

**Meeting of the Federal Open Market Committee  
November 6, 2001**

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 6, 2001, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Mr. Ferguson  
Mr. Gramlich  
Mr. Hoenig  
Mr. Kelley  
Mr. Meyer  
Ms. Minehan  
Mr. Moskow  
Mr. Poole

Messrs. Jordan, McTeer, Santomero, Stern, and Stewart, Alternate Members  
of the Federal Open Market Committee

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

Mr. Kohn, Secretary and Economist  
Mr. Bernard, Deputy Secretary  
Mr. Gillum, Assistant Secretary  
Ms. Smith, Assistant Secretary  
Mr. Mattingly, General Counsel  
Ms. Johnson, Economist  
Mr. Reinhart, Economist  
Mr. Stockton, Economist

Ms. Cumming, Messrs. Fuhrer, Hakkio, Howard, Hunter, Lindsey, Slifman,  
and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of  
Governors

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and  
Statistics and Monetary Affairs respectively, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Messrs. Oliner and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Kamin and Whitesell, Assistant Directors, Divisions of International Finance and Monetary Affairs respectively, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Office of Board Members, Board of Governors

Messrs. Cox and Goodfriend, Meses. Mester and Perelmuter, Messrs. Rolnick and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Dallas, Richmond, Philadelphia, New York, Minneapolis, and Cleveland respectively

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

Mr. Robertson, Assistant Vice President, Federal Reserve Bank of Atlanta

Mr. Rudebusch, Senior Research Adviser, Federal Reserve Bank of San Francisco

Transcript of Federal Open Market Committee Meeting of  
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CHAIRMAN GREENSPAN. Good morning, everyone. Would somebody like to move approval of the minutes of our October meeting?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection. Dino.

MR. KOS. Thank you, Mr. Chairman. I will be referring to the charts that were handed out this morning. 1/

The top panel of the first page depicts U.S. and euro-area cash and forward rates. U.S. 3-month cash rates, the solid red line, declined about 1/4 percent since the last meeting, while 3-month and 9-month forward rates declined by similar magnitudes as the string of data released reinforced expectations that policy rates would continue to be reduced. In the euro area, cash rates fell about 12 basis points but 9-month forward rates fell by more than 1/4 percentage point, widening the spread between cash and forward rates. The rate movements reflected reactions to weak data for the euro area as well as heightened expectations that the total amount of easing to come from the ECB would be larger than had been previously anticipated.

This morning's two-week refinancing operation by the ECB was under-subscribed by about 25 billion euros and the operation actually drained 23 billion euros, as banks expecting to be able to buy cheaper funds after this Thursday's ECB meeting did not have much demand for 2-week money. Overnight rates moved to about 4 percent after the operation's results were announced.

The bottom panel provides three snapshots of the Japanese yield curve in 2001--for February 28<sup>th</sup>, August 14<sup>th</sup>, and November 2<sup>nd</sup>. Broadly speaking, the curve continues to exhibit a very flat trajectory out to three years and then steepens for maturities beyond that out to 30 years. Rates at the very long end have stayed near 2.5 percent, reflecting both a premium for the longer maturity and the lesser market liquidity of bonds beyond 10 years. But the long rates perhaps also reflect worries about the prospect of significant government debt issuance, which may be necessary to finance a cleanup of the banking sector.

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1/ Charts used by Mr. Kos are appended to this transcript.

Staying with the Japanese markets for a bit on page two, the top panel shows the 5-year Japanese government bond (JGB) yield and the 5-year yen swap rate since January 2000. The middle panel depicts the 10-year JGB and swap rates for the same period. In both, the spread between the swap rate and the JGB yield trended near 25 basis points in early 2000, then began to narrow in late 2000 and early 2001 as yields started to fall and rates at the short end approached zero. By the summer, the 10-year differential went to zero and was even negative on some days. The 5-year differential narrowed a bit later and is now also near zero. So bank obligations in a country with known banking problems are being priced as substitutes for government credit. One interpretation would suggest that the market is already presuming that Japanese bank risk is sovereign risk. Another explanation can be found by looking at the flows that are creating this relationship. Japanese banks have been very large buyers of 5- and 10-year swaps. That is, they are receiving a long-term fixed rate and paying a short-term floating rate, which lately has been near zero. That is functionally similar to buying a JGB and financing it in the short-term repo market. The sellers of these swaps reportedly have been foreign commercial and investment banks. Japanese banks have added to their swap positions rather than purchasing more JGBs because of a preferential accounting treatment.

With small probabilities that short rates will move higher any time soon, the situation probably does not pose near-term concerns. But Japanese banks do have a stake in spreads staying tight and, given that the banks are also large holders of JGBs, in rates remaining low. Ergo, one quickly gets into the circular logic of the situation. The possible need to clean up bank balance sheets may force the government to issue more bonds to finance that endeavor, which in turn will raise yields and inflict losses on banks holding large JGB positions and large swap positions as well.

As for the markets' views on the state of Japanese banks, the bottom panel graphs the Tokyo stock exchange composite index and the bank sub-index. Both are down substantially since January of 2000. Interestingly, the bank sub-index has had its greatest underperformance in the last 12 months, precisely during the time that swap spreads began to narrow.

As we go through the next three pages of charts, I will briefly review a number of asset price relationships in major markets in the eight weeks since September 11<sup>th</sup>. The top panel of page three indexes the dollar's exchange rate against the euro, the yen, and the Swiss franc since August 1<sup>st</sup>. Despite the weak data on the U.S. economy, the dollar is back to levels where it traded in mid-August, having recovered from the post-September 11 losses against both the yen and the euro. It is still somewhat lower against the Swiss franc. The middle panel graphs implied volatilities, which have continued to come down to around 10 percent, compared to 12 percent in mid-August and 14 percent in mid-September.

Another vantage point into the seeming tranquility of the foreign exchange market is through risk reversals. This is an options trade that reflects whether market participants are willing to pay an added premium for protection against the risk of a rising dollar, in which case dollar calls are expensive relative to dollar puts. Alternatively, in the case of trying to protect against the risk of a falling dollar, dollar puts are favored.

Immediately after September 11<sup>th</sup> the marketplace bid up dollar puts, but since then this indicator--quite unusually--has moved to absolute neutrality for all three major currency pairs. The optimistic view is that market participants believe that exchange rates have achieved something of a sustainable equilibrium. Probably the more plausible explanation is that there is a lack of conviction among traders about the likely course of exchange rates. That hypothesis is also supported by anecdotal evidence in that there has been a pulling back of risk-taking in the foreign exchange market.

On page four, the top panel depicts a number of the major global equity indices since August 1<sup>st</sup>, but re-indexed to their closing levels on September 10<sup>th</sup>. In general, the major indices have moved in a correlated fashion back to pre-attack levels.

The middle panel graphs selected major emerging market indices. With the exception of the Argentine Merval index, most have recovered but not as much as the indices of developed country markets. There appears to have been more discrimination among emerging markets and between emerging and developed markets. Unlike the calm prevailing in the foreign exchange markets and despite the recovery of stock prices, implied volatility--at least as measured by the VIX in the bottom panel--has gone sideways at between 30 and 35 percent since the last meeting, but it is still somewhat elevated relative to historical patterns.

As shown on page five, spread relationships in fixed-income markets tell a similar story. Spreads continued to widen on higher risk assets, such as debt of emerging markets, as seen in the top panel. The high-yield spread has stayed relatively flat since the last meeting, but it has also remained at elevated levels despite the rally in equity markets. In contrast, spreads have actually narrowed for better quality obligations, such as agencies and swaps. Interestingly, the rising tide did not lift all boats in the investment-grade corporate sector. The spread in A2 corporate issues widened slightly. But even there, one needs to consider that absolute yields for A2 paper declined modestly. Moreover, the market absorbed a massive amount of supply, including that coming from several issuers who were refinancing maturing commercial paper and willing to pay the premium spread in order to get the deals done. Finally, at the short end, the implied volatility on near-term Eurodollar contracts has again been rising recently, pointing to some lingering uncertainty at the short end.

Turning back to the government yield curve, the top panel of page six depicts the benchmark on-the-run issues in yield terms along with the target fed funds rate since August 1<sup>st</sup>. Until the middle of last week the pattern of recent months persisted, with gradually falling yields--especially at the short end--and thereby a steepening of the yield curve. The Treasury's refunding announcement last Wednesday, which included plans to revise the buyback program and to suspend issuance of the 30-year bond, surprised the market in its timing and for that matter also surprised the Treasury in the extent of the market reaction. Yields fell sharply on Wednesday and Thursday as traders rushed to close out short positions in their trades, whereby they had been long the 2-year note or similar duration paper and short the 30-year bond. By this morning the long bond yield was at 4.86 percent or almost 40 basis points lower than the closing yield on the day before the Treasury's announcement.

The bottom panel depicts yield curves for A2 industrial corporate bonds, Fannie Maes, swaps, and Treasuries as of September 10<sup>th</sup> and as of November 2<sup>nd</sup>. In general, the pattern observed in the Treasury yield curve has spilled over to the other curves as well. Since September 10<sup>th</sup>, interest rates are generally lower and yield curves are steeper.

Moving to the commercial paper market, the theme there is that the year-end has come early to that market. The top left panel graphs the spread between 30-day A1/P1-rated paper and A2/P2 around year-end for three recent years. The 1997-98 period, in blue, was typical of many years until very recently. The black line depicts last year's sharply widening spread and the red line represents the current spread.

The top right panel shows the same set of relationships for 90-day paper. The trends are similar, though last year's widening began later and the size of the widening probably was influenced by the suddenness with which the California utilities had difficulty rolling over their commercial paper. This year's widening began soon after the events of September 11<sup>th</sup>. The downgrading of several corporations has reportedly made some managers unwilling to hold A2/P2 paper at year-end for window-dressing reasons, but many other fund managers have become unwilling to hold any A2/P2 paper under any circumstances. The wider spreads have been necessary to draw in new buyers, such as European institutions, to pick up the slack. Still, the A2/P2 sector has contracted by nearly 50 percent this year in terms of the amount outstanding.

The bottom panel shows the spread of 90-day A1/P1 commercial paper to 3-month Treasury bills on the left and A2/P2 paper relative to 3-month Treasury bills on the right. These two graphs indicate that the widening of the A2/P2 spread, at least so far, is strictly a matter of deterioration in the A2/P2 sector. Of note is how well the A1/P1 sector is holding up, with issuers able to sell paper at a cost of only 10 basis points or so more than Treasuries.

Finally, the last page depicts the relationship between the rate for general collateral (GC) in the repo market, the so-called “specials rate” for on-the-run securities, and the incidence of fails to deliver. The top panel graphs the GC rate in blue and the 5-year specials rate--that is, the rate to finance the on-the-run 5-year security--in green. The gray bars at the bottom represent the volume of fails reported by primary dealers for that security. The interest rates are all daily, while the volume of fails is collected weekly; the number represents the volume of fails on the reporting date.

The bottom panel has the same set of information for the 10-year note. The specials rate can be volatile from day to day, as dealer financing needs change. The upper boundary is the GC rate, which roughly tends to track the fed funds rate. The lower boundary is zero. When a security is very scarce, the cost of financing that security can fall to or near zero. But if dealers who are short the issue cannot borrow the paper, a fail will result. More cynically, a dealer can go short the issue and not deliver, knowing that with the specials rate so low there is almost no financial penalty to the fail.

While the fail situation in the aftermath of September 11<sup>th</sup> garnered a lot of attention and was extraordinary in its size, securities at times do go on special for extended periods of time, so a spike in the volume of fails is not that unusual. For example, as seen in the bottom panel, in May of 2001 the scarcity of the 10-year issue led to a surge of fails until the May refunding was completed.

I want to make two points here. First, as short-term rates have come down, the GC rate has come down as well. Second, the amount of elbowroom for the specials market to move around has decreased. The rate doesn't have to move very far from the GC rate to get to zero and create a situation that can lead to a rise in fails. Thus, even without future incidents of the kind seen on September 11<sup>th</sup>, in a low interest rate environment there is the risk of more instances where fails accumulate, at least for short periods of time.

Mr. Chairman, there were no foreign exchange operations in the intermeeting period. The temporary swap facilities with the ECB and the Bank of England both expired without being renewed in mid-October, and the amount of the swap facility with the Bank of Canada reverted to its normal size.

I will need a vote to ratify domestic operations, and I'd be happy to take any questions.

CHAIRMAN GREENSPAN. Will the emergence of fails in the order of magnitude we've been seeing lately impair the market structure in any ongoing way that should concern us?

MR. KOS. I don't think so. The cash market continued to function normally. There did not seem to be a spillover into the cash market. That might have occurred if the on-the-run/off-the-run spreads had widened, but we did not see that. The problem remained a back office problem that did not spill over into the front office. Of course, there is the risk that that might happen at some point but thus far it has been contained to the back office.

CHAIRMAN GREENSPAN. Yet the Treasury reopened the 10-year due to obvious concerns about--

MR. KOS. That's right.

CHAIRMAN GREENSPAN. What was the Treasury worried about other than fails? On the face of it, fails seem to be a disruption to the normal market process. If fails are benign, why does anybody really care all that much?

MR. KOS. I think it's the risk that I mentioned--that if the back office gets clogged up, then it affects how the traders behave.

CHAIRMAN GREENSPAN. Has that ever happened?

MR. KOS. I can't think of an instance when it has. In 1998 we had a different situation where liquidity was an issue, and on-the-run/off-the-run spreads widened then. But I can't think of an instance where we had that kind of spillover problem because of fails. Again, that was a risk that the Treasury was contending with, and I think it is the reason they made the decision that they did.

MR. REINHART. Historically, Mr. Chairman, the Treasury has been concerned that an environment in which investors are not sure they actually will receive the security they purchased may turn off some investors. As Dino pointed out, during the time the fails were occurring some foreign central banks were not making their securities available in the market because they were on the receiving end of fails too. They'd lend the securities out but weren't getting them back. So they



decided not to participate in the market because they in particular like the orderly receipt of their securities. I think the Treasury's argument is that if it fails to continue for a protracted period, then at the margin at least some investors will pare back their participation in the Treasury market.

CHAIRMAN GREENSPAN. I was slightly distracted, Dino, when you were explaining why it is that the Japanese banks are willing to take the lower yielding 5-year swaps rather than JGBs. Did you say it was for tax reasons?

MR. KOS. There's a preferential accounting treatment for swaps relative to JGBs; the latter go on their balance sheets.

CHAIRMAN GREENSPAN. You mean in terms of their capital?

MR. KOS. In part I think for reasons related to capital. Also, a bank may be influenced by not wanting to balloon its balance sheet, which is published. The Japanese accounting authorities are looking at changing that preferential treatment because the Japanese banks are using it as a loophole. The swap is designed to be what they call a macro hedge--that is, it is designed to hedge assets--and it can be excluded from the balance sheet. However, as the Japanese accounting authorities see it, the banks are using these swaps to hedge liabilities, which more or less turns the intent of the rules on its head. So the accounting authorities have been looking at this and thinking about whether to close that loophole. There is some pressure on them to continue to keep that loophole open, and I think the banks are waiting to see how the Japanese accounting bodies will rule.

VICE CHAIRMAN MCDONOUGH. I'd like to add a comment. However the accounting authorities rule, the situation is clearly one in which the Japanese banks are taking a massive interest rate risk at a time when they have enough risks in the portfolio. And this practice involves an additional risk that they should not be taking. Wearing my Basel Committee hat, I have been trying to bring that to their attention with absolutely no positive result.

CHAIRMAN GREENSPAN. Any negative results?

VICE CHAIRMAN MCDONOUGH. No, they just continue to ignore that risk.

Essentially, anything that will produce some additional earnings, however great the risk, is a risk that the banks are willing to take. And as Dino pointed out very well, if the Japanese government has to start issuing more government bonds in order to bail out the banking system, whatever is accomplished by putting in additional capital could easily be reversed by the hit the banks will take on the interest rate risk.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. In looking at a whole range of spreads--on-the-run, off-the run, bid-ask spreads, and risk spreads on different kinds of paper--could you characterize the state of the markets in recent days, relative to, let's say, just before the terrorist attacks?

MR. KOS. Well, in terms of how the markets are functioning, I think they are functioning fine. In terms of how market participants are discriminating among risks, I would have no reason to second-guess the assessments they are making. They seem to be putting in a greater risk premium on high-yield assets and on debt of emerging markets. So, to the extent that they are viewing the economic outlook as being weaker than had been the case, they are putting in a higher risk premium to those kinds of assets, which seems to be rational.

MR. POOLE. Right. But the spreads that would indicate how the market itself is functioning, such as bid-ask spreads, are back pretty much to where they were?

MR. KOS. I don't recall that there has been any meaningful widening of bid-ask spreads in the fixed income markets. And the on-the-run/off-the-run spread has not moved very much. So those indicators are not pointing to problems with the functioning of the markets.

MR. POOLE. Okay.

CHAIRMAN GREENSPAN. Further comments or questions? Mr. Vice Chair, would you make your usual motion?

VICE CHAIRMAN MCDONOUGH. I move approval of the domestic operations.

CHAIRMAN GREENSPAN. Without objection, they are approved. We now move on to Dave Stockton and Karen Johnson.

MR. STOCKTON. Thank you, Mr. Chairman. In my remarks at the last meeting, I said that if we were pressed to net the various risks to our projection of real activity, we saw greater downside risks in the near term and greater upside risks further out. The data we have received over the past month seem to have supported that view. We are now showing a much sharper contraction in real GDP into early next year than was incorporated in our previous projection. But, by the spring, we anticipate a stronger recovery. Partly on the thought that the more pronounced near-term weakness in the economy will spur additional action by Congress, we have built a more stimulative fiscal policy into this projection. That added stimulus, along with stronger equity prices and a slightly lower assumed federal funds rate, underlie the upward adjustment to our longer-term forecast.

So, how weak is the economy likely to be over the near term? As we noted in the Greenbook supplement on Friday, the October labor market report led us to mark down further the projected contraction in real GDP in the current quarter from about 2-1/2 percent at an annual rate to 3 percent. And with output and incomes weaker now, there will likely be some spillover in the form of further declines in demand early next year, leading us to revise down our first-quarter drop in real GDP to about 1/2 percentage point.

Even before receiving the October employment figures, we had been impressed by the exceptional weakness of the manufacturing sector; sharp inventory liquidations appear to be continuing this quarter, and the contraction in capital spending is intensifying. Moreover, reports have suggested that the service sector is softening noticeably.

The concerns raised by those developments were certainly reinforced by last Friday's employment report. Private payroll employment dropped nearly 440,000 last month, aggregate production worker hours fell 0.7 percent, and the unemployment rate rose 1/2 percentage point to 5.4 percent--all weaker readings than we had expected. To be sure, some of our miss on employment was in industries that have been directly affected by the events of September 11--for example, airlines, travel, and hospitality. We had cutbacks in these areas spread out over the next few months, and we may have just gotten those cuts sooner than we had anticipated. But the declines were deep enough and widespread

enough to make us reluctant to offset any of that larger drop in coming months. The bottom line is that we see the labor market report as signaling a greater near-term contraction in activity.

That certainly seems to be the case in the manufacturing sector, where the sharp drop in factory hours and the reduction in temporary help jobs--many of which are supplied to the goods-producing sector--indicate that the rate of decline in industrial production is steepening this quarter. October IP could be off around 1-1/2 percent for the month, setting up a possible double-digit annual rate of decline for the fourth quarter.

Those cutbacks in production are in large part a reflection of the ongoing efforts of businesses to pare inventories. As a result of those actions, as well as the surge in auto sales, we are projecting a substantial inventory liquidation of \$80 billion at an annual rate in the fourth quarter. Still, not much progress has yet been evident in reducing inventory-sales ratios.

The reason, of course, has been that final demand also has been weakening, especially the demand for investment goods. The falloff in new orders for capital equipment in September was stunning. As with all of the statistical reports for September, there may be less signal than usual in these data. But it is difficult for us to see how these readings could be pointing to anything other than a very steep drop in equipment spending in coming months. Indeed, the revision that we have made to investment spending accounts for a large fraction of the downward adjustment to our current-quarter forecast.

As you know, we incorporated a substantial hit to business and consumer confidence in our September projection--a feature that we have maintained in this forecast. Thus far, we feel quite comfortable with that assumption for the business sector. The cutbacks in employment, production, and capital spending have been swift and sizable. And our business contacts, who have been gloomy most of the year, have turned decidedly more so this fall.

However, I think it would be fair to say that there is still a large question mark about our assumption of a considerable sustained deterioration of consumer confidence. To begin with the obvious, at the same time that payrolls were being slashed by more than at any time in the past twenty years, sales of new motor vehicles soared to near-record levels. In our view, that surge has been induced by temporary incentives, and a payback is in store late this year and early next year--an outlook that largely appears to be shared by the automakers. But these developments could give one pause about our story.

Moreover, while we have seen significant deterioration in measures of consumer sentiment, the declines have not been as large as we had been expecting. For now, we are sticking with our assumption that recent events have shaken consumer confidence and that there will be an unusual degree of restraint

on household spending over the next few quarters. But that outcome is far from a sure bet.

We have now come to that familiar part of my presentation, where I recite for you the catechism of recovery. It should sound familiar because neither the questions nor the answers have changed all that much since last March. What ends this period of pronounced weakness and what will restore the economy to a more vigorous growth track? If it's any comfort to you, I did have our crack research staff examine the historical record, and they confirmed for me that there have been no instances, at least in the United States, of recessions that never ended. [Laughter] So, I am reasonably confident that, with your indulgence, if we stick with this story long enough, it should eventually come to pass. However, when is another matter. In our view, the basic elements appear to be in place for an upturn in activity by the spring.

The inventory liquidation will end, and even its abatement will provide support to production and incomes; in our projection, the runoff proceeds throughout much of next year, but it becomes a progressively smaller drag on real output. Much the same can be said for the capital spending adjustment. We do not expect an upturn in spending before the second half of 2002, but the significant negatives from this sector diminish as businesses better align actual and desired capital stocks and as sales prospects begin to improve.

The risks to this aspect of our projection remain considerable. As we noted in our report to the Committee in June, econometric models of investment spending leave a great deal to be desired. Consequently, it is difficult to use these equations with confidence to gauge where we are in the adjustment process. We do, however, have pretty good company here. The businesses that purchase and produce capital goods have failed to foresee the extent of the weakness in capital spending that has emerged this year. If excessive optimism lifted capital spending above the fundamentals in recent years, it seems possible for excessive pessimism to depress spending below the fundamentals for a time. We have built a bit of that effect into our forecast through an assumed weakening of business confidence, but the retrenchment in spending could continue to be more pronounced and more persistent than we have allowed for.

While the risks remain large, our best guess is that the inventory and investment adjustments will largely play out over the first half of next year, and will do so in an environment that receives considerable support from macroeconomic policies. By our estimates, the real federal funds rate is noticeably below its equilibrium value, suggesting to us that monetary policy is calibrated to produce above-trend growth once the transitory drags on spending wane.

Fiscal policy, too, is an important part of the story. We have substantially increased the size of the fiscal stimulus package assumed in our

forecast, and that added stimulus shows through to the top line of our projection. Two salient questions are: Will it happen, and will it be as potent as we are anticipating? I recognize that reading the newspapers in recent weeks might raise serious doubts about the likelihood of passing a sizable stimulus package, and gridlock is certainly within the realm of possibility. But, we believe that, with the full dimensions of the downturn becoming increasingly apparent, efforts will resume to reach a compromise.

The precise composition of any package is very uncertain, and we make no claim of special insight into how the political process will unfold. We took a stab by combining elements that have appeared palatable to both sides in the debate. We assume another round of tax rebates will be paid in the first quarter to those that did not fully participate in the last round. We built in additional spending for extended unemployment insurance and increased subsidies for health insurance for the unemployed. We also are assuming increased spending for infrastructure and security. Finally, we incorporated a three-year temporary tax incentive for investment that allows an immediate 30 percent expensing of qualified equipment and software expenditures; this is the provision incorporated in the House stimulus bill.

All told, our revised fiscal package adds nearly a percentage point to growth of real GDP in 2002 and about 1/2 percentage point to growth in 2003. Tax rebates are paid out early next year and are assumed to be largely spent in the first half. By the middle of 2002, we expect the expensing provision to provide an appreciable lift to equipment spending. As we noted in the Greenbook, because the provision is temporary, we expect the effect on investment outlays to be larger than if it were permanent. One reason is that the budgetary cost is lower, and there should be less offset through higher interest rates. Moreover, the temporary nature of the incentive will cause businesses to pull forward purchases that would have been made after the provision's expiration.

We have heard the argument that investment incentives, such as the one we have incorporated into the projection, will not be effective in a period when the demand for capital goods has been so weak. Quite frankly, we do not find this argument very convincing. To be sure, for some firms, tax incentives will not forestall further cuts in their capital budgets. But even with the steep declines that have occurred in capital spending over the past year, businesses have still purchased nearly \$1 trillion of equipment. So there must be many firms that are on the margin for some categories of capital outlays and for which the expensing provision will induce additional spending.

There are, however, plenty of other good reasons for second-guessing the staff forecast on this issue. In building the effect of the tax provision into our forecast of E&S spending, we have assumed only a muted effect in the first half of next year. In our view, there will be only a small penalty to be paid for

waiting to take advantage of the provision until a bit more clarity develops in the economic outlook. In our forecast, clearer signs of improvement should be apparent by next spring, at which point we project the stimulus from the expensing provision to mount. This timing was largely a judgment call, and either a quicker or a more delayed response seems possible.

One small side effect of demand stimulus that occurs through an investment incentive--such as is incorporated in this forecast--is that it raises capital deepening and productivity growth for a time, with consequences for the inflation outlook. Along with a somewhat higher projected value of the dollar, these positive supply influences offset a slightly lower path for the unemployment rate, leaving measures of core price inflation on a modest but more noticeable downtrend by 2003.

In sum, the risks surrounding our economic forecast remain wide, but, in our view, are two-sided. Rising equity prices, a steep yield curve, and soaring motor vehicle sales might be pointing to a fundamentally sounder economic outlook than we presented in the Greenbook. On the other hand, last Friday's employment data capped a long string of very weak reports on the economy and could be signaling that businesses are prepared to act aggressively to cut production and shed workers. In these circumstances, households will be vulnerable to a bout of deepening pessimism and significant spending restraint in coming months.

On that cheery thought, I'll turn you over to Karen Johnson.

MS. JOHNSON. We revised down our forecast for growth of real output abroad once again in this Greenbook. In part, we were reacting to the information received over the intermeeting period about production and spending in foreign economies. In part, we were recognizing that more pronounced weakness in the U.S. economy in the very near term implied more of the same for many of our trading partners. We now estimate that real GDP contracted at an annual rate of about 1/2 percent during the third quarter and expect that a similar outcome will be recorded for the current quarter. This projection of prolonged contraction in our average measure of foreign real output reflects widespread negative growth among the developing countries during the second half of this year. Among the industrial countries, recession in Japan is ongoing while the picture elsewhere is mixed: Real output appears to have turned down in Canada, to have become stagnant, at best, in the euro area, but to have continued to show a bit of resilience in the United Kingdom.

In constructing this forecast, we struggled with the need to specify the intensity and duration of the downturn abroad. The Greenbook baseline paints a picture of a global economy that is sluggish in the first half of next year and has clearly begun to rebound by the second half. Although we can identify the factors that we think will lie behind this path, we would be the first to admit that

picking the turning point requires a crystal ball rather than an economic model. In addition, news since the Greenbook forecast was finalized reinforces the downside risks to the baseline.

Our forecast calls for improvement in the developing countries to be evident early in the new year. For many Asian emerging market economies, this outcome will depend importantly on an end to the deterioration in the demand for high-tech goods and the beginnings of a recovery in production in that sector. It will depend as well on continued robust expansion in China, one of the few countries or regions in the global economy that has not shared in the widespread slowdown. Stability in global oil prices at recent lower levels will help, along with supportive macroeconomic policy in some of these countries.

The widespread recovery of foreign activity during 2002 depends critically on the rebound that is projected for the United States. Simply put, we are counting on the range of direct and indirect linkages--through which the slowing of U.S. growth over the past year imparted downward pressure on the rest of the world--to transmit positive spillovers. Strengthening of the U.S. economy will boost confidence, support asset prices, stimulate demand for exports from our trading partners to the United States, and contribute to a recovery in investment spending. For the major industrial countries, domestic policy stimulus of varying amounts is in the pipeline. Since their respective peaks, official lending rates to date have been lowered 300 basis points in Canada, 150 basis points in the United Kingdom, and 100 basis points in the euro area. We are expecting another 25 basis points soon by each of these three central banks, perhaps later this week in some cases, and a further 25 basis points by the ECB sometime in the first half of 2002. Fiscal stimulus was injected during 2001 in Canada, the United Kingdom, and several of the major euro-area countries. We expect some additional expansionary measures during 2002 in Canada and the United Kingdom, where surpluses allow more room for maneuver.

Two spots in the global economy--Japan and Argentina--are especially troubled by problems that are largely, but not entirely, domestic. The latest releases of economic indicators paint a bleak picture for real economic activity in Japan. And we see little in the prospects for either monetary or fiscal policy that could spark a turnaround in spending. The supplementary budget that now seems on track for passage in the Diet soon will provide a partial offset to what would otherwise be a large contractionary impulse from fiscal policy. But we do not see the measures now planned as up to the task of preventing further declines in real GDP during the first half of 2002. By the second half of next year, we have projected an anemic return to positive growth as private investment spending stops falling and stabilizes and as exports swing from declining to increasing. Both of these developments depend importantly on a general recovery in the global economy, including in the high-tech sector.



The situation in Argentina is evolving as we speak. The chaotic events of last week have brought into the open the prospect of a sovereign debt restructuring that now seems inevitable. The scope and terms of such a restructuring are slowly being proposed. Spreads on Argentine dollar-denominated sovereign debt spiked above 2500 basis points yesterday, as the market price of the widely watched bond that matures in 2008 fell to nearly 40 cents on the dollar. Deposit outflows from Argentine banks, where pesos and dollars still exchange one for one, have risen over the past week or so and shipments of dollar currency from U.S. banks to Argentine counterparts have again jumped.

Two “events” appeared to accelerate the downward spiral of the ongoing Argentine crisis last week. One was the apparent failure of the de la Rúa government to reach agreement with key provincial governors over the dispute about revenue sharing between the provinces and the federal government. Some compromise is needed in order for the government to achieve its stated fiscal objectives. A second bit of “news” was the statement by an IMF official during a press conference that acceleration of the planned December disbursements of IMF funds to Argentina was not being considered, thus quashing widespread expectations that those funds would be distributed shortly. Late in the week, Argentine officials apparently felt the need to announce something, so President de la Rúa made a statement on Argentine television that included some minor reforms of the tax and pension systems aimed at stimulating the economy. He also called for a debt exchange, with the intent of reducing interest costs on the debt, particularly in the near term, but as of now there is no proposal for additional funds from the IMF or other sources to support an “orderly” exchange. The government’s explicit position to date is that there will be no change in the current exchange rate regime.

In our Greenbook forecast, we have projected that real GDP will decline sharply in Argentina during 2002 and then be about flat on balance over 2003. While the actual path will no doubt differ from this, a substantial decline in output in Argentina is unavoidable over the forecast period. Our current thinking is that negative spillovers to real output growth of other countries in the region will be limited. This round of problems in Argentina has been unfolding for about a year, and financial market developments support the view that market participants do distinguish both Brazil and Mexico from Argentina. Spreads for Brazil remain around 1100, with those for Mexico much lower, and both the Brazilian real and the Mexican peso have appreciated on balance over the intermeeting period. Thus, despite the imponderables of the Argentine situation, we see average output growth in Latin America turning positive next year and strengthening further in 2003, similar to the pattern projected for the Asian emerging market economies and the foreign industrial countries.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. I have a question for David. You mentioned in your comments the possibility of weaker household spending and, of course, that was one of the alternative scenarios that you had in the Greenbook as well. The Greenbook analysis indicated that under this alternative scenario households would react more adversely than you anticipate in the baseline forecast. I was wondering if you could elaborate on what you're anticipating in that case, particularly in terms of external shocks such as terrorist attacks and anthrax scares that are so important to household spending and consumer confidence. Could you provide some more detail about what you are assuming in each of these alternatives?

MR. STOCKTON. Certainly. In our baseline forecast, we have assumed a significant hit to consumer confidence, one that is by our estimates sufficient to subtract roughly 3/4 of a percentage point from real GDP growth in 2002. So in the baseline scenario we are already expecting some additional weakness--an exogenous hit--beyond the weakening in consumer confidence one would expect as the economy weakens. We have that also influencing business spending in ways that we tried to calibrate, a spillover effect to other forms of spending as in other periods when there have been outsized movements in consumer confidence.

In our alternative simulations, version one removes that consumer confidence effect from the forecast so that you can get a sense of what it implies. In essence the stronger growth in that simulation is sufficient with unchanged policy to bring the unemployment rate back down to 5 percent or so by the end of the forecast horizon.

The second version, which is the even more pessimistic version, assumes a further percentage point rise in the personal saving rate--again, an exogenous further change--and again with consequences and fallout for the rest of the economy. That produces a much weaker economy and a

much higher unemployment rate. In that scenario, with an unchanged policy the unemployment rate moves up to 7-1/4 percent by the end of the forecast horizon.

I think there are two important and related risks in this projection. One, in the baseline projection, we have some weakness in consumer confidence but we don't really have a complete collapse in the consumer sector. And with some turnaround in activity by the middle of next year, we get through this period of economic weakness without a really large decline in GDP. One of the risks we've been highlighting for some time is that we're not highly confident that consumers will be able to withstand the kind of weakness we are currently projecting in the near term. That could obviously lead to a bigger fall in confidence that will feed back on the economy with fallout that extends into late 2002 and into 2003. As I noted in my remarks, certainly the data that we have received since the last Greenbook haven't been especially weak for the consumer side. Yes, we did see a very significant drop in retail sales in September and we expect some of that to be offset. But even that drop in sales and the decline we've seen in consumer confidence have not been so large as to make us think that we are already in the process of a confidence contraction. Whatever one makes of 21 million units of motor vehicle sales--and as I said, we have pretty much written that off as a signal of stronger consumer spending--it does at least pose in our minds some question about whether we have that story right. I think we will begin to see in the next couple of months whether our forecast is correct. A significant payback in the auto sector will confirm our view that there is going to be weakness in consumer spending. But right now that's still a forecast.

MR. MOSKOW. In your "weaker household spending" alternative, as you look forward do you envision a more or less stable environment in terms of the terrorist threat that we're facing?

MR. STOCKTON. That's a very good point. The answer is more stable. We have not built in escalating terrorist activities in the United States that would either significantly affect

consumer confidence or add significantly further to business costs. I wouldn't even know how to begin to produce such a forecast. But certainly there are some significant risks. Just as anthrax has been a concern in the past month, it could be smallpox the next month and something even worse the following month. I don't think our forecast begins to capture the potential consequences of that for consumer and business confidence. Nor does it capture the hit we might take to the productivity and business cost structure.

MR. MOSKOW. Thank you.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. David, I just wanted to probe a bit more on the impact you project from the assumed passage of legislation regarding a partial expensing provision. If you're right in your projection, that won't make much of an impact until we get to the second quarter of 2002. But from then on the effect is fairly significant. The analysis seems solid, but in an environment where we have so much excess capacity and a great deal of pessimism, intuitively it's a little hard for me to connect to it. Could you elaborate a little on that? In particular, I wondered if you looked at this at all from a disaggregated standpoint. In other words, I'm asking what particular industries might react strongly to this provision if it is passed.

MR. STOCKTON. We certainly did look at it at a disaggregated level. Perhaps my colleague, David Wilcox, can talk about the underlying theory of how we embedded this in the forecast in terms of its potential implications for different kinds of capital spending, in particular on shorter-lived versus longer-lived assets. Obviously this provision has a larger effect on the cost of capital for longer-lived assets than for shorter-lived assets. If you consider, for example, the computer area where prices are declining by 30 percent a year, the advantage of the expensing provision may not be quite so significant in terms of moving up any spending. So, we have looked

at it by industry but we certainly haven't gone through a very detailed disaggregated analysis. But maybe David wants to talk a little about how we actually worked with the models that we used to incorporate this effect.

MR. WILCOX. There's not a lot to go on. We don't have clean, historical experiments. We have some elegant theory and some consensus parameters. We attempted to calibrate simulation models to values that we think are sensible and that in other circumstances produce reasonable results. But history is not replete with temporary investment tax incentives of the kind that we're simulating here. And Congress is not notorious for following through in every respect with the specifics of its original announcement. So one possible risk that could attenuate the effect of the investment incentive is that, contrary to our assumption in the Greenbook, businesses may doubt that in fact the incentive will be allowed to expire at the end of the three-year period. In that case the provision wouldn't spur as much investment as we had assumed will take place. That said, there is econometric evidence that at least helps us to narrow the range of uncertainty a bit. We have a view about the long-run elasticity of the capital stock with respect to the cost of capital. We have some evidence on speeds of adjustment. We tried to piece together those bits of evidence using a simulation model to get a handle on how big an effect the proposed legislation might have.

MR. BROADDUS. Thank you.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Dave, one of your comments in your presentation surprised me a little, and that was the link that you described between capital deepening, productivity, and inflation. You emphasized the implications of a temporary investment incentive that raises investment, spurs additional capital deepening, and leads in a sense to a positive supply shock. In the Greenbook, though, it seems to me your emphasis was that on balance we face a negative supply shock because

of a significant slowing in structural productivity growth that is expected to occur for a couple of reasons, including a slowdown from an unsustainable pace of technology spending and also the reallocation of resources to security enhancements.

MR. STOCKTON. I should have been clearer about that. My remark in the briefing was really referring to the revisions that we have made in the forecast, which involved a downward revision in our price forecast at the same time that we're showing a lower unemployment rate. A piece of that story was the slightly faster capital deepening in 2003 that has been stimulated by the faster investment in late 2002 and 2003. You're absolutely right. As we noted in the Greenbook, you could look at the very sharp deceleration that we are projecting in wage inflation and, if you were so inclined, wonder why that is not showing through more forcefully into our price inflation forecast. The reason is that even with the improvement in structural productivity that we expect to see by 2003, the gains are still well below where they had been earlier. And we see this on net as a factor limiting the extent of the disinflation that we are likely to see over the next two years as businesses respond to that and attempt to rebuild margins that have become compressed significantly in the last year or so.

MR. MEYER. Just to follow up on that, the slowdown in structural productivity growth is really quite significant into 2002 in particular. We became somewhat familiar with the complicated dynamics of how that plays out on demand as well as inflation when we had an acceleration in structural productivity, so this is perhaps a factor that we should weigh in our real forecast as well.

MR. STOCKTON. I agree with that. We're not showing very much disinflation in the course of 2002 in part because of the unwinding of the positive productivity shock that we saw on the other side.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Dave, I have a question and also a comment about the forecast. In looking at the sources of weakness in the short term, a large portion of it comes from residential investment. It strikes me that there certainly are some positive fundamentals in this area. In September, for example, starts continued to increase. Moreover, the financial fundamentals in housing are still quite good and the falloff in permits was actually quite small. I can see that the negative effects of higher unemployment rates and the impact on confidence might be playing a role, but why does that seem to have so much of a role in the residential sector and, in my view, not much of a role in personal consumption expenditures? I ask because in your forecast personal consumption expenditures in the current quarter and even in the subsequent quarter aren't all that weak.

MR. STOCKTON. I'd note a couple of points. One is that our projected falloff in single family starts is not dramatic; it's certainly not dramatic if one thought we were witnessing a typical recession.

MR. PARRY. Eight-tenths of a percentage point of the decline in real GDP this quarter is due to residential investment, and that's a small sector.

MR. STOCKTON. We believe our starts forecast is reasonably aligned with the decline in permits that we saw and with what we think will be some depressing effect from the weakening in income growth. And we built in some additional weakness because of the assumptions we've made about consumer sentiment. So that is one of the places where the confidence effect shows up. We also noted that homebuilders have reported a noticeable falloff in both traffic and home sales recently. Again, none of this is suggestive of a major weakening in that sector; by my view what we built in is actually fairly mild. Certainly the percentage change at an annual rate looks fairly large because, as you noted, it is a relatively small sector. But that would be one of the upside risks that I think we were talking about in terms of how things have held up in the household sector. I think one

would have to say that housing also is an area where we have not seen the extent of weakness one might have anticipated. So that would be a part of the upside risk that we see associated with our assumptions about extra weakness in the household sector coming from confidence effects.

CHAIRMAN GREENSPAN. Do you know if there is anything special in the adjustment that goes from starts to value put in place that would be involved in this change?

MR. STOCKTON. Well, there is a bit in the residential investment forecast because the falloff in construction put in place has been greater for homes at the high end than at the low end. So the cost per start has been falling as well and that certainly adds to that weakness.

CHAIRMAN GREENSPAN. I think that's an issue.

MR. STOCKTON. But we do still have a falloff in single-family home starts in the quarter to 1.2 million units. That is a noticeable drop.

MR. PARRY. I also have a comment about the partial expensing investment tax incentive. Given that the proposal is for a three-year period, and recognizing some of the points Al Broaddus made--that the capacity utilization rate is so low and that the current economic situation is so poor and likely to remain so for a while--why wouldn't the resultant investment be back-loaded more? The lead times needed for much of the equipment are short. I don't know how you made the decision about how to spread out the investment, but as an alternative I think you clearly could have spread it in a way that is much more back-loaded than you did.

MR. STOCKTON. We certainly could have and we debated that. In the end, as I noted, more judgment than science was applied to how we spread it out. I would sound one note of caution about assuming that a provision like this won't be important by the middle of next year. When the economy starts to improve, there is a fair amount of tinder that can be accumulated in terms of stimulus from both federal tax and spending provisions, from monetary policy, and so forth. While



we're sitting here now in the midst of a significant contraction in output, it's obviously difficult to envision why businesses would be very excited about using an expensing provision. But coming on the heels of a year-and-a-half of significant contraction in capital spending, there could be a rush to take advantage of this incentive as sales prospects begin to improve. I wouldn't rule out even an upside risk to how we built this in; I think there are risks on both sides. Firms may wait until they are absolutely certain that the economy is on a path of trend or above-trend growth before they are induced by this provision to raise spending. On the other hand, there could be some reasons as well for them to want to take advantage of it early on, especially while prices in the capital goods markets are on the low side. I can't say that we offer much science here and, as I indicated, this is an area where we feel quite comfortable with your second-guessing us. But I think you could second-guess us in either direction.

CHAIRMAN GREENSPAN. There's also the risk that the provision will be not for three years but for one or two years.

MR. STOCKTON. Another risk, too, is that the provision could be smaller than now anticipated. This is not a very large temporary investment incentive. If the window were made shorter, we might see a more immediate effect. Or if the amount that can be expensed were less--along the lines of the 10 or 15 percent people have talked about as a compromise--the effects could be even more muted than we have in this forecast. So there is a lot of uncertainty. In the end we felt uncomfortable coming to you with a baseline projection that completely ignored what we thought were cumulating signs of additional fiscal stimulus. We had a very modest amount of fiscal stimulus in our last projection and our best guess of the mode is more along the lines of what we're showing now. But as I indicated, it's certainly possible that gridlock will reassert itself and nothing will happen.

MR. PARRY. Have we gotten any greater visibility about what is likely to happen in terms of Congressional action on this?

MR. STOCKTON. All I know is what I read in the newspapers, and that has not been terribly encouraging. Yet this would be the time when we might in fact not expect to hear much encouraging news, as parties on both sides position themselves for the hard negotiations that, at least in our view, will probably need to take place in the next month or so.

MR. WILCOX. I'd like to underscore two points that Dave made earlier. First, what we have built into the Greenbook projection is not a straight read of our model simulation. We did very substantially push back the investment response to the tax incentive precisely on the theory that businesses might plausibly respond to the heightened climate of uncertainty over the next couple of quarters by opting to wait. They might well decide in the context of a three-year incentive--if it does last that long--that there's very little penalty to waiting until some of that uncertainty is resolved. Secondly, we observed from the experience with auto sales in October that at least in a different context economic actors do respond quite vigorously and quickly to something that is seen as a temporary sale on a large capital item, namely motor vehicles in this case. It's conceivable that businesses may respond in a similar way.

MR. PARRY. That incentive is for a period of months versus three years.

MR. WILCOX. I will grant that the duration makes a big difference.

MR. PARRY. Right.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I've been thinking about what we might see in some of the data that will be published over the near term, in particular payroll employment and the impact of seasonal factors. I assume, other things equal, that the seasonals anticipate an increase in employment in December and

probably in November, although I'm not sure, and then some runoff in the first part of next year. Is that right?

MR. STOCKTON. Yes, and I think even in October we reach the front edge of a pickup in seasonal hiring. Obviously that seems less likely and is part of the reason why we would expect ongoing substantial weakness in the employment data.

MR. STERN. Right. So even if we don't get further substantial employment reductions, the seasonally adjusted numbers are likely to look fairly lousy.

MR. STOCKTON. Yes. We are expecting payroll employment to continue to contract at more than 200,000 a month over the next few months and to contract rather sharply in the first quarter of next year as well.

MR. STERN. Okay, thank you.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. I have a question about the interpretation of interest rate developments. In the pre-FOMC briefing you mentioned the common view in the marketplace that the budget deficit had something to do with the behavior of longer-term interest rates. It wasn't clear what your own view on that was. I was interested in Chart 1 in yesterday's Board briefing where you plotted the implied one-year forward rates, which currently are not that different five years out from those that prevailed on January 2<sup>nd</sup>, let's say. I would have expected the budget argument to make a big difference--to see more effect on interest rates, say, five years out and beyond the current cyclical situation. Yet those curves are not that dissimilar. In fact, the longer end is actually lower now, which is not consistent with the argument involving the erosion of the budget surplus. Would you offer your own view on that?

MR. STOCKTON. Sure. I'd say two things. One, we do think that the longer-run budget outlook and the accompanying fiscal policy that underlie that outlook have been factors influencing long-term interest rates. When I look at that implied one-year forward rate, it currently is showing those rates rising above levels that were prevailing in January--though you're right, not by a huge amount. However, the other news that we have received since January--this enormous contraction in capital spending--would have been a factor working to depress the view about where equilibrium real interest rates might be going in that period. So, in our view, we have seen some effect of the fiscal policy on the structure of interest rates and that certainly is a factor in interpreting what has happened. It's quite clear in our models--and we think there's some reasonably sound economic theory for this view--that equilibrium long-term real interest rates would be related to the long-run thrust of fiscal policy. So that's our interpretation.

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

MR. PARRY. Mr. Chairman, the fallout from the September 11 attacks has intensified existing weakness in the Twelfth District economy. The high-tech sector has been struggling for the past year and now the timeline for recovery has been pushed back by business firms in the aftermath of the attacks. The latest figures show that California's high-tech manufacturers reduced payrolls by more than 12,000 in the third quarter alone, which accounts for nearly half of the 29,000 jobs lost on net in the state. The impact has been especially visible in the San Francisco Bay area office market where vacancy rates recently rose above those in Los Angeles for the first time in recent memory. And with struggling companies accounting for much of the space made available through subleases, the full financial effect on landlords has yet to be felt.

More generally, construction activity has fallen throughout the District in recent months and a sharp drop in September may herald further weakening.

CHAIRMAN GREENSPAN. Is that residential and commercial?

MR. PARRY. It's primarily commercial. Southern California had been the main pocket of economic vitality in the District through August, showing substantial strength in housing demand and population-based services like education and health. But weak September employment numbers suggest that the slowdown may be taking hold there as well. The slowdown in southern California will be exacerbated by the ongoing reduction in travel spending resulting from the terrorist attacks. Compared to most areas of the country, the Twelfth District is somewhat more exposed to the travel slowdown, with states such as Hawaii and Nevada relying heavily on tourism dollars. Although travel sectors overall are less critical to District activity than the high-tech sector, a continued slowdown in travel activity on the order of 10 to 15 percent will reduce District growth noticeably.

Some impacts of the travel slowdown already are evident, with the latest data on new unemployment insurance claims confirming a sharp increase in District layoffs, especially in Hawaii and Nevada, in the weeks following the attacks. And Seattle will soon feel the impact as well when Boeing initiates production cuts and implements its planned layoffs of up to 20,000 commercial aircraft workers there. Moreover, state and local governments and their creditors are on alert in much of the District as many areas expect significant revenue shortfalls of up to 8 percent this fiscal year compared to pre-September 11 predictions. The negative impacts of the travel slowdown will be offset somewhat by increased spending on military hardware in some areas, including weapons systems manufactured in Arizona and southern California. However, the amounts spent by the federal government are likely to represent only a partial offset, especially in the short term.

Let me now turn to the macro picture. An official recession this year appears unavoidable. With the October employment report, the data in hand now have the depth and duration to declare a recession. Furthermore, given last summer's weakness in various monthly indicators, it seems likely that the start of the present recession will be dated back into the spring. Looking ahead, the recession in our forecast is not as deep as the Greenbook's. But our projected recovery next year develops more slowly than in the Greenbook forecast. Assuming a funds rate of 2-1/4 percent, we anticipate a more gradual pickup in growth, largely in response to monetary and fiscal policy actions. This recovery primarily mirrors the unusually gradual slowdown over the past year. It took a year for real GDP to decelerate slowly from growth of about 1-1/2 percent during the second half of last year to last quarter's decline of 0.4 percent. This slow erosion of growth reflected a long sequence of causal shocks: the jump in energy prices, the slowing in demand abroad, the bursting of the asset price bubble, the related re-evaluation of desired capital stocks, and, of course, the events of September 11<sup>th</sup>. Some recessions in the past resulted from one big shock, but this one seems to have had many causes. The unwinding of these many shocks also will take time, and in our forecast, recovery progresses fairly slowly.

Our inflation forecast is little revised. Our best estimate is for inflation of about 1-1/2 percent in the core CPE price index in 2002. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Economic activity in the Eleventh District continued to weaken over the past six weeks. Although the District economy had probably begun to slump even before our last meeting, output declines now appear to be more pronounced and widespread. Four of the District's usual economic drivers--air transportation, energy, border trade, and worker migration--have turned from plus to minus. As I mentioned last time, we certainly are sharing in the national economic

slowdown related to air travel, with Dallas a hub for American Airlines and Southwest, and Houston a hub for Continental. Activity in our energy industry has slowed too, responding to a decline in oil and gas demand.

Tighter security at the border also is having a significant negative effect on District economic activity. On the demand side, far fewer Mexican consumers are willing to bear the increased hassle of getting across the border to shop in our stores. They also have less money to spend owing to a decline in Mexican maquiladora output and U.S. tourism in Mexico. Our directors from border towns report a drop of 15 to 50 percent in retail sales in their areas. On the supply side, Mexican commuters who work in the District face rush hour wait times of two to four hours to cross the border, whether they come by car or by foot. Some have even taken to riding bikes so they don't have to stop to open the trunks of their vehicles.

With all these drags on Eleventh District output, virtually every economic statistic is signaling weakness. September's announced layoffs in the District jumped to three times the norm for the year and October's layoffs remain well above earlier levels as well. For the first time since we began constructing the Texas leading economic indicator index, every one of its components turned negative in September and overall the index showed the largest decline in its history.

About the only good news is that auto demand and construction activity so far appear to be holding up fairly well. As reported in the Beige Book, some of the District's industries most impacted by the terrorist attacks did see activity bounce back a bit during October. But overall we're not expecting District employment levels to regain their previous highs until sometime in the middle of 2002. The ripple effect has visibly spread out from air travel and mail service to hurt other businesses such as hotels, recreation, aircraft production, travel services, and retail trade, and those effects are leveraged even further through big declines in consumer confidence. Resources cannot

be allocated fast enough from areas of excess supply, such as the air transporters, to those of excess demand--security for example--to prevent large dislocations. And the newly unemployed high-tech workers are not likely candidates for airport security jobs. The adjustment is going to be very sluggish.

It comforts me somewhat that the stock market is back up to roughly where it was before September 11 and that it has withstood a lot of bad news subsequent to the attacks. That I interpret as the markets' best opinion about our economy's resilience and its ability to bounce back. Still, there is a long list of discouraging current statistics: industrial production, capacity utilization, durable goods orders, retail sales, existing home sales, initial jobless claims, consumer confidence, and more. Those statistics set the overall tone for today. The Greenbook increased its estimate of the contraction in GDP in the fourth quarter and I suspect that last quarter's numbers also are going to be revised down. Even so, we question whether the rebound is going to be as prompt or as strong as is shown in the Greenbook.

Given the unique nature of our situation, where an unseen enemy is working accurately to undermine our confidence, I wonder if the forecast that we have for next year may be wishful thinking as well. Hunches and hopes are somewhat sick. The risks are clearly on the downside for now and for the foreseeable future, and I'm not sure monetary policy can do much more than it is already doing. Market participants are insisting on further easing while suggesting that it won't help much. We keep saying the bias is for further weakness, which is obviously true. The markets keep taking that as a promise of more ease to come and we seem to be afraid to disappoint them. With a 2-1/2 percent fed funds rate and a 2 percent discount rate, this may be a good time to begin the transition to a penalty discount rate, with a larger cut in the fed funds rate than in the discount rate.



I'm told that the defenders of the Alamo at least used up all their powder. I suppose we should too. But the Alamo story had a rather discouraging ending. [Laughter] However, it would have played even less well in history had the Alamo's defenders been found with dry powder.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I don't have any good stories about the Alamo or anything similar. On the Friday morning before Open Market Committee meetings, I usually meet with a group of local investment professionals and economists from the District's largest banks. This group has a pretty good take on credit conditions locally and nationally, on market realities and expectations, and on risks in general. After a fairly gloomy go-around about near-term prospects, I asked if anyone saw light at the end of the tunnel. The only response was that by the fourth quarter profit comparisons should start to be made against the slowing economy of late 2000, making otherwise dismal behavior look a little better. Their take on the prospects for substantial fiscal stimulus was equally downbeat. They viewed the current situation in Washington as political gridlock and didn't expect anything like the near-term fiscal stimulus shown in the Greenbook. Monetary policy seemed to them to hold out the only hope. But they also seemed to believe that lower interest rates could do only so much to spur demand on the part of consumers who were either experiencing or fearing layoffs or on the part of businesses faced with sizable excess capacity, inventories to work off, and declining profits.

This overall assessment may be a bit gloomy for the nation as a whole. Auto sales in particular suggest that consumers have not gone into total hibernation and will react to a good--or maybe I should say spectacular--deal on interest rates, albeit largely by changing the timing of their expenditures. Moreover, the stock market is upbeat, all things considered. And I am a bit more confident than the group about the prospects for at least some fiscal stimulus.

Their outlook, however, is completely consistent with everything we know about the First District economy. We do not yet have any regional employment data past September 11, but available indicators suggest that New England's economy has declined recently, likely at a sharper pace than that for the nation. In part this is because the slowdown in the region occurred later than that in the country as a whole and our area is to some extent playing catch-up, but it also reflects the growing impact of a fall-off in high-tech equipment and software spending.

Both consumer and business confidence about the current economy are off substantially, and non-manufacturing respondents to recent business surveys are now seeing sales declines and have joined manufacturers in a negative overall assessment of business conditions. Initial claims for unemployment insurance rose sharply, and help-wanted advertising both in print and online deteriorated markedly as well. Sales of existing homes fell sharply in September and permits for new homebuilding trended down through August. Similarly, office vacancies were up substantially, to 8-1/2 percent in downtown Boston and to nearly 14 percent in the suburban markets. These vacancy rates might not seem high in an absolute sense, but, relatively, they are multiples of the rates prevailing a year ago and represent a sea change in Boston real estate markets.

Business conditions are not expected to get better any time soon. Surveys of business confidence see no recovery until well into 2002. A University of Massachusetts leading indicator index points to declining economic activity in Massachusetts for the next six months. And the New England economic project, in which our Bank participates, forecasts a sharp drop in regional activity continuing into the first half of 2002 followed by very slow growth.

On the national scene, the question no longer seems to be whether the economy is in recession. The latest employment and durable goods data seem to seal that. The questions now

focus on how deep and how long the turndown will be and what appropriate further policy action should be taken.

We see a similar trajectory in near-term economic activity as the Greenbook, even with its latest revisions that take into account last Friday's unemployment data. Negative growth is expected to be relatively short-lived--three quarters--even with that change in the employment picture, followed by a snapback induced by fiscal stimulus, monetary ease, and a revival of inventory spending. If cyclical turns are a fact of life at some point, and I think they are, the Greenbook and many other forecasts as well suggest that this contraction might not be such a bad one. But uncertainties abound. The unemployment report was unexpectedly negative. Claims data suggest that another jump in the unemployment rate may be a foregone conclusion. And the drop in durable goods orders doesn't bode well. My breakfast group may be overly gloomy but the risks to consumption and business spending that they discussed I think are real. Corporate profits have deteriorated significantly and analysts have been revising what had been overly optimistic forecasts. External sources of demand don't add much in what now appears to be a global recession. Fiscal stimulus may save the day, as the Greenbook suggests, but the possibilities for political gridlock are there, creating uncertainty both about the amount of stimulus and its timing. State and local government spending almost certainly will contract in early 2002, as these bodies dig in to rainy day funds and cut back spending in the face of decreased revenue. Monetary policy has eased aggressively and the stock market seems to have leveled off. But other aspects of financial markets--spreads and commercial bank credit tightening--suggest financing conditions that may be tougher than the level of real short-term interest rates implies.

That said, I keep arguing with myself about how to view these undeniably downside risks in terms of the stance of policy. How low should rates go? How fast should they get there? And

how easy will it be to tighten conditions when that is necessary? Much of the data we have on the current economy continue to reflect the tragedy of September 11<sup>th</sup>. Confidence, consumer spending, and even business investment might begin to look better with a little more time. Further monetary easing might help, but I think we also need to be careful not to overreact. I realize that inflation is not a current worry and that growth is now far below potential and will likely be so for some time to come. But policy easing has been particularly forceful to date. And I confess to some misgivings about rapidly approaching the point where nominal rates can no longer be reduced.

CHAIRMAN GREENSPAN. President Broadus.

MR. BROADDUS. Thank you, Mr. Chairman. Economic activity in our District appears to have declined further in October, but perhaps a bit more moderately than in the weeks immediately after the September 11 attacks. That partly reflects the pattern of retail sales, which dropped less sharply in October than in September, due mainly to strong car sales in our region--as elsewhere in the country--in response to the zero percent financing packages.

A couple of weeks ago Jerry Jordan, who apparently has been spying in my District, told me he had heard that a large annual boat show in Annapolis had surprisingly strong results. We checked it out, Jerry, and you were right. Sales were quite robust. But the reason given was that people want to enjoy themselves while they still can! [Laughter] I don't know whether that's a good signal or a bad signal.

Many of the retailers we talked to over the last couple of weeks in an attempt to get some sense of how they are approaching the holiday season, indicated that they are quite nervous about it and accordingly are building holiday inventories very cautiously. Elsewhere in the District, residential home sales and construction are still growing, but much more slowly than a year or so ago. We no longer see the signs of a possible bottoming in manufacturing activity that we thought

we might be seeing right before the terrorist attacks. In sum, with unemployment rising, both households and business firms in our region are generally nervous, and I would describe many of them as hunkering down.

Turning to the national outlook, in short I think it's problematic. The staff, as we know, has marked down fourth-quarter real GDP growth to minus 3 percent at an annual rate. And they see it remaining negative until the spring. On the face of it, one could see that as a pessimistic forecast. But in my view, as a number of other people have suggested, a strong case can be made that under the circumstances it is an optimistic forecast with a considerable amount of downside risk. I say that for three reasons. First, the Greenbook is projecting a loss of payroll employment of about three-quarters of a million jobs in the fourth quarter. Of course, we got more than half of that in October so the staff may already have revised that quarterly number, though I haven't seen it. In any case, we could get significantly greater job losses in this quarter. Second, the Greenbook still projects that the unemployment rate will peak at around 6 percent or perhaps a little higher. That would be a cumulative increase from the low point of a little more than 2 percentage points. But in four of the five recessions since 1970 the cumulative increase in the unemployment rate has been somewhere between 3 and 4 percentage points. Only in the unusually brief and quite atypical 1980 recession was the cumulative rise limited to only about 2 percentage points. Based on past experience, I think it's reasonable to expect that the 1-1/2 percentage point increase in unemployment that has already occurred will weaken household confidence further, continue to depress spending growth, and cause still more job losses and so forth. Third, the possibility of higher than projected unemployment in and of itself is not the only downside risk in this situation. Historically, rising unemployment in recessions has been associated with disinflation. The Greenbook is projecting some disinflation this time around, of course, but it is relatively mild. The slower growth in projected wages due to the

slack in the labor markets is accompanied by a slowing in productivity growth, so the decline in unit labor costs is restrained by that. But the disinflation could be more pronounced than projected. For the last several decades, disinflation has been seen as a good thing and many of us around this table have spent the better part of our Fed careers promoting it. But it is a potential problem today.

My main point, and this has been alluded to already, is that in past recessions the Fed has had the leeway to cut the nominal funds rate to keep the real funds rate from rising as disinflation has run its course through these periods of weakness. Today, we have only 2-1/2 percentage points of leeway left before the nominal funds rate hits the zero bound. We will have to match any further disinflation with nominal funds rate cuts just to keep policy at the same place. But that's going to eat up part of the leeway to cut the real funds rate, which we may need to do in order to counteract potentially serious weakness in the economy.

I have always believed that price stability is the goal of monetary policy. I still believe that. Often in the past I've argued for policy actions to preempt inflation as over time--over a couple of decades--we moved the trend inflation rate down. That was really the essence of our anti-inflationary strategy. And it has largely succeeded. But in my view the risk to price stability is different today. What we need to do now is to preempt disinflation--as novel as it is to think in those terms--and do so fairly aggressively to guard against the potential problem of the zero bound I mentioned a minute ago. Of course, the core PCE inflation rate, which is the measure I think most of us now focus on, is currently about 1-1/2 percent. I think that's pretty close to the inflation target we should be aiming for at this stage, for the reasons I just noted. And I believe we should focus our short-term policy actions, as best we can, on preventing that particular measure of inflation from falling much below 1 percent.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. As has been the case for some time, the District economy is tracking closely with the national economy. There are some oases of strength but I don't think they are particularly representative, so I won't spend a lot time on them.

Overall labor market conditions have eased and layoffs and initial claims for unemployment compensation are up. Office vacancy rates have begun to rise. That was certainly anticipated. Vacancy rates for other commercial properties are also rising and apartment vacancy rates are increasing as well. The expectation is that that will feed back on activity as projects currently under construction wind down. It has been a very strong year for single-family construction in the District but in that area, too, the outlook is less promising. Sales, especially at the upper price end of the market, have slowed and I anticipate that the region will have a lot of trouble next year duplicating the residential construction performance of the previous two or three years.

There has been some tightening in credit conditions overall, but my impression from talking to a variety of people is that decent quality credits can still be accommodated on reasonable terms. So I don't sense a huge amount of tension or a problem there.

By way of a few more specific anecdotes, I talked to the leaders of a couple of national retailers. They described their business over the last four or five weeks as okay relative to reduced expectations. One cited same store sales as running about 1 percent ahead of a year ago; that's down, of course, from what typically had been the case. But retailers generally seemed to think that things could have been worse, perhaps significantly worse. So that was their take on the situation. They also added that the discount business was doing better than the full service department store business, which is not particularly a surprise.

I talked to executives of a couple of large paper companies who also described their business as okay relative, of course, to subdued expectations. That has been a business in which it

has been tough to make money for several years. Those executives were quite cautious about capital spending going forward and didn't put a lot of weight on whatever programs Congress might gin up, but perhaps that view is specific to their industry. Finally, I talked to an official of a full service financial services firm who said that their sales of a wide variety of investment products have been quite robust recently.

As far as the national economy is concerned, I'm in general agreement with the contours of the Greenbook forecast. I suspect that the contraction in the current quarter may be a bit deeper than is projected in the Greenbook and it may take an extra quarter before we see a recovery sometime next year. Those are pretty much guesses on my part. Talking to business people in the community, their views are along the same lines. They expect business conditions to get worse before they get better and that the recovery will occur later rather than sooner. But having said that, we do know that the economy is very resilient even without the stimulus in place or in prospect. And, of course, we do have a lot of monetary stimulus in place and it appears to me that more fiscal stimulus is likely. This resilience is something that I think we need to bear in mind. Its implication, to me anyway, is that we want to calibrate policy very carefully from here on out so that we give ourselves at least a chance of winding up in the right place for a sustainable period.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. On balance the Seventh District economy has slowed further since we met in early October. We're in an unprecedented situation and uncertainty is very high. Many business firms and households are essentially in a wait-and-see mode regarding capital spending plans and consumption expenditures. Both businesses and consumers are described by the people we talk to as hunkering down.



The major exception, as discussed before, is the recent surge in light vehicle sales. They are rising in response to the zero percent financing programs far more than the automakers had anticipated. Our Big Three contacts expect sales to drop once these programs expire later this month but not as much as indicated in the Greenbook. The sense we get from automakers and from UAW contacts, given that labor costs are relatively fixed under their collective bargaining contracts, is that various incentive plans will continue to be offered this year and next year to try to prevent light vehicle sales from falling below an annual rate of 15 million units.

In the hard-hit travel and tourism sectors, there are few signs of any significant improvement. Airlines have cut fares and hotels are offering special deals. Airline load factors, however, are a bit more sensitive to developments in the war on terrorism than the fare cuts. Our contact at \_\_\_\_\_ said that after cutting capacity 20 percent their load factors were good in the first week of October but plummeted once the bombing in Afghanistan started, dropped more on news of anthrax cases, and fell again when government officials issued warnings about additional terrorist threats.

Our manufacturing sector continues to bear the brunt of the District's slowdown but economic weakness is spreading more rapidly into other sectors, especially retailing. Consumers seem more focused on family and home, so sales of home improvement items are doing okay but sales of luxury items are not. One contact, with over 140 shopping malls in 39 states, reported that mall traffic returned to pre-September 11<sup>th</sup> levels in mid-October, but consumer spending at the malls was still noticeably lower than prior to the attacks. Retailers generally are bracing for what they think could be the worst holiday shopping season in a decade. Many have canceled orders and refused delivery of goods in order to keep their inventories under control.

How consumer spending fares in coming months will hinge importantly on labor market conditions, which are deteriorating rapidly. The latest Manpower survey of hiring intentions for the first quarter of 2002 shows the largest year-over-year drop since 1980. These results won't be released publicly until November 21<sup>st</sup>, so they should be treated confidentially until then.

Boeing is one of several firms we know of that are pulling forward layoffs they had planned for later this year and 2002. Small businesses that last year were desperately trying to retain workers are now reporting a dramatic drop in worker turnover. Wage demands of employees are abating. A special survey showed that 35 percent of firms had reduced the size of planned salary increases since September 11<sup>th</sup>. However, a frequently mentioned concern is the double-digit increases in insurance premiums for employee health care.

In our banking sector, reports on credit availability are mixed. However, the risk of loss in C&I loan portfolios at small and large banks with significant exposure to middle market auto suppliers has increased dramatically as a result of the financial difficulties of these firms.

Turning to the national outlook, it's now quite clear that we are in a recession, as defined by the National Bureau of Economic Research. What is not clear yet is how severe it will be. The data in hand are still consistent with a relatively mild downturn as in the Greenbook and our staff forecasts. But as I've already noted, business sentiment is very weak and I am increasingly concerned about the fragility of consumer sentiment in this very uncertain environment. Given all I've heard from contacts, we could be facing a worse downturn than the staff anticipates and, of course, that assessment does not include any additional negative shocks from further terrorist attacks.

To be sure, there are some positives going forward. We have put a lot of monetary stimulus in place and we suspect that significant additional fiscal stimulus is coming as well. Also,

energy prices have fallen. And once final demand stabilizes, we will get some big contributions from inventory investment. Indeed, when all the positives align themselves sometime next year, we'll have to be ready to adjust policy appropriately. For now though, the risks remain weighted toward economic weakness.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. The negative economic trends in our District that reappeared in the third quarter now extend into the fourth quarter. Some sectors have continued to deteriorate as the risks and uncertainties directly attributable to September 11<sup>th</sup> play themselves out. In particular, tourism, rental car activity, and airline traffic, although now improving slightly, continue to be well below pre-attack levels. Airline flights are off 25 percent and planes are reported to be only 40 percent filled. Rental car companies are "defleeting" and also have canceled new fleet purchase orders. Miami's cruise industry has been hurt by a large number of cancellations and Renaissance Cruise Line has filed for bankruptcy. Hotel occupancy in Miami is down; hotels whose bookings typically run at about 75 percent of capacity are now at 45 percent. In Orlando, traffic at Disney facilities is running about 75 percent of normal. Disney reportedly has asked employees to volunteer for a 20 percent cut in hours and pay. In contrast, business at casinos and hotels along the Mississippi Gulf Coast has come back to about 90 percent of normal levels. The difference in the experience of the two areas appears to be due to the greater dependence on air travel for most of Florida's customers.

Turning to other sectors in the region, new and existing home sales appear to be slowing except for continued strong growth in South Florida. Inventories of unsold homes are reported to be too high in Tennessee and in northwest Florida. While the pace of single-family construction remains only slightly below year-ago levels, both multifamily and nonresidential construction have

weakened further. Merchants report heavy discounting and are anticipating a weak holiday season based on “early bird” shopping. While full service store sales are especially disappointing, discount chains like Wal-Mart and Target are posting solid year-over-year gains. Auto sales dropped precipitously in the early fall but, as others have pointed out, they picked up at the end of September in response to extended warranties and zero percent financing. In October sales have been extremely strong and are arguably, as the Greenbook points out, at unsustainable levels. Manufacturing continues to be weak and contacts note falling productivity, as more resources are diverted to heightened security. More lumber mills are closing and high-tech firms are reducing payrolls further. After having been able to report job growth better than the national average in meeting after meeting, we are now also feeling the employment pinch. Only Florida actually posted significant job growth in the third quarter. Prices remain subdued, though we hear continued reports of increases in liability and health insurance premiums.

As far as the national economy is concerned, the data that have come out since our last meeting have not been very encouraging. While the reported third-quarter decline in real GDP of 0.4 percent could have been a lot worse and may be revised lower, Friday’s negative jobs report makes it clear that the economy is headed toward what eventually will be defined as a recession. That’s really a side issue. The key question for policy, as others have already indicated, is how severe it will be both in depth and duration. Comparing the current situation with historical experience suggests to me that there are reasons to believe it will not be especially deep or prolonged. First, as almost everyone has already observed, monetary policy has eased steadily since the first of the year and is presently accommodative. Second, significant government and private sector spending stimulus have been put in place with the recent tax cut, and more government spending programs are likely. Security investment, rebuilding, and insurance payment flows are all

likely to bolster spending. Admittedly, these types of expenditures will not lead to productivity increases. I'm not especially worried about that because of the need to keep personal income moving up in the near term until business fixed investment recovers. While the added spending will help, it is really a form of stop-gap income maintenance. Third, while the economy received a major shock on September 11<sup>th</sup>, the banking and financial sectors are sound and have proved largely resilient. Our examiners tell us that banks continue to lend prudently and that, while some deterioration in loan portfolios has occurred, the losses are not especially worrisome at this point. Unlike the financial situation in most previous economic contractions, it's hard to argue that financial system weakness and reduced credit availability have contributed or likely will contribute significantly to the decline in economic activity.

Monetary policy over the past year has done what it is supposed to do and arguably virtually all of what it can do to shore up the current outlook. The more important policy question for the short term is fiscal policy, the impact of which will depend on how the federal tax and spending programs are actually structured. Since a further change in monetary policy will have little observable impact on Q4 performance, our focus should be on the projected path of the economy over the next year and whether we believe that path is achievable. While the range of professional forecasts for the next two quarters is quite wide, those forecasts are remarkably consistent and quite optimistic for the second half of 2002, as is the Greenbook. Our experiments with some of those models as well as with our own VAR model suggest that additional easing at this point is not likely to provide any meaningful spending. In some ways, it might even hinder the adjustment process that still needs to work its way out in many sectors of the economy. Additionally, the Greenbook simulations of alternative monetary policies suggest that with slack demand and higher unemployment additional attempts to cushion the economy will ultimately be associated with a

further uptick in inflation. Moreover, to achieve any of these paths requires policy to be more nimble than in the past, in terms of raising the funds rate as the economy begins to recover.

I must confess that it confuses me at least a bit when Al Broaddus and Bob McTeer swap hats! [Laughter] Nevertheless, my views today are probably closest to those expressed by Gary Stern. While we continue to face considerable uncertainty and downside risks, I believe we have come to a point where further policy responses should be more measured. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, the economy in the Tenth District has not really deteriorated since our last meeting, but that's not saying much since it is considerably weaker than it was before the events of September 11<sup>th</sup>. Layoff announcements have subsided somewhat but remain significantly higher than before the attacks. The composition of the job cuts being announced also has shifted in the last month, with more now outside the airline, aircraft manufacturing, and travel industries in our region. District manufacturing remains in a slump but it does not appear significantly weaker than last month. Outside of autos, consumer spending has not recovered from the initial fall after the attacks and retailers in many areas are very much worried about the upcoming holiday season. The convention and hotel business has not returned to normal either, due not only to continued concerns about safety and travel delays but also to cost cutting by businesses under earnings pressure. Housing activity has slowed in much of the District, especially in the high-end sector and particularly in Kansas City and Denver. Those cities are also being hit with slowdowns associated with layoffs in the high-tech sector. These layoffs also are increasing concerns about commercial real estate. We see a lot of subleased space emptying out right now.

And though Realtors are prone to point out that it's not nearly as bad as in the last recession, they are in fact worried.

Let me say a bit more on manufacturing. Preliminary results from our Bank's latest survey of manufacturers show that production was about as weak in October as it was in September. Our firms are more pessimistic about the future than they were in the previous month. For example, the six-month-ahead production index was down about 6 points in the survey. Among other forward-looking indicators, the capital spending index fell about 5 more points and the inventories of raw materials index also declined. So, looking forward, there is quite a bit of pessimism in the manufacturing sector.

Let me mention the energy industry. It has eased further since our last meeting. The District's rig count is now down about 25 percent from the decreased level in July, as the steep fall in natural gas prices since the winter has rendered some marginal wells unprofitable. Spot prices have turned back, as you know, and we're at about the 3.50 MCF level, which is a level that at least will sustain activity at about where it is now.

In agriculture, prices have dropped in the cattle industry, as you know, partly because of a drop-off in restaurant demand after the September 11<sup>th</sup> attacks but also because there is a large inventory in the feed lines. Crop prices also have been weak, although there's reason for a little more optimism there with storage levels not as high as they were a year ago. Overall, business conditions in the District are generally poor.

Turning to the national economy, I would agree with those who say we are in a recession. As for the outlook, while our forecast differs in some ways from the Greenbook, I would say that in terms of the outcome it's a matter of degree, not substance. In that context, though, I think it's important to look at two time frames. One is the immediate future--that is, the fourth quarter--which

will be negative and will remain negative as we move toward the first quarter of next year. The other is the intermediate term--the first half of next year and into the second half--where the outlook is more optimistic in both the Greenbook and, as others have said, in forecasts by private economists as well. That's due importantly to a very stimulative monetary policy, fiscal policy that is stimulative and should be more stimulative as we go forward, and to the fact that energy prices have fallen significantly.

In terms of policy, I think we need to be very careful, as we always are, but our task is particularly difficult now. In that context I'll say just a couple things in summary. Regardless of the funds rate, the fourth quarter will likely be negative and there's nothing we can do about that today. With a significant amount of stimulus already in play, the economy should recover in the first or second quarter of next year, and there's probably not a whole lot we can do about the timing of that recovery at this stage. I would also point out that we tend to get very nervous when we have taken actions and we're not seeing a turnaround, and I think we need to be very careful and patient in such periods. So, I can't help wonder if we shouldn't pause, knowing the downside risks are very serious as we look to the future, and watch events develop. Thank you.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. Overall underlying economic conditions in our District have worsened somewhat since our meeting five weeks ago. While there has been a slight rebound from the initial decline in activity we saw after September 11<sup>th</sup>, the underlying trend still has a downward tilt and our contacts acknowledge a good deal of pessimism regarding the rest of the year. The October business outlook survey gave us our first data on the District since September 11<sup>th</sup>. Prior to the attacks, manufacturing in our region appeared to be stabilizing. That is no longer the case. The index of current activity took a sharp downturn in



October, indicating that manufacturing activity continued to contract in the District and at a much faster pace than in prior months. Indeed, the index is now at levels we saw at the beginning of the year. There was a striking consistency across all the indices. New orders, shipments, and employment indices all fell sharply in October. Manufacturers' capital spending plans remained weak.

In our October survey we asked some special questions to try to gauge the effects of the September 11<sup>th</sup> attacks. First, we asked each firm how the attacks had affected their shipments and new orders. Half of the firms reported that shipments were unaffected. But 40 percent reported a decrease and 10 percent said it was a significant one. The results for new orders were more troubling, since over 50 percent of the firms reported a decrease in orders, suggesting that activity will continue to be weak in the coming months. We also repeated a question from a previous month's survey by asking firms when they expected to see a turnaround. The results indicate that many of the respondents are putting the rebound further out into the future than they had in the past. There was some good news, however, in that 75 percent of our respondents still expect to see a turnaround before the second half of next year.

Other economic indicators for our District are weak. Payroll employment in each of our three states declined in the third quarter and the unemployment rate increased. It will likely go higher in subsequent months, given the current pace of layoffs. Retail sales in the District are running below last year's pace. Zero percent financing has boosted motor vehicle sales in the region, as many others have indicated for their Districts, but dealers expect sales to decline later this year since the incentives are pulling sales forward as well as generating new sales. Indeed, dealers report to us that they are limiting their orders from the factories. Retail sales of other goods and services have risen in recent weeks but have not regained the levels seen before the terrorist attacks.

Finally, construction activity in the District, one of our better-performing sectors during this downturn, has eased somewhat. Homebuilders in the District generally report steady demand for new homes, with some softening in demand for higher-priced housing. Nonresidential construction activity has begun to fall off.

On the national level, the events of September 11<sup>th</sup> and their aftermath have significantly weakened the near-term outlook for the economy. Even before the attacks, the economy was more sluggish than many of us had forecasted earlier in the year. The initial estimate shows a contraction in GDP growth in the third quarter, which is not a surprise. And most forecasts, including our own, see a sharp contraction in the fourth quarter. Typically the longer-run outlook is the least certain, but these days most economists feel more certain about the long-run prospects for the economy than the medium-term. Assuming no further shocks, we see a pickup in activity next year, driven by the aggressive monetary and fiscal stimulus. The difficulty, of course, is determining when this pickup will occur and whether further monetary stimulus will help to ensure a better outcome.

My outlook is similar to the Greenbook's, although rebounds have been much stronger historically than the one we are now forecasting. In addition, a Philadelphia staff analysis suggests that forecasters typically underpredict the response of output growth to expansionary monetary policy. Nonetheless, the incoming data certainly point to continued economic weakness in the near term and one could easily argue that the current period represents a break with past history. The October NAPM survey, like our Bank's business outlook survey, indicates that manufacturing will continue to struggle. Labor market indicators point to accelerated job losses. The sizable drop in consumer confidence suggests continued weakness in consumer spending. The surge in October auto sales drew sales from the future, so vehicle sales are likely to fall in future months.

Nevertheless, the auto sales data illustrate the stimulative effect of interest rate declines even in times of increased uncertainty and unease.

So where does this all leave us? In response to the devastating events of September 11<sup>th</sup>, the Committee's focus appropriately turned to the immediate term and we acted swiftly and significantly. The fed funds rate is now 100 basis points lower than it was on September 10<sup>th</sup>. Two months have now passed since the attack. I certainly do not want to underestimate the amount of weakness we are seeing in the economy and that we expect to see in the coming months. I'm sufficiently unsure about the timing and strength of the forecasted recovery, even given the sizable monetary stimulus already applied to the economy, that I would support some further easing action.

However, it seems incumbent upon us to begin to shift our focus back to the medium and longer term. In so doing, we would acknowledge that a significant amount of monetary and fiscal policy stimulus has been applied to the economy. By almost every measure, monetary policy is quite accommodative and there is more fiscal stimulus on the way. Focusing on the medium and longer term would help us prepare the markets and the public for the time when the Committee decides that further rate cuts are not needed. It would also shift some of the focus from monetary to fiscal policy. It would give us more flexibility going forward as we gather additional data on the economy's current condition and its trajectory. Thank you.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Thank you, Mr. Chairman. I want to comment on a few of the highlights from conversations I've had with business contacts. The extent of the weakness in the U.S. economy and its impact on Asia I think was well illustrated by my UPS contact who said that his firm's volume outbound from Asia has been running only one-half of what UPS had anticipated. Of course, that's because expectations were for a lot of high-tech equipment to be shipped here and that

has not happened. The UPS outlook is that next year will be better than this year and they are anticipating about a 2-1/2 percent growth in volume. Volume this year is running about 10 percent below last year. UPS, along with many others, is cutting capital spending. The firm expects to reduce capital expenditures by \$500 million out of a budget that would otherwise have been \$2-1/2 billion, so the cutback is about 20 percent.

My FedEx contact said that in his discussions with customers their belief is that business is going to be flat to the end of this year and on into 2002. FedEx sees flatness but not substantial weakness from here. The firm finds that since the end of September volume has been very steady and predictable, though obviously not strong.

My contact at J.B. Hunt, which is a very large trucking firm, says that customers are rather pessimistic. Business this October was about flat compared with last October; the company had anticipated growth of 10 to 15 percent. The market for used large trucks has collapsed. My contact described it as a disaster and he is expecting a lot of bankruptcies in the trucking industry.

I would like to finish on a slightly positive note in terms of reports from my contacts, so I will mention that Wal-Mart, as others have noted, is doing rather well. Wal-Mart sales for the five weeks ended October 5<sup>th</sup>, which includes the immediate and subsequent post-attack period, were up 6.3 percent. The company's expectation had been 4 to 6 percent, so total sales over that period were actually a bit stronger than had been anticipated. Moreover, Wal-Mart is not cutting its capital expenditure plans at all and in fact has revised up slightly its forecast for next year from the expectations held before September 11<sup>th</sup>.

I want to make a comment on fiscal policy. The temporary investment incentives that are being discussed are really very treacherous. Policy actions are being considered and yet the best experts in the world don't know how to forecast what the outcome is going to be. That says to me

that it's a very treacherous policy instrument. There is a lot of experience with temporary investment credits of various sorts over the years and I think the experience is not very favorable. Sitting where we are today it might look as if an investment credit is going to be a positive for the immediate future, but I think it's going to involve a high probability of some greater difficulty later. If the economy were to rebound strongly, we would see great efforts to bring capital expenditures forward into the temporary window. That would make the economy even stronger. Moreover, it would raise a lot of problems in interpreting the incoming data and trying to anticipate how much fundamental strength really exists in the economy. If the economy remains weaker than anticipated, we're going to see proposals to extend the temporary provision but we won't know whether it will be extended or not. In my view, our history of temporary fiscal policy adjustments is not a good one and I think they are going to cause trouble rather than provide any assistance to the economy. That's all I want to say at this point. Thank you.

CHAIRMAN GREENSPAN. Okay. It is a little after 11:00 a.m. I understand that coffee is available next door. Let's take a break but try to be back in 15 minutes.

[Coffee break]

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, the Second District's economy has deteriorated further since the last report, but it is very unclear how much of the weakening can be tied to the terrorist attacks and how much would have happened in any event. Widespread transportation disruptions that developed immediately after the attacks eased substantially in October. That includes the subway service to lower Manhattan, which is now reasonably well restored. Our big problem is getting people from New Jersey to lower Manhattan. About 55 percent of the people who commute into lower Manhattan come from New Jersey and an average commute

time that was an hour and a half is now two-and-a-half hours. Efforts are under way to get more ferries and other rerouting of the rail and subway lines, but that continues to be a difficulty.

Businesses most clearly affected by the disaster include retailers, hotels, and other travel-related firms. Retailers note that sales in October remained well below plan at Manhattan stores. That mainly reflects fewer tourists, especially international tourists who spend substantially more than residents of New York or tourists from elsewhere in the United States. Manhattan hotels experienced their worst September on record. Business reportedly rebounded moderately in October. The outer suburbs and outer boroughs are pretty much back to business as normal.

The impact on the local labor market is not yet clear. An estimated 75,000 additional jobless claims, well above trend, were filed in New York and northern New Jersey in the five weeks after the attacks. Commercial real estate markets in Manhattan and the suburbs have not tightened as expected since the attacks. What seems to be the case, despite the enormous loss of office space, is that firms were hoarding office space during the boom years and they have discovered they can now give it up. Citicorp, for example, had about 400,000 square feet earmarked for further expansion that it was able to make available to Lehman Brothers with really no burden to itself. The further expansion is now less likely, so Lehman Brothers won and Citicorp won. In general the view seems to be that relocation--most firms are actually going to midtown Manhattan--can be achieved without much additional building. That puts an another question mark on "Whither lower Manhattan?" In that regard I'll mention an interesting side note. Last Friday Governor Pataki declared, after a great deal of pressure from the business community--including our Reserve Bank, which in some ways considers itself part of the business community--that he was creating a corporation for the restructure of lower Manhattan. The members of that group I believe will be named later this week. That's a very positive development because there has been a real question

about who is in charge. The answer is that nobody has been in charge and therefore the degree of uncertainty hovering over Ground Zero as it's now called and neighboring lower Manhattan has been greater than it should have been.

Not surprisingly, because of the downturn in the financial services industry, Manhattan apartment sales activity has been very thin. It's hard to gauge exactly where the prices are but they are probably down 10 to 15 percent, with very few deals actually taking place. Bankers report weaker loan demand, tighter credit standards, and increased delinquencies. The residential mortgage segment appears to be faring relatively well.

On the national level, we share the view about the general shape of recovery that the Greenbook describes and that Dave Stockton presented so well. On the international side, I'm inclined to believe that Karen's forecast is accurate, but optimistic, and that the downside there is probably even greater than it is domestically.

Regarding consumer confidence, the fact is that housing has held up rather well. And certainly the pace of automobile sales in October, at 21 million units, indicates that people want to buy cars. It's nice to have zero percent financing, but presumably people don't purchase an automobile even with no financing costs unless they want one in the first place. So I think there are indications that consumer confidence is holding up better than we might have anticipated. How long it will hold up at this level is a very big question, as many of us have discussed.

Business fixed investment is abnormally low even for a recession. There may well be enough of it waiting on the sidelines that fiscal policy directed at increasing investment will work. But in my view there are some very legitimate questions about whether that will be the case. In any event, partisan politics are alive and well. They did not go away except for a very brief respite after

the 11<sup>th</sup> of September. So I think there is a real question of when and if the fiscal policy that is being discussed will happen.

We believe that the downside risk is very clear and quite dismal. That is a view that is shared fully by the members of our board of directors and by those on our Small Business and Agriculture Advisory Committee. It is also the view of everybody that I and my colleagues at the New York Bank talked to in trying to ascertain what is happening in our District as well as nationally and internationally. So I believe our forecast is the best forecast that can be made under the circumstances but it is one where the downside risk is very clear and the role of monetary policy continues to be a vitally important one. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. Listening to everyone who has spoken so far leads me to feel that it's not much easier today than it was five weeks ago to know what to make of either the economic reports or the anecdotal information available to us. I come to each of these meetings hoping there will be less uncertainty than the last time--and last time was uncertain enough--but that doesn't seem to have been the case today based on our go-around.

About 150 years ago a clever economist made a reputation for himself by talking about the unseen versus the seen. He had a lot of fun talking about those things that were not so obvious, but rather important to think about. Of course, that concept wasn't new with him. It was in the works of Copernicus and Ptolemy also. Nevertheless, what people are not doing at all or are doing less of is not news to any of us. However, what they are doing instead--if we can find out what it is--is of interest and might give us some clues. For instance, based on a lead from one of our directors we found that ticket sales for the Ringling Brothers Barnum and Bailey Circus in the last two weeks of October at Cleveland's Gund Arena were 10 percent higher than a year ago. So apparently people



are doing something for the family, which seems to be consistent with other things we've heard. In fact, both a member of our advisory council and one of our directors reported that the composition of consumption spending that they have been seeing is consistent with the notion of a cocooning effect. A couple of remarks by previous speakers support that notion--for instance, the spending on home improvements and durable goods for one's home. I don't know whether the car sales phenomenon goes with that too or not.

A company that produces security glass for both businesses and residences reported that they were already having a very strong year and they experienced a sharp increase in orders after September 11<sup>th</sup>. Our contact said that all four of the firm's plants are running at capacity and their backlogs are lengthening. Also, the health-care sector has generally boosted capital spending since September 11<sup>th</sup>, both for facilities and equipment. My contacts indicate that the expenditures are primarily for emergency room facilities.

As for the retail sector, we stay in contact with Federated department stores and they reported that their October sales were down year-over-year but the decline was considerably smaller than they experienced in September and much less than they had expected based on what happened immediately after September 11<sup>th</sup>. Their thinking now, looking ahead to this quarter, is that they will finish the year down 6 percent from the fourth quarter of last year. They've revised down their expectations for the spring to a 2 percent decline, year-over-year, which is a smaller decline than they were thinking a few weeks ago. And for the second half of next year they have projected a 6 percent increase year-over-year. Our contacts at both Kohls and Federated told us that they now expect stronger year-end gift giving sales than they had previously. They analyzed the composition of sales over Halloween and now believe the desire to give gifts is much stronger than before, which may also be related somewhat to the cocooning effect.

Tying in with some of the remarks made earlier about the uncertainty regarding what is going on with auto sales, auto dealers in our District think that sales will fall very quickly. They said their strategy is not to have any inventory on December 31<sup>st</sup>. One director, continuing in the good news vein, said that Bob Evans, Applebee's, and Ruby Tuesday's all had the strongest September in their history, which is consistent with people driving to places instead of flying to Florida, for example. The bad news side of that is that auto accidents are probably up!

One of the sources we've been looking at is a company called Telecheck, which has 270,000 outlets across the country that report on purchases by checks. The data are analyzed now by a former It's a rather interesting report. Sales in New York City, which is a big market and heavily weighted, were down 5 percent October over October. Overall sales in New York State were down about 1 percent. Those were the only declines recorded in the survey either by metropolitan area or on the state level. The Southeast was the strongest region, led by Louisiana and by New Orleans in particular. Maybe it's those casinos! One of the strongest states in the survey was Ohio, where sales increases were well above those in California. And the metropolitan area of Cleveland was second only in strength to New Orleans. So we're not quite up there at the top, but we're pretty close.

Eleven years ago at this time, looking ahead to Desert Storm and in the midst of Desert Shield, it seemed that both businesses and households went into a mode of postpone the postponable. The attitude was: "Don't do it now if you don't have to; wait and see what is going to happen." We met with quite a few groups in recent weeks, including our directors, advisory councils, and the senior credit officers of all the large banks in the District, and asked them whether they see a similar response today. Confirming what we're seeing in the numbers, the answer was "yes" for businesses but "no" for households. How does one explain that to a large extent the business sector, especially

manufacturing companies, seems to have gone into a postpone and wait-and-see mode while households have not? Generally, the initial response among our contacts was: "Apparently my spouse doesn't read the same things I do!" But upon further discussion they said no, in fact it's the opposite. The spouse usually says: "Haven't you read about unemployment and the bad economy? It's our duty to go out and spend." Apparently businesses don't think the same way.

In our meeting last week with senior credit officers I asked them to imagine that a year ago, when making their budget plans for 2001, they had accurately forecast the economic situation of today in terms of broad measures of output, employment, and so on. With an accurate forecast of the macro economy I wondered what they would have expected with regard to their consumer loan portfolio. They said they would have projected a substantially worse outcome. They would have assumed a very negative hit to the consumer portfolio, but that has not happened. Asked why, they suggested that the refinancing boom might be a factor, with the lengthening of maturities and, of course, lower interest rates. One banker commented that his bank's mortgage department is buried. The general view is that household debt service burdens are actually lower now than they were a year ago. If that could be confirmed, I would think that's pretty good news. They also reported that their commercial real estate portfolios were in much better shape than they would have thought; in fact they described them as excellent, which is quite different from the experience 10 or 11 years ago. I asked about car loans, expecting that there weren't any. But they said car loans are in fact still increasing. I had forgotten about imports and transplants, such as Honda, which did not offer zero percent financing. Honda didn't go that route because it doesn't like it and thinks it's a mistake. Toyota and in fact many of the DaimlerChrysler models were not included in the zero percent financing deals either. And Jeep, for instance, is producing a Toledo model for which they can't keep up with the demand. Moreover, the loan officers made a point that is obvious, but I hadn't

thought about it: With every new car sale, a used car sale almost always occurs too, and the banks often finance those purchases.

Let me make some general comments on economic policy actions and the performance of the macro economy. It seems to me that a prescription for policy should be derived from a diagnosis. We never see all regions, sectors, and industries of the economy moving up or moving down together. There have been times in past history when we've seen weakness in sectors like housing and autos. Those situations often warrant a prescription of easier monetary policy; lower financing rates may seem appropriate. When I look at the fiscal policy under consideration today--and having listened to the staff this morning regarding the uncertainties about it--it's very hard to understand what might be going on, in the way of economic thinking at least. I don't know how what is being proposed or considered by the Congress is going to help any of the problems that we actually see now in the economy. It's easy to understand the need for separation of powers in the branches of government. And it's easy to understand that members of Congress want to raise their hands and vote for something. They want to be perceived as being a part of the solution. But it's not at all clear to me that anything that is being proposed under the banner of fiscal action is going to be on balance constructive. That assessment may be derived from my general bias in that I've always been skeptical about the thrust of fiscal policy actions. But I could easily talk myself into believing that the fiscal actions currently under consideration will do more harm than good.

On monetary policy I distinguish between the level of the fed funds rate and the reactions associated with announcements of changing it. The level, of course, is important because we need to know where the funds rate stands relative to some perception of the natural rate. That's crucial in assessing whether we are injecting a sufficient amount of liquidity for the macroeconomic circumstances to achieve the outcome we want. That's one issue. I look at where we are and

evaluate other information to tell me whether I think the funds rate level is appropriate or not.

That's quite different from the issue of announcements of the Committee's decisions to change the rate, which show up in the headline news. When I engage in the debate between "keep the powder dry" versus "take preemptive action," I think in terms of how many more announcements we might want to be able to make. That would lead me to suggest one-eighth of a point changes in the funds rate as more appropriate at this juncture because then we would capture more headlines. But that has nothing to do with whether I believe the current stance of policy is sufficiently stimulative or not.

Finally, my thinking is that over time the Committee should look at the balance of risks, not in terms of the statement that we put in our announcements, but in the sense of what kinds of mistakes are we more willing to make and how can we correct them. We know that mistakes are inevitable, but we need to assess which mistakes are more harmful or more difficult to correct. There was a time when we thought the greater risk was for policy to remain stimulative for too long because having to tighten dramatically would be difficult. So we thought it would be better to err on the side of restraint because we could always ease more readily. I now perceive, at least based on some of the comments made around the table, that the balance of risks is reversed. And that may be correct and appropriate. Now the view generally is that the risk of being too restrictive is the greater mistake, especially looking at the experience of Japan and theoretical worries in some other countries, resulting in either deflation or prolonged contraction. So the thought is that it's better to err on the side of more stimulus. While that may be correct, I think we should be saying, at least among ourselves if we don't want to go public with it, that we are more tolerant of running the risk of re-inflation than we were before.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. Our decision today, as Jerry Jordan has just indicated, comes at a time of great uncertainty. I think our challenge is to minimize the risk facing our economy in these uncertain times. As we have already indicated around the table, there are some positive signs that can't be overlooked. Certainly the strength in light vehicle sales is attributable to incentives to some extent, but there are those who believe that it's more than that and may reflect some positive sentiment remaining among households. Several forward-looking financial markets, particularly the equity markets and the futures markets--and perhaps even the level of the U.S. dollar--attest to a market expectation of a rapid rebound. And finally, as has already been discussed, monetary stimulus is in the pipeline and fiscal policy may well become more accommodative.

However, buried within these potentially positive signs are some negative ones, and we have already talked about those to some extent. The current strength in auto sales is probably borrowing from future demand and we can expect demand for autos to fall off. There is the possibility that the process of finding a fiscal stimulus package that works for all will produce fiscal action that is too little, too complex, and too late. And finally, the strength in equity markets may well erode quite rapidly and we could have a negative wealth effect as earnings fail to meet the expectations that are built into equity market prices.

Against the background in which much of the good news in the near term is potentially bad, certainly there's a lot of other negative news as well. Labor market weakness is spreading beyond manufacturing to other sectors. With the specter of growing unemployment likely to weigh more heavily on consumers, weakness in the labor market will mean, I think, smaller increases in wages and salaries going forward, potentially undermining consumption as a major driver of macroeconomic strength this year and next year. While the housing market appears to be robust,

there is some anecdotal evidence from building materials firms that suggests some weakening in the construction segment. One of our contacts noted that for the first time since late 1991 several construction firms plan to close down between Thanksgiving and Christmas because of insufficient order backlogs. Again that's a small sign of some uncertainty in an area that has been strong for some time.

More recent data on durable goods orders suggest that companies are hoarding liquidity and more firms than had been expected are holding off on putting new fixed investments in place. Participants in the bond market tell us that even the record-setting bond issuance, which could be seen as an indicator of business confidence, is better interpreted as indicating that the free cash flow for firms is insufficient to cover even existing investment activities much less support new ones. And finally, as I think Dave Stockton mentioned, survey indicators show that manufacturing is clearly contracting and I gather that our own IP numbers may well support that conclusion.

We haven't put very much weight on the international outlook, though I would agree with Vice Chairman McDonough that Karen's forecast seems to be the most reasonable one given the facts we know now but that the risks internationally certainly are very much to downside. And insofar as commodity prices tend to suggest the relative balance of supply and demand in global markets, certainly commodity prices are suggesting further slowing, not a pickup.

The question is how to guide policy with this confluence of developments. Recognizing the risk that we might do too much, I would still err on the side of continuing to be aggressive, which I think speaks directly to the point Jerry Jordan was just making. The best strategy when confronted with an ongoing deterioration is to move to offset the worst downside risk and prepare to respond to the upside in the unlikely event that we're surprised in that direction.

While it is true that monetary policy in the pipeline is already stimulative, it's important to recognize that we put that policy in place against a particular background of a forecast and outlook at the time and, if anything, the outlook has continued to erode. Accordingly, I think that does require ongoing policy response. The one mistake that a central bank can make when confronted with the type of erosion that we are facing, which may indeed include the risk of disinflation, is to move sluggishly in increments that are too small out of fear of hitting the zero bound too quickly. That cautious strategy is the most risky because it leaves open the possibility of a much weaker situation still in the context of little room for policy maneuver.

So, while Bob McTeer encouraged us to remember the Alamo, I would suggest that perhaps the experiences of the Bank of Japan and others might be important to remember as well. Thank you.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. An important theme at our last meeting was uncertainty. We were meeting reasonably close to September 11<sup>th</sup> and it was still hard to sort out the data. It's easier to do the sorting now. To paraphrase Murphy's Law, almost everything that could go down, did. It's pretty hard to find sources of strength in today's economy.

The list of downward-pointing indicators is long and getting longer: the Beige Book, employment, the NAPM survey, durable goods orders, consumer confidence, industrial production, commodity prices, foreign demand growth, and on down the list. What seems especially troublesome is that former sources of spending growth are beginning to weaken. Housing expenditures are beginning to slip and consumption is starting to fall relative to disposable income. As Governor Ferguson just noted, auto sales spurted but that could imply weakness ahead if the sales just reflect an immediate bunching of expenditures in response to the zero interest rate deals.



The stock market is surprisingly high, but that could be problematic as well. The earnings-price ratio is now virtually the same as the real AAA bond yield and this with analysts' earnings forecasts that are still implausibly optimistic. When and if more prudence strikes the earnings forecasters, or if more normal risk spreads assert themselves, stock values could fall as well.

Many commentators are now arguing that because all of this has happened as interest rates were cut, monetary policy must be impotent. Perhaps I'm preaching to the choir here, but since I think it's relevant for our decision, let me spend a minute taking on that argument. To be sure, monetary policy has been fighting very powerful downward forces this year, far more powerful than I think any of us imagined at the start of the year. Policy easings may not have had the curative effects that we had all hoped for, but I think the impotence argument takes things much too far. The essence of monetary policy is through the interest rate-cost of capital channel. In the Goldman Sachs financial conditions index this interest rate channel gets 90 percent of the weighting. In the FRB/US model its weighting ranges from 76 percent to 90 percent, depending on whether one takes one-quarter impacts or long-run impacts. And that channel has worked well this year. Short rates obviously have dropped sharply. Even longer-term, 10-year Treasury rates have come down from 4 to 3 percent in real terms since the start of their easing cycle last year and from 6 to 4-1/2 percent in nominal terms. These changes have held up final spending. This year the easing of monetary policy clearly seems to have held up spending for housing and consumer durables, especially autos. It's possible that it has even had some positive effect on investment, though it's obviously hard to make that case given the powerful downward impact of the capital overhang.

I will agree with the critics that there are both theoretical and empirical questions about some of the other ways that monetary policy allegedly stimulates the economy. One suspect channel

involves the foreign sector. It seems that a drop in interest rates doesn't necessarily lower domestic currency values, perhaps because it raises expected profits or perhaps because conditions might have become even weaker in other economies.

The other suspect channel involves the wealth effect. There seems to be no doubt that a rise in future productivity will raise equity values and consumption, as people try to consume some of their future anticipated income up front. But whether falling interest rates and rising relative house prices, which do raise computed net worth, should also raise consumption has always been a matter of some theoretical ambiguity.

So monetary policy is perhaps not as potent as some believe, but it still can have powerful impacts, still can be used to fight downward movements, and still has been effective in maintaining spending this year. In the face of the powerful downward momentum that seems to come with each day's economic news, I think we have no choice but to use our instrument as emphatically as we can.

Finally, let me say one word about reversibility, something about which I am not very worried. Much of the Greenbook recovery hinges on additional fiscal stimulus, which is somewhat in doubt for political reasons and is perhaps even economically treacherous. It's not so much of a stretch to say that the world recovery hinges on the U.S. recovery, which hinges on fiscal policy, which hinges on politics. That is an exaggeration, I admit, but not too much. It's easy for me to imagine a very slow recovery here and in the world and that should give us plenty of time to reverse course. But if conditions are such that we have to reverse more quickly, that would actually be fantastic news and we should be delighted to do that.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. Relative to the current Greenbook forecast, I believe that there are still asymmetric downside risks to the first half of next year but that the risks are more balanced after that time. Because of the near-term downside risks, I view the alternative scenario of still weaker consumer spending as identifying a material risk. Given that risk and considerations that, in my view, suggest that policy today should be set to err on the side of stimulus, the path of the federal funds rate in my forecast is more consistent with the easier monetary policy alternative simulation. Indeed, that would be the case even if I were beginning with the Greenbook baseline. Still, as David Stockton noted in his presentation, there is an unusual blend of pessimism and grim data on the one hand and signs of resilience on the other hand, further complicating the assessment of the outlook.

But my major concern relates to the question of the appropriate monetary policy relative to the forecast. My first concern here is that monetary policy may be less effective in this easing cycle than it normally has been because of the failure of the declines in short-term interest rates to pass through to other dimensions of financial conditions that matter more for spending. In that regard I recognize that my views run counter to the remarks we just heard and to many of the comments around the table this morning that have emphasized the amount of monetary stimulus already in the pipeline and its likely contribution to the vigor of the projected rebound.

Financial conditions indices, including the one recently constructed by the Board's staff, are sometimes subject to difficulties in interpretation. But they do in my view highlight the risk that financial conditions have improved much less than would have been expected based on the magnitude of the cumulative decline in the federal funds rate over this easing cycle. The Greenbook forecast presumably takes this into account. Indeed, I suspect it may be the reason why monetary policy is assumed to remain so stimulative, measured in terms of the real funds rate relative to its

long-term equilibrium value and relative to the economy's rebound. The implication of concerns about the improvement in financial conditions is not that we should rely less on monetary policy but that we may have to do more than would otherwise have been necessary.

Second, I wonder whether we need to take into account another aspect of asymmetric risk --what might be described as the two-states-of-the-world problem. The Greenbook, like most forecasts, seems to assume a one-time terrorist attack with a near-term effect on confidence that dissipates over time. That might be appropriate for a modal forecast. But relative to this assumption, there seems to be significant asymmetric downside risks, specifically of further terrorist attacks that affect confidence in the economy or perhaps for other reasons as well. The forecast for the first state of the world is therefore likely to be biased in an optimistic direction though, as David Stockton noted, we would be hard pressed to parameterize the downside risks associated with the second state of the world. Still this analysis suggests that the mean of the forecast might be interpreted as being below the mode in this case. So the question is how policy should respond to this type of uncertainty and whether policy should be set to err on the side of ease relative to the modal forecast.

This concern is reinforced by the implications of the zero nominal bound restraint. My remarks here will elaborate on the points that have already been made by President Broaddus and Governor Ferguson. Some have suggested that the initially low nominal funds rate should encourage us to keep our powder dry. To the contrary, I read the lesson from our study of the zero nominal bound constraint as pointing to an asymmetric policy response, one that is more rapid with respect to downside shocks. This allows policymakers to use a faster speed of response and compensate for the smaller possible cumulative decline. The result of the more aggressive policy would be to limit further declines in core PCE inflation, restraining it from falling below my long-

run target of 1-1/2 percent as it does in the Greenbook baseline. This maintains a cushion that would allow a larger decline in the real federal funds rate if needed.

This may be less of a pressing concern at the moment given the steepness in the yield curve and the opportunity for long rates to fall relative to short rates if the downturn is deeper or the recovery more gradual or longer delayed than now expected. A more rapid easing would, however, provide an opportunity for long-term rates to fall by more over the forecast horizon if the sharpness of the decline or the moderation of the recovery disappoints the financial markets. In any case, I take the lessons from the zero nominal bound analysis to mean we probably should move more aggressively in response to adverse shocks, not less when nominal short-term rates are already low.

My last concern is about long-term rates. While they have declined somewhat further recently, they have been sticky in relation to the cumulative decline in short-term rates. As a result, I have become concerned that we may have lost the ability to lower them further with monetary policy and, therefore, have quite limited leverage on aggregate demand. This stickiness may reflect in part, as David Stockton noted, the offsetting effect of a revision in longer-term budget prospects. But in my view, it may also reflect a divergence between the FOMC's forecast for the economy and the forecast implicit in the bond market, equity markets, and the federal funds futures market. Given the more robust forecast apparently priced into these markets--most evident in the expectation of an early and aggressive reversal in the federal funds rate--any further decline in the federal funds rate may be viewed as unnecessary, even damaging, and in any case short-lived.

As a result, I have mused, the best way to stimulate the economy might be not to lower the funds rate further but to encourage a decline in long rates relative to short-term rates. How can we do that, I hear you ask? [Laughter]

CHAIRMAN GREENSPAN. To say the least!

MR. MEYER. Perhaps, I muse again, we could do that by being unusually transparent-- that is, by informing markets that we view the economy as weaker than they appear to be assuming and that as a result the federal funds rate is less likely to rise as soon or as aggressively as they expect. As I said though, I am just musing here--I think--and perhaps amusing, [laughter] as opposed to making a serious policy recommendation.

CHAIRMAN GREENSPAN. You're on, Governor Kelley.

MR. KELLEY. I really should pass at this point! Thank you, Mr. Chairman. At the time of our last meeting, the economic horizon already appeared dark, but there was little hard data yet available to judge the severity of unfolding events. Since then we have gotten considerable information that indicates that we have on hand a steep and rapid decline that may be starting to feed on itself in a vicious cycle. It's not a pretty picture.

It continues to be my view that monetary policy played a crucial and appropriate role in the economy over the first half of the year. But we have now entered a period when its influence will be subordinate to the unfolding of other events, political and military, domestic and international, and how they impact on net with the psyche of the American consumer. Our challenge today is to identify how monetary policy can most usefully assist in assuring a positive outcome, and that will be discussed shortly. This will be an interesting exercise because even if everyone had precisely the same view of the economic outlook, several different policy prescriptions can be seen as the best way to go.

Although fiscal actions under consideration have been discussed earlier by several around the table, please let me make a brief comment on the expectations that a temporary investment tax incentive may induce a significant early spurt in capital investment. Obviously, such a tax break is quite attractive and tempting. However, given the present environment of extremely low capacity

utilization, rising unemployment, and weakening demand, this gambit may prove disappointing. Beyond whatever level of capital spending will occur regardless of events, a great many firms, especially the smaller ones that constitute half or more of the nation's production, are likely to conclude that attractive as this incentive may be, they simply cannot afford to acquire nonessential additional capacity when their existing capacity is so underutilized and the outlook is so uncertain. Larger and stronger companies who have more maneuvering room in managing their capital structure are better candidates to accelerate their investments. However, they may wait and see until the last minute before the incentive sunsets before making major discretionary commitments. If that day is in the second half of 2004 it may come too late to be of much help, as the tale of the economic recovery will by then have long since been told. If the economy is rebounding, they will be investing anyway and the incentive would be unnecessary. If the economy is still in the doldrums at that time, this incentive is unlikely to smoke them out, and policymakers will be searching for stronger medicine. Thank you.

CHAIRMAN GREENSPAN. Thank you very much. We now turn to Don Kohn.

MR. KOHN. Thank you, Mr. Chairman. The policy easing you have already undertaken--and in particular the 100 basis point reduction in the federal funds rate in the three weeks after September 11--anticipated a substantial downdraft in economic activity. Nonetheless, with the incoming data indicating that the economy is even weaker than expected, and by a considerable margin, the question you would seem to be facing again today is not whether to ease further but rather by how much.

To be sure, your answer is not likely to have an appreciable effect on the near-term trajectory of the economy, but it will alter interest rate expectations and asset prices now and in the future and, in so doing, will help to shape the eventual recovery. The extent of the contraction is important to your policy decision. The larger the output gap created as the economy goes through this current period of weakness, the stronger the rebound that can be accommodated consistent with satisfactory inflation performance over the longer run.

Market participants expect you to lower the funds rate today, and they have put a little more weight on a decline of 50 basis points than one of 25. The cumulative easing they have built into the yield curve stands at close to 75 basis points by early next year. Although whatever you decide is likely to have some effect on interest rates and asset prices, the changes may not be large--at least immediately. Much of the initial adjustment is likely to be in the expected timing of further ease--when markets see the funds rate hitting bottom, rather than in the level of the rate at that point. But the cumulative size of the anticipated easing will be affected, at least a little, and possibly more so over time, as the markets factor in their perceptions of your concerns and responses when reacting to future information. An important aspect of the decision today, then, is how you would like to nudge those expectations and asset prices in light of your assessment of the outlook, the risks around that outlook, and the costs of the economy deviating to one side or the other of its most likely path.

In the staff Greenbook forecast, only 25 basis points of further easing, along with greater fiscal stimulus than assumed in the last forecast round, helps to promote a rebound in activity after a relatively shallow contraction. Indeed, the added monetary and fiscal policy actions about compensate for the greater-than-expected near-term weakness, leaving the level of output at the end of the projection period close to where it was predicted to be in the last forecast round.

In a couple of respects, financial market prices suggest that participants in these markets foresee a stronger revival in economic activity than does the staff. Markets are anticipating a little more easing than the staff has assumed, but also a quicker and more substantial increase in the federal funds rate thereafter, presumably in response to a more rapid pickup in growth. The rise in equity prices and the substantial narrowing of risk premiums on junk bonds over the intermeeting period are particularly noteworthy in the face of downward revisions to near-term economic and interest rate expectations. This more favorable attitude toward risk suggests that financial market participants have become less fearful about future prospects and are expecting better earnings performance than is the staff. Giving some weight to the stronger tenor of market expectations would lend support to a decision to limit the easing at this meeting to 25 basis points.

Moreover, the Committee may prefer to reduce the federal funds rate only 25 basis points at this meeting even if it sees a high probability that further easing will eventually be needed. Moving gradually, rather than front-loading the additional ease, might have a number of advantages. Importantly, it could help you to calibrate the extent of your easing better. Additional time should give you more information about the economy's developing response to your earlier actions, which include some unusually large easings very recently. In addition, the nature of the fiscal response to September 11 could



well become clearer in the next month or so, and you will have more data to help sort out the more persistent effects of the attacks on consumer and business behavior. Moreover, the Committee may want to take account of the possibility that over the next several months the interaction of market expectations and fragile public confidence will weigh heavily on the side of further easing as the economy continues to contract. If the stance of policy is set now to fully anticipate that oncoming weakness, you could be faced with weighing the risks of disappointing the markets and the public on the one hand, or easing policy excessively on the other. If financial markets have done a reasonably good job in reading your intentions and building the policy actions you anticipate into current asset prices, little of the stabilization power of policy would be sacrificed by moving in more measured steps. In the present situation, market participants are likely to continue to anticipate at least another 25 basis points of easing after a 25 basis point move at this meeting. And that might be roughly consistent with your own estimate of what will be needed, though, as noted, the structure of market rates also incorporates a substantial policy tightening beginning later next year.

However, the risk in a gradual approach to policy implementation is that policy actions may turn out to be insufficient to forestall a cumulating, self-reinforcing, movement in the economy because the forces bearing on demand or prices prove to be stronger than the central bank or the markets anticipate, or because the economy is hit with another shock in the same direction. In the current circumstances, with incoming data and the near-term outlook considerably weaker than anticipated at your last meeting, and with the rebound still only a forecast, the Committee may see a more aggressive policy easing of 50 basis points as better calibrated to the prevailing profiles of the economic risks and the costs and benefits of potential alternative outcomes.

The recent data may indeed be consistent with a short period of weakness in which adjustments are compressed and the stage is set for a fairly prompt and robust turnaround, as the financial markets seem to believe. But they also may be symptomatic of a deeper and more prolonged contraction. The latter could occur as both households and businesses engage in a mutually reinforcing withdrawal to safer balance sheet and spending patterns in the face of the heightened level of uncertainty and concern about the future.

The forecast of a reasonably shallow downturn and robust recovery depends not only on a measured response of households to high levels of job losses, but importantly also on stimulative fiscal actions that have not yet been agreed by Congress and the Administration. Were such an agreement to be delayed significantly or structured in such a way as to be less effective than has been assumed, easier monetary policy would be needed to carry more of the load in stimulating the economy. And, a substantial shortfall in fiscal stimulus could require appreciable further monetary accommodation. The

decline in stock prices and the strength of the dollar this year have counteracted much of the effect of your previous easings, raising questions about how much stimulus from monetary policy alone is now in train to counter more persistent forces of restraint on private spending behavior over the next few quarters. Moreover, the downturn is unusually synchronous and interactive around the world, but global demand may not get much of a boost from monetary policy elsewhere--at least from policy in the other two main currency areas. The Bank of Japan is constrained by a lack of effective alternatives, and the ECB seems hamstrung from vigorous action by a desire to build consensus amid concerns about establishing price stability credentials in its initial years.

If the standard forecast is correct, were the Committee to ease by 50 basis points at this meeting and perhaps by smaller amounts in coming months, you would find yourselves next spring with a strengthening economy and monetary policy in a very stimulative position. But, unless the contraction is a lot shallower than most expect, you will also be facing an economy with a considerable margin of excess labor and capital that will be exerting downward pressure on inflation. In these circumstances, the FOMC should have ample time to begin to firm policy to forestall the onset of inflation pressures. If, on the other hand, the recent data signal that the economy is in a steeper contraction, you will want to have eased aggressively to cushion the fall and to foster a more rapid rebound.

If the Committee sees inflation as most likely to be moving down as slack accumulates in labor and product markets, it may perceive little benefit from risking a further shortfall from the expected path of the economy and see reasons to lean a little harder against that possibility. The cost of such a shortfall could be unusually large. Not only is there the potential for cumulating downward movements in output for a time, but that spiral could be prolonged under circumstances in which the nominal federal funds rate is already low and the forces of restraint turn out to be large and persistent. In these circumstances, economic slack could reduce inflation and inflation expectations so far that it became impossible for the Federal Reserve to drive real interest rates far enough into negative territory to counteract continuing weakness. If this is seen as a possibility, acting gradually--that is, "keeping the powder dry"--risks finding yourselves in that very situation. Therefore, it would be especially important to act preemptively to bolster the economy, limit disinflation, and forestall being "pinned to the zero bound," as the Bluebook put it.

Taken together, these aspects of the current situation may be seen as arguing for leaning on the side of another 50 basis point easing at this time, rather than 25. The larger action is likely to lower somewhat market expectations of the funds rate over the next few months, but the effects of such revisions in reducing interest rates further out the yield curve and in

supporting equity prices may be seen as providing a desirable extra margin of financial accommodation in the face of the downside risks and costs.

Whatever you do, the tenor of the incoming data on both output and prices and the downward revision to near-term forecasts would suggest that economic weakness continues to be more of a concern than rising inflation. At some point, near-term weakness will be balanced by the prospects of an expansion in the future that could give rise to inflation pressures, but for now and into the foreseeable future, the risks to achieving your objective for sustainable growth would seem to outweigh those to longer-run price stability. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Questions for Don? President Hoenig.

MR. HOENIG. Don, doesn't arguing for a 50 basis point cut, on the grounds that the economy may be worse than we thought likely, lead to arguing for an even larger cut because we ought to do all we can now given the limited inflation risks from such an action? You didn't mention making no change in the funds rate, but that would say that we reacted very strongly after the crisis--which I agree is what we should have done--and are awaiting the effects of those actions, which haven't even come into play yet. But the rationale for a 50 basis point move is that we are so fearful that we think we should make a large cut. It strikes me that that argues for an even greater cut given the uncertainty and the lack of inflation risk from that.

MR. KOHN. I think it depends on where you see the central tendency of your forecast. I believe the central tendency among Committee members is for something like the Greenbook forecast--some additional weakness followed by an upturn next year. We're talking about the risks around that central tendency. One could view 50 basis points of ease not so much as a response to the central tendency forecast, if that appears to be a reasonable forecast, but rather to the risks around that central tendency. By risks I mean not only the risk that the economy could turn out to be weaker and the rebound weaker, perhaps because the fiscal stimulus doesn't come through, but also the costs of falling short. We could end up with a very severe disinflationary pressure that policy would have trouble catching up to--being behind the curve, as Committee members sometimes like

to say. Getting behind the curve on the downside might be particularly costly at this time. If you had a very weak central tendency forecast, then I would agree that you should be considering a larger cut. But with a central tendency about like the staff forecast, I think we're really talking about the risk around that forecast.

MR. HOENIG. May I ask one other question? With a 50 basis point move, in your opinion are we going to affect the markets' expectations going forward? Will those expectations be completely revised and instead of 75 basis points of ease on the horizon from where we are will they talk about another 75 basis points from where we would be if we were to go with a larger cut?

MR. KOHN. I think a move of 50 basis points will have a relatively small effect on market expectations. After all, markets have already built in about a two-thirds probability of a 50 basis point cut. I don't put too much weight on the precise measurement of that probability, but you would not be greatly surprising them with such a cut. I would expect something along the lines of what happened after your last meeting when the markets were debating between a reduction of 25 or 50 basis points. You did 50, and the markets revised down the out-year Eurodollar contracts by 7 to 9 basis points. And I think that kind of response would not be an unreasonable one. So I would anticipate some downward revision, but not a big one in the immediate expectations.

MR. HOENIG. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. My question is along the same line. You've drawn--and maybe this is just my perspective--what seems to me to be a fairly stark difference between a cut of 25 versus a cut of 50 basis points. I must say I was troubled by your comment about getting ourselves into a liquidity trap without a 50 basis point cut. I understood you to say that a 25 basis point cut would

not work to avoid that problem. I found the starkness of your argument a little off-putting and I thought you might expound a bit more on that.

MR. KOHN. I think that's partly a function of how I structured the briefing, in terms of trying to give all the arguments for doing 25 basis points and then all the arguments for doing 50 basis points. It's clearly a matter of considerable judgment. And there are arguments on the 25 basis points side. This may be one of those unusual situations--President Jordan said he thought this might have happened over the last few weeks--where we really do get some information over the intermeeting period. As he remarked, we've been disappointed by that information. As many of you commented, the gridlock on fiscal policy may well persist past December 11<sup>th</sup>, the date of your next meeting. So I think there's that argument. The markets have built in more ease. You're only reducing expectations by a little. We could be getting a rebound next year. It's really more a question of where you want to take the risk. I don't think the differences between the two choices I described are as stark as you suggested, but there are differences in emphasis, differences in message, and differences in what might happen.

MS. MINEHAN. Let me say a little about the implicit comparison to the Japanese situation. We've been so much more aggressive in a very much shorter period of time than the Bank of Japan was. And our economy is so much more resilient--people use that word over and over--than their economy seems to be in terms of the expectations of consumers and the innovation of businesses and so forth. I recognize that there is a potential for all of the academic work we've put into the zero bound on nominal interest rates to come into play here, but I question the reality of those expectations or those worries in the context of where rates are now.

MR. KOHN. Well, you do have 250 basis points before you get down to where the Japanese rates are. So you have a ways to go. And I agree with you that our financial system--our

private economy and our financial markets--is much stronger than the Japanese system, which is really what is holding them back.

MS. MINEHAN. Right.

MR. KOHN. On the other hand, our economy is subject to some unusual shocks and we just don't know how businesses and households will be responding to unfolding developments. And there are downside risks. Some in the market see a bottom to the federal funds rate at 1-1/2 percent. So, the rate is approaching that level. It may be a little premature to have boxes in the Bluebook and a discussion around this table of the zero bound, but it's not that premature. One could construct a scenario in which there is a major loss in confidence, as in the alternative scenario in the Greenbook, or scenarios in which business activity and foreign economies are much weaker. I think we could all sit here and write down about three or four developments that would seriously weaken this economy. They would all have to occur at the same time--a number of very bad things happening at once--including the possibility of another terrorist attack. It's not impossible to imagine that six months from now the Committee could be dealing with some very, very low interest rates.

MS. MINEHAN. I don't put that out of the bounds of possibilities. It's a question of how much control we use in the process of getting there.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. I just have a comment on Don's presentation. I thought you were especially effective this time, Don, in making the case for both a 1/4 point move and a 1/2 point move. Indeed, it was a bit of a roller coaster ride for me. I felt myself being swayed first in one direction and then whipsawed back in the other direction. So it was an enjoyable ride! Thank you.

[Laughter]

CHAIRMAN GREENSPAN. Any further questions for Don? If not, let me proceed.

This is a particularly difficult period and I want to start off with a few important issues. The first is that we keep forecasting stabilization but there has been no evidence of it anywhere. We go from one Greenbook to the next with a projection of rising economic activity, at least beyond the near term. And, indeed, by the processes we employ for forecasting, that conclusion is inevitable. The alternative forecast would be one that violates the rules of statistical inference or, I should say, the great historical research that Dave Stockton set into motion, which concluded that the United States has never had a recession that failed to end. That general view is very helpful, I know, but the important issue is for us to be aware that we are witnessing developments that are quite extraordinary. As a number of you have mentioned, the international outlook is continuing to deteriorate. We currently are observing the obverse of the extraordinary accelerations that occurred in world economies during the latter part of the 1990s as a consequence of increased globalization--a development that is now seen as a two-edged sword. Indeed, the dispersion of growth rates in economies around the world has come down very dramatically.

There is an increasingly synchronous and mutually reinforcing pattern of economic activity among the world's nations, and we are beginning to see a gradual breakdown of barriers to stabilization as our economy goes from one stage to the next. The erosion is slow but persistent. It is a development that I don't think any of us has seen previously. We certainly don't put it into our econometric models, whether they are structural or VAR. Indeed, the one thing we can say about our models is that left to their own devices they will not project a long-lasting deflationary process. The coefficients and the structure of the models always produce an upturn at some point. There is a tendency to revert to the type of growth path that has characterized our economic history. We cannot presume that we can put a few exogenous assumptions into our models and then conclude the model predictions are telling us something. I submit that that is not true. We are telling the model

what to conclude by the way we have built it, and indeed the exogenous inputs that we put in will not induce a contraction unless we go far beyond the normal range of inputs that we have used in the past. Nonetheless, the real world has the potential to generate deflation, and I think we are moving gradually from a disinflationary process toward a situation where we could begin to experience outright deflation. I think that inflation rates finally are getting down to a level that can satisfy Al Broaddus, which is something I thought would never emerge. But the point is that he's right. At this stage I don't know what the next Greenbook is going to show, but I would wager that it will indicate a weaker economy. What is very disturbing is that we have not yet seen any underlying basis for stabilization. In that regard I found the comments around this room very distressing. To be sure, nobody has said that the economy is weakening substantially; it is not recovering, but neither is it going down precipitously.

There is one part of our economic system that is saying in effect that the economy is stabilizing. It is called the stock market, and I hope it is right. The stock market patterns of the last several weeks are essentially projecting a bottom in the U.S. economy and the world economy sometime in the early months of 2002. If the market were a person, I would ask about the basis for such a conclusion. Earnings expectations continue to decline, and we are seeing patterns that historically would suggest a rally in a bear market that may be perfectly consistent with a subsequent decline. I wish I could take greater comfort from the recent rally, but I have looked at too many stock market charts going back to the 19th century to take much comfort in recent developments.

I think the surge in motor vehicle sales is a fascinating phenomenon because I do not believe that we can explain it wholly in terms of price discounting. The problem unfortunately is that the estimate for October sales is so bizarrely out of the ordinary that even if there is a good deal



of real change in the demand for motor vehicles, sales will still have to come down very sharply just to get back to something resembling normal.

I think we are looking at developments that imply a very difficult policy issue. My first reaction to the employment data on Friday was to presume that the wisest thing for us to do today would be to move the funds rate down 25 basis points, given the downside risks, and to continue to make 25 basis point moves as long as we have to. I struggled through the weekend reviewing numerous anecdotal reports and looking carefully at the simulations that our models are creating. And most interestingly I took a really close look at what is going on abroad, where the data are not as good as ours but they are increasingly more disturbing.

I thought that your UPS report, Bill, was striking because it is anecdotally consistent with what we are seeing, namely a gradual but continuous contraction with no evidence of any degree of stabilization. I believe we are at a point where we are beyond disinflation and getting to the edge of a deflationary process. This means that even if we were to provide a great deal of stimulus, we would still have to deal with disinflation before we could create a problem of inflation. So we have a few stages to go through.

I must admit that one of the things I read which sort of struck me as being relevant was that little box on the "zero bound" that Vince and his staff put in the Bluebook. I thought it really addressed the key question.

I don't think any of us has a big dispute on the economic outlook. But there is a crucial dispute here. It relates to the issue of whether we want to keep our powder dry or whether we want to make sure that we put in enough shot to knock down the opponent before the opponent eventually does us in. I started with the view that keeping the powder dry was the wisest policy, but as I struggled through the weekend I came out where Al Broaddus is. The reason I would argue for such

an adjustment is that policy invariably gets down to the issue of what happens if we are wrong. And what I conclude is that if doing 50 basis points today is wrong--if it turns out that the economy starts to stabilize tomorrow and a lot of things go well--being required to move our funds rate target back up would be the most delightful problem we could conceivably face. I don't anticipate that. I think the chances of that happening are extraordinarily remote. I do think that if we have an inadequate response today, there is a danger--because as I see it we are at a critical point in the way this economy is functioning--that we will be taking too high a risk. I don't know what the future holds for us. I don't think any of us can know. But on the basis of what we do know, what is the downside if we do 25 and we are wrong or we do 50 and we are wrong? In my judgment the answer to that question is pretty forceful. As a consequence I must say that, after great struggle, I come out in favor of 50 basis points. I wouldn't go to 75 basis points largely because I am not absolutely convinced that I am right. If I were, I would argue for that larger move.

MR. HOENIG. May I ask you a question?

CHAIRMAN GREENSPAN. Sure.

MR. HOENIG. I would appreciate your opinion on this. By going with a 50 basis point change, are we likely to foster expectations, not just in financial markets but in the economy more generally, that we will do at least another 25 basis points and will that induce people to hold back because they anticipate further easing?

CHAIRMAN GREENSPAN. Yes. I think the expectation that we will do another 25 basis points will be built into the market. I'm not sure that's all bad. I very much suspect, in terms of the way Don put it, that we already have a goodly part of that further easing baked into the market. If we were to go 75 basis points, I would really be concerned about what the forward position of the funds market would be. And taking Bill Poole's general edict, we must be careful of

what we construct out there because how we respond to what is in the forward markets has a very significant impact. So I think it is far safer for us to be moving 50 basis points, and frankly that is what I would like to put on the table, and to continue in any case a bias toward economic weakness. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I support your recommendation, probably with the usual enthusiasm of the recently converted, because I entered the weekend with a view that we ought to ease by 25 basis points and over the course of the weekend changed my opinion. Somewhat symbolically I have a pond behind my house in Westchester County and there are a lot of fish in the pond. Therefore, I have two hawks, and the hawks enjoy fishing in the pond. This is a true story, though what will follow is not true. [Laughter] This past weekend--now we get into mythology--one of the hawks miraculously turned into a beautiful white dove. I was very confused until I realized that what was even more miraculous was that the dove spoke with a southern accent! [Laughter] And that convinced me even more that the 50 basis point move was appropriate.

MR. PARRY. Wow!

CHAIRMAN GREENPAN. I second that.

VICE CHAIRMAN MCDONOUGH. Let me respond to the question that Tom Hoenig raised on the market reaction. If we ease 50 basis points, the market will assume that we will ease at least 25 basis points more. If we ease 25 basis points, the market will make the same assumption but will be confused, I think, about whether we are slowing down just for the sake of slowing down, which I think is a bad message to send. If we ease by 75 basis points, that will create an immense amount of confusion, probably starting with the notion that we know a whole lot more with a greater degree of certainty than anybody else does and that the downside we're all concerned about is now

our central forecast. That would be very dangerous. So we certainly don't want to do that. The conclusion is that a 50 basis point cut, with the balance of risks still toward inadequate growth, is the right though difficult conclusion.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I agree with your preference for a 50 basis point cut in the funds rate. For me the downside risks to the outlook are sizable as illustrated by emerging data, which keep signaling lower and lower forecasts for real GDP growth. Also, as noted in the Bluebook and commented on by Governor Meyer and by you, a larger preemptive easing move now may reduce the risk of being constrained later by the zero nominal interest rate bound. I think that's another compelling reason to do 50 basis points at this time.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Mr. Chairman, I support your recommendation. The good news in what you said was that you came out with a policy that I support. But the bad news is that you actually scared me a bit more than I was already. Nevertheless, I do support your proposal.

Let me also address Tom's question. I've had a little trouble with this myself because changes of 50, 25, or even 75 basis points aren't that huge. And as Tom points out, if there's an argument for getting the funds rate down, why don't we get it down? The way I would rationalize what we're doing is that there is a sense in which we are speaking in code here. We've been operating under a procedure for a while where 50 points is viewed as a big change and the Fed being responsive. A move of 25 basis points is viewed as a little change and the Fed not being very responsive. Seventy-five basis points is language we've never used. So I think it's particularly important to be clear in our communication, as many people around the table have said. To me that's a powerful argument for continuing the dialog that we've already been having.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Mr. Chairman, I support your recommendation. I support it for the reasons that you gave.

CHAIRMAN GREENSPAN. Governor Kelley.

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

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Mr. Chairman, I view the risks relative to the Greenbook baseline as still to the downside in the near term. I believe that's a case for erring on the side of stimulus relative to the baseline, given the asymmetric risks and the relationship between the mean and the mode in the forecast. And I believe that's a case for moving more rapidly than otherwise, given the zero nominal bound constraint. For these reasons I support your recommendation of a 50 basis point decline in the target federal funds rate today and also your recommendation for a balance of risks statement toward weakness.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. I support your recommendation, Mr. Chairman, and I support it strongly.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I support your recommendation, Mr. Chairman, although I think Don did make good arguments for both of the alternatives he described. I am a bit concerned that if the tenor of the economy doesn't change until sometime in the spring, say, we're going to run the risk of either overdoing it or at some point having to disappoint market expectations. That risk may not be huge in this environment; it is there nevertheless.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. I'm sufficiently uncertain about the timing and the strength of the forecasted recovery that I support a cut of 50 basis points. I do worry a little about endogenizing expectations regarding what we'll do next and about how weak the economy really is. Having said that, I support the recommendation.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, I can support the recommendation, although I certainly came into this meeting favoring a move of 25 basis points. The way I see the issue is as follows. As you certainly have said on many occasions--and I have said the same thing--we believe that the U.S. economy has essentially undiminished long-run prospects. The question, I suppose, is when those long-run prospects will materialize. If we believe that they are coming in 2008 or 2010, that's a long time away. It seems to me that the tenor of the views around this table is that we may have a very, very difficult five years, and that the risks are decidedly on the downside for the reasons that people have discussed. I think our statements about the long-run prospects for our economy are part of the reason why long-term rates have not gone down very much. In my view we have expressed a lot of optimism about the outlook for the economy and I think those statements of optimism do not fully reflect the beliefs that we heard around the table today in terms of, let's say, the next three to five years. Would I bet my house on my own conviction on this score? No. Obviously, we're going through a very difficult period--one that has no clear analog in history, yet one where to date the absolute level of decline in activity has been mild. But we apparently are projecting a considerable risk of a steeper decline to come. So, if we really want the reduction in the funds rate to translate into declines in longer-term interest rates, I think we need to change a bit the tone of what we say in our statement and in our testimony and speeches. Presumably we do believe that the long-run prospects for the economy are sound and essentially undiminished and we should say that. But we

also need to say something along the lines--I don't know how to word this--that we have ahead of us, in calendar quarters or maybe even years, a very significant risk that the economy could require a period of prolonged and substantial monetary easing.

CHAIRMAN GREENSPAN. Let me just comment on that. First of all, if we seriously believed the time horizon was five years, then I think making a statement that the long-term prospects are optimistic is in any meaningful sense just wrong. When I talk about it, I'm thinking in terms of two years or something in that range. If in fact our comments are holding long-term interest rates up--if indeed we're that powerful--then I submit to you that if we take the position that the world is going to be awful for the next five years, we can create that result even if it's not in prospect now. So I would be careful about what we say we perceive. I personally don't believe that the problems are deep seated to the extent that we are looking at a situation like the 1930s or something of that sort. But I do think that we are going through a period where the next year or next couple of years is going to be subnormal. I don't know whether I'm talking about just the first part of that period or whether the second part also will involve less than adequate growth. But I'm surely not arguing that it's going to go on for longer than that. I have no evidence that that is the case.

MR. POOLE. I appreciate your comment on that. My belief--conviction would be too strong a word here--is that we will go through an adjustment, which when we look back at this period sometime in the future, will be regarded as a cyclical adjustment and not a change in the secular outlook for the economy. I think we will be pulling out of this situation along the lines of the Greenbook forecast. I view that as a very good outlook. But if that is really what we have in front of us, then it seems to me that we already have a very substantial amount of monetary ease in place. And to me the argument for 50 basis points today rather than 25 is not totally consistent with that outlook. That's what concerns me about looking at it this way. I am also concerned that there is a

sense in which we have double-counted the recent bad news. After all, we have cut the funds rate 100 basis points since September 11<sup>th</sup> in anticipation of bad news, the weak economic data to come. And we got the bad numbers. In part what we are saying today is that we are cutting the funds rate again by 50 basis points now that we see the actuality of the weak data.

CHAIRMAN GREENSPAN. But, remember, we have revised down the forecast since those earlier cuts.

MR. POOLE. I understand.

CHAIRMAN GREENSPAN. It's not as though the forecast remained unchanged from the immediate post-September 11<sup>th</sup> period. If it had, we would be in far better shape now. The outlook has deteriorated. That's the problem.

MR. POOLE. At any rate, where I come out is that I'm concerned about doing 50 basis points now and about the process that I think we are getting into. I'm not going to dissent; that's not my point. I'm just indicating the reasons underlying my preference for 25 basis points. The likelihood is that we will have more weak economic data ahead of us and I think the market will read in another 50 basis points of ease at our next meeting. I'm not sure that that dynamic is really helpful. That's essentially what I am saying.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. I've long thought that a variety of unforecastable internal and external shocks do happen and that there's nothing much we can do about that but try to interpret them and respond appropriately. And we can hope that we don't get a succession of shocks going in the same direction that builds into a cumulative process. To my mind the role of policymakers is often one of trying to avoid becoming part of the problem rather than part of the solution. I do believe that in some episodes in the history of this central bank and others in the



world the policymakers became part of the problem rather than part of the solution. That's the basis, too, for my comments earlier about fiscal policy. I'm not convinced that what is going on now in the fiscal arena is all that constructive. But actually I'm less concerned today than I was five weeks ago that monetary policy is not properly calibrated. At that time I was worried that things were moving in the direction of rational risk aversion so fast that we might find that the funds rate was too high to be consistent with the appropriate thrust of monetary policy. Given the Desk's net injections of liquidity over the period since then, I actually feel more comfortable that the level is not too high. Moreover, my confidence in the inherent resiliency of a market economy and its tendency to expand following shocks is undiminished. My uncertainty remains about what kind of internal or external shocks we need to be prepared for. So I would have been perfectly comfortable to stay with an unchanged funds rate at this meeting, given my reading of the events since October 2<sup>nd</sup>. Looking at the yield curve--the four-week, the three-month, and the six-month bill rates--it's hard to disagree with a cut of 50 basis points. I can't say that that's wrong. But I'm actually fairly comfortable with where we are.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I will take your lead on this. But I also want to express a differing view in the sense that while our economy obviously had a terrible shock, we have taken very aggressive and I think appropriate action and monetary policy is now in an accommodative position. Some time has to pass before we will see an upturn, even with this accommodative position, and I believe it will take place. I have confidence in the future. In my view the U.S. economy is quite different from Japan's in terms of its soundness and its ability to recover from the shock. So I would be comfortable with no change or a 25 basis point change today. I think we are raising expectations with this move of 50 basis points. People are going to be making decisions now

in the anticipation that there will be more ease to come and I think there is a risk to that as far as the economy goes as well. I will certainly follow your lead on this. These are difficult times and I realize it's hard to know the right answer. But I think we could afford to be more patient and let the flow of time work.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I, like President Hoenig, would be much more comfortable with a move of 25 basis points or even no change versus your recommendation of 50 basis points. I want to go through some of my thinking on this. I think it's right to ease further. I had the same kind of battle with myself over the weekend that a couple of other people in this room, including you, Mr. Chairman, have talked about. But I continue to believe that there's some need for caution. We have a lot of monetary policy ease in the pipeline and potential fiscal stimulus as well. It's important not to overreact. The recession seems to be baked in the cake now; the incoming data will be negative. But the process has to play itself out. And as Dave Stockton mentioned, recessions do inevitably come to an end.

There's not a lot we can do about the near term. Monetary policy doesn't work in the near term. It can be a support for confidence. And I think we provided support through our policy actions after the terrorist attacks; we put enough into the pipeline to bolster confidence. But right now I don't see further easing as a confidence-bolstering move. I think it is likely to work in the direction of confirming people's thoughts about the impotence of monetary policy because there won't be much effect in the near term. Instead, most of the impact will be felt next year--around the end of the first quarter or the beginning of the second quarter perhaps--when the economy is expected to be picking up anyway. And I have great faith that it will be picking up. How, when, and to what degree, I don't know, but I think this economy has a lot of resilience. In fact, people

have mentioned that lower rates now could actually increase long rates because the market apparently sees a quicker pickup than does our forecast.

There's probably not a lot of difference between a move of 25 or 50 basis points today. I don't see big differences in outcomes. I don't see the stark distinctions that Don was drawing and I don't see major differences in being wrong here. But I do think that a 25 basis point cut would suggest a bit more control on our part. I think it would show that we are being more forward-looking rather than focusing on the recent incoming data. To me it would indicate that wherever we stop the policy position might be a little less stimulative to the inevitable upturn than otherwise. I don't see the comparison to the current Japanese situation, though I fully understand the front-loading part of that argument. I don't think going 25 basis points versus 50 would indicate that the central bank in the United States is part of the problem rather than part of the solution. But all that said, I do take your points on the feedback effects of the international situation now and the potential for a downward spiral. And if the psychology doesn't work domestically, I think it does work a little on the international side. It's a tough call for me right now but I am willing to go with your leadership.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. I started out my comments earlier by saying that this is an uncertain and unprecedented time. That clearly was evident as we went around the room and heard the comments during the go-around, which I too found very depressing. I expected it coming into the meeting because all the data and all the anecdotes were so negative. I guess at some point we are going to get some positive anecdotes. I keep looking for them but I haven't found them yet.

There is clearly a risk that the greater caution we've seen by consumers and business firms could cumulate into a more severe recession. When one looks at the consensus of the forecasts that are out there, those forecasts seem to discount anything like that. I personally think the economy is going to be weaker than the Greenbook forecast and weaker than my staff's forecast too for that matter. Therefore, I do feel that a 50 basis point cut is safer and I support it. I, too, am concerned about the interconnectedness of the international economy and the feedback to our economy, which is the result of globalization--a development that, of course, all of us have supported for many, many years. I think we just have to watch the situation very, very carefully as we move forward. So I support your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Mr. Chairman, first I'd like to correct the record regarding Al and I swapping hats. The point of my remembering the Alamo was that even though the defenders lost the battle it was not because they were keeping their powder dry. So basically, he came around to my point of view! [Laughter] I agree with your recommendation.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, this is the most fascinating meeting in my six years at the table. People have often asked me if I ever change my mind during the course of a meeting and I always say "yes," but I'm not sure that I often do. Today is probably the exception. I not only went into the weekend but I came out of the weekend thinking that either no policy action today or a modest move was the right decision. I certainly have come some way during the course of the meeting and I think I understand the downside risks more fully. Having said that, I'm still of the view that a modest move today feels more right to me. I think Don made a credible argument for such a policy. I share the concerns of Cathy Minehan and Bill Poole that we may in fact build in

expectations for even more easing than we would like. I think there's even a chance of a scare factor; people will think that we believe the economy is far worse than they thought. Having said all that, I support your recommendation and understand the arguments for a 50 basis point move.

CHAIRMAN GREENSPAN. Will you read the appropriate wording?

MR. BERNARD. This is from page 13 in the Bluebook: "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 2 percent."

The sentence for the press statement would be: "Against the background of its long-run goals of price stability and sustainable economic growth, and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future."

CHAIRMAN GREENSPAN. Would you call the roll?

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
Governor Ferguson	Yes
President Hoenig	Yes
Governor Kelley	Yes
Governor Meyer	Yes
President Minehan	Yes
President Moskow	Yes
President Poole	Yes

VICE CHAIRMAN MCDONOUGH. You missed Governor Gramlich.

MR. GRAMLICH. May I vote also? [Laughter] I believe I'm entitled to.

MR. BERNARD. All right, Governor Gramlich. I have you voting "yes." [Laughter]

MR. GRAMLICH. I didn't think I was that transparent! I vote "yes."

CHAIRMAN GREENSPAN. The preliminary statement that has been drafted is very close to the previous one. It's very short and it will be circulated to you. In the meantime I request that the Board of Governors retire to the room next door so that we can act on a discount rate request. So, this meeting is in recess and we will return shortly.

[Recess]

MS. MINEHAN. Do you need a vote on this statement?

VICE CHAIRMAN MCDONOUGH. No.

MS. MINEHAN. I just want to ask whether it's really necessary to make what could be interpreted as derogatory references to enhancing security. It's clear that the diversion of resources to security enhancement will have a negative effect on productivity, but do we really need to say that in this statement? After all, the whole world is dependent upon people feeling comfortable with the security measures being taken because the world has changed forever, in my view anyway. People need to feel that these measures will be beneficial for the long term. I don't think we need to say this.

CHAIRMAN GREENSPAN. I think that's a valid criticism. Would somebody else like to comment on it?

VICE CHAIRMAN MCDONOUGH. Well, if we don't say something about the reduction in productivity over the short run, for whatever reason, the statement will suggest that we think productivity is going to bounce back as soon as this economic slowdown abates. That sounds too much like whistling in the wind. I'm not sure we need to blame it on protection and security measures. But I think we have to say that something is happening that likely will affect productivity adversely for a while.

CHAIRMAN GREENSPAN. No, I agree with that. I think the question is whether or not we phrase it in the way it is phrased here.

MS. MINEHAN. Can we just say that because of the economic slowdown or the cyclical impact or something like that productivity growth will slow?

CHAIRMAN GREENSPAN. No, there is a heightened risk premium that has occurred as a consequence of this. What we're talking about, in the extreme form, is the elimination of just-in-time inventories.

MS. MINEHAN. Yes, I know what you mean. But I don't think this is the time to be sounding quite so negative about security.

MR. FERGUSON. Well, could we say the "appropriate" or the "necessary" diversion of resources to enhance security or something along those lines to suggest that it is well understood that resources will be used in this way?

MR. KELLEY. I think the word "necessary" is good.

CHAIRMAN GREENSPAN. Yes, why don't we say the "necessary diversion of resources"?

VICE CHAIRMAN MCDONOUGH. Yes, that does it.

MR. PARRY. Or how about just the "reallocation of resources"?

CHAIRMAN GREENSPAN. No, "necessary" addresses the issue that Cathy is raising.

VICE CHAIRMAN MCDONOUGH. That turns it positive.

CHAIRMAN GREENSPAN. Is that adequate?

MR. GRAMLICH. Well, let me first comment on the broader point and I'll also talk about the words used. Continuing with Bill McDonough's whistling in the wind argument, I think we also have to show that we recognize this phenomenon, whether we call it a reallocation or a

diversion of resources. So I think we actually have to tie that in there. "Necessary" is fine with me. Also, there's a double clause in there with "and protect against disruptions." We might not need that. A lot of words are devoted to that sentence and it could be stripped down. But in my view we have to recognize not only that it will be a while before productivity comes back, but also that a diversion of resources is occurring. Otherwise the message just doesn't look real.

CHAIRMAN GREENSPAN. Would you feel better if we said: "The necessary diversion of resources to enhance security is likely to detract from advances in productivity for a time"?

MR. KOHN. How about "necessary reallocation of resources"? I think that was somebody's suggestion. That sounds a little better.

MR. GRAMLICH. Okay.

VICE CHAIRMAN MCDONOUGH. That's better.

MS. MINEHAN. But the economic slowdown all by itself produces a reduction in productivity.

CHAIRMAN GREENSPAN. No, the reference here is to structural productivity. I might note that the estimate for productivity in the third quarter is going to be coming out tomorrow. I don't know what the precise number is going to be, but it's going to show strong productivity in the quarter. If we subtracted out the September 11<sup>th</sup> problem, it would be supportive of the fact that there have been structural changes in productivity in the last four or five years.

MS. MINEHAN. Yes.

CHAIRMAN GREENSPAN. So it's not cyclical productivity we're talking about.

MS. MINEHAN. No, I realize that.

MR. JORDAN. Mr. Chairman, could I offer a slightly different perspective? It may be consistent with what is bothering Cathy. The last clause is a clear statement that productivity growth



is good. I might think that and everybody around this table might think that. But hypothetically, suppose 20 years ago we had substituted for the term “to enhance security” the phrase “to clean up the air and the water”? The vast majority of people believe that whatever is being done in our country to enhance security is for the good. For the tone of our statement to somehow suggest that it is really unfortunate that our country has to do this, I think is very undesirable.

MS. MINEHAN. That’s my point exactly. You stated it so much better than I did.

CHAIRMAN GREENSPAN. I agree with that. That’s why the words “necessary reallocation”--

MS. MINEHAN. I don’t think that takes away the negative tenor.

MS. JOHNSON. Pardon me, but it’s a measurement issue, isn’t it? The GDP doesn’t measure increased security; it doesn’t give better security a positive weight. Is there a way to get the word “measurement” in here?

SPEAKER(?). Measured productivity.

CHAIRMAN GREENSPAN. Yes, that may do it.

MS. MINEHAN. We’re trying to get across a very sophisticated concept here.

CHAIRMAN GREENSPAN. Yes, measured productivity. I think the key question as far as the statement goes is: Do we want to leave in “and protect against production disruptions”?

MS. MINEHAN. Yes, right.

VICE CHAIRMAN MCDONOUGH. I don’t think we need that.

CHAIRMAN GREENSPAN. The sentence is very long. Let me read it and see whether or not we need that phrase. “Although the necessary...” Do we want to say “reallocation” or “diversion”?

SEVERAL. “Reallocation.”

VICE CHAIRMAN MCDONOUGH. "Reallocation" is more positive.

CHAIRMAN GREENSPAN. "Although the necessary reallocation of resources to enhance security is likely to detract from measured advances in productivity for a time, the long-term prospects for productivity growth and the economy remain favorable and should become evident once the unusual forces restraining demand abate."

MS. MINEHAN. Did you keep in "advances in productivity" or did you say "measured productivity"?

CHAIRMAN GREENSPAN. The first reference is to measured productivity. The second one is to true productivity growth so I would leave the word "measured" out.

VICE CHAIRMAN MCDONOUGH. Yes.

MS. MINEHAN. But one could argue, along the lines that President Jordan did, that the actual productivity of the U.S. economy is better because of what might have been looked at as overhead expenditures on clean air and clean water. This reallocation of resources may turn out not to be a terrible development.

CHAIRMAN GREENSPAN. Let me tell you what the problem is. If we're going to get into this, we've got a serious problem, which is whether in fact we're measuring efficiency or improvements in the quality of our standard of living.

MS. MINEHAN. Right.

CHAIRMAN GREENSPAN. Environmental and other types of controls do not increase efficiency. They improve the quality of life. Measured productivity is efficiency.

MS. MINEHAN. The improved quality of life could make the overall labor force more efficient.

CHAIRMAN GREENSPAN. It's conceivable, but that's not what is being measured. One way of looking at it is that a lot of activities basically don't benefit us because they are in some sense protective. A big chunk of medical expenditures falls into that category; it depends on whether the expense is for preventive or curative purposes. What I'm trying to get at here is that this involves a very serious conceptual problem.

MS. MINEHAN. I know.

CHAIRMAN GREENSPAN. We don't want to get into that.

MS. MINEHAN. No, we don't. But I also don't think we want to come out with a statement that could be interpreted negatively. Granted, there are a zillion different sophisticated arguments one can make about why this statement is true. I still think the public interpretation of it will be negative with regard to security.

CHAIRMAN GREENSPAN. Can we say "the appropriate reallocation of resources"? I made the statement in testimony to Congress in very much this way. I got very positive responses.

VICE CHAIRMAN MCDONOUGH. Absolutely. I dispute the major premise here, which is that it's negative. I don't find it negative for the Federal Reserve to say that investment in security is a good thing, which is in my view what we're saying. I absolutely fail to see how that's negative.

MS. MINEHAN. Well, maybe it's just an interpretation. I think investment in security is a good thing right now. That's what we need.

MR. REINHART. Mr. Chairman, if you wanted to appear more neutral, the verb "detracts" may also seem negative.

MS. MINEHAN. Yes.

MR. REINHART. So if instead it said “is likely to slow the advance in measured productivity” I think that would pretty much go in the direction of neutrality.

MR. BROADDUS. I think that’s very good. I’d suggest the language “may restrain advances in productivity,” which is shorter and less awkward.

MS. MINEHAN. How about “may restrain advances in near-term measurements of productivity.”

VICE CHAIRMAN MCDONOUGH. You’re on a roll, Al! [Laughter]

CHAIRMAN GREENSPAN. Let’s do it.

MR. PARRY. “May restrain advances?”

CHAIRMAN GREENSPAN. Yes, in that context we don’t really need measured. Let me reread it. “Although the”--do you want to say necessary or appropriate?

SPEAKER(?). “Appropriate.”

CHAIRMAN GREENSPAN. “Although the appropriate reallocation of resources to enhance security may restrain advances in productivity for a time, the long-term prospects” etc.

VICE CHAIRMAN MCDONOUGH. Great.

MS. MINEHAN. That’s shorter.

CHAIRMAN GREENSPAN. I think that does it.

SPEAKER(?). All right!

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. May I just ask a question? In the second paragraph, third line, is the phrase “for the foreseeable future” new in this statement?

CHAIRMAN GREENSPAN. No, it’s part of the boilerplate.

MR. MOSKOW. We had it in previous statements?

CHAIRMAN GREENSPAN. Oh yes, it's part of the boilerplate.

VICE CHAIRMAN MCDONOUGH. We've had that in our statements since the Ferguson Committee came up with it.

MR. MEYER. It's in a slightly different location in this statement, but we always use it.

CHAIRMAN GREENSPAN. Okay?

MR. MOSKOW. Fine.

MR. KOHN. Mr. Chairman, may I suggest that the Committee reconsider using the word "necessary" to describe the reallocation of resources rather than "appropriate"? Several people suggested "necessary" during the course of the discussion and I think it may be a little better there.

CHAIRMAN GREENSPAN. I think that's a good suggestion. Is that okay with everybody?

SEVERAL. Yes.

CHAIRMAN GREENSPAN. I didn't think we could rewrite the press statement as a Committee, but we did! The next meeting is December 11, 2001. We adjourn for lunch.

END OF MEETING