have moved out of the climate, or the attitude, of seeing all the risks only on the upside to where I now sense a greater balancing of risks in this forecast than I did in previous ones.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. The Eleventh District economy continues to expand rapidly. Recently, we have had some upward revisions in Texas employment, which have put the state's employment growth at over 4-1/2 percent for the last 12 months. This is about twice the national rate and the strongest we have seen in Texas since before the 1986 oil price bust. Employment growth in the third quarter averaged a slightly more moderate 3.7 percent, but it appears to have accelerated as the quarter progressed. Even 3.7 percent is remarkably robust, given the very tight regional and national labor markets. We are not sure that we know where all the new labor is coming from. Relevant to its sustainability, growth has been evenly balanced across different metropolitan areas and across different industries. This balance has allowed growth to continue longer, at a stronger pace, and with fewer wage and price pressures than we might have thought possible when this expansion began about six years ago. Also relevant to sustainability, some of the sectors that were showing symptoms of overindulgence--construction, electronic equipment, and instrument manufacturing--have seen growth decelerate in recent months, and sectors that were lagging have begun to pick up. The border region, which was hit hard by the peso devaluation in late 1994, has benefited greatly from the turnaround in the Mexican economy.

Meanwhile, strong worldwide energy demand and Mideast tensions have brought boom times to the oil and gas exploration industry, placing the Houston economy on the same growth track as the rest of Texas. Oil and gas well drilling was operating near 70 percent capacity as recently as late 1996. It surged to over 108 percent of capacity this summer. Although it was back down to 93 percent in September, the high level of drilling activity has been putting substantial upward pressure on labor and equipment costs in that industry. Oil exploration is a much more sophisticated and high-tech business than it was 15 years ago. Consequently, the industry can remain profitable with oil prices as low as $17 a barrel, and some would say lower than that. But the technological sophistication of the industry means that it is also subject to bottlenecks when demand for oil rises. The supply of labor with the skills needed to work with the new technology is not very elastic.

If we look hard enough, though, we can find some things to worry about. Hiring problems are now widespread, and reports of wage increases are common in retail trade, business services, and among skilled workers in construction. In the retail trade sector, markdowns and discounting have become rarer. Business services firms find that they are able to pass on more of their rising costs to their customers. However, these upward wage and price pressures have not yet shown up much in the aggregate statistics. I have an anecdote that I think will win as the most unbelievable anecdote of the day, [laughter] but I hesitate to give it to you because you will not believe it.

CHAIRMAN GREENSPAN. Try us.

MR. MCTEER. We double-checked this one. One Dallas real estate concern has not increased its secretaries' base pay in seven years, but business is so good that each secretary now receives $5,000 per month in incentive bonuses. See, I told you!

MS. RIVLIN. Where do we apply?

SEVERAL. Yes.

MR. MCTEER. Just don't tell my secretary! The point is that some of these profit-sharing bonuses do not end up in the wage data.

I was going to say that some of you know about "the little engine that could" and tell you that in Texas we have the "big railroad that could not." [Laughter] I did mention last time that this problem was creating some fairly serious bottlenecks in the Southwest, and Tom Hoenig, Jerry Jordan, and Mike Moskow have already mentioned it here today. Those problems are rooted in the botched merger between the Union Pacific and the Southern Pacific railroads. They have been exacerbated by strong shipping demand. Southern Pacific stopped basic maintenance and cut workers in anticipation of the merger, and Union Pacific was slow to recognize the situation. Production at Eleventh District manufacturing firms has not been significantly disrupted, but costs have risen due to late, diverted, and lost shipments. Accidents have become a concern too, as long hours have caused railway workers to quite literally fall asleep at the switch. So far, rail customers have absorbed increased shipping costs. However, recent reports suggest that companies plan to begin passing these costs along to their customers. Strains are expected to ease early next year.

Disruptions to coal shipments, caused in large part by these railroad shipping problems, have contributed to the extraordinarily high natural gas prices, as have temporary operational problems at one producer's offshore wells in the Gulf. The bad news is that natural gas prices may remain high and volatile over the winter. The good news is that gas prices are expected to come down as the rail snafu unwinds and operational problems in the Gulf of Mexico are resolved. Over the long term, the news on natural gas prices becomes very good. As many as a dozen natural gas pipelines are under construction or being planned to bring Canadian natural gas into the Chicago and New England markets. This gas will begin to enter the United States by the end of 1998 and will mean lower gas prices in the United States for several years. That is bad news for Texas for these years ahead but good news for the U.S. economy.

Mideast uncertainties cloud the outlook for crude oil prices. Crude oil accounts for a much larger fraction of the energy market than does natural gas. The collapse of several Southeast Asian currencies will reduce the cost of electricity to high-tech manufacturing firms in the Eleventh District. On the other hand, it may have a significantly adverse effect on our chemical industry, which before the crisis had already found itself facing increasing competition from chemical producers in Southeast Asia. Moreover, the downward pressure on Latin

American currencies generally, and the Mexican peso in particular, may cut into future growth of the District's exports. We don't expect this effect to be large, but the level of uncertainty is high.

As for the national economy, I have no unique information to impart. All my comments on that are more in the area of interpretation and probably should best be left for later.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. Since the last meeting, the new data and anecdotal information from our region seem to confirm that the Southeast is now settled into a pace of economic growth that is very similar to that of the nation. That is occurring after our regional economy had led the nation for several years. I suspect that experience colors our view of the world, since we have watched our business people work through tight labor markets for some years now.

Retail sales in the region have been very uneven, but much of that seems attributable to the change in the opening dates of schools and some unusual weather. We talked to retailers about the upcoming holiday season. They now describe their outlook as one of cautious optimism, and that is a retreat from the unguarded optimism that they were expressing in late summer. Manufacturing activity has slowed in the District. Not surprisingly, apparel continues to be the weakest segment. According to our survey of manufacturing in the Southeast, which is to be released tomorrow, production in October was little changed from September. The backlog of orders has risen for two consecutive months. On the other hand, outlook indices for shipments, new orders, and backlogs will be reported as having declined after large increases in September. The anecdotal reports that we had been getting prior to that survey were more positive, with pulp, paper, and building materials leading the way and with extremely strong reports from the aerospace and oil-related industries. Speaking of oil, and building on what Bob McTeer reported, oil and gas exploration continues to expand in Louisiana. The already high rig count rose somewhat more in October. In fact, the pace of oil field leasing and exploration has caused the day rental rates for rigs and service boats to increase by 50 percent over the last year or so.

Residential construction in the Southeast has now slowed somewhat, but there is a noticeable shift in commercial construction from office and industrial structures toward retail space. Commercial space remains tight. Tourism continues to be one of the District's strengths, with tight bookings both for hotels and cruise ships. District job growth was marginally less strong than the national average in September. I believe this is the first time job growth in our region has been below the national average during this business expansion. Wage and price pressures remain modest, and expectations regarding future increases have not changed significantly since the last meeting. In fact, we have seen some easing of compensation premiums in construction in some areas. While the Southeast has lost jobs in the apparel industry, the displaced workers have been able to move to higher-paying, although low-skilled, jobs. [Laughter] That is a true story!

Nationally, I see a continuation of the good growth we have observed in overall employment and modest price movements. Clearly, consumer spending is going to bear watching, and I think it is yet to be seen how much the wealth effect or uncertainty concerning financial markets will damp spending in the fourth quarter and beyond. Our own reading of the evidence sees somewhat less of a wealth effect behind consumer spending than is reflected in the Greenbook and hence less sensitivity to stock market changes over the forecast period.

Investment spending has remained stronger than I expected, but anecdotal reports link more of that spending to projects that substitute capital for labor, motivated specifically by the rise in labor costs rather than the anticipation of increases in productivity or sales. One would probably expect to see this pattern when labor markets are tight and labor remains relatively more expensive than other inputs. To the extent this investment pattern is widespread, we may see stronger investment spending for a while longer than might be suggested by the capacity utilization numbers and commensurately greater GDP growth in the near term than might otherwise be the case.

On the inflation front, I see the outlook for prices, as measured by the implicit GDP deflator, about the same as the Greenbook, but that is without assuming a 75 basis point increase in the funds rate and without a major stock market correction. While I feel strongly that we should not lose the inflation gains that have been made, I am not quite as certain as the Greenbook that we are on an imminently inflationary path. I see little hard evidence to date that this is the case or that immediate and aggressive policy actions are necessarily needed to get us back on path. Indeed, the forecasts of the broader indices of inflation show less acceleration than does the CPI. The CPI, we have to remember, reflects the effects of the energy price swings in 1996 and 1997, which lowered the CPI earlier during that period, leading to greater projected relative upticks going forward.

Of course, any judgment on the probability of deterioration in inflation depends on an assessment of the current stance of policy. While the monetary aggregates have been somewhat expansionary over the past two years, the evidence for the past couple of months is that growth of the aggregates has declined somewhat. Moreover, real interest rates, as we interpret them, do not seem unusually expansionary, at least by historic standards, nor is this signaled in the exchange rate movements. With policy not accommodative, the individual price movements, including wages, should be viewed as relative price changes that need not necessarily feed through to higher price inflation.

As has been discussed this morning, the wild card in the economy at this time is, in fact, the volatility in the financial markets worldwide. Our own estimate, done before we got the Board staff's work, also suggests a 0.2 to 0.3 percent markdown of real GDP growth. I remain concerned, as does Cathy Minehan I believe because she explored this risk to the expansion when she questioned Ted Truman about the secondary spillover effects, especially from Japan. Less well publicized, even in Japan, until the last couple of days has been the pressure on the Brazilian and Argentine currency and equity markets. I believe the Brazilian market actually has declined more than the Hong Kong market over the last four or five weeks. This point was driven home to me last week when I had a visit from Argentina's ambassador to the United States. Should there be significant problems in Brazil, the fact that over 30 percent of Argentina's exports are to Brazil could put additional pressure on the Argentine economy. I see the risks not only in how much our real GDP growth may be marked down, but also in the possibility that the United States will have to step in and support the economies of one or another of those countries. Mr. Chairman, these are certainly interesting times. Thank you very much.

CHAIRMAN GREENSPAN. Indeed they are, and I think that is one of the reasons we are running so late. Let's take a very short coffee break at this stage. I mean short because we really are tight on time.

[Coffee break]

CHAIRMAN GREENSPAN. President Stern, you have the podium but don't hold onto it any longer than necessary! [Laughter]

MR. STERN. I will try to be concise. As far as the District economy is concerned, I can say the same thing that Mike Prell said about the national economy: virtually all sectors are strong. Labor continues to be in very short supply. I think there has been some upcreep in the rate of wage increases, but it certainly has not been dramatic, and it does not seem to have affected pricing as yet.

Just a couple of other comments about the region: Hotel occupancy rates in Minneapolis are quite high. We know first-hand that they are high not only currently but prospectively as well. We have been trying to book dates next year for director and other meetings, and we are running into difficulty. There are two new hotels under construction in downtown Minneapolis and two or three major commercial office towers, so we clearly are seeing some step-up in commercial construction activity in the largest metropolitan area of the region. The other comment I would make is that retail sales recently have been quite healthy, and if traffic in the malls is any indicator, the holiday spending season looks promising.

As far as the national economy is concerned, if I assume that the Greenbook has the various repercussions of what has been happening in Southeast Asia and elsewhere about right, then it seems to me that we face greater risks than are indicated in the Greenbook numbers. Let me explain what I mean by that. I think the immediate risk is for more of an acceleration of inflation than is projected in the Greenbook. I say that because it seems to me that there is a good deal of momentum to aggregate demand. There are gathering cost pressures. Labor is in even more short supply than was the case earlier, and credit availability is ample. But longer term, I think the risks may be on the other side. I say that because it seems to me that if we carry out the policy envisioned in the Greenbook and we get the assumed decline in stock values and associated negative wealth effects, the resulting sluggish growth in real GDP in 1999 and perhaps beyond will occur according to the Greenbook forecast in an environment where the saving rate stays at a quite low level. I can imagine circumstances where that saving rate may bounce up, if not in 1999 then certainly thereafter. If so, it seems to me that the higher rate of saving would add to the risks of an even more sluggish economic performance. So, my sense of the situation is that perhaps we are facing, both near term and longer term, greater risks than the Greenbook numbers suggest.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. The economic news from the Eighth District continues to be remarkably good. Business contacts in the District remain very optimistic about future economic prospects. However, tight labor markets are a concern. The District's seven-state unemployment rate, at 4.6 percent in September, remained below the national average. Payroll employment growth continues to slow, in part because of a shortage of available workers. Payroll employment grew at a 0.5 percent annual rate in the third quarter, well below the nation's 2.3 percent annual rate. District banks have been pumping a great deal of liquidity into the regional economy. Commercial and industrial lending has been strong as firms increasingly have turned to banks to finance investment in inventories and plant and equipment or to finance mergers and acquisitions. Although there has been some slowing in consumer installment lending, the most recent state sales tax data for the District suggest, on balance, moderate to strong growth in consumer spending. Mortgage lending has held up well in the District, even though overall levels of new residential construction remain below last year's high levels.

The national economy continues to expand at a rate above most estimates of long-run potential. An average of over 230,000 nonfarm payroll jobs per month has been added so far in 1997, a pace well in excess of long-run trends in labor force growth. Unemployment has been low by postwar standards for some time. There are signs of mounting wage pressures, including the $.13 increase in average hourly earnings in the manufacturing sector, which brought the pace of growth there to 7-1/2 percent at an annual rate over the last three months.

The third-quarter advance GDP report indicates substantial underlying strength in the economy. Final sales increased at a 5 percent annual rate and personal consumption expenditures at a 5.7 percent annual rate in the latest quarter. That is more demand pull than the economy can likely continue to supply. Further, we appear poised for a robust fourth quarter, notwithstanding the turmoil in Southeast Asian currency and equity markets. The fundamental effects on the U.S. economy of these international developments should be small.

Good news on inflation and declining inflation expectations have been major factors in producing the excellent economic performance so far in 1997. Nonetheless, I remain concerned that some of this year's good news on inflation has been due to factors that may soon abate. Most forecasters expect somewhat higher inflation in 1998. In the postwar era, when inflation has been lowered and then begins to turn up, it has often turned up quite sharply in the following 12 months. That could happen again, forecasts notwithstanding. Rapid M2 growth and even more rapid M3 growth over the past two years suggest that the stance of policy is not appropriately restrictive to lock in low inflation.

The question in my mind is surely when, not whether, inflation will escalate more rapidly. The fundamentals have not changed much since the Chairman's House testimony before the Committee on the Budget on October 8, which seemingly was made to prepare markets for a possible tightening. If anything, unsettled markets aside, given a high level of demand growth and accelerating wages, the situation has worsened from an inflation risk standpoint. Market conditions may cause us to defer any action today, but it seems to me that the challenge for monetary policy could be far greater going into 1998 and beyond if economic growth tapers off and inflation picks up as expected. We may be running out of room for continued deferral in taking an appropriately anti-inflationary policy stance.

Certainly, there have been some opportunities this year and last when the stance of policy could have been firmed without surprising the markets. Yet, it is hard to quibble with results so far, and inflation is unlikely to rise at the rate it did in 1990 and 1991. But I wonder, had we been more explicit among ourselves, if not the public, about our objectives, whether we could have locked in CPI inflation at 2 percent or less when the economy was expanding strongly. In my opinion, it will be very difficult to act opportunistically and lock in lower inflation in a weaker economy because of pressures to focus monetary policy on the real side, even if inflation pressures continue to mount. We cannot do much about the real economy, but we can and should use the current opportunity to lower the inflation trend a notch. Thank you.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. In the interest of brevity, I will touch on only a few highlights. The economy in the Philadelphia District is operating at a high level with tight labor markets, but the pace of demand has moderated some, notably in retailing and manufacturing. There are several other areas, however, that suggest that new attitudes are developing. Business demand for new office space is very strong, and landlords clearly are in the driver's seat. Commercial loan demand is also very strong, but the competition to make loans is intense. As a result, bank margins are thin and the terms are very liberal. Lenders, if reminded, remember the lessons of the late 1980s and early 1990s, but that influence on their current decisions is weakening. REITs have a lot of money. Armed with a lot of cash, they are bidding up the prices of almost any property that has some value. They still seem, at least in the Third District, to be more interested in buying than building, although I think that will change as prices exceed reproduction costs. In the credit card area, although there is justifiably a lot of concern, delinquencies have stabilized, albeit at a higher level than a year ago. Anecdotally, the credit card issuers have been trying to do something about the quality of their new issues. But I don't think what we're seeing suggests that they are successful because the new issues seem to have about the same quality as the older vintages.

In our market, wages had been going up in the 3-1/2 to 4 percent range. I think the typical increase is now settling in at a fairly solid 4 percent growth rate and labor markets are tight. Nonetheless, the familiar story is still there about the inability to raise prices, and I think that is holding overwhelmingly. I do not sense an increase in inflationary psychology.

Turning to the nation briefly, the situation is that demand was supposed to moderate but it has not, just as the inflation rate was supposed to accelerate but it has not. When we throw in the market turmoil that we have had, I think recent developments point at least to deferring a decision today. Nonetheless, given all the uncertainties as we look forward and weighing all the pros and cons, it does seem to me that the risks of overheating have increased somewhat. In particular, one is beginning to see some attitudes that could very well become excessive on the bullish side. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. The outlook for monetary policy has become more complex since our last meeting. On the one hand, the slightly stronger-than-expected third-quarter GDP report, indications that the momentum in economic activity has carried into the fourth quarter, and a decline in the unemployment rate in October all underscore and reinforce concerns voiced at the last meeting about the threat of higher inflation and the convergence of growth and utilization risks. On the other hand, the developments in Southeast Asia suggest a new downdraft on growth next year and further restraint on inflation, reducing the degree of tightening that would otherwise have been appropriate and adding an important element of downside risk that perhaps was absent previously.

How do these things balance out? Given the staff's judgment about the implications of developments in Southeast Asia, the dominant concern in my judgment is the momentum in demand and the recent and prospective declines in the unemployment rate that continue to point to a growing risk of higher inflation. While I am comfortable with the staff forecast of growth, I am concerned, as I was at the last meeting, that the unemployment rate might drift lower than projected by the staff and that inflation might rise more than they anticipate, reflecting my somewhat less optimistic assessment of trend productivity growth.

One doubt sometimes expressed about the need for further tightening in this environment is the possibility that increases in real interest rates this year have already imposed the requisite degree of restraint. Although the nominal federal funds rate has increased only slightly, the sharp slowing in overall CPI inflation this year has raised real short-term interest rates--computed by subtracting 12-month CPI inflation from nominal rates--by more than a percentage point. This method of computing real short-term rates is used by the staff, for example, in international comparisons of real short-term interest rates. The effect is qualitatively similar though somewhat smaller if real interest rates are computed, as in the Taylor Rule, by subtracting core CPI inflation from nominal interest rates. Should we therefore conclude that, in effect, a sufficiently aggressive tightening in monetary policy already has occurred to inoculate the economy against the risk of higher inflation? The most important considerations may be that the current level of real short-term interest rates, however high and however much they may have increased this year, does not appear to be restraining demand growth and that credit availability in general appears to be supportive of continued strong growth.

But the key to why overall financial conditions still seem to be highly supportive may be that real long-term interest rates, generally viewed as the more important force in aggregate demand, appear to have declined over the year, even predating the decline in long-term government rates during the current turmoil. The contrast between the increase in real short-term rates and the decline in real long-term rates reflects both differences in the movements in short-term versus long-term inflation expectations and differences in the movements in short- and long-term nominal rates. Long-term inflation expectations as measured, for example, by the median expected long-term inflation measure in the Michigan survey and inflation expectations in the Philadelphia Fed survey have not changed much over this year, in contrast with the sharp decline in actual CPI inflation and the smaller but still significant decline in other measures of short-term inflation expectations. Also, nominal long-term rates have declined compared to the small increase in short-term nominal rates. This is reinforced by the comments of President Broaddus about the recent de facto easing produced by the further decline in long-term rates.

Two other developments have reinforced the effect of the small decline in real long-term interest rates on the real cost of capital. First, there has been a further increase in equity prices this year, contributing to a further decline in the cost of financing capital spending. Second, the sharpest slowdown in inflation has been that for durable goods. Indeed, outright declines have occurred in the prices of some durable goods, and in comparison with the prices of overall output, the reduction in the relative prices of durable goods has further lowered the real cost of capital for such goods.

My message is that we should not take too much comfort in the rise in real short-term interest rates that has been produced by a decline in actual inflation and an accompanying decline in measures of short-term inflation expectations. The financial conditions that are most important in underpinning real economic activity continue to be highly supportive, indeed more supportive than at the beginning of the year. I conclude that if we want financial conditions to become less supportive, we will have to do the dirty work ourselves.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. Reports on the Second District economy have had a somewhat firmer tone in recent weeks: employment growth has accelerated; retail sales have picked up in mid-to-late October; retail inventories are in good shape; wage pressures are reasonably moderate; housing markets have strengthened; the New York City boom in tourism continues, and hotels are full and the rates are very high. Local banks report that demand for most types of loans is increasing at a steady pace, but I am happy to say that bankers seem to be showing somewhat greater restraint in the credit area.

Looking ahead at the national economy, I find myself mainly focused on what we know now that is different from what we knew at the last meeting. At that time, the likelihood of the emergence of inflationary pressures seemed sufficiently great that a monetary policy tightening seemed both likely and imminent. Our forecast for the fourth quarter is a little weaker than the Greenbook staff forecast but not very much. Next year and the following year continue to look quite positive in terms of growth, though a little less robust than 1997. Our staff forecast is based on some return to dependency on traditional models, and it therefore says that inflation will accelerate to a bit greater degree than does the Greenbook. But it is the inflation forecast that I find most problematic, both in the Greenbook and our own work. Since price stability is what we are trying to achieve, uncertainty about the inflation forecast is particularly challenging. The unusually good price performance of the last few years is capable of being fully explained by the combination of a stronger dollar, wage restraint, and the slow growth of health benefit costs. We all have been worried about how long those trends can continue. Obviously, wages and benefit costs could rise more without increasing inflationary pressures if productivity increases were to, in a sense, finance the faster rise in wages and benefit costs. Lo and behold, productivity does seem to be improving quite significantly; at least it was improving quite significantly in the second and third quarters. But again we do not know how long that will continue.

The changes in financial markets that already have occurred and the contagion effect that definitely is still going around the world are developments that are likely to reduce growth, and they may do so with a somewhat greater impact if they have a seriously adverse effect on consumer confidence. In my view, the result of all this is that the degree of uncertainty has increased. However, I believe that the urgency that I felt at the last meeting for an imminent change in monetary policy has been very considerably reduced.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. We find ourselves in a new situation. For many months, we as a group have recorded our awe and wonder at the continued strong performance of the U.S. economy and our varying degrees of concern about future wage and price inflation. We have shared our evolving theories about why there has been so little increase in wages in the face of low unemployment and why there has been no price pressure at all. And we have shared our guesses. The Chairman does not like me to use the word "guesses" so I will not use it publicly anymore, [Laughter] but it's okay to use it here.

CHAIRMAN GREENSPAN. I "guess" that is all right! [Laughter]

MS. RIVLIN. We have shared our guesses about when the world as we thought we knew it was likely to reappear. But we have not worried much about the rest of the world except to note that global competitiveness and the strong dollar were helping us fight inflation, and that the dollar was unlikely to go on rising much longer. Otherwise, the world economies seemed to be just perking along, indeed growing well enough to buy increasing amounts of our exports and all too willing to feed the voracious American appetite for imports. This month, however, we have been forcefully reminded that the increasing interconnections of global economies and capital markets were not just some cliche we all put in our speeches. Those interconnections are real and have added greatly to the uncertainty about our own economic future.

As I look at the Greenbook, I find myself a bit more optimistic than the Greenbook staff about the domestic economy and a bit more pessimistic about the international situation. My optimism about the domestic economy relates mostly to productivity. The Greenbook assumes that at least a substantial fraction of the recent good news on productivity is temporary and that it will revert to trend quite forcefully in 1998 because of the slowing of growth and because of very tight labor markets. I increasingly think it is possible that the confluence of tight labor markets, high investment, and technological change have come together to give us at least a sustained spurt in productivity increases. So, I am less sure than the Greenbook seems to be that we will need to raise interest rates in the near term.

Incidentally, I imagine myself making a speech a couple of years from now that would talk about what we did on the assumption that the Greenbook lays it out absolutely right. It is a hard speech to make. It says: we raised interest rates, we tanked the stock market, we cut the growth rate to less than half what we ourselves thought the potential growth rate was, we raised unemployment, and yes by then we are admitting that we overshot because we are beginning to lower the interest rate again. We did this because we were worried about inflation, which even in the Greenbook forecast was quite modest. Then we have to explain that although we were on the forefront of arguing that the CPI was overstated and should be corrected, it is really misleading to leave that correction in when we look at inflation. So, I would find this a very hard speech to make, but maybe we will not have to. [Laughter]

On the other hand, as I said, my pessimism about the rest of the world is a little greater than the Greenbook's. This is based on no real knowledge, just a feeling that there is a great potential for snowballing weakness around the world and that our immune systems in the United States may not be quite as good as we thought. We might get that stock market correction not by raising interest rates but simply by the contagion from abroad. If I am right, we also might face a much greater potential conflict between our domestic and our foreign responsibilities over time. We will be wondering what we ought to do if the U.S. economy is still growing very strongly and the rest of the world is a lot weaker.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. For the United States, October turned out to be an Octoberfest of sorts. There was plenty of activity, or froth, but it is still hard to tell if all that market activity is only foam or if there is something of more substance underneath. Like the fall event in 1987, we may be witnessing another departure of Wall Street from Main Street, but some stock market events do have real effects. At this point, I think the jury is still out. We are all struggling to assess the depth and extent of the Asian flu, but practically speaking, the forecast errors are extremely high. The outcome is going to depend on how the various players conduct their business going forward. I think that to say much else would only add to the speculation. While it may be too early to diagnose the severity of the Asian flu affecting Wall Street, we can make some comments about the health of Main Street.

In short, the economy is doing extremely well in all sectors. Business fixed investment has been strong. Inventory even appears low enough relative to sales that producers should remain busy at least for the near term. The labor market has remained strong. Consumers returned in the third quarter after the second-quarter pause.

While the Main Street economy looks good, I cannot believe that the current rate of economic growth is sustainable. As I said at the last meeting, U.S. demographics will not accommodate forever the filling of 200,000 or more new jobs per month. Strains are starting to show up. ECI wages and salaries have been increasing somewhat. Reports of supply bottlenecks are becoming a bit more frequent, for example, in transportation, at Boeing, and for specialty skill workers. Increased stock market volatility may be a sign of a fundamental reassessment of the outlook for earnings by market participants. If we get a 20 percent stock market correction, economic growth will be slowed by reduced consumer spending from wealth effects and by reduced business fixed investment as the cost of equity capital increases. In addition, profit pressures more generally may slow business fixed investment. Moreover, the Asian problems that we know about are likely to increase the drag that the external sector has on U.S. GDP growth.

So far, the pressures on resources from strong economic growth have not shown through to price inflation. Recent statistics have been quite impressive, especially the deflators reported in connection with the third-quarter GDP statistics. Improved productivity undoubtedly has contributed to this performance. We also have to recognize that some of the credit for the improving inflationary environment could be attributable to such temporary factors as the strong dollar, the international competitive situation, and the lack of supply pressures. The balance of these factors may be shifting in light of an international situation that remains quite tenuous. Although arguments can be made that point to differing outcomes, I tend to think that, on balance, inflationary pressures could be held at bay a while longer by the Asian turmoil. To be sure, inflationary pressures are still there, perhaps just below the surface.

It is interesting to see discussions of deflation appearing more and more in press analyses, and it is not just a few extremists who are putting forward arguments of worldwide deflation. I have a hard time buying into these arguments on a wholesale basis since so much of the U.S. economy is domestically driven and involves the services sector, which is less subject to the effects of worldwide excess capacity. I do, however, think that the people pressing the deflation thesis raise some interesting points. For example, how do we adapt to an environment with upward price pressures in some sectors but falling prices in others? Also, what are the effects of excess capacity in countries not dominated by market forces and thus less subject to competitive cost and price pressures? I suspect that these may be topics for future discussion.

In sum, however, the risks have shifted somewhat since the last meeting. The real economy is doing well and there is significant momentum in the short run, but some slowdown must be coming. Financial markets are unsettled. The question, of course, remains whether this is a temporary financial market event or whether there will be real effects not now anticipated.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. Most of the incoming evidence we have been talking about suggests that the economy is continuing to grow very robustly, quite likely well beyond what even an optimist like me would like to think of as sustainable growth. Certainly, it is true that there are widespread and credible expectations of a more or less spontaneous slowdown. Inflation indexes continue to come in remarkably subdued, and I must say that it is hard to see how monetary policy could be falling behind the curve, at least so far.

Nonetheless, absent extraordinary circumstances, I for one would be wrestling strenuously this morning with a question of whether or not the time had arrived for preemptory action.

However, as we know and have been discussing, extraordinary circumstances do exist in the form of turbulence in Asia and excessive volatility in many financial markets. We will not be able to judge for some time what the fallout of all these events may be, but it is certainly highly likely that they will act to some degree to damp the pace of the expansion. I can readily envision the possibility that the impact, once all of these dominoes have fallen, would be at or perhaps beyond the severe end of the range that we presently envision. If those events were coupled with a policy tightening, this instability could easily ignite a very undesirable and excessive chain reaction. This concern, together with the comforting belief that our policy is not falling behind the curve at this time--although I must say I am not nearly so sanguine as I was earlier about that--presents anew the line of reasoning that leads me to the same old conclusion, "steady as she goes."

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. As has already been said in this room, many reports suggest that the economy was very strong in the third quarter. However, the reports also indicate that inflation remains quite quiescent. Going forward, I think there are many reasons to be concerned that this good news on prices may soon come to an end. We are well aware of the labor market tightness from the latest BLS report and from the reports of the Reserve Bank presidents today. I also would note that a number of indicators suggest an upcreep in both wages and benefits. I admit that some of those indicators are anecdotal at this point, but we all recognize that anecdotal evidence is sometimes a leading indicator for developments that eventually show up in the aggregate statistics. Capital has been readily available to borrowers on very reasonable terms, and as Governor Meyer indicated, long-term interest rates, both real and nominal, have retained much of their recent declines.

However, some countervailing forces exist at this time. We have talked a great deal about the instability in Asia and the resulting fluctuations in our own stock markets. In this regard, I would associate myself with those who said they had some concern that perhaps the Greenbook forecast may be a bit optimistic in terms of both the rapid recovery of Asian markets and the limited spillover. I will admit that the only obvious evidence I have for this is the Brazilian austerity package.

More fundamentally, we have had two quarters of productivity growth in the range of 2-1/2 to 3 percent. The measured increase in productivity will obviously slow if economic growth moderates. But in the long run, capital deepening and the possibility of some improvement in the quality of the labor force provide a reason to hope for some continued good news on the productivity front.

In sum, as others have said, we are in a challenging and complex period. Several factors indicate that the risks are on the upside for inflation. However, recent instabilities in financial markets may well result in some slowdown in the U.S. economy and a slight decrease in risks for general price increases. Indeed, some of these instabilities create the likelihood of a heightened reaction to any policy move that we may make today. For the longer term, while I recognize that there clearly are some limits on capacity and we may be close to them, I am also mindful that we may be seeing some evidence of a payoff from capital deepening. Thank you.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. I would like to break my remarks into a comment on our overall policy stance and another on the question of timing.

On the issue of the overall policy stance, I have become persuaded that, if anything, the present federal funds rate is a little on the low side. I say that for three reasons. One is that in the staff forecast the unemployment rate is low and inflation is heating up. It is heating up at a very slow rate that is hard to observe, but it is heating up. The direction is clear. I believe monetary policy should stay ahead of the game in cases like this. Secondly, this is the first opportunity that I have had to listen to a go-around of the Reserve Bank presidents, but I think most of you were supporting that conclusion. Now, I know enough about the law of averages to realize that what the national statistics indicate will be reflected on balance in what Reserve Bank presidents say, but a lot of you were providing anecdotal evidence that is not necessarily apparent in the aggregate statistics at this point. I think there are indications in that evidence that some overheating may be on the way. Thirdly, I want to refer to some calculations that the staff has done on the Taylor Rule. As I understand at least the fitted version of that rule, it, too, suggests that the funds rate is a bit on the low side.

Having said that, let me turn to timing. There I find a real quandary because from the standpoint of domestic management alone, I think that the proper course would be to raise the funds rate promptly by--I don't know the amount--3/4 percentage point or whatever and that would be that. But then the international issue creeps in. There I think there are two considerations--one that a number of you mentioned and another that I have not heard mentioned too often. The one that a number of you have mentioned is that there are some risks that things could turn out to be a little worse than we have seen so far, and that might argue against a funds rate increase. The second is that I would be a little worried in terms of a concept that I will call "international citizenship." We are trying to "unruffle" or stabilize world currency markets, and if the United States were to raise its short-term rates at this time, that might put even more pressure on some of these struggling currencies. I worry about that both from the macroeconomic point of view and also in terms of what it says about international leadership and responsibility.

These considerations define what I consider to be a difficult balancing act, but I would join most of my fellow Governors in saying that I think this probably is not a good time to act even though we might favor some action from the standpoint of domestic management alone. So, I would be on the side of delaying a bit. I would also like to have the directive say something about international events because that is a major reason why I am coming out with this suggestion. Thank you.

CHAIRMAN GREENSPAN. Let's move forward with Don Kohn.

> MR. KOHN. Thank you, Mr. Chairman. At your last meeting, many Committee members were concerned that financial conditions were too accommodative to prevent strength in aggregate demand from raising resource utilization from already elevated levels, and hence imparting--or perhaps accentuating--an upward trend to inflation in 1998 and 1999. Indeed, there was a sense that tightening would be needed soon, perhaps at this meeting, if the expansion in economic activity did not demonstrate signs of slowing to a more sustainable pace.
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> In fact, the information becoming available since the meeting has shown economic growth continuing to exceed the growth of potential and utilization rates rising. As a consequence, a number of market commentators have suggested that, in the absence of financial market turmoil, the Committee would have been highly likely to tighten at this meeting. In my remarks, I will begin by examining some of the arguments behind this proposition, before turning to possible implications for policy of the turmoil itself.

Strong growth and rising utilization rates would weigh on the side of policy firming. Not only has the unemployment rate fallen, and to the lowest level in several decades, but manufacturing capacity utilization has risen to its highest level in 2-3/4 years. Moreover, with final demand exceptionally robust, prospects are good that the expansion of output will continue to exceed the growth of potential, as indeed it does for a while in the staff forecast. However uncertain the Committee might be about the NAIRU or the level of potential output, the chance that inflation will increase goes up with the level of resource utilization. From this perspective, if the Committee were concerned about the stance of policy before, other things equal it ought to be more so when the unemployment rate falls and capacity utilization rises, especially since the movements in both variables were larger than anticipated. As the Chairman has pointed out, a track for economic growth that continues to erode slack in available resources is, by definition, not sustainable. It was concern about a similar set of circumstances that led to the policy tightening of last March, and a forecast that resource utilization would continue to rise would be the strongest argument for a near-term tightening of policy, even before early signs of cost and price pressures began to emerge.

But, of course, other things have not been equal, and not only in worldwide financial markets. On the economic side, inflation continues to decline by many measures, generally falling short of expectations. One reason for this has been an uptick in productivity growth, which is holding down unit labor costs. These developments have contributed to a marking down of the staff forecast for future inflation, and they provide some offset in several respects to the signal for higher rates coming from robust increases in output. First, policy need not be as tight as it otherwise might be because lower inflation means the Committee is not as far above price stability--or any interim inflation objective--as it previously might have thought, both now and likely prospectively.

Second, improved price and productivity performance has boosted estimates of the growth of the economy's potential and shaded down notions of the range of unemployment rates that might be associated with rising inflation. As a consequence, at least in the Greenbook, the surprisingly strong expansion of real output and the decline in the unemployment rate so far this year have not resulted in as large an output gap as might have been expected from previous estimates of potential output. Moreover, continuing surprises in the output-inflation nexus suggest that high levels of uncertainty about underlying relationships persist and may indicate added caution before tightening in the absence of more concrete signs of oncoming cost or price pressures.

Third, the recent inflation performance has probably fed through to lower inflation expectations. It does appear that inflation expectations have been edging lower--at least judging from the behavior of nominal Treasury interest rates relative to rates on inflation-protected securities. Decreases in inflation expectations, if prevalent among households and businesses as well as among bond investors, would themselves tend to hold down any incipient increase in inflation, at least for a time. Moreover, declining inflation expectations have raised real short-term rates as the Committee has held the nominal funds rate unchanged.

Thus, recent domestic macroeconomic developments by themselves--encompassing the news on prices and productivity as well as on resource utilization--would not suggest that the case for a rise in the nominal federal funds rate had gotten overwhelmingly stronger, even in the absence of market turmoil.

In the staff forecast, the current level of the nominal funds rate was too low to contain inflation in the September Greenbook, and it remains so in the projections for the current meeting. An important reason for this is that financial conditions, broadly defined, do not appear restrictive or moving very much in that direction, even after recent market movements. It is difficult to see evidence that higher short-term real rates are being reflected in most other financial variables in the transmission channel or are restraining interest-sensitive spending. Intermediate- and longer-term real rates, for example, appear to be unchanged or even a little lower over recent months, judging either from the rates on inflation-protected securities or from real yields calculated by subtracting survey-based measures of inflation from nominal yields. And funds continue to be available to businesses on favorable terms in equity and bond markets and at financial intermediaries. In sum, there does not appear to have been any appreciable change in the interest rates or credit conditions that have fueled continued above-trend growth. Moreover, without trying to put too fine a point on it, the recent behavior of money does not suggest that households or depositories are facing any greater constraints on their liquidity. While money growth has been moderating in recent months, it has been doing so from unusually rapid rates earlier in the summer, and the deceleration is in line with expectations for M2 based on the Greenbook forecast, and somewhat less than expected for M3.

The staff forecast does embody some effects on U.S. economic performance from the recent worldwide market turmoil, but those effects are limited and they do not damp activity enough to forestall a rise in inflation. Indeed, the need for eventual policy tightening would still be a close call in the staff's "worst case scenario."

If, in light of the risk of increasing inflation pressures, the Committee were inclined to tighten at an early date, global financial developments might still suggest reasons to postpone action, at least for a short time, to assess ongoing market conditions here and abroad and their economic implications. The effects of recent developments abroad on the United States depend importantly on how political and economic systems in affected countries respond and to what degree skepticism about the prospects for emerging markets spreads to other countries, some of whom are important to us as financial and trading partners. As Ted noted, the course of events abroad appears to present a greater risk of damping than of boosting economic growth relative to the Greenbook forecast.

Right now, a firming would come as a complete surprise to market participants. Partly, this reflects the fact that the FOMC's assessment of inflation risks is not generally shared by investors. Not only do futures market rates indicate that markets do not expect tightening in the near term, but the flat yield curve can be read as expressing very low odds on rising interest rates for some time to come.

Market participants also perceive the skittishness of markets themselves as another impediment to tightening at this meeting. It is difficult to predict the response of nervous markets to an unanticipated policy action. I suspect that interest rates would ratchet substantially higher across the yield curve, as investors reassessed not only their read on Federal Reserve intentions but also perhaps marked up their evaluation of the risk of inflation itself, given the Federal Reserve's evident concern. The chance of outsized spillovers to markets abroad--with feedback perhaps to the United States--would seem to be magnified in the current situation, especially because such an action, coming on the heels of the Canadian, German, and British tightenings, might suggest to markets a general trend of rising rates in industrial countries.

By themselves, skittish markets and unpredictable effects are not reasons to avoid firming policy if the Committee saw appreciable inflation pressures developing fairly soon, particularly as those pressures would only build if needed action were postponed. In such a situation, a sizable correction in debt and equity markets would be an integral aspect of monetary restraint. Delaying action might only impose more disruptive adjustments later, especially if it were feared that delay would only feed the over-optimism of markets. In that regard, one lesson from the turbulence of recent weeks is the resilience of U.S. asset markets, undergirded by the apparently deep-seated optimism of investors. The wild swings in financial prices and the front-page coverage they received would seem to have given investors reason enough to re-examine risks and risk-adjusted returns. Yet the net change in equity prices and risk spreads in the United States has turned out to be quite small. If the FOMC believes that financial conditions broadly defined are independently restraining demand, sufficiently less accommodative conditions are unlikely to evolve by themselves. Still, if economic circumstances were not seen as indicating a pressing need for action in the near term, the Committee very well could favor waiting a bit. Delay would give it the opportunity to see where and whether markets do settle down and to better assess spillover effects on the U.S. economy.

CHAIRMAN GREENSPAN. Thank you. Questions for Don? If not, let me move forward.

Something unusual is going on in our numbers system that I think has a bearing on issues I have raised in FOMC meetings over the last two or three years. The important and striking statistic relates to the issue that Governor Rivlin raised, namely that the staff is projecting a slowing in productivity growth in its Greenbook forecast. That slowing in and of itself is the major force that is engendering an increase in inflation. I think it is important to ask ourselves what evidence we have one way or the other on this issue.

First of all, if we disaggregate the staff's forecast of labor productivity into capital deepening, changes in labor quality, and total factor productivity, we will find that total factor productivity--the usual residual that all of us have been taught to interpret as an embodiment of technological gain--appears to have risen in 1997. Indeed, if the synergies that we have been observing in different segments of the capital goods markets continue to materialize, we could very readily expect that residual to grow even more rapidly in the years ahead. But even if total factor productivity stabilizes, then the labor productivity numbers that are in the Greenbook, as best I can judge, are probably much too low. Just using the internal data that are not exactly built into the Greenbook forecast but are incorporated in the Board staff's evaluation of productivity associated with capital deepening, the residual actually goes down *significantly* in 1998 and 1999. And if one were merely to assume that total factor productivity remains at the 1997 level, then instead of getting productivity increases of 1.6 percent in 1997, 1.2 percent in 1998, and 0.9 percent in 1999, productivity would rise from 1.6 percent in 1997 to 2.0 percent in 1998 and 2.3 percent in 1999.

I do not know what the actual productivity data will turn out to be. I don't think the staff can predict this; I don't think we can; I don't think anybody on the outside can. But it is very important to recognize, as Governor Rivlin has indicated, that a significant part of the pressures implicit in the price forecast, to which we are responding, rests on an evaluation of what that residual will be. I would suggest that if we look at the data on the current underlying cost structure, it is clear that the evidence, if anything, has been indicative of very constrained cost pressures. You may recall that earlier this year when we were looking at the quite remarkable and persistent rise of profit margins, we also were looking, given that prices were not increasing very much, at very slow rates of increase in total unit costs, about two-thirds of which are unit labor costs. Those data have not changed at all. Unit labor cost increases for nonfinancial corporations are roughly estimated by the staff to have been approximately 0.2 percent in the third quarter. The unit labor cost increases for nonfinancial corporations are at an annual rate of something less than 1 percent. While we do not as yet have any firm data on nonfarm productivity, though we will get a preliminary estimate shortly for the third quarter, the staff estimate is a rate of increase of approximately 3 percent following a rise almost that large in the second quarter. Compared with the nearly 4 percent advance expected for the third-quarter productivity of nonfinancial corporations, that implies what we previously knew, namely, that noncorporate productivity is very badly underestimated. Indeed, the actual productivity numbers for nonfarm businesses are doubtless much larger than the increases being reported.

Needless to say, all of this is important because it suggests that we may in fact finally be getting some acceleration of productivity in the statistics after observing, as I had indicated in earlier meetings, a very significant pickup in plant and equipment expenditures. This can be looked at in two ways: one, as an indication of very significant increases in prospective earnings starting in 1993 when the acceleration in investment spending began; and two, as evidence--after the continued strong growth and indeed further acceleration of such investments in recent months--that after a number of years we may finally be getting sufficiently higher profit rates from new facilities to suggest that the previously prospective increases in earnings have indeed begun to materialize. Those prospective increases were based on evaluations by plant managers of various new technologies that have become available and the ability of those technologies to increase factory floor productivity and its equivalent in the nonmanufacturing area.

So, we are looking at an acceleration of investment in capital goods, which presumably are being purchased because the required rate of return is there. And as some of you have mentioned, part of that acceleration probably stems from an endeavor to replace labor, whose availability is diminishing rapidly. I think this type of productivity increase is real in the sense that it is not inconsistent with the anecdotal reports. Indeed, it's the earlier data that were inconsistent. The statistics we are seeing now seem to square readily with what we observe is going on in most companies.

Of course, this is important because we can have an increase in compensation per hour, which indeed I suspect the numbers are showing, without unit labor costs moving up to a point where they are pressing on profit margins or affecting the price level. I know we had a significant increase in average hourly earnings in October, but a good part of that was the result of overtime and of mix shifts, which I gather brings the published 0.5 percent monthly figure down to 0.3 percent on an adjusted basis. And we probably are still picking up some spillover from the rise in the minimum wage. So while I believe there has been some acceleration in compensation per hour, certainly in the ECI and especially in wages and salaries, I still see it as rather modest and unit labor costs being held in check to a significant extent by what appears to be accelerating growth in productivity.

At the last meeting, I looked at what was a very poor trend in labor availability, and I suggested that by this meeting there would be a 50/50 probability that we would have to move. The argument I was making then, before we had a reasonable fix on the third-quarter productivity numbers, was that we were running out of available labor at a particularly rapid pace. Not only was unemployment falling, but the number of people not in the labor force who wanted jobs was declining quite appreciably. The October labor market figures, which were just released, made that far worse. The decline in the number of people in the labor force who wanted to work but did not have a job was quite pronounced in October and the "not in the labor force" group who wanted a job also dropped quite appreciably, seasonally adjusted. In effect, we are confronted with an extremely tight labor market, one that will inevitably continue to lead to movement on the wage side. But it is unclear at this stage which is moving faster, productivity or wage acceleration. At the moment, I do not think we can tell.

I'm not sure, even without the Asian financial turbulence, that I would have argued for a rate increase at this meeting largely because the developments that are emerging are of such an interesting, if not important, magnitude that it will take one or two more months of CPI and other price measures to see what is going on. Also, not insignificantly, we are waiting for a decline in profit margins, which I must say we have been projecting now quarter by quarter, Greenbook by Greenbook going back seemingly to the 19th century! [Laughter] I suspect that is not literally true, but I think it is a very important issue because, as I have said earlier, the first sign that we will see is that profit margins will begin to be squeezed. If that happens, we are going to get a nice, fat contraction in the stock market. I am not sure how this process is playing out, but in any event to quote Governor Kelley, "We do not have to 'wrassle' with it at this point." You didn't put it quite that way; I'm paraphrasing!

MR. KELLEY. Wrestle.

CHAIRMAN GREENSPAN. Okay, wrestle.

VICE CHAIRMAN MCDONOUGH. He is from the sophisticated part of Texas.

MR. KELLEY. I am sensitive to that!

CHAIRMAN GREENSPAN. In any event, as I judge our discussion, we are not going to have a serious problem in reaching a decision on whether we move today. As nearly all of you have indicated in one way or another, moving today given the Asian situation would invite extraordinary financial disruption. Whatever we believe we may have to do in December or later, I think it is quite appropriate for us to stand pat today. But I still think that with the asymmetry of pressures in the labor markets, we have no real choice about maintaining an asymmetric directive toward tightening. As I read what all of you have been saying to a greater or lesser extent, that seems to be where most of you stand. Vice Chair.

VICE CHAIRMAN MCDONOUGH. I stand exactly where you do, Mr. Chairman, "B" asymmetric.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Let me offer at least a slightly different perspective. In the absence of developments in Southeast Asia and the related turmoil in world financial markets, I believe a 1/4 percentage point increase in the funds rate would have been justified today. In my judgment, this move would have been consistent with the concerns voiced at the last meeting, concerns that were reinforced by the stronger-than-expected growth of GDP in the third quarter, the decline in the unemployment rate in October, and the upward revision to the GDP forecast for the fourth quarter. Such a move would have insured the procyclical movement in short-term interest rates that I believe is so important to achieving our macroeconomic objective.

Let me comment a little on my views on productivity. I frankly do not see anything amiss in the staff forecast of a sharp slowing in productivity growth next year. GDP growth slows in that forecast from 3.8 percent to 2.2 percent. If we get the slowing in GDP growth anticipated by the staff, then actual productivity growth should be quite sharply below trend productivity growth. The staff estimate of that trend may be a little high, but I think it is defensible. I would not want to go higher than it is.

The second point I would make is that I do not believe the anticipated reduction in productivity growth would be an important factor contributing to higher inflation. The reason is that I think pricing is done more off trend productivity than off actual productivity. I believe the slowdown in productivity growth is the key story behind the projected downturn in profits. So, the behavior of productivity is really more of a profits story than an inflation story. But I certainly agree that there is a lot of uncertainty about what that productivity trend is going to be, and that is why I focus on utilization rates. From the standpoint of monetary policy, I think that is really what needs to be kept in mind. Utilization rates continue to increase, but I think it would be prudent to accompany that increase in utilization rates with a somewhat firmer monetary policy.

CHAIRMAN GREENSPAN. In manufacturing?

MR. MEYER. I think we have to look two-fold: I am focusing more on the labor markets for all the reasons that you suggested, but I also agree that the gap between capacity utilization and the unemployment rate is important. If that gap widens further, then my view would be altered a little. There is also no question in my mind that developments in Southeast Asia and to a lesser extent the stock market correction and the uneasiness in world financial markets fully support delaying any move to a tighter policy. The reason is not only because of the turmoil in financial markets but because of some uncertainty about just how sharp the economic impact is going to be in Southeast Asia and what the spillover effects to other developed economies and therefore to the United States are going to be. So, I think there is a premium on additional information that comes only from waiting. In my view, that does caution some patience, but again I would be concerned if we did not respond over the longer term to increases in utilization rates.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I am in basic agreement with you, Mr. Chairman. I want to add a couple of thoughts even though I know the time is late. I want to make clear my thinking because it has undergone a bit of a change.

My comments on a set of more balanced risks notwithstanding, I do believe there are real inflationary concerns about the underlying momentum of the economy. These relate to tight capacity constraints, the momentum in both consumer and business spending, the absence of any real sign of a drag from fiscal policy, and very accommodative capital markets. But I have begun to ask myself whether I really believe that this combination of factors will cause inflation to tick upward so that growth needs to be reined in at this point. We have not seen inflation actually change; in fact, it has gone down over the past year by most broad measures. I still hear anecdotally from almost everybody I talk to in the First District a marked unwillingness to raise prices even though there is a sense that wage pressures are growing. I think this pricing restraint is only going to be intensified in the near term by the Southeast Asian turmoil both because of reduced prices for competitive products and actual reductions in the cost of components for U.S. goods.

I still think the best guess is the traditional one, the one that is embodied in the Greenbook, that we need to move to tighten policy fairly soon to head off a strong inflationary impulse. But I for one would like to do that on the basis of something more than a blip in wages that can be, at least in part, attributed to minimum wage impacts. I would like to see more evidence of rising inflationary pressures to strengthen my confidence that after a fairly long period of getting inflation trends wrong, we finally got them right. In that regard, I am in full agreement with your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I agree with your policy conclusion. I would point out, though, that I do not agree with you because of the Southeast Asian uncertainty. I agree simply because, although I am very concerned about the momentum in the economy, I do not think that we can offer an explanation for raising interest rates today that would be acceptable to the public, given the price data and the analysis behind those data. So, I agree with you on policy.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, it seems to me that, even taking account of the market turmoil and what is happening in Asia, the basic economic case for tightening policy is considerably stronger today than it was at the time of our last meeting or even a few weeks ago. My view is that our best course of action is to go ahead and raise the funds rate modestly today. A modest tightening would have the great advantage of putting the Fed back into play and it would allow long-term interest rates to resume their role as automatic stabilizers.

I recognize that an action like this carries significant risk. It could produce a very adverse market reaction. We could be blamed for that, and that possibility obviously is an argument for delaying any move. But I think the key point is that delaying a move also involves, in my view at least, significant risk. In particular, if the economy continues to strengthen at anything like the pace we have seen recently, then I believe we have to face the possibility of a significant inflation scare. If that happens, the markets will get a "double whammy." First, as interest rates begin to rise and the discount factor on equity prices rises along with it, that would have a negative impact on markets. Second, if we ultimately have to play catch-up and take strong action, which risks a recession, that obviously could have doubly adverse effects. It is this latter possibility that really frightens me. To be sure, the probability of that outcome may be less than 50 percent--maybe it is well below 50 percent--but I don't think it's negligible in the current environment and the consequences of that kind of outcome would be very undesirable. To me, that would be the worst case scenario, the one we really need to avoid. I would not want to write Alice Rivlin's speech, but I wouldn't want to write this speech either. It is a tough call.

So, I strongly favor a modest tightening move today. Yes, there are risks in moving today, but in my view there also are significant risks in not moving. It seems to me that the recent, at least relative, market calm might give us a brief window to act. I believe we need to take advantage of it today.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I concur with your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. I concur with your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Rivlin.

MS. RIVLIN. So do I.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, some indicators show that the economy is experiencing a positive supply shock. For instance, despite the robust growth in real GDP, nominal GDP growth since early 1996 has not been that much higher than its average since the end of the last recession. At the same time, other indicators such as the unemployment rate suggest that we have overshot potential and risk a sustained increase in inflation. I believe one way to balance these conflicting signals is to look at the recommendation from a policy rule that takes into account both risks in inflation and output behavior. Our version of the estimated Taylor Rule suggests that tightening policy by roughly 50 basis points by next quarter would be appropriate. Ordinarily, this would make me vote for an increase in rates as a form of insurance against rising inflation, and it is very tempting to take that position today. However, given the recent instability in financial markets, I would be willing to wait a while before raising interest rates. Consequently, I support alternative "B" with asymmetry.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I, too, support your recommendation, Mr. Chairman. It seems to me that financial markets are too sensitive at this point for an action on our part. Having read recently about some previous financial episodes in Southeast Asia and elsewhere, I also have a suspicion that that circumstance may turn out to be a bit worse than we currently expect, with implications both for financial markets and perhaps for somewhat greater spillovers to the real economy.

Having said that, though, if we were in more normal circumstances--and clearly we are not--I think I would want to get started with a little more restraint today. I say that because as I assess the risks, as I discussed earlier, it seems to me that the value of some restraint today would be that we would get a more favorable inflation performance than the one we are otherwise risking and perhaps a smoother path for the economy as well.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I agree with your recommendation, but I would add that were it not for the financial volatility stemming from events in Southeast Asia, I think we would be much more likely to act today based on developments in the real economy.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I agree with your recommendation.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. I favor alternative C, like Al Broaddus, but I could accept "B" on the basis of unsettled market conditions. I believe inflation is likely to rise in the near future as I mentioned in my earlier comments, and I think, as Al does, that there are risks in waiting. So, I believe it is very important that when the Committee becomes convinced that inflation will rise, it must be prepared to act promptly and forcefully. Strong actions like those taken in 1994 send a message that the FOMC will not tolerate rising inflation. In my view, such actions would encourage markets to build in expectations of permanently lower inflation.

Let me close with a longer-term thought expressed in the form of a few questions. What are the FOMC's intentions? Do we like seeing inflation below 2 percent? Does the public know it? I think, as I have said before, that we ought to be more explicit about our longer-term objective. In that event, it would be much less likely that our actions would be misinterpreted as being anti-jobs or anti-growth. I believe the last five years of relatively low and stable inflation have demonstrated to businesses and consumers the desirability of relative price stability. It comes back to a comment that Jerry Jordan made about how "Main Street" would perhaps be more supportive of our moving than we might think. I also believe that long-term interest rates likely would be lower because of a reduced inflation risk premium. And finally, I think it would probably take less forceful actions to contain inflation and inflation expectations because of enhanced credibility. Thank you.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. I concur with your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. This expansion will ultimately come to an end when the speculative excesses and imbalances have built to a point where we have no choice but to take strong action to deal with them and put the economy into a recession. The speech I would not want to have to write is one saying we never saw it coming and when we finally recognized it, we had to take much stronger actions and cause a recession. Apparently, I am not as convinced as others that the problems to which we ultimately will have to react will be in consumer prices or even in wages or other measures of labor costs. The problem may not be in output markets but in asset markets as suggested by historical episodes in this country, notably in the 1920s, and in Japan in the late 1980s. In those episodes, inflation was never apparent in consumer prices or wholesale prices, and the policy reactions were too late. I think we have to think more broadly about where we see the signs of the excesses that we need to deal with.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. I support your recommendation, Mr. Chairman. I agree with those who say we have not given up terribly much today by allowing ourselves a little more time.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I also concur for the reasons that Mr. Guynn just expressed.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. I concur with your recommendation.

CHAIRMAN GREENSPAN. Let me ask the Secretary to read a "B" asymmetric directive for purposes of voting.

MR. BERNARD. I will be reading from page 14 in the Bluebook. Page 14 follows several pages of tables and charts: "In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5-1/2 percent. 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, a somewhat higher federal funds rate would or a slightly lower federal funds rate 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, please.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
President Broaddus	No
Governor Ferguson	Yes
Governor Gramlich	Yes
President Guynn	Yes
Governor Kelley	Yes
Governor Meyer	Yes
President Moskow	Yes
President Parry	Yes
Governor Phillips	Yes
Governor Rivlin	Yes

CHAIRMAN GREENSPAN. Thank you very much. Our next meeting is on December 16th. We will now adjourn for lunch.

END OF MEETING