

Meeting of the Federal Open Market Committee

November 3, 1987

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, November 3, 1987, at 9:30 a.m.

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

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

Messrs. Guffey, Melzer and Morris, Presidents of the Federal Reserve Banks of Kansas City, St. Louis, and Cleveland, respectively

Mr. Kohn, Secretary and Staff Adviser  
Mr. Bernard, Assistant Secretary  
Mrs. Loney, Deputy Assistant Secretary  
Mr. Bradfield, General Counsel  
Mr. Truman, Economist (International)

Messrs. Fousek, Lang, Lindsey, Prell, Rosenblum, Scheld, Siegman, and Simpson, Associate Economists

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

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

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Mr. Coyne, Assistant to the Board, Board of Governors  
Mr. Promisel, Senior Associate Director, Division of  
International Finance, Board of Governors  
Mr. Slifman, Deputy Associate Director, Division of  
Research and Statistics, Board of Governors  
Ms. Low, Open Market Secretariat Assistant, Division of  
Monetary Affairs, Board of Governors

Messrs. Balbach, Beebe, Broaddus, J. Davis, T. Davis,  
Mmes. Munnell and Tshinkel, Senior Vice Presidents  
Federal Reserve Banks of St. Louis, San Francisco,  
Richmond, Cleveland, Kansas City, Boston, and  
Atlanta, respectively

Ms. Lovett, Vice President, Federal Reserve Bank of  
New York

Mr. Weber, Assistant Vice President, Federal Reserve  
Bank of Minneapolis

Secretary's Note: Prior to this meeting, notice  
had been received of the election of W. Lee Hoskins  
as an alternate member of the Federal Open Market  
Committee for the period October 9, 1987 through  
February 29, 1988, and Mr. Hoskins had executed  
his Oath of Office.

Transcript of Federal Open Market Committee Meeting  
of November 3, 1987

CHAIRMAN GREENSPAN. Good morning, everybody. Will somebody please move the minutes? [The minutes were moved and approved at this point.] Mr. Cross.

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

CHAIRMAN GREENSPAN. Any questions of Mr. Cross?

MR. BOEHNE. I have a question that may be broader than for Mr. Cross. A week ago, we were talking about walking a thin line between the dollar and the domestic economy and I get the feeling that that thin line has broadened out some since a week ago. How wide is it and do we have a policy or don't we have a policy? Is it the Treasury that's making U.S. policy or are we just kind of letting the market take us where we go or do we have some sense of where we want to go with the dollar? There have been a lot of changes in seven days.

CHAIRMAN GREENSPAN. Why don't I respond to that, and then Sam Cross can correct me. There have been significant disputes over the years as to precisely what the relationship is between the Treasury and the Federal Reserve with respect to the question of exchange rate intervention. As I understand it, even though there are disputable issues here, we largely tend to follow Treasury's lead in this question. The Treasury's position, while basically favorable to the Louvre [Accord] as a general procedure, is that they nonetheless are interested in making certain that we don't endeavor to defend a particular position which is indefensible. And, I would think that while the general view of the Secretary sort of backed and filled on various occasions, ideally, he would like to see the markets stabilize on their own without any actions on our part, whether through monetary or intervention policies. But, should that not occur, his willingness to commit U.S. resources is limited. And the general impression that I get, although it is not articulated necessarily sharply at all times, is that if the market moves us down gradually without any secondary consequences until we reach a market equilibrium, that would suit the Treasury just fine. There is, however, I think a general awareness that this all could get out of hand and that there could be a lot of dangerous, secondary problems. But it is the Secretary's view--maybe I should use the word "hope" because that is more relevant--that that will not materialize. So, I would say at the moment, that while the Louvre [unintelligible], it is clearly fading; and it will continue to do so unless and until there are dramatic policy shifts on the part of the Treasury, which I must say to you, I think would not be appropriate. Irrespective of what has been happening recently, I would say that we are not freely floating but we are floating in a way in which the degree of intervention that the Treasury is willing to commit is very minor.

MR. FORRESTAL. Mr. Chairman. Is there, if you can tell us, any plan to reconvene the G-5 or G-7? Things have changed markedly, obviously, since the Louvre agreement. I must say that the reason I ask that question is that I find it a little anomalous that we are draining reserves to defend the dollar while, at the same time, we are

adding reserves to add liquidity to the domestic economy. Maybe it's considered to be a disorderly market at this point, or potentially disorderly, but it seems a little anomalous to me to have this divided policy in a sense.

CHAIRMAN GREENSPAN. There is an element of that. There is a very fundamental question that we never seem to confront: How successful is intervention under various, different conditions? I think that the major thrust of our policy, as I understand it, is basically to exhibit our hand [to show] that we have not completely lost interest in the exchange rate, leaving the impression that should something really significant occur, we would be in there with both feet. But, that is a very mild position, I think, relative to what it was several months ago, and certainly at the beginning of the Louvre agreement. But, as best I can read it, there has unquestionably been a significant change in the position at Treasury in the last several months.

MR. FORRESTAL. Do you think that they will be thinking about another Louvre-type meeting?

CHAIRMAN GREENSPAN. Well, not necessarily. Do you mean to reset the exchange-rate question or just to get the G-7 meeting for coordination?

MR. FORRESTAL. Well, I was thinking of both.

CHAIRMAN GREENSPAN. At the moment, I think that there's a disinclination on our part to do it unless we have something to bring to the table. If something significant materializes out of these negotiations currently going on, then I would suspect that we are dealing with the possibility of a G-7 meeting which, in effect, would endeavor to exchange fiscal actions on our part with comparable actions on the part of Germany and Japan. Presumably, at that point, they would revisit specific paragraphs of the Louvre agreement, probably to reset where the intervention points would be. We have now run through all intervention points of which I am aware.

MR. BOEHNE. Do you have any insight as to why Karl Otto Poehl was so blunt last night? In one sense, they had a lot to lose with a weaker dollar, and the sense I got out of his remarks was, if the dollar weakens, so be it. This strikes me as--

MR. MORRIS. I think they are very much concerned about too much intervention increasing the German money supply as it did in 1978; and they want to avoid that.

MR. JOHNSON. I think they are more concerned about that than the dollar exchange rate. They pretty much got all their trading partners pinned down in the EMS, and I think that's about all they care about. If the EMS were to break up, you would see them concerned.

CHAIRMAN GREENSPAN. There is concern of that. I found that President Poehl is, I would say, somewhat less firm than Mr. Stoltenberg on this question. And, I think what Manley Johnson is talking about is really to the point: they have constructed for themselves a series of monetary targets carved into granite by means

unknown to anybody; and the credibility of the Bundesbank is at stake. If you go into the market and intervene heavily, you may think you are fully sterilizing [unintelligible] but it sort of leaks all over the place. I think that there are significantly different views. I would gather, but I'm not sure, that what President Poehl was saying last night necessarily is speaking for the German government in total, but it does reflect a significant part of his views. You were there, Jerry. Is that your impression?

VICE CHAIRMAN CORRIGAN. I don't think it's just the money supply question. I think that President Poehl, in particular, believes that if push comes to shove, the Germans and the German economy can handle a somewhat stronger mark and weaker dollar. And he quite firmly believes, whether anyone happens to agree or not, that the risks are squarely on the side of the United States--that the risks of a weaker dollar are greater risks to the United States than they are for Germany and--

CHAIRMAN GREENSPAN. And that's probably correct, too.

VICE CHAIRMAN CORRIGAN. I think it is correct. I was just going to say that I find it hard to violently disagree with that. The question that I think Ed Boehne is raising goes beyond the technical mechanism of the Louvre or anything else and that is: What are the risks? At least that's how I think of it. What are the risks of one set of policies, however broadly defined, versus another set of policies? I ask myself this question: What event of a foreseeable nature could really get us in the soup again? And I'm thinking, in part, of the events of the past couple of weeks. I must say that I think the dollar is still high on that list. If the dollar were to fall out of bed--however one might choose to define that--first of all, whether we like to admit it or not, I think the dollar/domestic interest rate linkage is still there. I'm not quite sure it is--or ever was--as precise as some people thought, but I certainly think that linkage is still there. I think the danger is clear; I can't assign probabilities to it but the danger is clear that you can end up with the worst of both worlds: a lower dollar and higher interest rates. The collapse of the exchange markets could easily trigger a renewed outburst of chaos in the financial markets. There is one particular thing that we have to keep in mind, and that is that a decidedly weaker dollar could be the straw that breaks the camel's back, especially for the Japanese stock market. I think that is a very real danger.

MR. JOHNSON. Why don't they do something about it?

VICE CHAIRMAN CORRIGAN. What could they do? What they should have done was do something several years ago. But what should they do right now?

MR. JOHNSON. I'm just saying that's their responsibility rather than ours.

VICE CHAIRMAN CORRIGAN. Well, that may be; but we can't be indifferent to it.

MR. HELLER. Let me go back for a second to Germany. I think you are quite right. There has always been a split between the

Finance Ministry and the Bundesbank. The Finance Ministry, as well as all the regional presidents of the State Central Banks, has always wanted to have a strong dollar because they were more concerned about the employment effects, while the Bundesbank clearly was more concerned about inflation. I think it is questionable whether President Poehl would have a majority on that council if he wanted to have a policy that would defend the exchange rate at the present time. So, in essence, he has to give in to a majority on his governing board. As far as the dollar is concerned, however, I disagree with you a little, Jerry. The danger of the dollar falling out of bed has been very substantially reduced during the last week because we now have [an exchange rate against the mark of about] 1.70, and not even the [unintelligible] that will go below 1.60. When you are on the high perch, the danger of falling is not much higher; so a freefall becomes less and less of a likelihood because the markets will support the dollar at some level. I think we are getting reasonably close to that level.

MR. CROSS. I would read it the other way: that it gets more precarious as we get into these new and heretofore unseen levels. The possibility of people getting really frightened and responding in some way--

MR. HELLER. Like the stock market, I think it's going to bounce back.

MR. JOHNSON. At this stage, really, the perception in the markets, given the new world we are in, trying to defend the dollar with higher interest rates here--I think that's where you would see a tailspin.

CHAIRMAN GREENSPAN. I think we have to remember what the issue of the dollar is. It is not that it is falling per se, but that whatever it is doing creates a judgment in the market that it will continue to do that. There are really two ways to look at this and that is really, I think, what divides the economic fraternity at this stage. If, somehow, somebody could wave a wand and move the exchange rate down sharply to a point where the expectation of future change was zero, then the yield spreads between intermediate or long-term issues in dollars and those denominated in the other currencies would dramatically come together; and we would get the type of stability that we would like. The problem, unfortunately, is that the other potential is that a sharply [falling] dollar merely will be extrapolated, as Sam Cross has implied. Here, we don't know, largely because we don't know where the bottom is. Obviously, the lower we are the closer the bottom is, by definition. Exchange rates tend to be non-negative, though sometimes you wonder. Judging from the way the markets have been behaving the last several weeks, I think the probabilities that a freefall is about to happen or could happen have diminished. Unfortunately, the trouble is that even if the probabilities have diminished, the consequences of that event are extremely dangerous. Even if we get to the point where we are all fully, unequivocally, convinced that there are no secondary reaction problems in the exchange rate, I think we had better keep up our guard.

MR. ANGELL. If we were to go back to 1983 and 1984 and have people look at it in terms of where the dollar should have been at

that point in time, the dollar didn't stay within what anyone would suggest was a workable U.S. balance-of-trade level. When the market could go to the extreme on the upside and run the dollar up to 161 on our index--when any careful analysis would say that that didn't make any sense--why do you have such confidence that somehow or other on the downside true market forces will prevail in the midst of political whims and a political climate that could be devastating? A truly floating exchange rate environment is really quite different than an environment in which you have political posturing and then it appears that [the floating exchange rate environment] is gone. It seems to me that there is extreme danger that at some point in time the dollar could become a serious problem. Given the Treasury's policy, I think we have only one choice: we have to make domestic price level stability our primary objective and, if the world believes that, then I think the dollar will be okay.

CHAIRMAN GREENSPAN. The only way we can do that is to eliminate intervention, assuming it works in the first place, and do it through market rates.

MR. ANGELL. Of course.

CHAIRMAN GREENSPAN. And you will find, as you just heard, that you have people who don't agree with you on the other side of this table.

VICE CHAIRMAN CORRIGAN. I don't think it's quite that black and white. I think there is something of a workable middle ground and we have to try to find it.

CHAIRMAN GREENSPAN. That's what we're doing at the moment.

VICE CHAIRMAN CORRIGAN. Manley, when you're talking about a brave new world, the thing that is most new and most brave about this world right now is that we have no policies. We have no fiscal policies; we have no exchange rate policies,

MR. JOHNSON. That's exactly what I mean. There are a lot of things new here; there are a lot of changes in expectations. We really don't know. We are on uncharted waters.

MR. ANGELL. But instability breeds instability, and that's something we have to be very careful of.

MR. JOHNSON. Maybe I'm off in the bushes somewhere, but I think it's clear to the market that the risk on the dollar today is mainly being caused by foreign central banks who are resisting the kinds of pressures on their markets and are forcing the dollar down. For us to try and deal with that situation here would be catastrophic.

MR. ANGELL. Being in such a position, with our fiscal deficit and our balance of trade deficit, as a net debtor nation, I don't understand how we think we ought to blame all these problems on someone else. To me, that's naive. We have to run policy in a manner that is consistent and sound. And what's appropriate for our domestic economy can very well be appropriate for the others, if we consider price level stability important.

CHAIRMAN GREENSPAN. We are now on agenda item 12 or 13. May I ask you to hold such remarks until we discuss policy questions? Are there any more specific questions of Sam? He never had a chance to answer questions.

MR. HOSKINS. I have one question--and this is back on the dollar again--and it has to do with your sense of any large short positions currently in the market. In other words, is there a perception that the only risk is on the downside and not on the up? If that is the case--

MR. CROSS. We don't get the impression that there is an opportunity to flip it and get a big run on the other side. The corporations have been noticeable nonparticipants for some time, generally speaking; everybody tended to sit on their hands during all of this chaos that was occurring in the market. So, the short answer is, I'm sure there are a lot of people shorting the dollar but we are not, so far as we can tell, in a technical position where we could flip that and get a runup.

MR. PARRY. Doesn't the futures market support that conclusion?

MR. CROSS. Yes.

CHAIRMAN GREENSPAN. Does anyone have any further questions for Sam?

MR. CROSS. On the question of [unintelligible], the Federal Reserve does have the legal authority to intervene and the Treasury has the legal authority to intervene. But there are a number of statements and letters and so forth to the Congress which indicate that from the point of view of the Federal Reserve, we will operate in cooperation and coordination with the Treasury on these matters, given the Secretary of the Treasury's role in international financial policy. And it is important that we not act in direct violation of Treasury's stated views; or if we did, it would be such a major event that we would feel it necessary to tell the Congress. So, basically, we have operated for many, many years on the basis of trying to work these matters out with the Treasury.

MR. BLACK. There's a constitutional basis for that position.

MR. CROSS. I'm not disputing that.

CHAIRMAN GREENSPAN. There's a wonderful debate that goes on in the legal literature, which somebody gave me earlier on and which I found fascinating. I came away from it deciding that this [arrangement] works in ways that are very mysterious.

MR. CROSS. I have another comment, Mr. Chairman. We have been operating through this period more or less simply to resist the downward pressures and not in an aggressive way, as you can tell from the numbers. We have done \$500 million since last Monday; the Japanese have done about almost \_\_\_\_\_ and the Germans have done almost \_\_\_\_\_. And there have been very, very heavy purchases of dollars by the British, partly for reasons other than the dollar situation, but it adds up to total dollar purchases in the past



week or so of, I would say, over \$5 billion. So, we have done a relatively modest amount.

CHAIRMAN GREENSPAN. If there are no other questions, I will seek a motion to ratify Mr. Cross' activities. I also need a motion to approve a one-year extension in the swap line agreements. Approved. Mr. Sternlight.

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

CHAIRMAN GREENSPAN. Why don't we wait [on the leeway recommendation] and see first if there are any questions on your report?

MR. MELZER. Peter, on your assumption of excess reserves of \$1.2 billion, how long do you think that will be in place?

MR. STERNLIGHT. Well, in fact, we upped that a little further yesterday, President Melzer, to \$1.5 billion based on what we were seeing from actual holdings of excess by some of the smaller institutions that already had a lot, and because some of the major institutions had built up such a lot of excess that we didn't think they could get rid of it all and still have some positive balance on the day. That's relevant to this current reserve period; we will be looking again at the next reserve period. I have no reason to think that we would be thinking in such high terms for the next reserve period, but we'll have to evaluate it as we get into it.

MR. MORRIS. Peter, during most of the year, the bond market has been very sensitive to the foreign exchange rate, but in recent days we have seen the dollar under a lot of pressure and that has not been transmitted significantly to the bond market. How do you appraise this?

MR. STERNLIGHT. I think it's a bit of an on-and-off thing now. It certainly is not the overwhelming presence and the tick-for-tick linkage that was there early in the year, although on some recent days the bond market has weakened in response to the dollar weakening. But, as I mentioned, I thought one reason for that linkage having been muted recently was that [market participants] saw the earlier weakening of the dollar as likely to be followed very rapidly by some tightening of monetary policy, whereas in the current context, they don't see that as following on so quickly. There is still concern, though, that a weaker dollar is a discouraging factor either to new inflows of foreign capital into our market or perhaps a reason for foreigners with existing holdings in our market to want to pull out. So there does remain some sensitivity, but I think it's less.

CHAIRMAN GREENSPAN. I think we have to be careful here when we say that a lower dollar basically induces individuals to be less interested in dollars. Obviously, that goes against everything else we know: that the lower the price, the greater the demand. In a technical sense, every time we get a change in the exchange rate which leads to a change in long-term yields, what we are looking at, in effect, is a change in the far-distant forward position of the exchange rate. In other words, if the exchange rate is falling and the bond market is collapsing--assume it's against the yen and the yen-denominated securities are not moving--what effectively is

happening is that the short-term decline in the dollar-yen relationship is creating an expectation of a very much sharper decline in the future. That's the critical issue. It is the expected rate of forward deterioration in the exchange rate which translates into basis points on the yield spread in the long-term, risk-free instruments. And, it is conceivable that we will get to a point--at some point, I hope--that the exchange rate will arrive at a level which the markets perceive will not go very much further, and the forward position of the dollar will begin to rise and we will get a decline in long-term interest rates. The danger here is that with the huge block of U.S. dollar-denominated securities outstanding, psychological cracks could induce tremendously rapid changes and create high degrees of instability. So, I think that something happened last week. I think one can argue that there has been an odd form of delinking--that there is a presumption that declines in the dollar do not imply that there will be future declines in the dollar. The trouble is that it might be what happened last week, and it may be what's happening this week, yet next week the markets might turn right around on us and go in the other direction. But, I do think it's important not to think of it in the sense of a tight linkage about what Federal Reserve policy is going to do, although it does seem that way. I think we have to remember that we are dealing with real variables and that the markets tell us a great deal in this respect.

MR. JOHNSON. Peter, my interpretation of what has gone on in the bond market lately is simply that it was just some backing off from some of the flight to quality. When things were extremely sensitive and unstable, we had a lot of movement in the Treasury securities on the long and the short end--maybe a little more on the short end, but a lot all over the yield curve. And I think as the stock market has shown some stability over the last several days, we probably have seen less pessimism there, and probably some movement back out of the quality assets--I don't know if back into the stock market, but maybe into other types of instruments. I don't know what your reading is, but if that really is going on, it seems to me that maybe those excess reserves will start to wind down a little. My guess is that quality spreads look a little better than they did before; maybe not, but that's my impression.

MR. STERNLIGHT. I have some impression of some of those tensions abating, some subsiding of the flight to quality. Somebody was saying a couple of days ago that the flight to quality has landed; I think that is probably going too far. But I think there is some backing away from that. Nevertheless, I think it remains a basically sensitive picture. I just had a report a few minutes ago indicating a further stock price decline today. It was down 40 some points in the opening half hour or so.

MR. KOHN. It was down 60 points at five after ten and bill rates were going back down again.

CHAIRMAN GREENSPAN. What was the bond market doing?

MR. KOHN. It was essentially unchanged, but it had been down sharply earlier and has rallied.

MR. PARRY. I have a question about borrowing. Since October 19th there has been a change in the willingness to borrow. What are

your assumptions about how the demand for borrowing may change over the next week or two? Are you assuming that basically the shift is going to continue over that period or that there is going to be a restoration of more normal relations?

MR. STERNLIGHT. I think it's terribly hard to say. My sense would be, as you say President Parry, that there has been some reluctance to borrow; but it's very, very difficult to come up with even the rough and ready kinds of pronouncements that we have tried to make in the past about a relationship between borrowing and expected funds rates.

MR. PARRY. Wouldn't that suggest that as long as there is that uncertainty it's probably wiser to focus on rates rather than borrowing levels?

MR. STERNLIGHT. Well, I think there has to be a lot of flexibility in anything we try to--

MR. PARRY. I'm sorry, I'm not used to using words like that!

CHAIRMAN GREENSPAN. What's the funds rate expectation at \$450 million borrowing under normal conditions?

MR. PARRY. Probably 7 percent or a little below.

MR. KOHN. Seven percent or a little below. I guess the equations that we estimated might say a bit below 7 percent--perhaps 6-3/4 or 6-7/8 percent.

MR. PARRY. That's what I think.

MR. HOSKINS. Let me ask Peter a question. I might be too sensitive to the markets, having just left those wharves. But in this environment if, for technical reasons, the funds rate were to trade above 7 percent, what in your judgment would the perception be with respect to either Federal Reserve policy in general or the linkage to the dollar?

MR. STERNLIGHT. I guess it would depend partly on whether it was perceived that what was happening was occurring for some deliberate reason on our part or despite what we were doing. The interpretation of it would depend on how our role was seen in the whole thing. A good many people would say that's in the range of their expectation, I suppose. If I had to pinpoint an expected range now, narrowly, it might be 7 percent or a shade under; but I don't think 7 or 7-1/8 percent cropping up occasionally would be terribly disturbing in that context, either.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I just have two questions in areas that I need to be educated on. First, when you were talking about our policy of lending securities, did I hear you say that we had not been willing to lend for a short sale? Maybe I just didn't hear you.

MR. STERNLIGHT. Yes, that has been the past standard.

MS. SEGER. How do we know? Do you ask them in advance what they are going to do with the proceeds?

MR. STERNLIGHT. They certify that they are not borrowing to facilitate a short sale.

MS. SEGER. I see. My second question: When we have been so-called "accommodative" in the last couple of weeks, why have we done all these transactions with repos? I realize a million dollars worth of repos has the same reserve impact as a million dollars of direct purchases of T-bills, but I think the market perception of what we are doing is different in the one versus the other. I guess I just don't understand why we have done it [that way].

MR. STERNLIGHT. In mid-October, the beginning of that period, the outlook was that we had a reserve need for what is now the current period but that in the following period there would be only a modest reserve need. So, if we had done a lot of outright buying then we would have had a concern that we would come up to an overabundance of reserves and it could be awkward, as these are not the kinds of markets where we would want to try to be going in and draining reserves. As the period went along, we kept getting revisions of the out periods, so it looked as though we would have a more long-term need. If one had it to do over again, it might have made sense to have done some purchases outright. I don't think our broad purposes of providing liquidity were ill-served by concentrating on repurchase agreements, though. This gave us a chance to have a rather continual presence and to be providing relief to what was potentially one of the very sore points in the system, the ability to get day-to-day financing. So I don't think that part of it worked out too badly.

MS. SEGER. Thank you.

CHAIRMAN GREENSPAN. Any other questions for Mr. Sternlight? You have a recommendation?

MR. STERNLIGHT. Yes, Mr. Chairman, I have a leeway request. Current projections suggest a somewhat enlarged need for outright purchases in the upcoming intermeeting period. Normal seasonal needs for currency and increased required reserves could be enlarged even further if current financial market tensions persist. While we may want to leave a sizable margin of needs to be met with repurchase agreements, it would also be useful to have the flexibility for substantial outright activity. I recommend a \$3 billion temporary increase in the normal \$6 billion leeway, although we may not need very much of the enlarged amount.

CHAIRMAN GREENSPAN. Why don't we separately move on the actions the Manager has taken since the September meeting and then settle the motion on the specific request? Motions approved. Mr. Prell.

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

MR. MORRIS. Mr. Chairman, yesterday I talked to Tom Jester of the Survey Research Center at the University of Michigan and he said that in a survey taken after the stock market decline, that decline turned out to have had a very sharp effect on consumer

confidence. He said they think the big effect is not going to be the wealth effect on consumer spending but the uncertainty. He thinks consumers' reduced confidence level as to the future, generally, is likely to produce a major slowdown in consumer spending. He thinks the confidence index they report will be showing about a 10 percent drop when it next comes out.

CHAIRMAN GREENSPAN. We also got the Conference Board index in a post October 19th [survey] and it didn't show that at all. So we have a problem on how to read these things. Mike, why don't you report on the differences for just a second?

MR. PRELL. Well, both of them were down. The Michigan survey's sentiment index was down, as President Morris noted, in the period after October 19th. Basically, they had about a third of their month's sample in that period and they looked at that group alone. Obviously, the statistical reliability is less, but they felt that the sharp drop was statistically significant. That put the level well below the plateau we have been at, and that is the clear distinction from the picture that one gets in looking at the very limited poll that the Conference Board did after October 19th. That showed a drop, but it was only a small departure from a very strong uptrend in the last several months; it seems to have reflected people's perceptions that the job opportunities were very good, and that propels that index directly in a way that the Michigan index doesn't reflect.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I have a comment and two questions concerning the Greenbook forecast. My comment: considering the modest wealth and cost of capital effects of the stock market decline, and also what is referred to as an expected appreciable fall in interest rates, it's surprising to me to see real growth for 1988 at less than 2 percent. Now, my first question deals with real disposable income. We have talked about this in the past but I think it has even greater importance today. Real disposable income in the Greenbook forecast rises so slowly relative to real GNP that I really doubt that that forecast will occur. The difference in growth rates is 1.2 percentage points. In our forecast, there's a difference of one tenth of a point; in the Blue Chip consensus of 30 economists, it's two tenths of a point. A distinction of that magnitude is, I think, pretty much without historical precedent. It is my understanding that the way that occurs is that you have an increase in inflation as a result of higher import prices, which causes the PCE deflator to rise very substantially relative to the GNP deflator. And, as I am sure you know, the relationship between the PCE deflator and the GNP deflator is one of the most stable relationships we have. We looked back to 1973 and that relationship varied between .988 and 1.021. In the forecast, it gets up to 1.026, which is an incredibly high level. I don't think it has ever been that high. And my question is: If you had a ratio between the PCE deflator and the GNP deflator which is more traditional, how would that affect the staff's forecast of both?

MR. PRELL. Clearly, one of the things in our forecast that all along has been a key factor affecting the pattern of output growth happened we believe, in large part, because of the exchange rate depreciation. Partly because of the oil price movements earlier, we believed that we would have some erosion of real disposable income

growth and thus some damping of consumer demand, which would release the resources to support the substantial improvement in real net exports. I might just say that the pattern we are projecting is not a departure from what we have been seeing over the past year or so. Rather consistently, PCE prices have been rising faster than GNP prices in a period in which real disposable income growth has been considerably slower than real GNP growth. We have a continuing decline of the dollar in our forecast and we have a continuation of this pattern of relative price movements. We looked at the historical record. We think there are perceptible relative price movements that can be seen during a period of the dollar's appreciation--an interruption of a previous trend. We have seen this ratio of PCE prices to GNP prices rising rather markedly over the past year and we expect that to continue. Clearly, if somehow this didn't occur, there would be implications for income shares and output patterns that could significantly affect the outlook. We think this really has been a perceptible trend recently and that the conditions that brought that about will be prevailing still in the future.

CHAIRMAN GREENSPAN. Bob, I think it rests on two issues: one is the movement of import prices at a rate higher than domestic prices; second, and just as important, is the renewed share of imports in total domestic demand. You need both to have this effect. The interesting question is: How do you get this small a number? Is it the fact that your import price estimates are much lower than the staff's?

MR. PARRY. No. I think what happens in their forecast is that the higher import prices show up very dramatically on the consumption side but not on the investment side.

CHAIRMAN GREENSPAN. But we are importing computers on which the prices are going down; that's probably the reason that it's happening.

MR. PARRY. Well, perhaps this will happen, but I don't think it has happened to date. I'm not sure. I will have to look at the 1987 data; I'm not sure we agree on that in the second half.

CHAIRMAN GREENSPAN. I think you're raising a terribly important question here. I think it's important that we get that right.

MR. PRELL. If I could just cite some figures: Going back to the third quarter of 1986, the PCE fixed-weight price measure rose 1 percentage point faster than the GNP prices; in the fourth quarter it was 0.7 faster; in the first quarter of 1987 it was 1.2 percentage points faster; in the second quarter it was 1.1 faster; and in the third quarter it was 0.8 faster. We have a more moderate relative movement in the forecast than we have been experiencing. We also have looked at outside forecasts and, generally, they have this relative movement in a similar range; some of them have it less than ours, some of them have it considerably more than ours. When we look at the fixed investment prices and what might be going on there, there may be some wrinkles in terms of the construction of the index. As I understand it, that is constructed largely out of PPI data, which would be the domestically produced goods. You might not have the direct kind of import price measurement in the way these numbers are

constructed as you do with consumer goods, which would sample imports directly as well. That's a minor factor.

MR. PARRY. The statistical work that we have done indicates that all of the increase in the PCE over that period that you just cited can be attributed to oil and none of it to foreign exchange.

MR. PRELL. We would certainly be happy to consult further with your staff. In the second half of last year, energy prices in PCE were falling rapidly.

MR. PARRY. Yes, but it depends on the lag, of course.

MR. PRELL. Well, I guess we differ on this. We have had some discussion with your staff who raised the question with us and--

MR. PARRY. It's a difference in the forecast.

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. One number that surprised me a little in the Greenbook--especially the contrast between the 1988 number and the 1987 number--was the capacity utilization in manufacturing, which is inching up. If you look at producers' durable equipment, it is still going up at a rate that is in excess of real GNP. The unemployment rate, as you pointed out, is leveling off. Is the driving force just the composition of imports--that they have such a heavy weight in manufacturing? Or what explains the increase in the utilization rate?

MR. PRELL. Obviously, as you know, it's a confluence of two things. One is how fast industrial output is growing, which is quite sensitive to the mix of output in the economy; and the improvement in trade is reflected in growth of industrial production and a manufacturing component that is stronger than overall GNP growth by a point or more next year. The other component in this calculation, obviously, is an assessment of capacity growth. Business fixed investment, which had been weak for a while, rebounded in the last couple of quarters; some of this rebound reflected a spurt in automobile sales which presumably will not be sustained. Of course, it takes a little while for growth in PDE to feed through the substantial increases in the stock of capital goods. We have a relatively weak investment outlook, so from that side of things we wouldn't see tremendous additions to capacity over the coming year. We have a relatively moderate growth in capacity--about 3 percent or a bit below--

MR. HELLER. But that's higher than your GNP number. That's precisely the point.

MR. PRELL. It's higher than GNP but it is in line with the growth of industrial output and slightly below the manufacturing growth rate. So we get this very slight inching up--it probably should not be called inching but milimetering up--of the capacity utilization rate. Assessing capacity utilization is always difficult. As you know, we recently put out our annual revisions; the revisions didn't really adjust the overall level very much but there were noticeable changes in some of the industries. We have to be alert to

whatever we can pick up on what is going on in actual capacity. The linkage between investment and actual capacity is not all that tight.

MR. BLACK. Mike, with businesses having become so much leaner and meaner in recent years and increasingly willing to bring about permanent layoffs and temporary layoffs, some of our contacts have been telling us that if the downturn does intensify, they would expect the unemployment rate to jump pretty sharply because of this changing attitude on the part of businesses. Does that seem reasonable to you? If so, have you factored it into these high unemployment rates that you are projecting here?

MR. PRELL. Well, I hope so. Of course, to the extent that they are currently lean and have not been hoarding extra labor, as there are dips in output, there is not going to be as much room to reduce employment. Of course, once we have determined how aggressive they are, then we would [know more about] how persistent the effect of weakness will be. We have distinctly slower employment growth in our forecast than we have been experiencing; and we do have the unemployment rate going up, read literally here, 0.4 of a point over the next couple of quarters from the 5.9 percent level we saw in the past month. It's hard to say how far this would go once the process is underway; but our forecast is one in which we have only a brief interruption of the recent growth path. And under those circumstances, we presume they would not have unloaded tremendous amounts of [unintelligible] labor.

MR. BLACK. I agree pretty much with your forecast. It just struck me as an interesting thought, since business people seem to feel that they will not hesitate this time like they sometimes have in the past.

MR. PRELL. Many of them clearly have more flexibility than in the past because of their use of workers who were not strictly on their payrolls but were hired through temporary help firms. So, those workers probably would be laid off during--

MR. BLACK. It is interesting that they got so much leaner with such a big rise too in the participation rate in the labor force. It seems to have happened.

MR. PRELL. Mr. Corrigan has probably perceived one of the sharpest jumps in unemployment.

MR. BLACK. He may see some jumps of other types too.

VICE CHAIRMAN CORRIGAN. I don't know about the demand for BMWs and Mercedes, but that shouldn't affect the productivity numbers too much. Actually, they should go up.

CHAIRMAN GREENSPAN. Are there any further questions?

MR. PARRY. It appears to me that recent developments have had a very substantial impact on [your forecast for] final sales and inventories in the fourth quarter. There's a very large impact on inventories in the fourth quarter and then these unintended inventories are worked down over 1988 and that's in large part why growth is so weak in 1988. Why is there such a large impact on final



sales in the fourth quarter, given the assumptions about modest impacts of wealth and cost of capital effects in recent developments and also the lower interest rate? What if you have an inventory situation that really colors that entire forecast very substantially through the end of 1988?

MR. PRELL. Well, it's very difficult to assess precisely what the demand and production adjustments are going to be in this short period of time. As I suggested in my remarks, we built in a fairly prompt response of consumption and we also built in a fairly prompt response of production. The inventory accumulation we have is a combination of the automobile inventory rebuilding that is occurring as sales have dropped off after the special incentive period, and the automakers' having moved up their production a bit from the very low third-quarter level. We also, though, have some significant accumulation outside that sector. Some of that is involuntary but, going into the early part of this quarter, some is still voluntary in the manufacturing sector where it appeared that inventories were very lean and that there was some desire to at least keep the stocks in line with sales. So, I think it's a mixture of voluntary and involuntary elements that leads to some adjustment early next year in production. But, we have assumed a relatively smooth path for developments in the next several months.

CHAIRMAN GREENSPAN. After the fourth quarter?

MR. PRELL. Apart from the auto situation.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I just wanted to tell Mike that I admire his courage for attempting to put specific numbers down on a sheet of paper because, although I'm older than most of the people sitting at this table, I can't think of a time in my lifetime when we have had comparable events in the financial markets. So I'm not sure I know how your econometric models can pick anything up when the data fed in are like what we have just been through in the last couple of weeks.

MR. PRELL. Well, we don't rely totally on our econometric models, of course. Sometimes we depend on them very little when the circumstances suggest that there are just tremendous departures from the historical norms--shocks that would disturb recent trends. But, I guess in this case I'd say that they are reasonably supportive of this kind of view. It's clear, though, that there are downside risks in this forecast, should the stock market have a more dramatic effect than we have gauged it to have at this point.

MS. SEGER. One thing that concerns me, as I said before--whether you formalize it or don't formalize it mathematically--is that not having experienced this kind of period, I just suffer from uncertainty about what it will bring. Also, I wonder if a 20 some percent decline in the Dow on one day is really the equivalent of four months' worth of 5 percent declines each month. I have a feeling that it's not comparable. I don't know, but I have a feeling that there are a lot of things in here that, at least based on my inexperience, I cannot really judge.

MR. PRELL. I did try to highlight the fact that this might have greater shock value than it otherwise would have, if that's possible.

CHAIRMAN GREENSPAN. I think we are now at a point where not only Mr. Prell has to be adventuresome, but the rest of us do as well.

MR. PRELL. I think the amount of courage that is required is far less for the staff than for the policymakers.

CHAIRMAN GREENSPAN. Does anyone want to open up [the discussion] around the table? Mr. Boykin.

MR. BOYKIN. Mr. Chairman, uncertainty certainly prevails down my way. In looking at what might be appropriate for forecasting, we really would not have much basis for argument [with the staff forecast], but in our own forecast we have come down a full point; that is very judgmental, obviously. As far as the effect on our District economy, our initial reaction is that probably whatever the effect, it is likely to be a little less in the Eleventh District than in the rest of the country, simply because we are so much farther behind the rest of the country. We have seen signs of sluggish growth in the District. We think the situation continues to be extremely fragile. The real estate problems keep coming up and are a pervasive cloud in the psychology. The earnings reports that we have just gone through with our financial institutions, and the added provision for loan losses--most of it triggered by real estate--just put another damper on that. The cautious optimism that I tried to express for a couple of meetings seems to have abated somewhat. I'm not sure we can even be cautiously optimistic right now.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. With regard to developments in the Twelfth District, I think economic conditions remain relatively upbeat and, at this point, very few effects of recent financial developments have shown up yet. But, it's clearly too early to see the real effects. We are, however, seeing broad-based effects of the reduced value of the dollar, in addition to the greater exports of lumber and selected agricultural products that I mentioned previously. For example, a Utah steel plant which was formerly owned by U.S. Steel recently reopened and it was interesting to note that part of the decision to reopen was based upon a German firm's five-year commitment to buy 40 percent of the plant's production. I think that is rather interesting. In addition, the price of titanium dioxide, which is a key ingredient in paint, has increased substantially due to the dollar's decline; and a major paint manufacturer in our District is turning increasingly to domestic suppliers. So wherever we look, we seem to be seeing some effects of the declining value of the dollar in terms of expanded export opportunities or increased import substitution.

With regard to the overall economic outlook, we estimate that the wealth and cost of equity capital effects of the stock market decline would reduce real GNP by slightly less than 1 percentage point, assuming an unchanged path for interest rates. Given the easing that has already occurred and the expected lower path for interest rates that is mentioned in the Greenbook, we would have

growth closer to 2-1/2 percent than 2 percent and the employment rate basically unchanged.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Well, like Mr. Prell, I think I will divide my comments into pre-event and post-event. Starting with the pre-event activity: certainly, the District continued to operate on a reasonably favorable basis, much along the lines that I previously have been reporting, with the exception of the auto industry. The manufacturing sector has been moving along pretty well and the employment statistics have been good, very much in line with the national numbers. The steel business is operating again at very, very high levels; the demand for steel products is the best we have experienced in our area since 1981. The delivery times have stretched out very considerably and many products really are being sold on allocation. Construction activity remains reasonably good. The conditions in agriculture are continuing to improve; land prices are up and commodity prices have improved somewhat. By and large, the harvest is in and it really has been a very good harvest in our area.

Moving to the post-event comments, it is too early to assess the damage but, so far at least, I don't sense from any of the people that I talk to that any of these fundamental trends that I've just noted have been badly affected. Certainly at the outset, consumer spending was affected; there was a decline in retail sales as we went through the market trauma, but that seems to have leveled out. I am told from people who have October retail numbers in our area that, by and large, retail sales came in this October about level with last October. Looking ahead to next year, the retailers are reducing their expectations but, so far, nobody has suggested a negative trend on retail sales. On the auto side, it's awfully early to tell, but one of the major producers that I talked to yesterday said that they are reducing their sales [estimates] for 1988 cars and trucks together by about 800,000 units; but they do emphasize that it's very, very early yet to assess how the consumer will react. On capital expenditures, so far I have been quite impressed that there are no early signs of a sharp curtailment. Most of the companies that I've talked to--those that have significant programs in place--intend to continue, unless there is a very sharp downturn in the economy. They have embarked on programs that they say they will, by and large, stay with. And I do find that quite encouraging. So net, I think it's still too early to assess the damage. I keep being favorably surprised that our early assessment isn't a little more negative than it is. I think our expectations for next year will certainly be down a bit, but it is far too early to quantify. We are just going to have to go through a period of some uncertainty. Nonetheless, so far things seem to have come through better than I might have expected.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Well, there haven't been any actual changes that I can see in my District. It's more that the worry level has risen. What I sense is that the psychology is more important than the wealth effect; if we have another shock in the market I think we would have a real tumble in psychology; if we continue to mend without another shock I think the effects may be minimal. This psychology is apparent in some of the conversations that we have had with regional retailers.

Their merchandise for the Christmas season is already on hand, so they are stuck with it one way or another. While no one we've talked to has observed any decline in sales yet that they can attribute to the financial markets, their view is that if Christmas sales do run below plan, then they are going to run their inventories much lower than they ordinarily would, and that would affect their spring ordering. So, I think they just don't know. They are thinking beyond the Christmas season if that turns out poorly. The same attitude is apparent in manufacturing as well, where I think most manufacturers feel that the orders that they have on their books are there and they are going to fill them. What they are concerned about is six months out. But, overall, my sense is that the risks have changed in the economy. Whether they have changed a lot or a little remains to be seen; but they have changed in the direction that real growth will be lower than we thought. If we are wrong, then we'll probably be wrong in the sense that we'll have still lower growth. And I think the risks have shifted, too, on the inflation side; to some extent, concerns that we had about inflation six weeks or so ago are alleviated. I admire the bravery of Mike Prell and the staff for forecasting precise numbers and I think their numbers are reasonable--not because they are necessarily right, but because I can't improve on them. They seem to be broadly reasonable. Just one other point: I do keep hearing some very favorable news on the export side. At my last full board of directors' meeting and other meetings around the District, people spoke almost with one chorus: the news coming in from their salespeople is that they are able to compete in the export market, both by selling abroad as well as by competing with the imports that have been coming in.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, the statistical information on the evaluation of the economy in the Sixth District that we had prior to October 19th reflected continued improvement in the District. Economic activity seemed to be very good pretty much across the board. I would echo what Ed Boehne just said about exports: they seem to be increasing, and we also are getting reports about better export performance. It's very difficult at this time, I think, to assess any impact in the region of the events of a couple of weeks ago. Everyone I talk to says it is business as usual, although I find that a little hard to believe because I am sure that many businesses are re-assessing their plans for the future. But, at the moment, nobody has indicated to me that they have made any change in their business plans. I think what they are really saying is that they feel that it is too early and they are adopting a "wait and see" attitude. The only preliminary indication that we have that people might expect less robust activity is that many firms--the majority of those that I talked to--are, in fact, repurchasing their own stock. And, of course, the Christmas sales are going to be very critical. One concern I have is that I have been hearing scattered reports that deposits have been moving out of thrift institutions into the banks, reflecting greater public confidence in the FDIC than in the FSLIC and the thrifts. That's not a widespread movement, but it is something that I have noted. The regional banks see very little impact from the weak equity markets, given their loan portfolios and the relative strength of regional growth. That was reflected in their stock declines, which were much less than for money center banks.

Like others, I think it is very, very difficult to come up with a precise forecast on the national economy, although I think we have to make an attempt to do that in order to set policy. We have moved our forecast down somewhat, although I think we would show a little greater strength than the Greenbook. But it's not a matter of great difference. We would move our forecast down further if we continued to see increased volatility in the markets. I might just note, in passing, that we are developing an alternative forecast which is a less comprehensive one than others; I don't want to place a great deal of emphasis on it at the moment, because it only has one quarter of experience. But that one quarter was very good--better than most of the comparable forecasts. That model shows much less growth in the fourth quarter and through 1988 than most of the others that I've seen. So we will continue to develop that model and watch it carefully. But, in general, I think the Greenbook forecast is about on target.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. This seems to be a day of confessions, Mr. Chairman, and I will have to join those who confess that they don't have much confidence in their own projections. I have less now than I typically do, of course, which is saying that I don't have a great deal. We have these two elements of uncertainty to be sure: first, we don't know what the impact of the decline that has occurred in the stock market thus far is going to be; second and more importantly, we don't know how much further domestic and foreign markets may decline. And I don't think a further decline is a risk we can completely rule out. So, the uncertainty level is extremely high. But we don't know the answers to these questions. Assuming that the market settles down somewhere in the 1900-2100 range, I think the staff's forecast is pretty reasonable; I don't think we could improve on that a great deal. That seems to be what the business people in our District feel; at least that's what we have been able to uncover up until now. But I do think there's a lot of risk in this, regardless of where you come out. It is clear to me that there has been a big blow to inflation and to inflationary expectations in the short run from this. But if the decline turns out to be as moderate as the staff has projected, and as we have endorsed, I don't think it's unreasonable to suppose that by the middle or last half of next year the same kind of worries that we had on the inflation front earlier might reemerge. And I think that we ought to have that in mind as a definite possibility as we address what we do in the immediate future, because the effects of actions we take now are going to be felt down the road, and we ought to be well aware that that possibility is at least out there.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Responses in our District to what has happened in the financial markets have been all over the lot. Of course, people have been preoccupied with the baseball season until recently!

CHAIRMAN GREENSPAN. I missed it. What happened there?

MR. STERN. I am sure the staff can prepare a memo! Initially, there was a lot of concern coming from the financial community; that seems to have diminished. There have been some scattered reports of postponement of purchases of big-ticket items but

first of all, it seems to me, that is to be expected. Second, I would reiterate the word "scattered" because it by no means is universal at this juncture. One of our contacts who is pretty well plugged into the retail picture--not just locally but nationally--reported that his company opened six new stores the day of the collapse of stock prices and business in all of them was terrific.

MS. SEGER. That's because they were giving things away that day.

MR. STERN. Well, I'm sure they highly promoted the openings; on the other hand, these were all in new communities for them. He also had been to a national retailers' trade convention and reported when he came back that, basically, people were reasonably confident about the Christmas season. Again, though, I think you would have to make a distinction between those people selling big ticket items and those selling more normal kinds of goods. I think his statement pertains particularly to the people who are selling the broad-based, moderately priced, kinds of consumer goods. We have heard some more generalized comments about people reassessing their capital spending plans for 1988. I guess that's the one thing I would point to at this juncture.

With regard to the national economic outlook, I certainly support the general tenor of the Greenbook forecast although I guess my own view, and the one that comes out of our forecasting model, is that the economy will grow more slowly pretty much throughout 1988 than indicated in the Greenbook and, of course, more slowly than we had thought previously. I think the major difference is in capital spending and, for what it's worth, that does seem to be consistent with the view that people are reassessing their capital spending intentions and will probably do some postponing. At the risk of perhaps going beyond courageous to foolhardy, we did run the model out through 1989 to see what it produced. While originally I thought that was maybe just an ill-advised exercise, in fact, it produced some reassuring results. It showed a resumption of growth pretty close to 3 percent and a continuation of moderate inflation. I would not put a lot of emphasis on all this, obviously, but it seems kind of consistent, if you think that what is going to happen is some postponement of expenditures in 1988. That ought to suggest that 1989 could be a reasonably good year, assuming we don't get further large down [unintelligible] in things here. So for what it's worth, I simply report those results.

CHAIRMAN GREENSPAN. But we will hold you to it.

MR. STERN. I have lots of time to revise.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Echoing what Gary Stern said on the retail front, I talked to a national retailer in our area and he said they looked at the week-by-week comparison of sales at their outlets throughout the country in the two full weeks since October 19, and only one store showed a decline in that first week. That was the World Trade Center store and sales picked up in the second week. He is really quite optimistic; his attitude is that this is not going to have an impact. Now, you

have to believe that the loss of wealth, long-term, will have some impact. But I guess my own feeling, based on this isolated comment and other comments I have heard, is that it's a little too early to try to sort it all out and to decide how to respond in a long-term sense.

The other comment that I wanted to make is that the area that shows particular strength in our District is manufacturing employment. Implicit in what Jerry Corrigan was saying about the risks of a lower dollar, it seems to me, would be the inflationary risk at a micro level. I think what we have been seeing in terms of pressures on capacity and wage rates has really been on the manufacturing side. When I say that, I base it on anecdotal evidence; I don't mean that it has been reflected in the data. And to the extent that a rapidly declining dollar causes a more rapid external adjustment in [the manufacturing] area, it seems to me that we could get greater price pressures in those industries that are producing for export or are import competitive--the shoe industry, the apparel industry, and some other industries where even before the most recent developments, we were already hearing reports of some pressure. So I think on the inflation front, that is something to be mindful of on the micro level.

CHAIRMAN GREENSPAN. Vice Chairman Corrigan.

VICE CHAIRMAN CORRIGAN. In the very near term, Mr. Chairman, I don't think there's much doubt that the stock market and related developments do work in the direction of weaker spending and lower inflation. But I am not at all sure as to amounts and I am not at all sure what one should infer for the longer term. There are probably several dozen scenarios that anybody could think of. Unlike Mr. Prell, I don't have to put one on paper but, in my thinking, there are two more likely scenarios in the near term. One is that the financial markets, and by that I mean all of them--exchange markets, bond markets, stock markets--kind of settle in more or less where they have been in the last couple of days. I don't know where they are right now, so I have to qualify that. But suppose the Dow settles in at the 1900-2000 range, the long bond settles in at 9 percent or a little more or a little less, and the exchange markets are roughly in line with [the levels of] recent days. Now, in that scenario, my hunch is that economic performance will be respectable but not spectacular over the intermediate term--probably something like what I heard Mr. Parry describe, which I don't consider to be all bad, by the way. The other scenario, which I think has to be thought about along with that one, isn't so pretty. And that's a scenario in which for whatever reason--because the exchange markets go south or the budget negotiations rupture--there's a sudden hit to the system. Who knows what the exact trigger might be, but we could find ourselves confronted with another very, very difficult and turbulent set of conditions in the financial markets. Obviously, I can't put a probability on that. But if I were to just think of the two broad scenarios that would warrant the closest attention from a policy point of view, I guess those are the two that stick out in my mind. Interestingly enough, at least from my perspective, they both seem to me to have the same immediate policy implications in that they both imply the need for a great deal of caution in policy, and a very measured and disciplined approach to policy in which we maintain maximum flexibility for the future.

I would also, if I may Mr. Chairman, like to make a comment or two about the longer-term situation as I see it, because I think it's extremely germane both to where we are and to policy options for the future. There is, of course, a great deal of discussion in all circles about imbalances in the U.S. and the world economy, whether in terms of trade or payments or whatever. But, we should not lose sight of a couple of powerful forces on the domestic side that I think are germane. One is the dramatic increase in debt, in leveraging, that we have had in recent years: the ratio of overall nonfinancial debt to GNP--and I understand all the limits in the data--has risen from something like 1.41 in the early 1980s to almost 1.81 early this year. It may be coincidence--it probably is--but the fact of the matter is that the last time we saw that ratio in a range that high was in the late 1920s. And it's not all government debt, although government debt has a lot to do with it. Since the first quarter of 1984, the net issuance of equity is down \$270 billion and corporate debt is up \$600 billion. Again, if you look at this problem of government deficits and savings, it's really quite dramatic. In the late 1970s, the general U.S. government budget deficit as a percent of net private savings averaged about 10 percent. It has risen sharply throughout the 1980s, peaking at 66 percent in 1986. Indeed, in 1986 the federal budget deficit itself absorbed more than 90 percent of net private savings. And even in 1987, that absorption rate relative to domestic savings will fall only to the mid-50 percent range. I stress that because in the context of all this discussion about budget packages and all the rest, I think we have to keep in mind that, even under the best of circumstances, the kinds of things that are talked about in the area of budget reform are really quite small. Indeed, there is a great likelihood that the budget deficit in 1988 in absolute terms will be larger than in 1987. It is in that context, I think, that a lot of these acute dilemmas and very, very sharp risks have to be evaluated and considered.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. It seems to me that the economy was headed for a box in a corner and it wasn't going to work the way it was [earlier]. We had really slow money stock growth for a nine-month period. But we had something else going on that it seems to me has been missed somewhat--that is, the dramatic improvement in labor productivity. Now, I know you wouldn't expect me to mention the manufacturing sector of the U.S. economy, but it is much larger than agriculture. Manufacturing is 24 percent of our economy and we have a 4-1/2 percent growth rate in labor productivity in that sector. And that improvement is running faster than any edging up of wage rates, so we have unit labor costs falling in a dramatic way while the dollar exchange rate is adjusting. That leads, of course, to what I think we expected to have happen--dramatic increases in real exports: 17.9 percent in the second quarter and 16.8 percent in the third quarter. And it seems to me--and here's where I differ somewhat with the staff forecast--that that is apt to continue. I see no reason why that won't tend to continue as far as the eye can see, because there are just so many adjustments underway, given the wonderful new opportunities of labor productivity. That, of course, carries with it a need to have higher capital expenditures in the Rust belt, the manufacturing sector; and so that makes our economy stronger than it otherwise would have been. Then, on top of that, instead of reducing government deficits by \$73 billion, according to the staff forecast we



have a \$16 billion increase in the deficit. So that's an \$89 billion [swing] and it just seems to me the economy wasn't going to work. The stock market event seems likely to bring some relief in that it might be expected to slow consumer spending enough so that there is room for this other rather rapid expansion to continue. But this doesn't give us a bad inflation environment at all; it indicates, of course, with this productivity going the way it is that you have less inflation. In fact, it seems to me that the inflation rate in 1987 is just unbelievable, in view of the oil price rebound and the import price adjustments. To have the CPI, which should have more imports than other measures of inflation, peak out at 6.2 percent in the first quarter, and move down to 4.6 percent in the second quarter and 3.6 in the third was just unbelievable. So, in a way, everything was going all right except that expectations were bound to derail the train; and those expectations came out of the lack of understanding as to how inflation wasn't going to return; it wasn't there in spite of the fact of a falling dollar. I don't know that there's any appreciation of the way in which the Federal Reserve's commitment existed in that environment. So, we have a rather unusual occurrence. With regard to the forecast, the one item that I think seems like a rather rapid reversal for the fourth quarter would be the income velocity of money. The income velocity of money spurted up to about a +4 percent annual rate in the third quarter from zero in the second quarter; and then it looks to me like it falls at about a 6 percent annual rate in the fourth quarter, which would be a swing of velocity of 10 percentage points. That seems a little stronger than I might expect. The real trick is: how can we maintain confidence in the domestic value of money in a period of declining foreign exchange rates for the dollar?

CHAIRMAN GREENSPAN. President Morris.

MR. MORRIS. Mr. Chairman, I too agree that the outlook is extremely difficult to forecast because we are in a fairly new situation here. But, it seems to me that the events of recent months suggest that the Louvre Accord was an agreement to maintain the U.S. exchange rates at levels that were not sustainable. We have had difficulty financing the deficit this year with private capital inflows. In the first quarter of this year, that reluctance of the private foreign investor to keep on providing money at the pace needed was reflected in the downward movement in our exchange rate; but that was stopped by the Louvre agreement. Subsequently, it seems to me, the pressure generated by this reluctance of foreign investors to put as much in as they had so willingly in earlier years was reflected in rising interest rates. We had marvelous stability in the exchange rate but our bond rate was under upward pressure because of reduced foreign demand. And that is what ultimately led to the big drop in the stock market. The market had become extremely overvalued relative to bond rates of return. Standard & Poor's 500 was yielding 2.7 percent at a time when intermediate-term governments were yielding almost 10 percent. That was the biggest spread between dividend yield and intermediate-term bond yields in history. So it was clearly an unsustainable situation. Now we have to try to figure out how we permit the dollar to adjust downward without that being transmitted into upward pressure on the long-term bond markets. And I think that's going to be a very tricky proposition for us. But there is no doubt in my mind that we have to go to a much lower level of the dollar. The question is: How can we keep the domestic economy moving ahead even at a relatively modest rate in that context? I attended a

meeting at the St. Louis Federal Reserve Bank where a couple of bright young people from the Board presented a superb paper. I hope that it has been distributed at the Board because it tells a lot about why we have not had any more adjustment in our trade account than we have had thus far. And the reason is that the import price levels have gone up at an amazingly low rate. In the most recent period, reported yesterday I think by the Bureau of the Census, import prices went up in the third quarter by less than 2 percent; I think that reflects, and the paper supports this, that foreign producers who have gotten into this market are very reluctant to give up markets here and are going to try to hang in here as long as they can. It seems to me that it is going to take a level of the dollar well below any long-term equilibrium level to begin to make the kind of progress I think we have to make in reducing our foreign deficit. So our problem for the next few months is going to be a very tough one: How do we handle this ball of wax on the declining dollar and avoid not putting all kinds of pressures on long-term bond rates that are going to be very destabilizing for the domestic economy? If we have another runup in rates, we are going to see a new low in the stock market. I don't think there's any question about that. So, I think it's a most unstable financial situation. I wasn't around in 1929--at least I was not old enough to know what was going on--but I can't recall a period when we have had such an unstable financial system as we have right at this moment.

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. At the last meeting, I argued that we were moving toward a much better balance in the real economy and I think that is still on track. I think we now are moving also toward a better balance in the financial economy. While there is uncertainty around, we have eliminated some of the excesses that Frank Morris was taking about a minute ago. If you look at the stock market, after all, we came from a high of over 2700, so the glass has been drained by about 25 or 30 percent but it is still three quarters full. And that is not a bad position. Essentially, we are back to where we were at the beginning of the year. In one fell swoop, we have wiped out inflation, or sharply reduced inflationary expectations, and that has given us a lot more breathing room on the interest rate front as well. And now I think what's in train is a better balance in the world economy as well, with exchange rates now getting very close to levels that would be sustainable on a long-term basis; and the imbalances in the world economy will be reduced, as a lot of people have talked about before. By the way, on the budget deficit side, the lower interest rates also clearly will help in holding the budget deficit to approximately current levels. And nobody has been talking about the threat of protectionist legislation; that has also gone away, I think, to a large extent. So, I think there are a couple of bright spots in a gloomy situation that we shouldn't overlook. I agree that there is all this uncertainty but, if we keep following that path, I think we will see the light of day pretty soon.

CHAIRMAN GREENSPAN. Is there anyone else?

MR. JOHNSON. I really don't have much to add but I'll put in my two cents' worth. I basically agree with Ed Boehne's view about the domestic economy that it's too early to tell what the effect is going to be of all this. We really don't have any serious data at

this point to evaluate the situation. I think we are probably not going to get data that we are going to feel confident about, in terms of being symptomatic of the effects of this, until a couple of weeks, maybe. Retail sales data are three weeks away; we may have some early car sales data and things like that but the orders impact of this is down the road. There's a lot of information that still is not available; the only thing we really have at this point is some of the sentiment indexes. So, we don't know how to read the overall impact, although I agree with Ed that it's hard to imagine sentiment improving as a result of this. I think it's pretty clear that there is an additional air of pessimism about the outlook that didn't exist before and that expectations definitely have changed. What effect that's going to have is difficult to tell.

If you look right now at the fundamentals in the economy, they do look good; I agree with Bob's point on that. Things are adjusting fairly nicely in the way that we expected and in the way the staff had described in the forecast. We are seeing a transition, I think, from domestic aggregate demand to more externally generated growth. I think that is positive and it still seems to be continuing. One of the things I worry about now--after the fact, with this change in the financial markets--is that that export-led growth may come under some pressure. Even though the dollar is obviously weaker, it is going to improve, I think. In that relative sense, other problems are going to [damp] the prospects for export-led growth. One of the issues in the financial markets is that foreign stock markets around the world actually have fallen more than the U.S. market. In percentage terms, they have all come down by more than the New York Stock Exchange composite. So, the stock market impact abroad is greater than it is here. What that means is really not clear. But combine that with [these other developments]: the fact that interest rates in those countries are relatively higher because of the fall in interest rates here recently and the not very large adjustment in interest rates abroad; the fact that their currencies are appreciating, and therefore, damping their ability to export; and the fact that if income is going to be falling here, we are going to be demanding less in terms of imports from those countries. So, not only is there going to be an income effect on them, there is going to be a substitution effect. And I think the question is: How strong are those economies going to be? And how strong is our external performance going to be under those conditions? I don't really know; I just think there are big uncertainties. And I agree with what Jerry said: we need some flexibility at this stage, but it's really too early to tell what is going to happen. We need to maintain our flexibility, but we need to face the reality that the world has changed. Sentiment and expectations are different, both in real growth and in inflation; and I think we have to acknowledge that.

MS. SEGER. The two words that I think describe most completely what is going on are confusion and uncertainty. All of the business economists and business people I have spoken with in the last couple of weeks admit to both of those. Practically no one pretends to know exactly what the impact of the financial market disturbances will be, but almost everyone expects some sort of an impact. Probably the most dramatic adjustment that I witnessed was at

where, unfortunately, the event caught them in the middle of the planning season for 1988. They immediately knocked 5 percent off their sales forecast up through the next year and also looked for

two plants to close--a truck plant and a car plant. Their view was that back in the early 1980s, when the auto industry was going into the pink, they said they were cutting off a finger at a time rather than doing major surgery. So, this time around they want to be prepared for more dramatic and significant adjustments if, in fact, they are needed. They are watching very carefully what is actually going on so that they can do additional adjustments if necessary. They also have made some dramatic changes in the management of their pension funds, which are very, very large. They have cut back on the percentage invested in equities. They also have cut back on the percentage in long bonds and have moved into a very liquid position. I just mention that because I think it is one specific example that some people in the business world are reacting.

Not knowing what is going to happen, I guess one of my nightmares is that what might happen is that consumers will cut back on their spending, as Mike has laid out in the Greenbook estimates, except that they will cut back a little more dramatically even than we are estimating in the next couple of quarters. The rich lawyers will continue to buy Mercedes and Peugeots and Hondas and things like that that are produced abroad but they will cut back on their consumption of domestically produced items and, therefore, we will get sort of a double whammy: we will have the weak consumption but, also, we will not see the import situation improving as much as we are expecting now, and as much as I certainly would like to see. Yet, I am not saying we are going to get a recession; I don't really know. But I think we ought to think about what the risk is, and ask: If we do get a recession, is that going to help the problems that Jerry Corrigan has ticked off? I don't think so. Going into a recession with a heavy debt load doesn't usually make the debt load any lighter; it just makes it look a lot heavier to service. Also, I don't think that a recession here would help our trading partners. As I read the growth numbers in Germany, Japan, Canada, and some other countries, it seems to me that they are not all that robust anyway. They do depend a lot upon their business dealings with us and, therefore, I can't imagine that we wouldn't take many of them with us, which in turn, would make our new-found ability to export a lot more difficult to take advantage of because you have to have somebody to buy those exports that we now can produce efficiently. So, to summarize, I just am concerned. And I really think that we ought to watch the incoming data extremely carefully for signs of more weakness than we are now expecting.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Very briefly, Mr. Chairman, I think most things have been said, but just to get on the record here: While I agree with Bob Boykin and others that the situation is fragile, particularly in the Eleventh District, which I am still pretty close to, I share Bob Heller's view that there is a lot of room for being optimistic about a light at the end of the tunnel. The risks here, I think, are two primarily. Number one, as Ed Boehne and others have said, no more shocks is the key. If we can avoid that, I think things will be enormously optimistic. I also agree with Governor Seger that it is very important that we--and I mean we in the corporate sense--do whatever we can to avoid a recession, which is in nobody's interest at a time like this. So, those are the two things that I would like to keep a weather eye to: have no more shocks and avoid a recession to

the extent that we can do that. I would like to comment briefly on Jerry Corrigan's concern about the high level of debt, which has been one of my favorite themes also. I think that ties together with Frank Morris' comment about the pressure for market share that people feel. The creation of all of this debt has put people in a situation where there is enormous pressure to produce; that's not only true for foreign economies and their pressure to maintain market share here but it is also true domestically. People who are in debt need to keep their jobs. So perhaps if there is a good side to all of this debt creation, it lies in the fact that it puts tremendous pressure on everybody to be productive and, thus, it should have a long-term downward drag on the inflationary concerns that we all have.

CHAIRMAN GREENSPAN. We haven't heard from Presidents Guffey and Hoskins. Do either of you wish to add to the body of knowledge?

MR. GUFFEY. Well, Mr. Chairman, I don't think that I can; so I will respectfully pass.

MR. HOSKINS. I would speak only with some trepidation, since my first FOMC meeting by telephone resulted in a 508 point drop in the stock market. I will make another observation, however. I have been a Reserve Bank President about three weeks now and I've probably participated in more FOMC meetings in that time than any other three-week President. In terms of the Fourth District, it is probably very typical--similar to what Si Keehn has indicated. We polled [District contacts] prior and after the problem in the market and, basically, heard of no major pullbacks in either capital goods or on the retail side. The only comment I would like to make is that I do have some concerns about the dollar and any attempts to keep it at a level that is other than what the market wants, particularly, if we signal that as policy makers through interest rates.

CHAIRMAN GREENSPAN. In view of the time, it's probably advisable to break for coffee, assuming that it hasn't gotten cold yet. Then we will come back and Don Kohn will brief us on monetary policy.

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

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

CHAIRMAN GREENSPAN. Are there questions for Mr. Kohn? Mr. Stern.

MR. STERN. Given all the uncertainties and everything, what do you have for the forecast of aggregate growth for the first quarter or two of next year. You seem to have a sharp, or at least what I would call a significant, slowing late this year. I'm just curious about what you have.

MR. KOHN. We would have growth picking up in the first couple of quarters of next year, primarily because of the effects of the lower interest rates in the fourth quarter. For example, we have M2 picking up a little to a range of 6 to 7 percent in the first half of next year rather than the 6 percent we have this year. We have M1

slowing down a little, but that's partly because demand deposits push up the fourth quarter. Basically, we have these offsetting effects: we have interest rates declining and that tends to push up growth, especially as the previous increase in interest rates wears off toward the end of this quarter and the beginning of next quarter; but, of course, we have lower income growth and reduced wealth, and that tends to keep monetary growth down. We see some stronger growth--

MR. PARRY. Why is there such a significant change going from November to December?

MR. KOHN. On M1?

MR. PARRY. Yes M1, and a little on--

MR. KOHN. It's partly the monthly averaging results of the gyrations in demand deposits.

MR. PARRY. All right.

MR. KOHN. In fact, we had demand deposits not declining until another week or two; they declined earlier than we were expecting, so I'd expect a lower November and then a little stronger growth rate in December. It wouldn't affect the September-to-December path.

CHAIRMAN GREENSPAN. Any more questions?

MR. MORRIS. I have an impossible question for you, Don. If the dollar goes down significantly in the next couple of months, which I think is going to happen, how do we prevent that from spilling over into a rise in bond yields? That is the conflict we are going to be faced with in the next month, it seems to me.

MR. KOHN. I'm not sure you can. But my thinking on this is that the important variable here, as to whether or not that happens or the degree to which that happens, is the way people are assessing the economy. Think back a year or a year and a half ago, to 1986, when we had easier monetary policy, dollar declines, and the bond market declining for the first part of the year. Now, oil prices and inflation expectations were important there; [they were expected] to be stable through the rest of the year even as the dollar continued to decline. But that was in an environment in which inflation wasn't expected to pick up: incoming data were suggesting very little inflation and the economy was widely viewed at that time as being quite weak. So, I think if a dollar decline occurred in an environment in which people thought that the economy was weak or that the chance of a pickup in inflation wasn't large, then the bond market effect would be muted; but if the economy didn't look [weak], as a response to the stock market, for example, and the dollar started dropping rapidly, we could be back where we were this summer.

CHAIRMAN GREENSPAN. Any other questions of Don? Let me start off with a review of where I think we have been. In a certain sense, we have been very fortunate for the last couple of weeks. We chose to supply the demand for excess reserves in the system. We did it essentially by endeavoring to target the funds rate because, obviously, if we target the funds rate then we automatically supply

the demand for reserves at that interest rate. And, in that context, it's crucial that you come out with the right rate. I think we fumbled into it and, at least in retrospect, it looks as though it came out to be about where it should be: namely, slightly under 7 percent. As a result, I think we have seen a marginal return toward the normal relationships, defined in this context as reflecting the differential yield spreads and the basic flight--or crash--to quality that seemed to be occurring at that point. We can go on with this policy for a while, and my impression is that we have very little choice but to do that. I think, however, it is important to remember that we have a number of sequential dangers out there. I think the one of utmost importance, against which all efforts have to be directed, is what I would call a flight from the future. At the moment there is investment going on in the longer term of this country. In other words, people are buying longer-term bonds; they are still buying stocks, and yields are not all that bad; the exchange rate is soft but it's [not] falling on its face. It is not all that difficult to imagine a less developed country scenario where what we had would have led to a dramatic collapse in the exchange rate, a huge rise in long-term bond rates, or the effective disappearance of the long-term bond market. Obviously, under those conditions the stock market would fall away and everything would implode into the short run. And the bill rate would collapse, and we would have all these crazy, horrible events that none of us thinks can happen until we see them. Now that's the type of scenario that would force us, just to preserve the system, to move the discount rate up two or three points. And then we would get into the types of problems that a historic monetary collapse always creates. We are far from that at this stage, but I suspect a lot nearer than we would like to believe, because financial markets have been so inherently unstable, just looking at the variations in volume and prices. The evaluation process which runs stocks the way they have been running in the last two weeks suggests a degree of uncertainty--especially a degree of uncertainty, potentially, in the foreign exchange markets. We could very readily see a major endeavor to shift portfolios out of dollar-denominated securities into those denominated in other currencies. That obviously can't be successful, after the fact, but it can have powerful effects on the exchange rates. I think, as a consequence, this is a potential danger out there.

Obviously, we have to be very cautious about how we move from the path that we are on toward a more stable regular policy-oriented position. Consequently, as I said, I see no real alternative to trying to operate, roughly, along the lines of what we are calling alternative "B" at this stage. Hopefully, if this situation continues to stabilize, we will be able gradually to pull away from funds rate targeting and allow the supply of excess reserves to fall with the decline in demand. At that point, obviously, we will be seeing a closing of the bill rate/funds rate spread and presumably we will be seeing the longer-term corporate Baa less U.S. Treasury spread come back down, and the junk bonds even will look almost saleable. But we are still a goodly way away from that; we are still not normal. These are not anywhere close to normal relationships, normal credit conditions, or normal attitudes in the market. I think there's a sense of relief out there, but I don't think it's anywhere close to a sense of stability. The fact that we have had a 500 point drop in the Dow, as far as I'm concerned, has now changed all the program trading, all of the different types of risk operations [unintelligible] people

take. It's hard for me to see the stock market going all the way back to where it was. I think the risk premiums that are now associated with what could happen have [unintelligible]. It is conceivable, therefore, that in retrospect this whole thing could turn out to have been a remarkable blessing. I must tell you that the odds of it coming out that way cannot be very large, but they are not zero either.

In any event, strangely, I don't think we have a policy problem, at least as I see it, as to what our policy should be, because it seems that it should be just an automatic continuation of what we have been doing, so we can phase into something more permanently. There is also the issue of how we portray ourselves to the public. And that's not only the issue of what we do but of how we say it--how we write down the directive--because this particular directive is going to be disaggregated in such detail that periods and misprints are going to be read as having great, great importance. So, I merely wish to say that I'd appreciate not only your thoughts and your usual comments here on the issue of policy--the borrowing--but also your recommendations on how we portray ourselves to the public at large in the specific formulation of the directive, taking any revisions from what we tentatively put down in the Bluebook. Governor Angell.

MR. ANGELL. Yes, Mr. Chairman I'm delighted to have you take that position. I support you and alternative "B" and borrowings of \$450 million. But I'd like to suggest somewhat of a variation on that in regard to the fed funds range. Ordinarily, we would leave it at 5 to 9 percent; but it seems to me that there are about three reasons why we might lower that to 4 to 8 percent under alternative "B". And in part, this speaks to how that would be interpreted as people read these minutes. In regard to President Morris' comments about upward movement in interest rates, a dramatic movement upward to the 9 percent fed funds level seems to me very unlikely; that probably would be destabilizing in financial markets. So I'd really rather have that upward bound down a point. I'd also like to have the lower bound down a point to 4 percent because, while we are not anticipating it, there might be some circumstance between Open Market Committee meetings that would give us the flexibility [to move] downward, and that might be appropriate. So, 4 to 8 percent on the fed funds range, even though it would maintain the policy stance about where we are, would give us a slight variation. Frankly, I would prefer staying with variation II of the language [shown in the Bluebook], which is the more normal expression. It just seems to me that the additional language shown in variation I could pose difficulties. The very nice thing about the statement that was released by the Board Tuesday morning, October 20th, was that it was very simple and short. And I would prefer in variation II to have the words read "slightly greater ... might" and "somewhat less ... would" be acceptable.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Well, Mr. Chairman, you're very persuasive in terms of keeping things where they are, but I have a somewhat different interpretation of where we are. It seems to me that we are somewhere between alternatives "A" and "B"; we may be closer to "B" than to "A", but I think that we are in the "A" - "B" range for policy, with a federal funds target of something under 7 percent,



perhaps 6-7/8 percent or just a touch higher. It strikes me, therefore, that if we go with "B" that we will, in effect, be tightening somewhat even though it's a subtle tightening. And I sense that if we deviate at all from where we are, that it might be better to ease just a touch. So I come down being in the alternative "A" column. It's true that we have a lot of uncertainty and we don't know what's going to happen. But I do think there have been enough changes, at least in terms of shifts in the direction of the risks, that it is important for us to help anchor the lower rates that we have achieved the last couple of weeks. And it seems to me that something closer to "A" than "B" helps to do that, because those lower rates that we have had are important for offsetting the effects that we are going to get from the stock market. I think that it ought to be clear that the Federal Reserve is trying to do that; and I think that alternative "A" does that less ambiguously than alternative "B". Clearly, there is a risk in the dollar but, as I judge the situation, we're not talking about very much of a change in rates and it seems to me that the environment is such that we could probably absorb that risk at the moment. I would prefer Variant I of the language because I think it says more clearly what we are doing, and I think it's important that the directive that we put out says what we're doing. Even though the language is different, and we have words like "being flexible" and so on, that's exactly the situation that we are in. So it seems to me that's what we ought to go with. If we go with alternative "A", then I think some symmetrical language is appropriate, with "somewhats" and "mights" on both sides. Now, we are effectively operating on a federal funds strategy. When we were on a federal funds strategy in the 1970s, we tended to have Open Market Committee meetings every three or four weeks. As we moved more into a reserve-based strategy, we were able to lengthen out the meeting intervals to every six weeks or so. So it seems to me that wherever we set the funds rate today, we are going to have to look at it very frequently. And I would think that we ought to plan at least one telephone meeting two or three weeks hence, simply because if you're going to operate on a federal funds target, by necessity you have to have more meetings.

CHAIRMAN GREENSPAN. May I just interpose that we have interpreted what we are doing as alternative "B". Let's try to make certain that we are not dealing with differences of current perception. Don, do you want to address this issue? What I don't want to happen here is to have differences which really relate to what we are doing as distinct from where we want to be.

MR. KOHN. We, of course, wrote "B" as \$450 million because that's what we have been writing into the reserve path. I think you can make an argument, and Peter perhaps will want to comment on this, that we really have been operating a bit easier than a \$450 million borrowing level might suggest. If you wanted to be certain, or as certain as you can be on this sort of thing, that the center of gravity for the funds rate really was below 7 percent and that it's more likely to average in the 6-3/4 to 6-7/8 percent area and touch 7 percent only seldomly, then a \$400 million borrowing target might give you a little more assurance in that regard than a \$450 million borrowing target. And maybe that is a little more consistent with what we have actually been doing. Peter, do you have more?

MR. STERNLIGHT. No, I think that would make my point; I regard that kind of thing as within the flexibility that is stated in the directive.

MR. BOEHNE. Well, rather than say alternative "A", "B", or "C", let me say that I would prefer to have the funds rate centered on 6-3/4 to 6-7/8 percent rather than around 7 percent. Now whether that's "A"--

CHAIRMAN GREENSPAN. Well, that's actually where we are.

MR. ANGELL. That's where "B" would be.

CHAIRMAN GREENSPAN. That's where we think we are at the moment.

MR. BOEHNE. But we are talking here about alternative "B" delivered--

MR. JOHNSON. Just take whatever borrowing is consistent.

MR. BOEHNE. Right, but as I read the Bluebook, under alternative "B" we're talking of a funds rate centering more around 7 percent.

MR. ANGELL. No, no.

MR. JOHNSON. That's what "B" says.

MR. BOEHNE. That's what "B" says, yes.

CHAIRMAN GREENSPAN. I think that's a rounding question.

MR. BOEHNE. Well, I'd like to round it to 6-3/4 percent, if that's current policy. I'm for current policy; if that's "A", I'm for "A".

MR. ANGELL. Mine also would be [current policy]. I would presume that bringing the wide range for the fed funds rate down to 4 to 8 percent would be more consistent, in the short run while we are in this period of greater flexibility, with a short-run policy in which we would really hold it and not let it go to 7 percent and not let it go above 7 percent.

CHAIRMAN GREENSPAN. Ed, what borrowing number were you thinking of? Are you thinking of \$250 million, which is what the "A" number actually is?

MR. BOEHNE. Well, I am not very concerned about the borrowing figure. I want a 6-3/4 percent funds rate.

CHAIRMAN GREENSPAN. You are targeting the funds rate?

MR. BOEHNE. If that takes \$300 million in borrowing, I'm for \$300 million; if it takes \$400 million, I'm for \$400 million.

CHAIRMAN GREENSPAN. Well, the borrowing assumption is in there. When you're dealing with this sort of market it just breaks away from--

MR. BOEHNE. That's right, so I don't think--

CHAIRMAN GREENSPAN. You have to make a distinction of whether you want to do borrowing or you want to do the funds rate.

MR. BOEHNE. I want to do the funds rate; that's what I want to do.

CHAIRMAN GREENSPAN. You have made your point. President Black.

MR. BLACK. I think the point at which you arrive has to be dependent in part on what you think really happened to the stock market: whether it came from real shocks or liquidity shocks or some combination. I lean to the view that it was more real, along the lines of what Frank Morris was describing earlier, in that the earnings-price ratios had gotten totally out of line with the bond yield. And then there were a couple of sparks that set it off: the problems in the Persian Gulf and the likelihood that we were going to enact some very severe protectionist legislation. At the same time, I think there were liquidity shocks once this happened. And I think we met those liquidity shocks, as we ought to in such a case, when we issued a statement that we would provide liquidity. But as far as these real shocks are concerned, I don't think there's a lot that we can do about that through policy. So, I would come out, I think, right where you did on this, Mr. Chairman. And like Ed Boehne, I would look through the borrowing to the federal funds rate and [seek a rate] of around 6-3/4 to 6-7/8 percent, which I had interpreted as being a little on the easy side of "B" as it was written in the Bluebook, but which you now have convinced me is really what you had in mind. In view of the way in which this directive is going to be dissected, I think it would be good to go with Variant I. But there are a couple of references in there that would bother me and might confuse the market. If you look at the references to greater flexibility on lines 105 and 106 of the draft that was distributed with the brown cover, that need for greater flexibility, I think, could be a little confusing to the market. It isn't clear to me what it means and I don't think it would be clear to the market. I would hasten to add that this reference to our intention to ensure adequate liquidity is perfectly clear to me and I think it's obviously appropriate. So, on the wording of this, I would tend to end up the same way Governor Angell did in saying somewhat lesser restraint "would" and slightly greater restraint "might".

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I would favor Bluebook alternative "B", which I would interpret to mean a funds rate of around 6-3/4 to 7 percent. It seems to me that with rates at that lower level relative to what we had been looking at six weeks ago, we will offset most of the negative effects of what has happened in the stock market. In addition, I would favor Variant I and it seems to me that, given the uncertainties, symmetrical language would be appropriate.

CHAIRMAN GREENSPAN. I'm sorry, what language?

MR. PARRY. Symmetrical.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, I agree entirely with your analysis of the situation, given the uncertainty and the potential for additional instability in the market. I think that alternative "B" is the correct alternative for policy in the short term. I would target the federal funds rate at 6-3/4 percent; I wouldn't worry about borrowing. In order to get the message across to the markets as to what we are doing at this very critical time, I would favor Variant I. One point I would make is that the foreign exchange market developments seem to me to be more significant than indications of inflationary pressures, so I would be inclined to move that up in the hierarchy of expressions there. And I think it is important to keep the language related to frequent consultations. We need to let the market know that we are aggressively and actively involved in this whole situation. I would prefer a tilt in the directive towards easing, which would lead me to favor asymmetrical directive language.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, I'm right along with everyone else. I favor the 6-3/4 percent funds rate, which I guess I would have described as "A-" or "B+" going in [to this discussion], but your description of "B" puts me there, so I don't have any problem with that. On the borrowing number I was thinking \$300 million, but I guess that becomes whatever it becomes, given the funds rate that we're looking for. On the language, I favor Variant I; I think saying as well as we can what is going on is important. Of course, that won't be released for about six weeks and that's a while down the road. If any misinterpretation seems to be going on in the markets as to what we are doing, maybe another statement such as the one released earlier would be called for. I thought that was very, very appropriate. I like things even on both sides as a rule, so symmetric language always appeals to me.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I favor alternative "B". I have one question I want to raise. If you look at the directive in the policy record that comes out Friday and then you look at this language here, it's really not clear what "existing" means. Nowhere in the policy record is it memorialized that there was an adjustment in the borrowing target; we don't put borrowing targets in there. I think it was generally perceived, but it is not recorded there in any fashion. That may be something to think about. In any case, I would like to express a little concern along the lines of what Jerry said about balance here. There has been a major shift in policy; and the broad perception of policy, I think, was that we were headed toward further degrees of tightening at the last meeting. That has been washed out and there has been some easing. Now, on the balance side my argument would be this: I guess I never felt that we could defend a particular level of the dollar--that's going to be set by market forces. So, maybe now the fact that the dollar has moved down and there haven't been major

adverse effects to that is okay. In the short run I think we can influence how that transition to the different levels takes place and whether it's orderly or not. But it seems to me that any changes in monetary policy that we make now add to the perception that all that is happening is that the dollar is adjusting to reasonable market levels. What I'm trying to say is, if it's perceived beyond that that monetary policy is being conducted in a fashion that we really think we have the latitude to run out of sync with the rest of the world, that would be very damaging to that future psychology that you've described. In other words, I think we have lost the flexibility to ignore what goes on in the rest of the world here. Policy coordination is important and I hate to see us take a policy stance in the short run that might fuel that perception that we somehow backed off the need to do that for all the reasons we have discussed on the financial and the real side today. So, in any case, I favor "B" and symmetrical language. I think Variant I is fine but I come out where Bob Black is: in a sense there are too many statements in there dealing with the extraordinary circumstances; it might convey more of a sense of uncertainty about current conditions than we want to convey. I think I'd stick with what Bob suggested on that first statement--

MR. JOHNSON. What did Bob say? Did he say just take out that other sentence, or what did he mean?

MR. MELZER. Well, I think what he was saying was stay with the desire to ensure the provision of adequate liquidity. But the statements about flexibility in open market operations in lines 90 and 91 and then around line 105 or so in the part about the frequent consultations would be thoughts I would be inclined to take out. I think our actions are more important than our words, and I think the perception of our actions in the financial markets is a positive one. I think the perception is we are doing the right thing.

CHAIRMAN GREENSPAN. Norm tells me that the adjustment and the switch will be noted in the next policy record.

MR. MELZER. It will be?

MR. BERNARD. That's our normal way to do it, yes.

MR. KOHN. But not in the one that will be released Friday; you're right about that.

MR. MELZER. Right; so in the verbiage that leads up to this directive we are indicating--

MR. KOHN. Right, the one that will be released Friday leads up to the last meeting.

MR. MELZER. I think that's fine.

MR. KOHN. It does have a paragraph in there, however, noting that the Committee has been consulting daily over this period; so it says that the Committee has been meeting and reviewing operations.

MR. MELZER. If we are adopting the existing degree of reserve restraint now, that somehow implies that a change, in a policy sense, occurred prior to this action.

MR. KOHN. Right; and that would be covered in the policy record associated with this meeting.

MR. MELZER. But let me ask you this, Don: If there had been a telephone call at which that was specifically put to a vote would it then have been reported as an addendum?

MR. KOHN. In the one that comes out Friday, yes.

MR. BERNARD. Yes.

MR. MELZER. You know, that's a small subtlety.

MR. KOHN. A possibility, if the members would want it, would be to expand the paragraph that has been added [to the policy record that comes out Friday] that mentions the consultations. We could reference something about some easing in policy to go with that language.

MR. MORRIS(?). Yes, I think it would be desirable to do that.

MR. KOHN. That would be released this Friday.

MR. PARRY. I think that would make some sense.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I am happy to get on the "B" band wagon, or some variant of the "B" band wagon, I guess. It seems to me that that is the appropriate posture for us at the moment. In my mind, we have moved a significant degree already, and I think the results generally have been satisfactory. One danger that I think we want to avoid here is what I might call oversteering; and I think holding with something like "B" is a step towards avoiding that reaction. I think Frank Morris has posed a dilemma: How do we keep weakness in the dollar, if it persists, from spilling into the bond market? I bring up that subject just as a reminder that I think the most logical way to get out of that trap is to actually succeed in doing something meaningful in fiscal policy here. But that's still a very much unresolved matter.

CHAIRMAN GREENSPAN. Indeed it is.

MR. STERN. But that's another reason why I would--

MR. BLACK. It is something we don't have a lot of control over.

MR. STERN. No we don't; we probably don't have any. But I think that's another reason not to oversteer or overreact at the moment. We don't know how that is going to play out and we don't have much influence on it. I would prefer some language like Variant I just because, as Tom [Melzer] and some others have suggested, these

are extraordinary circumstances and I think our language should reflect that. I guess I'm not all that concerned about exactly how we fine tune that language at the moment. I would pick something like "B" as a starting point, and I personally would prefer asymmetric language in favor of lesser restraint because it seems to me that it is highly more likely, as we go forward here, that if we are going to move at all that is the direction we are likely to want to go.

MR. PARRY. If your concern is about the dollar why would you then go in that direction?

MR. STERN. No, I didn't say I would resist declines in the dollar; I just said that I think the outcome may be largely out of our hands.

MR. JOHNSON. By a variant of "B", did you mean the revised version of "B"?

MR. STERN. In my mind, it's something like a \$400 million borrowing target with the expectation that the federal funds rate will be 6-3/4 or 6-7/8 percent or thereabouts.

MR. JOHNSON. Okay, that's what "B" means from now on, right?

CHAIRMAN GREENSPAN. Yes. We do have a problem here, though. Let's focus on it because I may have to re-poll [those who have commented already]. Listening to everybody so far, everybody is locking into a funds rate that is very much more narrow than the funds rate that we are stipulating in this directive. The question that we have to decide is this: In the process of formulating this directive do we go with these very broad funds rate ranges, which is what would be consistent with a specific borrowing target, or do we go with a much narrower funds rate target, however we publish it, and have a much broader range on the borrowing side? It's very difficult to encompass the type of funds rate targeting that we have been hearing around this table in terms of 5 to 9 percent or 4 to 8 percent. This is a choice.

MR. MORRIS. Mr Chairman, I might request that we eliminate that last sentence in Variant I, because we are talking about stabilizing the funds rate for a short period. It is a temporary policy, and I don't think it makes any sense to talk about a range of 4 to 8 percent or 5 to 9 percent. I think we ought to admit that we have temporarily changed the operating procedures; and that would imply that we ought to get rid of that last sentence and not talk at all about ranges that way.

MR. BLACK. Mr. Chairman, I don't think it's all that different from what we have, in fact, done. We have had this wide range but it has been understood that we have had a borrowing number that was associated with a much narrower federal funds range. And we didn't change that [sentence] then. I think we probably would have met and changed that borrowing level or changed it without meeting.

MR. ANGELL. Well, I would certainly be opposed to our going to an announced narrow fed funds target. It seems to me it is very important that we do not have the semblance of returning to the 1970s style, which would really require frequent consultations to move it,

and would give some the impression that over the long run we might be willing to allow whatever reserves might be consistent with that. I would much prefer to have the wider range but with a temporary understanding, as we have had in these recent weeks, that we expect it to be in the 6-1/2 to 7 percent area.

VICE CHAIRMAN CORRIGAN. Let me just make a couple of comments about policy generally, and then I may have some language here that can encompass a lot of what is being said. First of all, to return briefly to this exchange rate question, I don't approach the exchange rate as a matter of theology; I approach it as a matter of trying to balance the risks. And my principal point on the exchange rate is that I do see very real risks of a further substantial depreciation in the value of the dollar. I know certain things that it will do: it will add to inflationary pressures at home; it will work in the direction of putting greater pressure rather than lesser pressure on interest rates at home. I don't know how it works; but I know the algebraic signs. And I also know that, at least in the short run, it raises more questions about growth prospects abroad, in part, because of another elongation in the J curve. Now, I have to balance those risks against the hope that it will somehow accelerate the turnaround in the U.S. trade deficit, in a context in which there are a host of uncertainties--such as growth prospects abroad--that I think are more important than the exact level of the exchange rate. So again, it's not a matter of theology for me; it's a matter of where are the risks and what are the greater risks. Then, there is this question of debt deficits and debtor nations. The point that I was trying to get at in bringing that up before is that whether we like it or not, history tells us in rather unmistakable terms that a country that finds itself in the position that we find ourselves in right now is going to have higher interest rates than would otherwise be the case. There may be an example someplace, somewhere in history that's contrary to that, but I don't know of it.

CHAIRMAN GREENSPAN. It doesn't exist.

VICE CHAIRMAN CORRIGAN. I don't think it exists. The only other point I'd make is on this question of a measured approach to what we are trying to do here. I favor alternative "B" as Governor Johnson defined it a moment ago. But let me, if it's agreeable to you, Mr. Chairman, suggest some language here.

CHAIRMAN GREENSPAN. Go ahead, sure.

VICE CHAIRMAN CORRIGAN. This is built on Variant I, and I think it gets at a lot of the things that you have been saying. The first sentence, without prejudging decreasing or maintain or whatever would read: "In the implementation of policy for the immediate future, the Committee seeks to [decrease somewhat/maintain/increase slightly] the degree of pressures on reserve positions sought in recent days." Tom, I think that gets at your point. And I would remove the next sentence after the semicolon completely. Go down to the next sentence "The Committee ..."

MR. ANGELL. What was your first your sentence again?

VICE CHAIRMAN CORRIGAN. Take out all that stuff after the semicolon. I'm at Variant I. The first sentence reads: "In the



implementation of policy for the immediate future, the Committee seeks to [decrease somewhat/maintain/increase slightly] the degree of pressures on reserve positions" and I would insert "sought in recent days."

MS. SEGER. You think the markets know what that means?

VICE CHAIRMAN CORRIGAN. Yes, I think they do.

MS. SEGER. Okay.

MR. ANGELL. Recent days or recent weeks--either one?

VICE CHAIRMAN CORRIGAN. Well, either way; we can come back to that.

MR. KEEHN. Jerry, what's wrong with the next phrase?

VICE CHAIRMAN CORRIGAN. Well, let me come to that in a minute because what I was going to suggest in the next sentence, Si, deals with that, I think. "The Committee recognizes that the volatile conditions in financial markets and uncertainties in the economic outlook may call for a special degree of flexibility in open market operations" and then insert "depending, in particular, on demands for liquidity growing out of recent or prospective developments in the financial markets."

MR. PARRY. Would one be willing to say instead of "may call for" just "calls for"?

SPEAKER(?). Sure.

VICE CHAIRMAN CORRIGAN. But the idea, Si, is to get that all into one sentence so it's not too overburdening. Then the next sentence--and in my mind this is crucial--would start: "Apart from such considerations", in other words apart from the providing liquidity, etc. Then you would have your regular sentence with the somewhat or slightly lesser or greater reserve restraint. In other words, that next sentence would stay as it is. Others may not agree with this, but contrary to what somebody said, I personally would take out the sentence on the next page about relatively frequent consultations. We certainly can do that and may do that, but I think we ought to be trying to project not business as usual but not that we are ready to jump out the window ourselves. So, as I see it, Mr Chairman, a directive couched more or less in those terms would allow us to do what you certainly want to do and I gather what a lot of other people want to do. But it would stop short of a directive that becomes a federal funds rate directive. And at least in my judgment, it provides a bridge to go from these extraordinary conditions right now to a more "normal" environment, if circumstances permit.

CHAIRMAN GREENSPAN. What would you do about the very last phrase on the funds rate range?

VICE CHAIRMAN CORRIGAN. I'm agnostic on that; I would have a broad range there--5 to 9 percent or 4 to 8 percent; I wouldn't worry too much about that.

CHAIRMAN GREENSPAN. Okay, I will put your variation on the table. President Morris.

MR. MORRIS. I think I've already said my piece, Mr. Chairman. I have nothing to add to it.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, I'm certainly in favor of maintaining the current policy, which I interpret to be alternative "B". And I must say I like the Corrigan wording of Variant I; I prefer Variant I to Variant II because I think it is a more honest statement of what we are doing, particularly with the language that he is proposing to amend it. I'd have a slight bias in the wording toward easing, and using "would" [for easing] and "might" [for tightening]. I'd be in favor of maintaining a broad range for the fed funds rate. And I don't feel strongly about it, but I think in the interest of consistency and stability I'd stay with the 5 to 9 percent.

CHAIRMAN GREENSPAN. I'm sorry, what was the last phrase?

MR. KEEHN. In the interest of consistency and stability, I'd stay with 5 to 9 percent, but I don't feel very strongly about it.

CHAIRMAN GREENSPAN. Okay. Governor Heller.

MR. HELLER. I'm also in favor of "B" and I like the Corrigan language. Like Mr. Keehn, I'd go with the asymmetrical version. But on the fed funds rate, I think we should narrow it just a bit. You know, 5 to 9 percent--that's a barn door. I think the old practice of centering it around the expected value is useful. So if we narrow it a little--and everybody seems to be saying 6-3/4 percent--and insert 5-3/4 to 7-3/4 percent we have a 2 percentage point range rather than a 4 percentage point range. Maybe that gets a little of that feeling in there without moving to a very narrow fed funds rate specification.

MR. PARRY. That barn door is no wider now that it has been for years.

CHAIRMAN GREENSPAN. Oh no, it's different in the sense that it depends on what you are targeting and what you are leaving as a residual. So in that sense there is a meaning in doing that; the question is whether in so doing we also suggest a change in policy that we don't want to communicate.

MR. PARRY. I think so.

SPEAKER(?). I think that would, though.

MR. ANGELL. I think that would; that would indicate 6-3/4 percent. I wouldn't do it.

MR. HELLER. Well, I'm in favor of making policy clear rather than obfuscating.

MR. HOSKINS. I think if the Desk comes in on either side of the market around 6-3/4 percent, it is going to be pretty clear to the

market very quickly where we are; and they are not going to pay much attention to the borrowings.

MR. BOEHNE. I think that's right.

CHAIRMAN GREENSPAN. [Unintelligible] but it's one thing to be pegging the funds rate, which is not what the Desk is doing, and it's another thing to sort of be taking a shot at it in some direction. To peg the rate would have some interesting implications. Governor Kelley.

MR. KELLEY. Mr. Chairman, I'm very much a mainstreamer here. And I have nothing to add in the way of new reasons from what has been said around the table. I would go with Variant I because I think we need to be seen as being on the accommodating and concerned side here, with asymmetric language in the direction of ease. I favor alternative "B", and I would cut the announced funds rate range back to 4 to 8 percent, again to indicate tilting in the direction of ease.

CHAIRMAN GREENSPAN. For the Corrigan language?

MR. KELLEY. I like the Corrigan language.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. Yes, I think I'm right in line with everyone else: alternative "B" as we have defined it, Variant I, Corrigan language, and asymmetric. I think we are going to have a bit of a problem if during this intermeeting period we finally decide that we can move to a borrowing target. Making a transition from funds rate targeting to that could be a little touchy, even though we don't know when we will decide all of a sudden that things are stable enough to go from a 6-3/4 percent center of gravity on the funds rate to a \$400 million borrowing target, or whatever. I don't think it's going to work that smoothly. We may need to think about how we make that transition at some point; that might be a good time for a call.

CHAIRMAN GREENSPAN. I'd like to respond to that: I don't see how we can do that without a conference call. Governor Seger.

MS. SEGER. I guess I can go with "B" but as I reread the Bluebook here for the seventh time, it looks to me as if Don Kohn was saying that all of these alternatives--"A", "B", and "C"--assume financial markets will return to conditions of normalcy, whatever that is.

MR. KOHN. Well--

MS. SEGER. And down deep in my stomach I'm just asking myself: What if, in fact, we don't? Which alternative should I vote for? Should I vote for "A" now because that possibly would allow us the greater opportunity to deal with abnormal times or do I go with "B" and assume that if the roof falls in we will at that point make a policy shift?

CHAIRMAN GREENSPAN. If the roof falls in there is nothing to choose between those two alternatives.

MS. SEGER. Then you go to "E" and "F" or something like that. So having said that, I would go with "B", the Corrigan language, and the asymmetric language tilted toward ease. And on targeting the fed funds rate, frankly, I would rather see it a little on the soft side of 6-3/4 percent rather than between 6-3/4 and 7 percent, because I think the fed funds rate is viewed as out of line now with other short-term rates. If we are really interested in communicating clearly what market participants--

MR. ANGELL. You want what on the fed funds rate?

MS. SEGER. I would put a range in the statement, but I'm saying as an operating matter that I'd rather see us go to the low side of 6-3/4 percent rather than going 6-3/4 to 7 percent. I would rather see us really targeting somewhere between 6-1/2 and 6-3/4 percent because I think that the funds rate is quite a bit out of line with other short-term rates.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I would join those who would opt for "B" with asymmetric language towards ease--that is, if "B" as it has been defined means a funds rate around 6-3/4 percent or a bit higher, and I think it clearly does. I also would adopt the Corrigan language, particularly if I understood Jerry correctly, that he wants to delete from Variant I the language referring to relatively frequent consultations. I think that highlights something that six weeks or eight weeks from now, when this is released, perhaps will have more meaning than we want to give to it. On the federal funds rate range--although quite clearly we are targeting the federal funds rate within some very narrow range, it is under very unusual circumstances--to change that language in the last sentence from 5 to 9 percent to 4 to 8 percent is a bit meaningless and, in my view, unnecessary. I'd leave it at the present range and keep it as broad as it is.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. I don't have anything to add to what has been said with respect to alternative "B". I think I like the Corrigan language; I'd prefer the funds rate about where it has been--I don't have any problem with that. I would not want to err too much on the high side in terms of a federal funds rate over 7 percent because I think that might send the wrong signal to the market. I think the point that Manley Johnson raised is an important one: that it may be difficult when do we shift from a mode of providing liquidity back to some kind of monetary aggregate. And I think I would be remiss if at my first opportunity with all of you I do not mention the monetary aggregates. In that regard, they have been growing slowly relative to trend for six months or more. The staff projection for M2 is 4-1/2 percent, fourth quarter over fourth quarter and that's down from a trend rate for two years of roughly 9 percent. That usually is considered a significant change with some real impacts; however, that's not for this meeting.

CHAIRMAN GREENSPAN. I think we can feel the consensus, which surprises me in a sense but--

MR. ANGELL. Could I ask a question about the Corrigan--

CHAIRMAN GREENSPAN. We didn't listen to what Governor Heller--

MR. HELLER. It's a very minuscule point: in the draft directive with the brown [Class I] cover, lines 20-21, we say "business capital spending was strong in the third quarter and forward indicators pointed to continuing gains." I think that's a little strong. It's certainly getting a lot slower. Maybe we could just drop "forward indicators pointing to continuing gains."

CHAIRMAN GREENSPAN. It is not "pointing"; it's "pointed".

MR. HELLER. Yes, "pointed".

MR. KELLEY. No, that's an important difference.

MR. HELLER. Yes but pointed to continuing gains, though.

CHAIRMAN GREENSPAN. Well, it's technically correct if you think about it. It is past tense: that the indicators in that period pointed to continuing gains.

MS. SEGER. Since then it has changed.

CHAIRMAN GREENSPAN. It's not discussing the continuing gains, it's discussing the indicators.

MR. HELLER. Well, I certainly misread it and I think others may misread it too.

CHAIRMAN GREENSPAN. Does anybody else feel strongly about that issue?

MR. HELLER. Well, mine is not a strong feeling but I just thought there was a--

CHAIRMAN GREENSPAN. Technically, that statement is correct. It's only a question of how you read it.

MR. HELLER. I think it sets the wrong tone a little; that "continuing gains" is what bothers me. Maybe you want to say: And while forward indicators pointed to continuing gains, this is no longer true.

MR. BLACK. You can say way back when they--

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Yes, I'd like to look at the Corrigan language. Where it says "may call for a special degree of flexibility". I think that's that first sentence where he added a phrase. Would it be okay to say "may continue to call for a special degree of flexibility because"

VICE CHAIRMAN CORRIGAN. I'm not sure what it says right now because it was sent out to be typed about 10 minutes ago; it hasn't come back yet.

MR. ANGELL. Well, I understand, but I'm just looking at the amendments.

CHAIRMAN GREENSPAN. May I make a suggestion? This might not be a bad idea since it is a very crucial directive. I think it would be useful to have it xeroxed and circulated so everyone has a chance to take a shot at it. Is that--

MR. ANGELL. That's all I'm asking, yes.

CHAIRMAN GREENSPAN. Does anybody have any further comments at this particular stage on substantive questions? It's fairly obvious that there is a consensus basically on "B", however we define it, and asymmetrical language towards ease. Everyone is talking, essentially, 6-3/4 to 6-7/8 percent on the funds rate, but I presume, to depict it in the usual wider range. And Jerry Corrigan is getting rave reviews and we will use his language. However, before we finalize it, let's take a look to make certain that we are all talking from the same set of notes.

VICE CHAIRMAN CORRIGAN. Let me see it.

MR. ANGELL. Would our transition borrowing be expected to be \$450 million or \$400 million?

CHAIRMAN GREENSPAN. I would say \$400 million.

MR. ANGELL. Okay.

VICE CHAIRMAN CORRIGAN. Let me just take a look at it.

MR. ANGELL. The words that I wanted to look at here would be to continue to call for a special degree of flexibility, which would be an indication of continuing what we have been doing rather than of some new policy. And then I have trouble with that sentence: the outlook for monetary growth over the months ahead is subject to unusual uncertainty. I'm not sure what that means; it seems to me that the only uncertainty when you look at Don's new figures is that it looks as if we have had a liquidity bulge. But certainly we don't expect uncertainty in regard to the downside do we?

MR. KOHN. No, that's why I had in that reference to somewhat greater than expected. If you keep reading, it says on lines 100 and 101: "but more rapid growth is possible should preferences for liquidity be particularly strong." That was exactly the point I was making. You may not need the sentence on "subject to unusual uncertainty" if you have those sentences that follow.

MR. ANGELL. I'm just not sure what that sentence says. It seems to me that the uncertainty is somewhat directed at one side.

MR. MELZER. When you say "apart from such considerations," it seems that it's not necessary down below to have "conditions in the financial markets" in there again.

VICE CHAIRMAN CORRIGAN. Right; that's right.

MS. SEGER. So we have to make this asymmetrical right?

VICE CHAIRMAN CORRIGAN. I guess so.

MS. SEGER. I thought it was lesser reserve restraint would and slightly greater might. Isn't that what we--

VICE CHAIRMAN CORRIGAN. The sentence I think should read: "Apart from such considerations slightly lesser reserve restraint would or slightly greater might".

MR. ANGELL. No, somewhat, slightly.

VICE CHAIRMAN CORRIGAN. Somewhat lesser reserve restraint--

MR. ANGELL. Would or slightly greater restraint might.

VICE CHAIRMAN CORRIGAN. Okay.

MR. MELZER. You need a comma after "would," too.

VICE CHAIRMAN CORRIGAN. And the economy, strength of the business expansion, etc.

CHAIRMAN GREENSPAN. Governor Angell, are you still concerned about that money growth reference?

MR. ANGELL. Oh, it's not--. I think the way it is now changed would [unintelligible].

MR. KEEHN. Earlier, somebody suggested that in line 5 we change that "outlook may call for" to "may continue to call for". That's appropriate.

MR. ANGELL. Yes.

CHAIRMAN GREENSPAN. Should we put 4 to 8 percent in for the funds rate range or would you prefer 5 to 9 percent?

MR. GUFFEY. I'd prefer just to maintain 5 to 9 percent.

CHAIRMAN GREENSPAN. Can I have a quick rundown on the copy of this Corrigan language for 4 to 8 percent or 5 to 9 percent?

Vice Chairman Corrigan - My own preference was 5 to 9.  
Mr. Angell - 4 to 8.  
Mr. Boehne - 4 to 8, but not a strong preference.  
Mr. Boykin - 5 to 9.  
Mr. Heller - 4 to 8  
Mr. Johnson - Totally indifferent.  
Mr. Kelley - 4 to 8  
Ms. Seger - 4 to 8  
Mr. Stern - 5 to 9  
Mr. Keehn - 4 to 8

MR. JOHNSON - I'm totally indifferent, but you might even drop the whole sentence.

MR. ANGELL. You're not voting on that?

MR. JOHNSON. Yes, I'll just be agnostic.

MR. HELLER. Well, 4 to 8 is closer to zero.

VICE CHAIRMAN CORRIGAN. [Unintelligible] around 6 to 7 percent.

CHAIRMAN GREENSPAN. Before we vote, let's have Norm Bernard read the directive.

MR. BERNARD. In the implementation of policy for the immediate future, the Committee seeks to maintain the degree of pressure on reserve positions sought in recent days. The Committee recognizes that the volatile conditions in financial markets and uncertainties in the economic outlook may continue to call for a special degree of flexibility in open market operations depending, in particular, on demands for liquidity growing out of recent or prospective developments in financial markets. Apart from such considerations, slightly lesser reserve restraint would--

MR. ANGELL. Somewhat.

MR. JOHNSON. Somewhat lesser.

MR. BERNARD. --or slightly greater reserve restraint might be acceptable depending on the strength of the business expansion, indications of inflationary pressures, developments in foreign exchange markets, as well as the behavior of the monetary aggregates. While the outlook for monetary growth over the months ahead is subject to unusual uncertainty, the contemplated reserve conditions are expected to be consistent with growth in M2 and M3 over the period from September through December at annual rates of about 6 to 7 percent, but more rapid growth is possible should preferences for liquidity be particularly strong. Over the same period, growth in M1 is expected to be well above its average pace in the previous several months. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 4 to 8 percent.

CHAIRMAN GREENSPAN. I also read from everything I've been listening to that the official borrowing target, to the extent that it's required, is \$400 million.

MR. ANGELL. Yes, that word respectively isn't needed is it? The word respectively should be out?

CHAIRMAN GREENSPAN. It's out, if you put it the way--

MR. ANGELL. Right.



CHAIRMAN GREENSPAN. Since it is 1:30 p.m., I think we ought to vote on this and get to lunch.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Boehne	Yes
President Boykin	Yes
Governor Heller	Yes
Governor Johnson	Yes
President Keehn	Yes
Governor Kelley	Yes
Governor Seger	Yes
President Stern	Yes

CHAIRMAN GREENSPAN. The vote is unanimous. The date of our next meeting is Tuesday and Wednesday, December 15th and 16th. Do I hear a motion to adjourn?

SPEAKER(?). So moved.

CHAIRMAN GREENSPAN. Without objection, to lunch.

END OF MEETING