

**Meeting of the Federal Open Market Committee  
December 11, 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, December 11, 2001, at 9:00 a.m.

Present:

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

Messrs. Jordan, McTeer, Santomero, and Stern, 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  
Mr. Baxter, Deputy General Counsel  
Ms. Johnson, Economist  
Mr. Reinhart, Economist  
Mr. Stockton, Economist

Ms. Cumming, Messrs. Fuhrer, Hakkio, Howard, Lindsey, Rasche, 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

Mr. Connors, Associate Director, Division of International Finance, Board of Governors

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

Mr. Whitesell, Assistant Director, Division of Monetary Affairs, 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

Mr. Rasdall, First Vice President, Federal Reserve Bank of Kansas City

Messrs. Eisenbeis and Goodfriend, Meses. Krieger and Mester, and Mr. Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Richmond, New York, Philadelphia, and Dallas respectively

Messrs. Bryan, Judd, and Krane, Vice Presidents, Federal Reserve Banks of Cleveland, San Francisco, and Chicago respectively

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

Transcript of Federal Open Market Committee Meeting of  
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CHAIRMAN GREENSPAN. I would first like to welcome our new members—Susan Bies and Mark Olson.

MS. BIES. Thank you.

MR. OLSON. Thank you.

CHAIRMAN GREENSPAN. Would somebody like to move approval of the minutes of our November 6<sup>th</sup> meeting?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Is there a second?

MS. MINEHAN. Second.

CHAIRMAN GREENSPAN. Without objection, they are approved. Mr. Kos.

MR. KOS. Thank you, Mr. Chairman. I'll be referring to the charts that were distributed to you this morning.<sup>1</sup>

The top panel on the first page shows U.S. and euro-area cash and forward rates. The 3-month U.S. dollar deposit rate, the solid red line, is little changed since your last meeting and as you can see the 3-month forward rate largely tracked the cash rate. But the 3-month deposit rate 9 months forward, the red line with narrow dashes, reflects the volatility of expectations in the past month. First, the 9-month forward rate moved upward after release of the stronger than expected retail sales report on November 14<sup>th</sup>. Then it declined about 1/2 percentage point after the November 27<sup>th</sup> Michigan Confidence report was weaker than expected and comments by Governor Meyer were perceived as keeping the door open for a further easing of policy. Subsequently, on December 5<sup>th</sup>, that rate rose again after the nonmanufacturing NAPM index--an indicator that generally receives little notice--rose sharply and heightened expectations for a near-term recovery. Friday's weak employment report did not alter the optimism that is built into forward rates. That leaves the market in a somewhat unusual position of having priced in a bit more ease in the near term--indeed 22 out of 24 primary dealers expect an easing at this meeting--but then an aggressive tightening beginning sometime in the second half of 2002.

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<sup>1</sup> The charts used by Mr. Kos are appended to this transcript.

In the euro area the ECB reduced policy rates by 50 basis points on November 8<sup>th</sup>, two days after the FOMC action, and cash rates--shown in the solid green line--have been stable since then. Forward rates fluctuated mostly in response to U.S. data. On balance, the market expects that short-term rates probably will decline by another 25 to 50 basis points over the next few months.

As you can see in the bottom panel, interest rates in Japan remain very low. The discussion in Japanese financial circles is about what further steps the Bank of Japan (BOJ) can take to make policy even more accommodative. So one might ask why forward rates are beginning to drift higher. The answer is not fully clear. Certainly, there is no expectation that the BOJ will abandon its zero interest rate policy any time soon. One possibility--and I stress it's only a possibility--is that forward rate agreements, which are obligations of banks, are beginning to reflect a credit risk premium that is not showing up, at least not yet, in other money market instruments.

Turning to page 2, the charts on the top half of the page depict the volatility of Treasury yields over the past 45 days. The top left panel graphs the 2-year yield along with the target fed funds rate. The top right panel graphs the 10- and 30-year yields. In general, these yields moved in very much the same pattern as the 9-month forward rate I mentioned earlier. They rose in early November because of optimism about the economy, retraced that rise as the optimism cooled, and then spiked higher despite data on some days, such as Friday's weak labor market report, that would typically be associated with lower, not higher, interest rates. On balance, 2-year yields have risen a bit more than 1/2 percentage point over the intermeeting period and the spread between the 2-year note and the fed funds rate has risen to 100 basis points, the largest this year. Yields on 10-year and 30-year Treasuries rose about 75 basis points.

The complaints from market participants about volatility can be supported by the data in the bottom chart on page 2. The red line is the volatility of daily yield changes in the 2-year note, measured in basis points on the left scale, since February 1988. Fluctuations have been smoothed by using a 60-day moving average. In general, during most of that period this measure of volatility moved in a range of 3 to 6 basis points and usually between 3 and 5 basis points. Recently, the volatility of the 2-year note was as high as 7 basis points; that level had been approached briefly a couple of times in the mid-1990s and was exceeded only in the late 1980s. The chart also graphs the target fed funds rate over the same period. The relationship between the two rates is not perfect, but casual observation suggests that spikes in volatility are frequently associated with anticipation of the end of a monetary policy cycle or are coincident with the beginning of a new one. For example, the volatility spike in 1992 occurred at end of the early 1990s easing cycle and the 1994 spike coincided with the tightening cycle that began in February of that year. Again, the relationship is not precise and I don't want to make too much of it. Nevertheless, it is possible

that at least some of the volatility in recent weeks reflects indications that the bond market is beginning to adjust to expectations that the forward markets are taking more seriously, namely that this cycle is nearing a conclusion.

Another question is why have yields on coupon securities risen so high? Expectations about economic recovery are certainly part of the story. The rally in the equity market suggests that this factor is at work there as well. But it is difficult to explain the scope and speed of the move by that explanation alone. The second factor at work may have been positioning among dealers, speculative funds, and other investors. A number of strategies involved going long in Treasury bonds, especially at the short end of the curve. This worked fine for most of the year, but the trading attracted many imitators and created ingredients for a pronounced effect if everyone were to head for the door at the same time. Third, corporate supply has continued at a rapid pace. And a fourth factor cited recently is the reputed impact of hedging by large mortgage investors. With rates rising, mortgage investors tend to sell Treasuries to maintain their duration targets, a point I'll talk about a bit more in a minute. Finally, there may have been a calendar effect. November 30<sup>th</sup> is the fiscal year-end for a number of large investment banks and December 31<sup>st</sup> the year-end for almost everyone else. With dealers scaling back positions and individual traders protecting their bonuses, it was not an opportune time to have large demands for liquidity from both investors and hedgers on the same side of the market. Ultimately, the dealer community absorbed this supply but only with a large price adjustment. Perhaps any one of these reasons alone would not explain the fluctuations we've observed, but a shift in perceptions, a position overhang, a price insensitive group of hedgers, and a risk-averse dealer community came together at a delicate point in time.

The fourth factor I mentioned was the importance of the mortgage market. That market has grown substantially in recent years, increasingly influencing the Treasury market. The top panel on page 3 graphs the outstanding supply of publicly held Treasuries and the outstanding supply of mortgage-backed securities (MBS). Five years ago the Treasury market was twice the size of the MBS market. Now the two are converging. And if one takes a broader definition of the MBS market, its size is bigger still.

The bottom panel graphs the yield on the 10-year Treasury note and the estimated duration of the aggregate MBS market from September 4<sup>th</sup> to December 7<sup>th</sup> of this year. I should stress that this is an estimate by one investment bank and differing assumptions regarding prepayment speeds could change the duration, though the overall pattern should be similar. When yields fell in September and October the duration of mortgage-backed securities also fell, as prepayments rose and investors received cash flow sooner than expected. In that environment, asset managers will buy Treasuries or swaps to maintain their duration target. Even if the hedging is via swaps, ultimately swap dealers will hedge themselves with Treasuries and the net result will be

the same. When Treasury yields rose in November, the duration of mortgage-backed securities, shown in the blue line, rose sharply. Following their models in such circumstances, large mortgage holders sell Treasuries, which contributes to rising rates, which in turn extends the duration of mortgage portfolios and leads to more selling until the process finally dissipates.

Because mortgage portfolios are managed against a duration benchmark and because hedging behavior is driven by similar models, asset managers will to some extent be price insensitive. If the volume of those sales or purchases is large enough, given the set of liquidity conditions, it could influence prices in ways that are counterintuitive to new pieces of information. That may have been the case last Friday when the weak labor report was followed by higher, not lower, yields. Finally, given the swiftness with which American homeowners refinance mortgages in response to lower yields, mortgage-backed securities are becoming more concentrated in fewer pools than in the past. And this implies that as a mortgage pool gets closer to the point where refinancing is economically advantageous, the impact of related hedging will be larger. As of November 30<sup>th</sup>, mortgage-backed securities paying coupons of 6-1/2 to 7 percent represented 60 percent of the entire outstanding MBS market.

Turning to page 4 and the corporate market, the top panel graphs the spread between A and AAA corporate bonds and also the spread between BBB and AAA corporate obligations. On balance, spreads were relatively stable despite the continuing large supply and the Enron bankruptcy; the BBB spread rose slightly while the A spread narrowed. The spread of high-yield bonds to Treasuries, not shown here, actually narrowed from 850 basis points to 715 basis points.

The bottom panel depicts changes in commercial paper spreads as the year-end approaches. The red line shows the A2/P2 minus A1/P1 spreads for 1997-1998. The green line is the spread for 2000-2001 and the blue line is the spread for the current year to date. On the left side are the 30-day spreads and on the right side the 90-day spreads. Both the 30- and 90-day spreads widened earlier this fall after 9/11 but actually have begun to narrow more recently. And both are narrower than in the comparable period last year. One reason, and perhaps the main reason, is that the A2/P2 sector has shrunk substantially as many A2/P2 companies exited their CP programs and instead issued longer-term obligations, generating breathing room but also increasing their interest cost.

Turning to page 5 and developments in Japan, the top panel graphs the dollar-yen exchange rate since September 3<sup>rd</sup>. The dollar has been appreciating gradually since the BOJ's late-September intervention and the close of the Japanese fiscal half-year. In part, the yen's depreciation may be due to the performance of the Japanese economy, which has deteriorated, with few forecasts looking forward to a strong recovery in 2002.

Recently the dollar-yen exchange rate has also been influenced by a boisterous, if sometimes confused, debate in Tokyo about the BOJ's monetary policy. Within some Japanese policy circles, the BOJ is being urged to buy foreign bonds as a way of easing its monetary policy still further. Now, whether the BOJ buys Japanese government bonds (JGBs) or foreign bonds, the reserve impact in yen is the same. While stepping up purchases of JGBs may add more liquidity and weaken the yen, buying foreign bonds is viewed as a more direct way to influence the exchange rate. Hence, the foreign exchange market is monitoring this very closely for signs as to whether monetary policy and more traditional foreign exchange intervention will be converging. Adding confusion to this mix is uncertainty about the U.S. response to the idea. Newspaper stories have suggested that the Administration favored it, or more subtly that a weakening yen would be acceptable as part of the broader effort to counteract deflation in Japan.

The middle panel shows the 10-year JGB yield over that same period. JGB yields have stayed low despite recent downgrades of Japan's debt by both Moody's and S&P and despite the talk about the Bank of Japan purchasing foreign bonds. Presumably, such an action by the BOJ would remove or reduce the activity of a very big buyer of Japanese government debt.

The bottom panel depicts the Topix composite index, which has risen slightly since its post-9/11 low. But the Japanese stock market has not had as much of a recovery as those in other countries. Bank shares continue to decline, as confidence in Japan's ability to clean up the bad debt problem deteriorates still more.

Finally, let me say a word on domestic reserves management. Since the last meeting we have been building up our holdings of long-term RPs to help meet needs associated with the seasonal growth in currency. We expect that currency will have increased about \$23 billion from its late-October level to its peak in early January before beginning to unwind. Over this roughly two-month period, our holdings of 28-day RPs will have risen a net of about \$8 billion and are expected to peak at \$32 billion or so before reverting to the low \$20 billion range by sometime in February.

Mr. Chairman, there were no foreign operations in this period. I will need approval of our domestic operations, and I will be happy to take questions.

CHAIRMAN GREENSPAN. I've been hearing talk in the last week to ten days or so about this issue concerning whether or not we, the United States government, approve of this notion that has surfaced in Tokyo of purchases of long-term U.S. Treasuries by the Bank of Japan. We are the government. What in fact is our opinion on this issue? I guess we're not the government! [Laughter]

I know of no official who has made any comments, certainly not publicly. Has anybody spoken to the Treasury? There are only two possible sources: Larry Lindsey at the White House or John Taylor at the Treasury. I haven't spoken to them about this issue. Has anybody?

MR. KOS. I have had conversations with lower level officials of the Treasury. The views have been somewhat vague in the sense of suggesting that if the yen goes down because of actions taken to stimulate the economy, that's one thing. But if there's a deliberate attempt to weaken the yen, that would be another.

CHAIRMAN GREENSPAN. Well, how in the world can you distinguish between purchases for one reason or the other?

MR. KOS. Absolutely, that's the difficulty.

CHAIRMAN GREENSPAN. Maybe I'll ask somebody the question. I won't have to ask you, though I may have gotten a clearer answer out of you than I will from them! [Laughter]

I find this correlation between the 10-year Treasury yield and duration in the mortgage-backed securities market bizarre. It's not a correlation that one normally sees; it's one we see only when one of the variables departs from the other. I look at these weekly jiggles or daily jiggles that are occurring and I wonder what this correlation would look like if you went back to before September 4--the first observation on your chart.

MR. KOS. I haven't looked at that. One should look at it over a decade or so and we haven't looked at it back that far. But I think--and this is only a hypothesis--this correlation has been getting tighter over time and the reason relates to the trends depicted in that top chart on page 3. That is, the mortgage market has been getting bigger and there are more methods for hedging and managing the mortgage books. As mortgage books first of all become concentrated--and there are some very

large holders of mortgages out there--and as models become similar, the impact is greater both because of the size and the technique.

CHAIRMAN GREENSPAN. In the study the change has not been that great in the last few months. What would happen if you went back to the spring? Do you have any idea?

MR. KOS. I don't, but that is work we will do.

CHAIRMAN GREENSPAN. My problem is that when I see somebody publish a chart like this I know the earlier data don't fit because if they did, the producer of the chart would show them.

[Laughter]

MR. KOS. I haven't looked at that.

MR. REINHART. Mr. Chairman, they are highly correlated because they are functionally related. The prepayment speed is a function of the level of mortgage yields, and given the close relationship--

CHAIRMAN GREENSPAN. Yes, I know that. Sure.

MR. REINHART. Right. And if you look at a short period where there hasn't been much change in the underlying pool of mortgages, that function is going to show up as much closer. If you stretch this back over time, where there is a bigger diversity in the outstanding pools of mortgages, then the correlation will be changing. So I think you're right. If you take a snapshot, a relatively short window, they are going to be highly correlated because basically you are looking at prepayment speed for a given set of mortgages that all have similar coupons.

CHAIRMAN GREENSPAN. Clearly, the 10-year Treasury note is a crucial element in the calculation of the option-adjusted duration.

MR. REINHART. Exactly. It's a crucial element given the net extent of the distribution of mortgages. In a relatively short period of time, the distribution of mortgages isn't changing so you

really see the function. Over time, as the distribution of mortgages changes--as some age and as prepayments occur--then you're going to see a weaker relationship. So when Dino and his colleagues go back and examine this, they'll see a shifting relationship. In any short window, though, you'll see a relatively close one.

CHAIRMAN GREENSPAN. Further questions for Dino?

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

CHAIRMAN GREENSPAN. Without objection, they are approved. We'll now move to the economic situation. David. Oh, today it's a "double David." Karen is back?

MR. HOWARD. Yes.

CHAIRMAN GREENSPAN. Karen, I hope your mother is doing well.

MS. JOHNSON. Yes, she is, thank you.

CHAIRMAN GREENSPAN. Gentlemen.

MR. STOCKTON. Thank you, Mr. Chairman. The data that we have received over the past month presented the usual ups and downs for us to contend with. But before I discuss the details of our interpretation of that news, I thought I would take this rare opportunity to make the case that, at least in broad terms, events are unfolding just about as we had anticipated. In labor markets, employment has been falling at a rapid clip in recent months, and the unemployment rate is on a steep upward trajectory. As we had expected, the manufacturing sector is bearing the brunt of these cutbacks in jobs, and factory output has continued to drop. Overall activity appears likely to have contracted at a moderate pace in the fourth quarter, led once again by a sizable liquidation of inventories and ongoing declines in capital spending. These were all important features of our November projection.

In writing down our near-term forecast, we were influenced importantly by readings on the labor market and by the available production indicators. For the second consecutive meeting, we received a monthly labor report only two days after we published the Greenbook. For having devised that meeting schedule, Mr. Kohn, your good Secretary, will not be receiving a holiday gift from the Research Division this year! [Laughter] To be sure, Don was, as usual, attentive to the needs of the Committee by enabling your access to these important data before the meeting. But the schedule also virtually ensures maximum embarrassment to those of us on the forecasting staff.

In the event, the surprises in last Friday's report were less embarrassing than those of a month ago. The unemployment rate rose to 5.7 percent last month, a steeper rise than we had anticipated. And, after declining nearly 490,000 in October, private payrolls tumbled an additional 325,000 in November. We had been expecting a drop of about 250,000. But the report presented some positives for us as well. The workweek rose, and total production worker hours did not drop as much as we had been looking for. All in all, it was a weak report. But it probably was not as weak as some of the headline figures would suggest and, on balance, it was not materially different from our expectations.

The events of September 11 continued to cast a shadow on the labor market. Job losses were once again sizable in the airline industry, and levels of employment in areas such as hotels and amusement remained depressed. Not surprisingly, the hiring of security guards has been brisk, but this provides only a small counterweight to losses elsewhere. Health care is the only major sector in which job growth appears to have been unaffected by the economic downturn this fall.

The most prominent feature of November's labor market report was the continued extraordinary weakness in manufacturing and related industries. Manufacturers shed more than 160,000 workers last month, while help-supply jobs dropped nearly 90,000 and wholesale trade employment declined 25,000. Although the falloff in employment and hours might suggest another very large drop in industrial production in November, we are expecting only a modest decline--perhaps down about 1/4 percent for the month. The reason is that, in a number of areas where hours declined significantly, we have more reliable measures of physical product that show greater strength. Still, assuming another moderate drop in December, IP will be off at nearly a 9 percent annual rate in the fourth quarter, very close to the weak performance that we had anticipated at the time of the last meeting.

This concludes the self-congratulatory portion of my remarks, and I shall now return to a more familiar motif characterized by a combination of confessions and excuses. There have been some developments in the incoming data that have had important implications for our forecast going forward. While production and labor market indicators have been coming in close to our expectations over the past month, we have been consistently surprised by the strength of the readings on final demand. Sales of new motor vehicles remained much stronger in November than we had anticipated, even making allowance for the extension of the recent incentive programs. Retail sales outside of autos bounced back more sharply in October than expected, as did the consumption of services. New home construction and sales have also exhibited greater resilience than we had expected. In the business sector, shipments of capital

goods moved up on balance in October, and the rebound in new orders was even more pronounced.

These readings have presented us with an especially challenging signal extraction problem. In almost every case, the rebound in October followed a sharp drop in the preceding month that was, at least in part, related to the events of September 11. In most of these areas, we had anticipated some improvement, but one that was stretched out over a few months. The October increases might just indicate that we had the timing wrong. Alternatively, the data could be signaling that underlying final demand is stronger than we had been thinking. True to form, our econometric and statistical filtering models suggest that the best interpretation is probably a little of both--a quicker snapback and stronger underlying demand. And, for the most part, that is how we have constructed the near-term forecast; we have revised up the growth of final sales in the current quarter, but not by the full extent of the October surprise in the spending data.

The incoming data have led us to alter one other important aspect of our forecast. We no longer expect an appreciable further hit to consumer confidence stemming from the events of September 11. As I noted last month, the extraordinary strength in car sales had given us pause about this element of our projection, and that concern intensified over the past few weeks. Both the continued firmness of the available measures of consumer confidence and the actual strength we have observed in household spending led us to remove most of the restraint we had imposed on our consumption forecast in anticipation of a serious retrenchment in confidence.

Taken together, these changes have led us to mark up our projection of final sales to show a 2 percent annual rate of increase in the fourth quarter rather than the 1-1/2 percent rate of decline that we had projected a month ago. Because we don't see corresponding strength in production, we have revised up our forecast for the growth of real GDP only a bit--from a drop of 2.4 percent in the last Greenbook to a decline of 2.1 percent in our current forecast. Obviously, this forecast requires a much sharper liquidation of inventories to reconcile the disparate revisions we have made to the near-term outlook for spending and for production. In the case of motor vehicles, we have some hard evidence suggesting that this is, in fact, occurring. But outside of motor vehicles, our projection of a \$75 billion annual rate runoff of inventories in the fourth quarter is still largely forecast, not fact.

These revisions also have implications for the dynamics of the economy as we move into next year. The combination of more upward momentum in final sales and deeper inventory liquidation suggests the likelihood of greater impetus to production in the coming months. That added impetus is obscured a bit in our forecast because we pushed back by a couple of months the second round of tax rebates assumed in our fiscal package. But we would characterize our

forecast as one in which the economy will be entering 2002 on a stronger note than we thought likely a month ago.

In that regard, there are some notable upside risks to this outlook. A significant further positive surprise to sales could cause firms to revise up their plans for production both quickly and sharply to meet higher sales and to rebuild depleted buffer stocks. Signs that materials prices could be firming--such as have been apparent in commodity markets in recent weeks--would provide further incentive for these actions. With the stance of monetary policy remaining quite accommodative, faster sales growth might also lead firms to retrieve capital spending plans that had earlier been shelved. Add in some knock-on multiplier-accelerator effects, and the economy could pick up a stronger head of steam next year than we have anticipated.

Clearly, participants in financial markets appear to be expecting a more ebullient outcome than is incorporated in the staff forecast. The increase in rates implied by fed funds futures, the declining risk spreads, and the rise in the stock market over the past few weeks suggest that a considerable shift in sentiment about the economy has occurred over the past month or so. I'll admit that my jaw has dropped on a couple of occasions at the extent to which rates have moved all along the yield curve in apparent response to data that we do not see as having especially high information content. The non-manufacturing Purchasing Managers' report and the preliminary Michigan survey certainly come to mind. But, I don't think the signals from the financial markets should be ignored entirely either.

We made an attempt in the Greenbook to gauge how large a revision in the economic outlook would have been required to generate the shift in the path of the expected funds rate that we have observed between FOMC meetings. Needless to say, that exercise should be taken with an ample grain of salt. The results suggest that financial market participants have likely revised up their outlook significantly, but the size of that revision does not seem implausible.

So why haven't we shared fully the market's enthusiasm for incoming information about the economy? I have already noted that we are a bit leery about reading too much into what must be considered still very tentative improvements in the spending data. Moreover, we still see considerable drags on activity going forward. Even allowing for the recent improvement in the stock market, the deterioration that has occurred in household net worth over the past year and a half seems likely to restrain household spending and keep the saving rate on an uptrend over the next year or so. In addition, our earnings forecast does not provide much encouragement for further strong gains in the stock market. And, while we can't rule out a faster recovery in investment spending, we are hearing few reports yet of a significant change in business sentiment regarding capital spending. Finally, we do not expect the rest of the world to provide much stimulus to activity in the United States.

Indeed, we see a few conspicuous downside risks to our projection. The stock market is one. The equity premium implicit in recent stock valuations has again gotten mighty low. It is not difficult to imagine a disappointment similar to that which occurred last summer if the recovery is weaker next year and earnings fail to rebound with the vigor currently anticipated in the markets. We remain worried about the possible fragility of consumer spending in coming months. With the labor market continuing to weaken, consumers may at some point pull in spending plans more sharply than we have now allowed for. Perhaps we have thrown in the towel too soon on our story of deteriorating consumer confidence. Moreover, if household spending were to sour appreciably, it is hard to see how we would get the upturn we are projecting in capital outlays next year.

A final downside risk to the projection concerns our fiscal policy assumptions. Aside from the earlier-noted modification to the timing of the tax rebate, we have not changed our package for this forecast. But it is clear that the probability of gridlock has risen significantly over the past month. Moreover, the possibility that a package will be enacted that is larger than the one we have assumed also appears to have gone down. The risks to this portion of our forecast would appear to be skewed to the downside.

With respect to our inflation projection, we have made another small downward adjustment to our forecast for core PCE prices. The indirect effects of lower projected energy prices, continued favorable news on inflation expectations, and a small upward revision to structural productivity led us to mark down our forecast of core PCE inflation by 1/4 percentage point in both 2002 and 2003. We now expect core prices to decelerate from about a 1-1/2 percent pace this year to a bit above 1 percent in 2003.

Dave Howard will now continue our presentation.

MR. HOWARD. Our overall outlook for foreign economic activity is little changed from the outlook we had at the November FOMC meeting. We see continued weakness in the near term, with a recovery taking hold during the course of next year. In 2003, foreign growth is projected at about 3-1/2 percent. Our forecast reflects importantly the projected U.S. recovery, monetary easing already put in place by several key foreign central banks, an assumed absence of significant spillovers from Argentina's troubles, and stable conditions in the oil market. The Greenbook forecast was finalized on Wednesday, but economic developments, of course, have continued to unfold, including in two areas that are important to our view of the global economy.

On Friday, December 7, the Japanese authorities announced that real GDP in the third quarter fell 2.2 percent, at an annual rate, about what we had estimated in the Greenbook. The decline in the third quarter was led by a large

drop in private consumption expenditures, suggesting that the household sector is weaker than has been widely believed. Private investment held up surprisingly well in the third quarter, but recent monthly indicators point to sharp declines in the next few quarters. The third-quarter report and the revisions to back data that were released at the same time have not caused us to alter our forecast of Japanese economic activity. They have, however, confirmed our pessimism about Japan's prospects.

Argentina's long-running economic and financial difficulties continue. On December 1, the Argentine authorities announced a series of measures intended to slow the drain of funds from the banking system and from the country's foreign exchange reserves while the government conducts a restructuring of its debts. These measures include limits on cash withdrawals from banks and controls on transfers of funds abroad. Late last Wednesday, the IMF determined that Argentina had not made sufficient progress in its adjustment program to be eligible for the \$1-1/4 billion loan tranche that Argentina had been counting on as a means of funding some upcoming debt payments. Argentine Economy Minister Domingo Cavallo countered with talk of suspending payments on debts. Subsequent discussions between Argentine officials and the IMF reportedly have produced an agreement on an additional \$4 billion in fiscal restraint in 2002. Cavallo, of course, has to deliver, and he is likely to face considerable political opposition. Details of the new fiscal plans are expected to be released today or tomorrow.

Financial markets so far have taken these developments more or less in stride. Argentine spreads rose about 100 basis points between last Wednesday and this morning. More important, at least from the point of view of the staff's forecast, Brazilian and Mexican spreads actually edged down during that same period. Equity markets in Brazil and Mexico have been firm.

There are many reasons to believe that Argentina's financial troubles will be relatively contained. There has been a very long run-up to this crisis, and indications are that investors have anticipated it, have diversified their risks, and are now--and have been for a while--differentiating among emerging market economies. Moreover, most important emerging market economies now have somewhat flexible exchange rate regimes, which eliminates one area of vulnerability. There are, of course, many reasons to worry as well: Emerging market economies have a history of crises; policies in these economies are far from perfect; and, given the current delicate state of global economic conditions, emerging market economies at the moment would seem to be particularly susceptible to adverse shocks to confidence.

CHAIRMAN GREENSPAN. Questions for our colleagues? President Poole?

MR. POOLE. When I look at the details of the forecast, clearly the timing of the consumer recovery is an important piece of this story. And I think your forecast has a significant increase in the saving rate in the first quarter of next year and a continuing negative on consumer durables, which I assume is a good part automobiles. Now, one of the things that struck me is that the nature of labor contracts in the auto industry essentially has turned a lot of labor costs into fixed costs. I don't quite understand the past behavior of the industry, but one of the reasons why I suppose they were so willing to introduce all these incentives was that they were stuck with those labor costs anyway, so why not get something rather than nothing. Presumably that motivation would continue in the first quarter and thereafter, so if the underlying demand is on the soft side we might see another round of incentives of some sort. Does that argument make sense? And if so, how much weight would you put on it in terms of the shape of the durables part of the forecast?

MR. STOCKTON. That argument certainly makes sense. It is actually an issue that we have struggled with and in some sense we revised up our forecast a bit in the face of both the response to the strength in auto sales and what we can see happening with motor vehicle production going forward. In our view, however, that would not imply that there won't be any adjustment on the production side. We think that may mute the production adjustment, and in our forecast we have production falling in both the fourth quarter and the first quarter before leveling out in the second quarter of next year. In part we have followed what we are hearing from the automakers themselves, which is that they are going to be extending downtime during the Christmas holiday period, and that some of these production cuts are actually going to occur. But, when push comes to shove early next year, it's unclear whether or not they will decide to extend the incentives for an even greater period of time. I think it is certainly a possibility and it's an upside risk to the projection both of auto sales and auto production that we've built into this forecast.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. At our board meeting last week at the New York Fed we had a considerable discussion about the possible effect on the economy of additional terrorist activity. My own view is that the big surprise of 9/11 was that we thought it couldn't happen here and that if there is more terrorist activity, the American people will respond quite strongly. Do I gather correctly that your forecast essentially says either that there will be no terrorist activity or that if there is it will not have a significant effect on demand?

MR. STOCKTON. I think that is exactly what is implicit in this forecast. As I believe we noted at the time of the October meeting, we just didn't know how to cope with such an event in the forecast other than to make the assumption that it won't occur or that if it does, it won't have a big effect. But that clearly looms out there as an enormous uncertainty. We just didn't see any way in which we could sensibly provide any value added by trying to build in such an event into the forecast.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. David, as always, I can't quarrel with the baseline forecast because I don't have an alternative that is more convincing or in which I have more confidence. And I always find the alternative simulations and assumptions that you provide to be useful. But this time more than usual I have a problem reconciling the policy assumption in the baseline forecast with the forecast itself. It's not that I'm convinced that the forecast is wrong. But if it is correct, I have trouble understanding the policy assumption. Or if the policy assumption turns out to be correct, I don't see it as consistent with this forecast. Maybe you've answered my question in your forward-looking futures-based scenario in the Greenbook. But let me at least try with you a mental exercise that I would have wanted to run. And that is, imagine that we get to October of next year and that you have nailed the forecast exactly. Nominal GDP accelerates in the second quarter as you have it; in the third

quarter it goes to 6 percent and real GDP is up to 4-1/2 percent as you have forecast. And suppose all of the associated information that would have been released on a weekly and monthly basis goes along with that kind of forecast. In that environment, I think the 30-year rate and the 10-year rate would have marched somewhat higher as that scenario unfolded. Certainly the 2-year rate would have marched higher and I expect that 3-month and 6-month yields would be considerably above where they are today. Then I try to imagine your producing a forecast that says yes, all that has happened and the 2 percent fed funds rate is still correct. I can't get that to square because to me a ceiling on the funds rate of 2 percent would produce an explosive increase in the monetary base, assuming that all the rest of the data come out exactly as in the baseline.

MR. STOCKTON. Where I might differ with your presumption of how these developments could unfold is with respect to long-term interest rates. We think a couple of things are going on there. One is that we would expect, if the Committee were not raising interest rates as much as the markets currently expect--or as the markets began to realize that the outcome was not going to be as strong as they currently anticipate--that there would be some subsidence in long-term interest rates. The way in which we thought about our policy assumptions was that, through 2003, we saw an economy that was still running with a considerable degree of slack in resource utilization and one in which inflation was still headed lower. Therefore, the imperative to raise rates would not be so clear that we were going to build it into our forecast by the second half of 2002. As you know, we do have rates on an uptrend in 2003 as the economy gathers even more strength and as the unemployment rate begins to turn down. Even then, the environment is still one in which we would expect to see some deceleration in overall measures of inflation.

MR. JORDAN. But your answer suggests that the consensus private sector forecast is for even stronger growth than in your baseline forecast of 4-1/2 percent real GDP in the third quarter and 6 percent nominal. That's not what I saw in the last Blue Chip forecast.

MR. STOCKTON. Yes, indeed. But I don't think the Blue Chip forecast or our forecast is consistent with what is currently built into fed funds futures. In some sense the experiment that we tried to construct in the Greenbook was to ask how much of an upward revision would the markets have had to make in their outlook. Now, that wasn't designed to tell you what the markets' forecast is. I don't really know for sure what it is. But my guess is that it would have to be stronger than the one we're showing to justify the markets' expectation of a more aggressive tightening action by the Fed as early as they see it. So that would say that the consensus private forecast is probably closer to the Greenbook than what appears to be embedded in financial markets now.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. I had a question on the stimulus package. You identified rather clearly what the short-term benefits are, and you obviously placed a lot of emphasis on that. I was just wondering if you've given any thought to the longer-term impact of this package beyond the forecast horizon, particularly as it would affect multifactor productivity and capital deepening. Are there any longer-term costs involved that we should be thinking about?

MR. STOCKTON. I don't think there are very significant longer-term costs in the package we have designed. We have designed a package that we thought was sensible--and we still do think it's quite sensible from an economic perspective. Whether it makes any sense politically is a different matter. It was designed to provide stimulus for the economy over the next two years without imposing long-term budgetary costs. Most of the items that we have built in--the temporary investment incentive, which has a big effect, and the one-time sets of tax rebates--obviously would go away. So

we don't really see those as necessarily having longer-term budgetary consequences. Now, one could certainly imagine that something might be labeled a short-term stimulus for the economy that really would impose longer-term budgetary costs. Obviously, any kind of permanent change in either spending or taxes would feed forward and would produce bigger effects on long-term interest rates, more crowding out of private investment, and therefore less capital deepening going forward. But that's not what's in our forecast.

CHAIRMAN GREENSPAN. But I think the question was more related to what I assume is the effect of moving up a tranche of capital investment and getting an earlier technology.

MR. STOCKTON. Yes.

CHAIRMAN GREENSPAN. And presumably that's suboptimal from a market point of view, but the question basically is whether the effect is big enough to make a difference.

MR. STOCKTON. The suboptimal part I'd say would be of a second order. Certainly in the longer run, because that package goes away, the cost of capital is not affected. You'd still have the same capital-output ratio over the longer haul and the same level of productivity at some point.

CHAIRMAN GREENSPAN. The capital-output ratio is the same but the composition of the capital may not be optimal or as effective as--

MR. STOCKTON. Certainly to the extent that temporary tax policy is used to provide the stimulus, private decisions are distorted in the short run, and we would have a suboptimal capital stock. But I think that would be a pretty small effect.

MR. MOSKOW. Have you actually done any analysis on this, David? Is there anything written--any papers or studies--on it?

MR. STOCKTON. Well, since the proposal of some kind of temporary tax incentive was put forward, we've been working hard to develop the analytical apparatus. Obviously we have a

couple of problems in doing that. One is that there just aren't enough observations in the data to justify thinking that we're going to be able to estimate this very precisely. So what we did was to use several different analytical models, parameterized to replicate some of the key features of the economy, and then we tried to examine how sensitive the outcomes that we get are to the assumptions that we have made. What we put in the forecast I'd say would be consistent basically with both "putty-putty" types of models of investment and the "putty-clay" models of investment. But there can be big differences, depending upon the cost of capital adjustment. This relates to some of the issues that we talked about in the productivity presentation at your meeting last June; some of those parameters can make an important difference in the size of this effect. We don't have any research papers on this currently available but it's something that we will have to continue to work on.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Let me explore a couple of related issues. Dino talked about the different explanations various market participants are giving regarding the jump in the yield curves. A couple of people that I've talked to in the Boston area really have been affected, in terms of the way they look at the market, by the level of volatility. They view the uncertainty quotient relating to some of the yields as significant, particularly on the bond side where they see a market that is not as deep because of corporate supply conditions. On the equity side, the question of how to interpret what the equity markets are saying is a very interesting one, given the drop in inflation expectations and the rise in equity prices and in yields on the bond side. I'm wondering whether, if instead of extreme optimism, we're seeing as well a degree of real uncertainty. There's perhaps a desire to climb on and not be left behind but also--if one combines the volatility and the lack of depth of markets--some underlying uncertainty about where things are going. Those market moves may not be as clear a message of strength as one might be inclined to interpret them. I wonder how one factors that into one's thinking.

A related issue, I think, involves what you said in answer to President Jordan's question when you talked about excess capacity and your forecast of the unemployment rate and a declining rate of inflation even into 2003. The declining rate of inflation is at odds with most of the other major forecasts and may be at odds with the way the market sees it as well. Could you comment on both of those points?

MR. STOCKTON. With respect to the financial markets' assumptions, to the extent that some of the factors that Dino cited have been at work, one wouldn't necessarily expect those to persist over the next two years.

MS. MINEHAN. Right.

MR. STOCKTON. And in some sense we have not level-adjusted our forecast for all of the recent upward movement in long-term interest rates on the assumption that some of that will fade away over the course of the first half of the year, as the situation becomes clear. So that volatility goes down.

On the stock market portion of it, I don't want to pretend for a moment that our baseline assumption was any better than the other two that we put into the Greenbook as alternatives. We certainly have had five years of experience with forecasting either flat or declining stock markets only to be consistently surprised to the upside. Could that happen again? Could that be the process that we're starting to see, or are equity market participants just looking beyond the near term? Maybe they are just better able to look through this near-term disappointment in profits that we see occurring and are willing to anticipate a stronger rebound in both activity and earnings down the road. I think that's a real possibility. I also think, given how low the equity premiums have gotten, that there is still downside risk in that portion of our forecast.

With respect to inflation, we see the environment on the pricing side as one in which core measures are more likely to be going down than up. We're already seeing what we think is the front edge of some deceleration in compensation. We think both structural and actual productivity are likely to improve somewhat over the forecast period. We made a small nod in the direction of some of the good news that we've received on inflation expectations. And the energy markets also suggest that the indirect cost pressures coming from energy are likely to subside some. So when we put that together, despite the fact that there is some reacceleration of activity, it looks to us as if there will still be little upward pressure--and more likely downward pressure--on inflation going forward.

MR. REINHART. Just an observation, President Minehan. It is certainly true that if you look at implied volatilities on bond contracts, either the 10-year or the long-term Treasury securities, they are very much elevated. They are in a range we haven't seen since 1993; in some way it's similar to the observed volatility that Dino showed in his presentation. But the implied volatilities have come off in the stock market, so it isn't obvious--

MS. MINEHAN. Yes, it was the bond market volatility.

MR. REINHART. It isn't obvious that the equity markets are more uncertain now than they were for most of this year. And in the Greenbook financial projection David didn't respond completely to the run-up in long-term yields over this intermeeting period in the same way he didn't respond completely to the remarkable and inexplicable decline in the previous intermeeting period that was associated with changes in Treasury debt management. So if I were to add to your and Dino's list of market-specific events that have affected the amplitude of the swings in yields, I think I would also have to include the discontinuation of the 30-year bond.

MS. MINEHAN. Yes.

MR. REINHART. So some of the run-up we've gotten in this period reflects some rollback of what we saw last year.

CHAIRMAN GREENSPAN. How far are we from inserting some mortgage-backed security duration variable in our macro model?

MR. STOCKTON. Far enough that I don't care to comment! [Laughter] I don't see any immediate prospect.

CHAIRMAN GREENSPAN. I'm wondering because this conversation is leading us in a very peculiar direction. What concerns me about it is that we are seeing this very high sensitivity to long-term mortgage rates, for example in the extraction of home equity that tends to lead promptly to consumption expenditures. I wonder whether or not we're going to find that the convergence of those two lines on the stock-of-debt chart--Treasury and mortgage-backed securities--may have some macroeconomic significance. I hate to find us doing macro simulations and then orally commenting on why it doesn't work in these terms. At some point you're going to want to put a variable in there hopefully to capture this.

MR. REINHART. All the macro simulations you will care about will be at the shortest a quarterly frequency; and probably you'll really only want to think about it in terms of year-by-year effects. A lot of these market mechanisms, including the changes in the duration of mortgage-backed securities, affect the amplitude of interest rates in a relatively short period. But I'm not willing to say that the level of the long-end of the yield curve is noticeably higher because of these mechanisms relative to a year ago--

CHAIRMAN GREENSPAN. I know you're not because it's not in the forecast! [Laughter]

MR. STOCKTON. Well, we'd still think those longer-term rates would be strongly linked to saving and investment flows in the economy. That would be important. I will anxiously await

Dino's further research on this correlation between the option-adjusted duration and the 10-year Treasury. I wouldn't want to ignore an important piece of forecasting information here.

VICE CHAIRMAN MCDONOUGH. That research project got shifted to New York!

[Laughter]

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I'd like to ask two short questions. The first one is to Dave Stockton and perhaps Don Kohn. In the Greenbook and also the Monday morning briefing there was a report about the Michigan survey of one-year-ahead inflation expectations, indicating that it dropped to 2.8 percent in September, to 1 percent in October, to 0.4 percent in November, and then bounced back to 1.6 percent in December. It seems to me that there's some potentially very interesting information there. After all, we're very much interested in what is happening to the real federal funds rate. I just wondered how those data, admittedly volatile but still considerably below what we have been looking at in the recent past, are influencing your views about the real interest rate as far as the fed funds rate is concerned?

MR. STOCKTON. Well, certainly, the point we were trying to make in our briefing was that we also find this very interesting. We pretty much wrote those data off when they dropped those first two months, thinking that it was completely outside historical experience. We were inclined to think it was a fluke. The longer the decline persisted the more we felt that we needed to at least consider the possibility that it was giving us some information about a drop in inflation expectations.

MR. PARRY. So, you don't think policy is as easy as you previously thought?

MR. STOCKTON. Well, maybe Don will want to comment as well. But I certainly don't think that there has been a 2-1/2 percentage point rise in real short-term interest rates as perceived by anyone involved in spending decisions at this point. However, the survey results might be, on the

margin, a reading that you would want to take on board in assessing the stance of policy--just a piece of an inflation forecast that should not be completely ignored from the perspective of the current setting of policy.

MR. KOHN. I certainly agree with what Dave said. And the fact that long-term inflation expectations haven't changed very much would lead one to discount this survey result a bit. The question would be whether the implied rise in real short-term rates is exerting upward pressure on intermediate- and long-term rates. But I think we can explain--more or less as President Minehan and Dino have tried to do--why those long-term rates have risen through just the general optimism plus the volatility. I don't think, as yet anyhow, that a rise in real short-term rates is putting upward pressure on real long-term rates. But if inflation expectations were to continue to edge lower, that would be something you would need to take account of in assessing the stance of policy.

MR. PARRY. I'd also like to ask Dave Howard a quick question. The revision to the forecast for Japan is pretty stunning, particularly real growth being revised down 1/2 percent in 2002. In addition, there's deflation in every quarter through 2003. One has to begin to wonder about the impact of this in the financial sector. My question is: What is your current view about the probabilities of a crisis in the financial sector in Japan in light of this possible forecast outcome for the next two years?

MR. HOWARD. I think it's safe to say that it is a major risk. We have the Japanese economy coming back a bit toward the end of the period, mainly because world economic growth picks up. The Japanese do not yet appear to be fully ready to take the kinds of measures that need to be taken to remedy their problems. We see the problems sort of simmering there for the indefinite future I'm afraid, and certainly through the forecast period.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Just one follow-up question. I wasn't very clear before on the issue of the drop in inflation expectations. With inflation being a measure of resource capacity use--whether or not we have excess capacity--is it possible that the declining inflation expectations are telling us something about people's expectations about unemployment rates and pressures on capacity in the future that is significantly different from what the stock market is telling us about the optimism for real growth?

MR. STOCKTON. It could be, except that in the same survey from which those inflation expectations are drawn the unemployment expectations haven't really deteriorated as much.

MS. MINEHAN. They haven't dropped at all?

MR. STOCKTON. They have deteriorated some but nowhere near as much as one might have imagined if the outlook for inflation were the primary motivation. It could just be that people are thinking that 2002 will be an excellent year in terms of low consumer prices. Obviously, people could be hearing about zero percent financing for autos, great deals on airfares, and lots of discounts in the stores. I think it's perhaps more a reflection of that than of some enormous shift in their views about the economy going forward, which have been relatively firm.

MR. KOHN. The longer-term inflation expectations embedded in the yield curve dipped right after the September attacks, hit a low point at the end of October, and have come back up again. But on balance they haven't changed appreciably since last summer. So they're not showing the same--

MS. MINEHAN. The same bounce as the shorter-term expectations.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. On that same point, Dave, in the Michigan survey the 5-to-10-year inflation outlook didn't budge. And the survey that our people do together with the folks at Ohio State University showed the same thing. That survey indicated a very near-term drop in inflation, which correlates with people's experiences at the gas pump and with rebates and so forth, and zero change in the longer-term expectations. Measures of inflation expectations beyond a year or two don't seem to have moved at all.

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

MR. PARRY. Thank you, Mr. Chairman. Economic conditions in the Twelfth District have been weak, but there were a few signs of improvement recently. It's now clear that the terrorist attacks severely damaged economic conditions in tourist-dependent areas. In October, travel-related employment fell about 3 percent in Hawaii and Nevada. Significant losses were evident in most other states as well and on net the District's transportation and services sectors contracted substantially. As a result of the shrinkage in these sectors and others, new claims for unemployment insurance surged and unemployment rates increased noticeably in most areas. Since mid-October the surge in such claims has receded somewhat but the levels of claims remain elevated, suggesting that unemployment rates in these areas probably rose in November as well. The San Francisco Bay area has seen rapid job destruction all year, especially among high-tech companies. Unemployment there has increased by around 11,000 people per month since the first of the year and that pace doubled in October. Accordingly, the share of job losers in California's unemployment pool has risen. And if unemployment durations last as long as usual, we're likely to see additional increases in the unemployment rate in the future.

On the positive side, housing markets remain healthy. A primary exception is the San Francisco Bay area where home prices have started to decline a bit. But in most other areas, demand for new and existing homes has been solid and the pace of residential construction remains high.

Moreover, industry output and sales figures show some indication of a turnaround in high-tech manufacturing. At this point, however, a rebound in demand for high-tech equipment that is strong enough to get the industry back on a solid growth track does not appear imminent. And with Boeing committed to cutting about 15,000 jobs nationwide between December 14<sup>th</sup> and January 25<sup>th</sup>--most of them on the West Coast--the outlook for the District's manufacturing sector more generally remains weak in the near term.

Also troubling are the District's state and local fiscal positions, which have deteriorated further since we last met. Most states have cut or have proposed cutting agency budgets by up to 15 percent and several have frozen hiring as well. This will put a damper on economic activity, especially in California, where growth in state and local government jobs has been a key factor supporting continued expansion in Southern California and the Central Valley this year.

Let me turn to the national picture. The weakness in November employment put a bit of a damper on the generally more positive tone of recent economic data. Still, there are more positive signs that I believe are worth noting. Car and truck sales have been outstanding in October and November. Of course, that reflects a temporary surge in response to zero interest rate financing deals. Still, I believe it is encouraging from the standpoint of consumers' confidence in the future that so many people are willing to undertake such commitments. The recent increase in the admittedly volatile new orders series also is encouraging, especially since the surge was led by orders for computers and semiconductors, sectors that had led the recession. And finally, even though third-quarter productivity growth was revised down recently, I believe the 1-1/2 percent increase is robust

considering the decline in real output in that quarter. Relatively strong productivity growth over the past year reinforces the view that the economy is cycling around a trend growth rate that continues to be significantly higher than the one that prevailed before the mid-1990s.

Overall, recent data seem broadly consistent with our forecast as well as the Greenbook's that the recession is likely to be relatively mild. And financial market developments since our November meeting reflect greater confidence in that view. The steepening trajectory for federal funds and Eurodollar futures rates is notable in this regard.

Our forecast shows a drop in real GDP of 1-3/4 percent in the current quarter. We're assuming another 25 basis point cut in the funds rate at this meeting and we anticipate a rather gradual pickup in growth in response to monetary and fiscal actions in combination with the end of the inventory and investment cycles. The recovery in 2002 in our forecast is less pronounced than that in the Greenbook in part because we are a bit skeptical about how quickly firms would take advantage of the proposed partial expensing rules for investment. Of course, such legislation has to pass.

Our inflation forecast is little revised, with slack in labor and product markets holding the increase in the core PCE price index to just over 1-1/4 percent in 2002. While the recession appears likely to be fairly mild at the present time, that outcome is quite vulnerable to the possibility of negative shocks. It's not difficult to come up with a list of candidates. Confidence is fragile and could be adversely affected by expected increases in unemployment, a negative turn in the war, or more terrorist activity. A large decline in equity or real estate values could deepen the recession. And given the deadlock in Congress, it's not clear how much additional fiscal spending or fiscal stimulus will be forthcoming. Thus, even though it seems likely that economic growth will rebound next year without any further policy action, a case could be made for an additional easing of policy as a bit more insurance. Thank you.

CHAIRMAN GREENSPAN. President Moskow

MR. MOSKOW. Thank you, Mr. Chairman. The Seventh District economy remains weak and I must admit I'm having difficulty reconciling the numerous press reports of an imminent recovery with what I'm hearing from my business contacts. So far, most contacts in the Seventh District are not seeing signs of a bottom, let alone a recovery. As we all know, airline travel has been significantly below last year's levels. And according to one major carrier, bookings for the Christmas holidays show no improvement from Thanksgiving relative to last year. The CEO of Boeing indicated that they are not expecting air travel to return to pre-9/11 levels for another 28 to 42 months. About the only positive news I heard from the travel and tourism sector was that people were starting to respond to price discounts offered on cruises and hotel rooms. But activity in this sector generally remains very weak.

In the steel industry, about half of the current output of the domestic steel industry is being produced by firms that are either operating under or have filed for bankruptcy protection. Moreover, one major steel distributor we talked to is expecting another down year in 2002.

Construction activity in our District definitely has slowed. On the residential side, softening has been reported around the District. In particular, demand in the Chicago apartment and condominium market, which has been booming for several years, is down sharply. Vacancy rates are likely to rise further as many additional units will be coming on the market over the next year from projects that are already under construction. Despite these negative developments, we have not seen any adverse spillover to the banking sector, as bankers have limited the excess use of leverage by developers and have better diversified their loan portfolios relative to previous cycles. Nonresidential construction activity has slowed in virtually all areas. Office vacancy rates have risen, particularly in Indianapolis where one-fifth of downtown office space is now empty.

On the other hand, there were a few positive reports about demand picking up for medical instruments, defense-related parts and components, and security equipment. And according to one manufacturer, customer stocks of machine tools have fallen to such a low point that orders for tools are starting to pick up. Incentive programs continued to boost light vehicle sales more than expected last month, and October and November are now in the record books as the highest back-to-back months for such sales ever. A year ago inventories were well above desired levels; now they're very lean. Indeed for some models, dealers are lucky to have even one in their showrooms. But dealers are being cautious about restocking, and automakers have not boosted production significantly because they know that the recent sales pace cannot be sustained. In fact, one of the Big Three firms indicated that sales weakened considerably in late November and early December.

The experience in the light vehicle industry clearly illustrates that consumers are very price conscious, and as a result many retailers are offering sizable price discounts. Sales so far in the holiday shopping season, however, have been disappointing for most retailers we've talked with, and as I noted last time their sales expectations were fairly low to begin with. But as retailers keep reminding us, sales are often concentrated toward the end of the holiday shopping season, so we really won't know until then how good or how bad sales actually were.

Reports on labor market conditions generally indicate further slackening. Research by our staff confirms that a pickup in demand for temporary help tends to precede recovery in the labor market. We have two very large temporary help supply firms headquartered in our District. They differed on their assessment of whether there was any bottoming in the demand for manufacturing workers. One thought maybe there was; the other said definitely not.

Turning to the national outlook, the economy is clearly in recession and the November employment report indicates that activity has not bottomed out yet. The breadth of job loss extends

beyond manufacturing. The Greenbook forecast has an economic rebound taking hold by the second quarter of next year. Our analysis and most consensus forecasts point toward a qualitatively similar rebound. An important feature of the data so far is that the deterioration in labor markets appears not to have spilled over into an unraveling of consumer sentiment and household spending. Price discounting, low interest rates, and low energy prices are clearly positive forces offsetting the weak employment situation.

However, I see three major risks that potentially could weigh on activity for some time. First, despite the favorable experience to date, I think the uncertainty associated with the 9/11 attacks and income losses from the weakening labor market could result in a sustained period of hunkering down by households. This could dampen growth in consumption and residential investment by more than assumed in the consensus outlook. Second, I think we may have a good deal further to go in unwinding the capital overhang that became evident following the bursting of the high-tech bubble. And third, the widespread nature of the slowing in economies throughout the world makes me concerned that global activity will be weaker than we're anticipating. So on balance, I see the risk for growth in the United States as continuing to weigh substantially on the downside.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. It appears that the economy in the Dallas District has finally joined the national recession. Growth has been slowing since the fall of 2000, but employment continued to rise until this past September. The widespread layoffs in the travel and entertainment industry, combined with reductions in high-tech employment and a slowing in the energy sector recently, have brought about the first employment declines in the Eleventh District since 1986. Mexico's recession and the increased difficulty of crossing the border are making matters worse, as retail spending along the border has declined significantly from a year ago.

Two other sources of strength in the Texas economy in recent years have been construction activity and export demand. Both have turned into sources of weakness recently and are expected to remain so. Construction activity has been declining since early this year and reports of over-capacity in some office and expensive home markets suggest that construction investment will continue to slow. When oil and gas prices are low, as they are now, expansion of petrochemical facilities usually offsets some of the local slowdown. However, that is not happening this time around because of extreme over-capacity in the chemicals business.

Exports in a wide range of product categories and to all parts of the world have been declining for more than a year and our contacts expect little change in these trends. Defense-related spending seems to be one of the few areas of strength. Semiconductor demand may have reached a bottom, but our contacts concur with the Greenbook analysis that it will be a long bottom and that the demand from the telecommunications sector likely will not pick up until the second half of 2002 at the earliest. This is a significant negative for the telecom corridor just north of Dallas.

I concur with the broad outlines of the Greenbook forecast, though I'm a touch more optimistic that GDP growth will resume in the first quarter. But I agree that on a fourth-quarter-over-fourth-quarter basis growth in 2002 will probably be around 3 percent. I think it's notable that the Greenbook suggests that most of the weakness in current-quarter GDP will be accounted for by inventory reductions and that final sales are holding up surprisingly well.

On the inflation front, I concur with the respondents to the University of Michigan survey who seem to have bought into our rhetoric a few years ago that we were only one recession away from price stability. We now seem to be getting the disinflation we wished for, but in my opinion we're still a long way from deflation.

On the policy side, I see the economy stabilizing or at least not getting worse. If economic conditions do deteriorate, I'm confident that we will get plenty of fiscal stimulus. In fact, it's possible that we'll get plenty of fiscal stimulus whether the economy needs it or not. With about two-thirds of our monetary policy stimulus still in the pipeline and lower energy prices likely to be with us for months to come, it would appear that there is no shortage of policy stimulus at this stage of the game. And with the world economy continuing to show signs of weakness, I'm not particularly concerned about a potential outbreak of inflation in 2002.

Overall, I see the balance of risks we face as having shifted significantly and to such an extent that I think we should pause in our policy easing. I believe the balance of risks is still tilted toward weakness, but not so much that the easing in the pipeline shouldn't be sufficient to deal with it. Perhaps the best Christmas present we could give the financial markets at this stage would be a message in our statement that the Fed sees some signs of stabilization and is taking a wait-and-see posture before acting again. When I first came into my job and inherited Harvey Rosenblum as the Bank's Director of Research I asked him if he had any rules of thumb concerning monetary policy. He said, "Yes, when in doubt, don't ease." And I think that's about where we are now. In my view, any additional benefit of further easing now is likely to be more than offset by the disadvantage down the road of having to reverse that easing earlier than otherwise. Thank you.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, economic activity in the Tenth District is likely to be lower again in this quarter. The manufacturing sector remains in a slump and labor markets are soft. However, the consumer sector shows signs of having turned a corner. In our opinion, housing, consumer spending, and auto sales are pointing up. We interpret these data as suggesting that economic activity in the Tenth District may be at or near its bottom.

More specifically, the Bank's November manufacturing survey found that production was lower than a year ago, capital spending continued to decline, and firms were not yet done paring inventories. On the positive side, though, the weakness is less than it was last month. The year-over-year decline in production was not quite as great as in October and was significantly less than in July when the manufacturing slump appeared to be at its steepest. In fact, some of the anecdotal reports that we've received recently from a number of our directors suggest that they are seeing a pickup in orders and actually are talking about hiring additional workers.

Having said that, the labor markets have eased and are continuing to ease in the District. In our latest labor market survey, only a quarter of the firms reported any difficulty hiring or retaining workers, and that's the lowest percentage in our survey's history. However, while unemployment rose in October, initial unemployment claims fell in November and layoff announcements in November were the lowest we've seen this year.

Consumer spending in the region has held up better than many people expected. Mall traffic was healthy immediately after Thanksgiving, and sales during the first 10 days of the holiday season were up modestly over a year ago in most places. And the anecdotal data we've gotten have pointed predominantly toward fairly strong consumer sales. Residential construction and home sales rebounded from the drop-off after the terrorist attacks. As in the case of retail sales, the lower end of the market is doing noticeably better than the higher end. Home sales in Denver were not as far below year-ago levels in November as they were in September or October, despite mounting job losses in that city. On the negative side, however, Realtors throughout the District say sales of high-end homes remain very soft.

Energy activity has fallen since our last meeting. Conditions in that sector have been a bit diverse in the District, with Oklahoma showing a fairly noticeable decline in activity because of their

higher costs of extracting gas from their resources and Wyoming actually seeing a continued high level of activity because of their lower costs. Price pressures in the District are in fact very minimal as we see it.

Turning to the national economy, Mr. Chairman, my views have only strengthened since the last meeting. I still believe it is helpful to split the outlook into two time frames, the very near term and the intermediate term or second half of next year. Within these two time frames, I think growth will decline in the current quarter, turn around probably late in the first or in the second quarter of next year, and be more robust in the second half, which is very similar to the Greenbook outlook. For this quarter and the first quarter of next year the economy, as I said, will remain weak. But my point is that there's not much we can do about that today. As for the intermediate term, growth in the second half of next year appears likely to be relatively strong without requiring further action on our part. Like the Greenbook, I expect growth in the second half to be close to 4 percent. The factors generating this growth have been noted elsewhere and I'll just highlight them.

Monetary policy, in my view, is accommodative and is contributing to strengthening demand. Fiscal policy right now is stimulative and could become more so in the future. Energy costs are declining, and the contribution from the change in inventories should begin to be positive in the first or second quarter of next year. Certainly, there are risks to consumer and business confidence that we have to be mindful of, and the weakness in foreign economic growth is also worthy of note. With our current policy stance, which is accommodative, the consensus forecast--both inside and outside the Federal Reserve--seems to be for stronger growth in the second half of next year. Finally, it seems to me that we should not take actions now on the basis of events or shocks that we cannot anticipate or even assign probabilities to today. Thank you.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. While overall business conditions in the Southeast remain weak, we're beginning to get hints of at least some marginal improvement in the consumer and related sectors. Retailers in our area indicate that Thanksgiving holiday sales met or exceeded their lowered expectations. This is largely consistent with the most recent data on same-store sales nationally. Merchant inventories are reported to be lean and retailers are guardedly optimistic about the prospects for the holiday season. Home construction and sales, while off their peaks, remain at high levels, driven by lower mortgage rates.

In contrast, while record auto sales occurred in October as a result of manufacturers' incentive programs, one of our directors who owns a diverse set of dealerships in the Atlanta area reported the worst month ever in November. And our contact at Ford indicated that their sales in the Southeast were the weakest in the country last month. Additionally, weakness continues in the commercial real estate sector, with commercial vacancies increasing in every major market. At the same time, manufacturing has continued its 15-month contraction and tourism shows little sign of recovery.

Speaking of tourism, while we know that September 11<sup>th</sup> had significantly adverse effects, particularly on the desire to travel and stay in hotels, the important question is how persistent will that shock be. Recent developments shed light on both the persistence issue as well as on how the ripple effects are playing out. Specifically, they suggest that the shock to business travel has been significantly shorter-lived than the shock to leisure travel. Our contact at Delta Airlines reports that overall air traffic has returned even more slowly than the pessimistic outlook the industry gave the federal government in the first weeks following the disaster. Delta tells us that while traffic slowly continues to come back, it is currently 20 percent below the pre-attack business plan and revenue is still 30 percent below that plan. The recovery in business travel is also reflected in major business

centers like Miami, where CVB hotels have seen a pickup in business traffic. In contrast, occupancy rates on Miami's South Beach and other localities frequented mainly by tourists remain desperately low, as the key European leisure traffic has essentially dried up. As a consequence, Disney has postponed indefinitely opening the first 3,000 rooms of an almost 6,000 room resort in Orlando. AAA indicates that requests for theme park tickets in the Southeast are 80 percent of last year's sales, but their data indicate that most of the travel to these facilities is by car, not by air. Attempts at price discounting have not worked to induce leisure travelers to return to the skies. They remain "fear sensitive." In contrast, the evidence is that business travel is clearly more fare sensitive; airlines have recognized this and are discounting business fares in order to sustain momentum in that area.

Reflecting the reduced air traffic, car rentals in Florida for the past week are down some 25 to 30 percent from a year ago. ANC Rental Corp, which owns Alamo and National and relies primarily on air traffic for patrons, has filed for Chapter 11 protection, and a senior industry contact suggested that not be far behind. In an effort to cut costs, car rental firms in Florida are reducing their fleets and have dumped an estimated 50,000 vehicles onto the used car market in the past 90 days. Interestingly, Hertz is not among these companies. It's a subsidiary of Ford and has been prevented from responding to market pressures in the same way as the independent firms. Two Florida cruise lines have also filed for Chapter 11 protection, and two others have merged.

The fallout from these travel-related developments is also being felt in the services employment statistics. The Sixth District was home to some of the strongest growth in services employment in the nation during the 1990s. In particular, almost 40 percent of Florida's 7 million plus workforce are employed in the provision of nonfinancial, nonretail services; the state has about 50 percent more people employed in hotels and related activities than the national average. As a result,

the slowdown in tourism has hit service-related jobs hard and will continue to do so for some time in the future.

We have continued to press our regional contacts for insights into when we might expect to see some recovery in investment spending. While excess capacity in most industries certainly will discourage spending to add capacity, there are now some signs of renewed spending on technology. Our contact at the corporate headquarters of UPS in Atlanta tells us that while they have cut spending on trucks and planes, they are planning a 6 to 7 percent increase in technology spending next year because of its central and growing importance to their business. Likewise, a contact from Cingular Wireless, a major telecommunications firm serving our region, tells us that they plan to go ahead with substantial investment in a new generation of technology next year in hopes of getting a jump on the competition.

On the national front, I believe the extraordinary uncertainty affecting the national outlook, which concerned us all at the last meeting, may be resolving itself at least somewhat. While I'm not in any way suggesting that the economy has turned around, it would appear that the run of high frequency data released in the last week or so has been more positive and could be suggestive of a response to the stimulus already present in the economy. As noted in the Greenbook, personal spending is up relative to expectations and the manufacturing sector has begun to show some signs of life. And several major tech firms, including Intel and AMD, have revised upward their sales expectations, so perhaps that sector may be on the verge of bottoming out. The new technology spending plans of a couple of the large regional companies I just cited a minute ago are consistent with that view.

As Dave Stockton noted, a major difference in the outlook from our last meeting is the prospect for additional fiscal stimulus, which now looks more problematic than it did a month ago.

That is reflected in one of the alternative Greenbook simulations. This would cause me more concern except for the fact that we have a direct stimulus from the significant drop in energy costs, which has added to income and has lowered costs. We estimate this has added as much as 1-1/4 percent to disposable personal income in the second half of this year--and our estimates do not take into account the extra bonus of a warm winter so far.

As we move to our policy discussion, I would join President McTeer in urging patience, in light of indications of an emerging recovery. The prospect of a recovery is also supported by the improved situation in equity markets. I am not convinced that a further move at this time will alter the near-term path of the economy by speeding up the recovery. Finally, I'm not enamored with the argument that we need to move now as a precaution against further shocks, as yet unrealized.

In short, I don't think we need to do something just to do something or simply to ratify market expectations. I think it's probably time to give greater weight to longer-term considerations. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. The New England economy slowed further since our last meeting and remains largely in sync with national trends. That is, the nation is now officially in a recession and so by extension is New England. Payroll employment for the region declined in October and job levels in every state are below their earlier highs, though for the region as a whole employment still remains slightly above its year-ago level. The regional unemployment rate continues to be below that of the nation but the regional rate has jumped up at a faster pace recently. Looking forward, a significant increase in initial claims for unemployment insurance suggests that the unemployment rate will rise even further. In addition, help-wanted advertising deteriorated markedly in October, with print ads falling about 40 percent on a year-over-year basis. Online job listings have

not fallen as much and their rate of decline has abated a bit. That may signal some bottoming out in the market for high-tech workers, but overall prospects for the job situation in New England seem weak.

Our Beige Book contacts reported in November that the region's commercial real estate markets deteriorated in the last few months, with the Boston area affected most significantly. After almost a decade of markedly below average vacancies as compared with the nation as a whole, Boston's rates have converged to national averages over a period of only four quarters and in the process have tripled. Rental rates, not surprisingly, have come down as well, especially in the suburban markets. Contacts say that commercial markets outside the Boston area have been less tight during the previous few years and as a result have felt the slowdown in recent months to a lesser degree.

Manufacturing continues to be weak, with employment declining by 4 percent in October on a year-over-year basis. In particular, the value of manufactured exports has fallen significantly and at a much faster pace than in the nation as a whole. So, the situation in the region is looking much gloomier than only a few short months ago--in the early to mid-summer.

One striking indication of this is the downturn of Massachusetts State revenues. Through the end of fiscal 2001 in May, revenues were growing at a pace of 4 percent--below plan but solid. Beginning in June, revenues stopped growing and in fact dropped by 3 percent; that drop has continued through today. That is a sharp and sudden swing, which I think reflects the broader experience in the region--a mild slowdown in the spring and then a sudden negative jolt as the summer began. Obviously September 11<sup>th</sup> did not help but it now seems that the slowdown was well at hand before that tragic day.

One key question after such a drop in activity is: When will things get better? We held several meetings in the last few weeks aimed at gauging answers to that question. We met with local business people to talk about business prospects, particularly with regard to technology spending. In addition, we reviewed several measures of regional sentiment--consumer, manufacturing, and high-tech business confidence--along with a set of economic indicators for Massachusetts alone. Finally, along with our Beige Book calls we also contacted a series of temporary help agencies in the region.

Taken together, the data and anecdotes suggest that New England consumers, manufacturers, and high-tech sector executives do not expect an improvement in economic conditions before the second half of next year, nor do the leading indicators forecast a turnaround. Many contacts in temporary staffing firms indicate that business may improve late in the second quarter or possibly early in the third quarter. Manufacturers and retailers see the upturn further out in the second half. But contacts in software and IT firms are much more uncertain, and the predictions they give when pushed are generally concentrated in late 2002 or early 2003. Some tech executives say the technology recession will be longer and deeper than that of the rest of the economy and report that more shakeout is still to come among technology firms.

Finally, to end the regional discussion on a bit more upbeat note, our New England Advisory Council met last Friday and that group of small business people clearly sees this period as not only a time of uncertainty and challenge but also a time of opportunity. Most members of the group reported that one or more product lines remain strong and commented on this being a period when attention to customers and/or innovative products or services would pay off in terms of increased market share. A member of the group from a technology consulting company reported a very recent major positive change in U.S. bookings. Based on his personal contacts, he believes this spate of new business was shared by the major consulting firms like McKinsey and Bain as well.

Business remains poor outside the United States, however. He attributed these increased bookings to the stock market upturn, which he regards as a leading indicator for the consulting business. Several members noted an increased ability to hire skilled workers, which had enabled them to be more innovative and source new products and services in house. The two problems faced by all were the increasing costs of insurance--not just for health care but for property and unemployment insurance as well--and a lack of bank financing except on a fully secured basis. In sum, these small businesses in New England seem at this point to be weathering the recession well and preparing to be stronger competitors when the economy turns up.

Turning to the national scene, certainly the equity markets seem to think the time is near when economic activity will turn up. But I wonder whether that seeming confidence is a bit premature. My reading of the incoming data, particularly as they relate to employment, is that the upturn may be further out than the market expects. And my confidence in the strength of the upturn in 2002 projected by both the Greenbook and our own staff forecast is less than 100 percent.

After a first-quarter pause in spending, the consumer continues to be the mainstay of the forecast, with the dramatic surge in motor vehicle sales in October and November evidence of their resiliency and confidence. Even outside of autos, real durable goods spending rose over 1 percent in October. However, real income fell sharply and the only recently elevated saving rate collapsed. Consumer borrowing may not be growing at the same pace as it had been, but debt service as a share of disposable personal income is rising to levels that are historically quite high, at least relative to the last 20 years or so. Combine falling income, rising debt burdens, and the potential for rising unemployment as seen in initial claims data and layoff announcements, and it may be a recipe for the sharp consumer retrenchment we have yet to see in this recession. In fact, our Bank's forecast sees

unemployment rising about 1/2 percentage point higher in 2002 than does the Greenbook, which combined with falling inflation suggests a potential for considerable excess capacity.

The inventory swing from 2001 Q4 to 2002 embodied in this Greenbook projection really is quite significant, particularly given how little data we have on inventories as yet. That swing, along with fiscal stimulus, drives a relatively robust upturn in 2002. We see a similar though smaller version of this mechanism at work. But there are certainly risks that the inventory depletion and rebound will be much milder and, as I noted, there are risks with respect to consumer spending. Corporate profits are dismal and the high P/E ratios in the S&P 500 reflect both rising Ps and rapidly dropping Es. I think the very euphoria of the stock market right now is a risk in and of itself and not so much an indicator of optimism. If the market were to adjust to more normal P/E ratios with a drop in price, that could well feed back to even slower business spending and declines in consumer wealth and confidence.

Finally, both the Greenbook and our own forecast contain a rather sizable amount of fiscal stimulus. As each day passes without some consensus in Congress, both the timing and the amount of such stimulus come into question. The alternative Greenbook scenarios suggest that a lack of fiscal stimulus could negatively affect 2002 growth and unemployment rates in a significant way. Moreover, whether or not the federal government acts, state and local government spending likely would need to be contractionary in early 2002 to bring state budgets into balance.

At our last meeting I argued that while the economic picture was clearly negative and the risks remained on the downside, I thought the more cautious forward-looking policy would be to move rates downward in small steps. I recognize the logic in aggressively addressing economic weakness in the absence of inflation, but I believe we have done that. I continue to believe that the resilience of our economy and the health of our banking system, just to name two factors, make it less likely that

we will face a deflationary spiral. I also think it's generally not wise to move policy in fear of potential disruptions that have not yet occurred.

In that regard, there are glimmers of light at the end of the tunnel. Durable goods orders and semiconductor chip sales may be signaling a turnaround in business spending. But I think they're only glimmers as yet, no matter how they are received by the equity markets. Risks remain weighted toward weakness beyond that incorporated in our forecast, and inflation is quiescent if not declining. Given the uncertainties on the fiscal side, there may well be room for a bit more policy ease, though I do have some measure of agreement with several of my Reserve Bank President colleagues about how close a call this is. I still favor the cautious approach, but taking out a bit more insurance right now against the downside risks strikes me as a reasonable and measured step. Thank you.

CHAIRMAN GREENSPAN. President Broadus.

MR. BROADDUS. I don't have a whole lot to say about our District economy that is new. Overall activity seems to have continued to decline in November. In particular, retail activity in our region fell sharply in November, based on information we received in the monthly survey we conduct. Much of the decline seems to be the result of a drop-off in car sales. Moreover, most of the retailers that we talked to are not optimistic about the holiday season. There's a lot of discounting going on at all levels and in all categories of stores. Only the big box discounters like Wal-Mart and Target seem to be having fairly good results so far.

In the manufacturing sector also the news that we're receiving is not favorable. Shipments, new orders, and order backlogs all declined further in November overall. Many manufacturing companies are either reducing their capital budgets further or freezing them. A few manufacturers among those we talk with regularly did report some pickup in business and a few indicated that they're

reconsidering some of their earlier decisions to cut capital spending. But those firms are definitely in the minority.

On the national economy, clearly there may be more reason for optimism regarding the outlook today than there was at our November meeting. Others have made a number of comments about that already. The stock market is up, Treasury bond rates are up, credit spreads have narrowed, and the federal funds futures market suggests that market participants expect policy to be tightened more aggressively next year than was expected earlier. There is some evidence, though I would say it is limited, in the recent economic reports that the contraction in activity may be moderating. And at least some indicators--the Michigan survey, for example--suggest that consumer confidence may be stabilizing. Also, the small increase in nondefense capital goods orders in October could be an indication that the rate of decline in business spending on equipment may be slowing a bit. But in my view the downside risks in the outlook are still material. So let me play Scrooge and underline them. Cathy Minehan and others have already made some of these points.

First, I would suggest that the optimism so evident in financial markets may reflect to some extent the assumption on the part of a lot of investors and others that this recession is going to end in the spring because the average postwar recession has lasted about 11 months. But this assumption may well be unwarranted if this recession is different from the go/stop kinds of cycles we have experienced in recent decades. The optimism may also reflect confidence that fiscal stimulus will be forthcoming and that when it comes it will be effective. But in my view--and others have said this too--it's not clear that fiscal stimulus will be forthcoming. And even if it is, it's not clear to me that it necessarily will be effective.

Beyond that, the latest hard economic data we have are not as a whole rosy in my view. The Greenbook reports that, despite indications of somewhat more favorable news with respect to

equipment investment, the staff is now forecasting a very significant further drop in spending on equipment and software in the current quarter. And while people have recognized the weakness in labor markets, I wonder whether we may be minimizing just how weak that November job report was. After all, the level of payroll employment was about 200,000 jobs lower than had been anticipated before the report was released. And the rise in the unemployment rate over the last three months has been the fastest increase in a long time--since 1982, I believe. Moreover, the drop in manufacturing jobs, at 163,000, was the biggest decline so far in this cycle and, of course, that number has been coming down now for a long time. With weak labor markets, of course, the risk is that the contraction could be deeper and longer if household confidence is shaken. Confidence may be adversely affected by job losses that have already been reported, if people are concerned about losing their jobs or about the prospect for slower growth in wages and income.

One other statistic that I think underlines the downside risk is the sharp deceleration in one-year-ahead inflation expectations as measured by the median response in the latest Michigan survey. As Bob Parry mentioned, that number dropped from 2.8 percent in September to 0.4 percent in November. The December survey showed a rebound, but the level is still much lower than in past months, looking further back into the past. Some of this decline may be transitory, related to what is happening to fuel prices and so forth. But I think there are broader reasons to be concerned about disinflation. The Greenbook estimates that core PCE is currently running at a rate of about 1-1/2 percent and the staff is forecasting that it's going to come down 1/2 point to 1 percent by 2003. Moreover, focusing again on labor markets, it seems to me quite plausible that the unemployment rate could peak at a higher level than is now being projected in the Greenbook. If that happens, I think that would have an impact on wages and also implications for disinflation going forward. Fortunately, to this point our reductions in the nominal funds rate have prevented the disinflation that apparently

already has occurred from pushing up the real funds rate. But I continue to believe, given all the information we have, that we need to do what we can to keep real short rates from rising in the near-term future.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I'm not sure I have a lot to add at this point, so let me be brief. I've reported for a long time now that the District economy has been tracking the national economy rather closely. As a generalization that still is the case, but let me make a few comments about things that are a little different or new.

Clearly, labor market conditions in the District have eased--that is not new--but the unemployment rate has actually risen very little to this point. And I would have to say, as best I can judge from anecdotal reports, that holiday hiring was better than I had anticipated earlier. The major retailers I've spoken with seem satisfied so far with holiday sales--relative to their subdued expectations let me add. Nevertheless, they are not complaining inordinately about what they are seeing. The pattern in sales that has been evident for quite some time--with discounters doing better than full service department stores and specialty apparel people somewhere in the middle--seems to be continuing, based on same-store sales data and discussions with these retailers. The large retailers also indicate that they have made no adjustments to their capital spending plans for the next year or so. History tells them that if they cut back, they will find that they've done it just as the economy starts to improve and will wish they had proceeded with the additional stores. So, on those grounds, they haven't changed their capital spending plans.

In conversations with some people from several large financial services firms, we hear that their business with consumers remains very active both in terms of demands for credit and sales of financial instruments, though demands from the business side are slow. And finally, while

commercial construction activity is slowing in the District, housing activity as measured either by construction or sales continues to be reasonably robust. It certainly has held up longer and better than I would have expected by this stage.

As far as the national economy is concerned, I'm more confident than I have been for some time that something like the Greenbook forecast will materialize. The basic story as I see it is that the strength in consumer spending is restraining the weakness this quarter. There will be some payback for that next quarter but then a more sustained improvement will get under way. The latest data indicate to me that, if nothing else, the economy is clearly in a process of stabilizing. It is not falling off a cliff. And as I said, I find the Greenbook story reasonably convincing, although I would certainly not be astonished if it took another quarter or so for the recovery to get under way. I think timing is always a matter of considerable uncertainty.

As I've commented before, housing activity is a measure we might consider in thinking about the mindset of the consumer. After all, the purchase of a house is a long-term commitment. When people are willing to buy a new home, that involves a 15- or 30-year commitment, even allowing for sales and refinancings and so forth. And the housing activity numbers continue to suggest to me that consumer confidence remains reasonably healthy.

I would also note that whenever economic activity starts to pick up, it's likely to take us some time to recognize that upturn unless all series turn positive at once. My experience is that that rarely, if ever, happens. So even if the economy starts to improve in the second quarter my guess is we won't recognize that with much confidence until the third or the fourth quarter. I would think, by the way, that the unemployment rate is going to continue to go up for some time. That seems to me to be almost baked in the cake.

Finally, I will restrain myself and not discuss policy preferences at the moment.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. Underlying economic conditions in the Third District have remained essentially flat since our meeting five weeks ago, suggesting that the economy has once again stabilized. This is an improvement relative to the conditions I reported here at the November meeting, when the District's economic situation was worsening. We know that consumer spending will be an important impetus to the recovery. Holiday sales in the District have not been as weak as many had feared, although it's still too early to make predictions for the season as a whole. Regional data do not yet show a broad-based pickup in retail sales, and some of our retail contacts are expressing concern that sales may remain weak into the spring. And consumer confidence in our region continued to decline through November.

The housing market has not fared as well in the region as it has in the nation. While housing permits and the value of residential construction contracts were up in the spring and summer, they've remained flat since then. The falloff in residential real estate markets is expected to be a modest one, however. Business investment is not likely to contribute to growth in our region, at least until the second quarter of next year. Investment in structures by businesses declined this year and nonresidential building contracts in our three states dropped dramatically over the last few months. Vacancy rates in the city of Philadelphia and its suburbs are up about 5 percent since the beginning of the year. The market is not as overbuilt as it was in the 1980s, so the real estate cycle will not be as deep as in the previous recession. Of course, this also means that real estate will not be the engine of growth for the recovery.

Equipment spending by respondents to our South Jersey survey, which includes retailers, service firms, and manufacturers, was down in the third quarter and is expected to grow only modestly over the next six months. In November, manufacturers in our business outlook survey reported that

they expected no rise in capital expenditures, including structures and equipment, over the next six months. Manufacturing in our District remains quite weak. The indices of general activity, new orders, shipments, and manufacturing employment in our survey have not recovered from the steep declines reported right after September 11<sup>th</sup>. Survey results suggest that there is some inventory correction still to come in our manufacturing firms, with about 1/3 of the firms reporting in November that they plan further cuts in inventory. When asked when they thought the recovery would occur, over 70 percent of the respondents to our surveys, including manufacturers, retailers, and service firms, expected to see some improvement before or during the second quarter of next year. But the service firms and retailers were somewhat more optimistic than the manufacturers. This is consistent with the Philadelphia staff's forecast, which suggests some modest pickup in employment in all three of our states by the second quarter of next year accompanied, however, by continued increases in unemployment rates in our region.

It is also consistent with many forecasts for the nation as a whole. For example, the median forecast from our fourth-quarter Survey of Professional Forecasters also predicts economic recovery in the second quarter of next year, as does the Greenbook. My own view for both the region and the nation is a bit less optimistic. I think it will take some more time before businesses and consumers feel the recovery is in place--perhaps by midyear or the third quarter--although I must admit that the error bands around these forecasts make it difficult to distinguish among them.

Consumer spending is the key element in all the forecasts. Obviously the pattern of growth will be affected by auto sales, which were pulled forward by the zero percent financing deals and, therefore, will fall back next quarter. Nonetheless, in most forecasts consumption is the engine of growth next year beyond the first quarter. As growth of consumer spending accelerates, inventory building resumes, followed by a pickup in investment spending, which helps solidify the recovery.

Philadelphia staff analysis of the behavior of leading indicators during previous recessions suggests that we are on path for such a recovery. However, I remain somewhat concerned that the economic recovery could be delayed, even given the sizable monetary stimulus applied this year, which no doubt has helped to attenuate the downturn.

In particular, two parts of the recovery scenario appear problematic. First, the strength of the recovery is dependent on further fiscal stimulus, the details of which remain to be worked out. Secondly, weak labor market conditions could undermine consumer confidence and spending. Should this happen, the timing of the recovery would be later and the magnitude smaller. That said, as I discussed last time, I believe the Committee should begin focusing on the medium- and longer-term, recognizing that the full effects of its actions--those implemented throughout the year as well as any action taken today--are felt with a lag. We need to prepare the markets and the public for the time when further rate cuts are not needed, and I think a more measured approach today to policy is appropriate. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. First, I'm surprised by Al Broaddus's negative tone on the labor report because I really expected him to come in here and note that West Virginia, which is more in his District than in mine, had its lowest unemployment rate in the history of the data series.

MR. BROADDUS. I started to do that but in light of the reaction to what I said about West Virginia last night, I thought that might not be wise. [Laughter]

MR. JORDAN. And about nine other states registered drops in their unemployment rates. Our region enjoyed spring-like weather last week, setting a record high of over 70 degrees on one day. So even the shutdown of LTV steel production did little to reverse the gradually building optimism.

The range of opinion of people we talked with ran from those who are expecting noticeable improvement in their business in the first half to those who merely believe that the economy has stopped contracting but are not confident that a pickup will occur in the near term. Even the hard-hit heavy truck manufacturers believe that we are at or have already passed the absolute low, although most think that it will be late next year at best and more likely in 2003 before there is a noticeable increase in truck production. My guess is that the strong rebound in auto sales plus the continued firmness in residential real estate markets in our area have helped restore confidence more than just a little. An accumulation of small stories--such as a GM stamping plant announcing last week that it had openings for 200 people and a data services company in Kentucky saying that it plans to hire several hundred people in the coming year--has mitigated somewhat the long-expected loss of steel worker jobs in the region. One steel company executive went so far as to say that she hopes the bad prospects last long enough to get the consolidation that we need in the steel industry. A large regional bank announced that they are reinstating hiring bonuses in an effort to fill the continuing large number of openings that they have. Health-care organizations are now the largest employer in many of the metropolitan areas in the region and they continue to report hard-to-fill openings and considerable wage pressure.

Construction spending continues to be strong except for the building of hotels and restaurants, which has stopped completely. We were told by a union official--this probably reflects what Jack Guynn was saying about his area, too, though I don't know what share of hotel/restaurant/hospitality workers are unionized in his region--that nationally the union expects to lose half its members. A director in the construction industry reported that since September 11, over \$3 billion of commercial construction has been either cancelled or suspended because the lenders cannot get insurance or its cost is prohibitive.

On retailing, as Gary Stern was suggesting, we're all accustomed to retailers expressing disappointment with holiday sales. They've been doing it for 50 years at least! But now what we're actually hearing is that they are pleasantly surprised. In some cases such as Kohl's--one of our directors is on their board--they actually have had very strong sales. For other companies like Federated, sales haven't fallen as much as their worst fears and, therefore, they express some satisfaction with how the holiday shopping season has played out so far.

We surveyed all of our current and former Small Business Advisory Council members last week and the tone of their remarks was similar to what Cathy Minehan said about her group. They are weathering the downturn better than they had expected, so their reports were not strongly negative in tone.

On the fiscal picture, I have a little different perspective than what I've been hearing so far this morning. Namely, I think the stalemate between the executive and legislative branches is a very positive long-term development in that it has gone a long way toward disabusing the public of any residual notion they had that there was such a thing as a discretionary countercyclical fiscal policy.

[Laughter]

One of the interesting developments in this recession--especially since September 11<sup>th</sup>--has been the difference as compared with 1990 in both the behavior and the perspective of households and businesses. If you recall, at this point in 1990 with Desert Shield leading up to Desert Storm, both households and businesses seemed to go into a hunkering down, worst case, mini-max mode--an "avoid the worst outcome" type of approach. Households simply have not done that this time, whereas businesses seem to be acting very much as they did in 1990. Everybody in business is from Missouri! They're not going to believe in anything good until they see it in their order books or sales. Well, from this starting point one of two things can happen: Either households will belatedly turn

pessimistic and become more conservative or businesses will finally shake off their pessimism and conservatism about the outlook. Either scenario has major implications for the set of financial market conditions that will be associated with whatever economic developments actually occur.

GDP in the current quarter, which only has 20 days to go, will be a negative number, if the Greenbook is right, and it's going to be negative because of a very large decline in inventories. That's not necessarily a bad thing, either for our own economy or for our trading partners around the world. So maybe we ought to be hoping for a negative fourth quarter if inventory liquidation is what it is going to reflect.

I can't forecast interest rates even as well as most people can, but I'm fairly confident that we're going to have a flatter yield curve a year from now. Especially if the Greenbook forecast is right, I see the yield curve flattening mostly from the short end. It's a question of how we get from here to there. I've been puzzled about all these reports that we are expected to cut the funds rate at this meeting by 1/4 or 1/2 point. Most people surveyed--and I don't know who these people are--say we're going to cut the funds rate. One of my directors is on a government affairs council for the American Bankers Association and they had a meeting very recently, I think at the beginning of last week. Over 100 bankers attended and, after listening to an economic briefing, they were asked to indicate whether they thought the Fed should lower the funds rate at its meeting today. He said no one raised a hand among the 100 or more people there. And when asked if they thought the Fed had already cut rates too much, he said almost everyone raised his or her hand. So I asked my Community Bank Advisory Council that first question last Friday at our regular meeting. One banker did say that she thought we ought to cut the funds rate by 1/4 point today simply because it was already built into expectations--I guess she reads the newspaper--and everybody else said no.

I still think about the level of the fed funds rate differently from the way I think about an action to cut the federal funds rate. If I look at the level, I don't see a need for additional insurance. I believe we are providing an adequate amount of liquidity at the current level of the funds rate. An action to change the funds rate is news that will be broadcast on CNBC and CNN and it's going to get a headline. The issue is: What is the message we're sending and to whom are we sending it? If we want to send the message to Main Street, then perhaps we ought to cut the funds rate 1/16 of a percentage point. It doesn't matter how much we cut it; we get the headline regardless. But I think there may be some merit, as a few people have suggested, in disappointing the Wall Street expectations of a cut. By doing so we may signal a more positive tone, indicating that we are comfortable that the outlook is improving. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Okay. Let's break for coffee, which I presume is outside.

[Coffee break]

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. I will try to fill in a few interstices of the discussion without repeating what is already before us. My Wal-Mart contact said a couple of things that I thought were very interesting. He said that when Wal-Mart compares prices of items being sold this holiday season that were also sold last holiday season, the prices of these identical items are 16 percent lower this year. I think the retail environment can only be described as brutally competitive. My contact also said that there is a lot of evidence that consumers are very cautious. It looks as if people may be waiting even more than usual to purchase items in the holiday shopping period this year. They may be planning to pile up purchases at the end of the season or may just be waiting for lower prices. There is a higher percentage of layaway purchases than usual. That's not a retail strategy that many of us around this table use but some parts of the population do. There is also a continuing preference shift among

consumers away from premium products toward so-called value products, the lower priced items in a line of merchandise. Inventories at Wal-Mart are in very good shape, right on track with where the company wants them to be. My contact said that for the first time he's finding that the softening in the labor market has made it easier for Wal-Mart to hire sales associates. You may remember at earlier meetings that I said Wal-Mart continued to find a lot of tightness in the labor market for that level of skill.

My FedEx contact said that absolutely nothing had changed in their situation since we talked six weeks ago, except perhaps that heads are not hanging anymore. It looks as if things are just settling down. His firm's forecast for next year shows a flat first calendar quarter over the first quarter of this year and they're anticipating some improvement in the second quarter and beyond.

I note that Jack is trying to horn in on my UPS monopoly here. [Laughter]

MR. GUYNN. I won't do it again, I promise!

MR. POOLE. That's okay. I'm from Chicago and I believe in competitive markets, [laughter] including for information. The overall tone at UPS seemed to be a little more bullish than at FedEx. My contact said business has been fairly good and UPS is anticipating that volume in the beginning of next year will be up by 2.2 percent--that is their business plan--compared to the first part of 2001. This year's volume is coming in about flat compared with last year.

My contact at J.B. Hunt, a trucking company, says that business is particularly slow. His firm sees no basis for optimism about the first quarter of next year.

Let me make a couple of comments on the national economy. There has been a lot of discussion about fiscal policy and I think it's worth reflecting on the fact that the Greenbook really can't make any assumption other than that temporary is temporary and permanent is permanent. But I think a better way to view fiscal policy right now is that fiscal policy is in play and is likely to be in

play for some time to come. When we think back to the early 1990s, a stimulus bill--I think it was called an investment credit at the time--was under consideration at the beginning of the Clinton Administration but was not enacted. Then there was a tax program that was enacted narrowly. After that, fiscal policy was settled for quite a long time. It began to be discussed again during the election campaign last year. Now fiscal policy is in play, and I think we're going to see continuing discussions about adjustments. Fiscal policy is not going to be a source of stability in our outlook. We cannot expect that everything will be resolved, however this stimulus bill comes out. That's not going to be the end of it, I think.

It seems to me that we are in the neighborhood of a cycle trough. I don't know exactly what that means, but I'd say it means the trough will occur within the next few months. That's consistent, of course, with the Greenbook forecast.

One other comment I'd make is that I think it's clear that household behavior is not characterized by expectations of ongoing deflation. People are responding to sales incentives as a reason to buy rather than to project that better deals will be available in the future. Therefore, the sales incentives are leading to additional sales now rather than the postponement of purchases with the expectation of getting an even better deal by waiting another few months. So, that's my take on the current outlook.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. For some months now the economic statistics have been very negative. All year the Greenbook has been responding to these statistics by revising down its forecast, as have the Blue Chip and other forecasters. But we now find ourselves in a more ambiguous situation. Some indicators still look weak but others are turning up. We may be approaching an important crossroads for monetary policy.

The list of indicators that are beginning to show signs of strength, or at least stabilization, is long. In the last month the NAPM durable goods orders, personal spending, and construction spending have all turned up. Consumption of semiconductors has risen as have computer shipments. Nonfuel commodity prices have increased lately, perhaps indicating future strength in demand. And oil prices have dropped, which paradoxically could be an expansionary force. Bond and stock markets are both indicating that credit markets think better times are ahead. But welcome as these signs are, one should not get carried away. Fans always feel good when their team's losing streak has ended but this does not make their team a strong team. [Laughter] As the recent employment reports indicate, the economy is still soft and it will take a long run of good news before we can declare the recession or the soft period over.

Perhaps because of the imminent signs of strength, it now seems less likely that Congress will pass an economic stimulus package. My own most likely Greenbook forecast has become the one labeled "no fiscal package." An important boost in the baseline Greenbook forecast is given by fiscal policy assumptions, specifically the acceleration of depreciation loss. If I assume that the fiscal package doesn't pass, I can sidestep this debate between Jerry Jordan and the Greenbook forecasters on the exact impact of that package. The forecast in that no fiscal package scenario shows another year of sub-trend economic growth, with growth not returning to trend until sometime in 2003 and with the unemployment rate peaking at 6.4 percent, which is a long way from full employment by anybody's definition. Moreover, it's almost too gruesome to mention, but the economy is still vulnerable to negative shocks, whether from further terrorism or just plain negative economic shocks.

For whatever reason, short-term anticipations of inflation by those responding to the Michigan survey have taken a sharp drop. When combined with the high unemployment, the low oil prices, the incipient drops in measured inflation, and the fact that productivity is holding up

remarkably well for a recession, there are solid grounds for projecting lower inflation as the Greenbook has done. Indeed, there are solid grounds for projecting lower inflation *than* the Greenbook has forecast. Given all this--the still weak economy, the still vulnerable economy, and possible reductions in inflation--I think one can make a very strong case for a further easing of monetary policy more or less in line with what the Bluebook has called "a perfect foresight policy." That's a self-congratulatory label, though one that suits my present purposes! [Laughter] But in contrast to my feeling for most of this year, the case for further ease is not quite as compelling today. Thank you.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The Second District's economy has shown clear signs of rebounding from the depressed levels noted in my report to you at the last meeting, and there are further signs of downward price pressure. Consumer spending in the District seems to have rebounded in November but remains below pre-attack levels. Retailers across New York State report that sales were up 2 to 3 percent from a year earlier over the Thanksgiving weekend but were flat in the following week. In both weeks, sales were said to be particularly sluggish in New York City.

Construction and real estate activity have been mixed. Manhattan's office market softened further in October despite the loss of the Trade Center. Manhattan's apartment sales and rental markets also have softened since the attack. However, single-family home sales throughout New York State rebounded in October with prices remaining well ahead of year-earlier levels. Both single-family and multifamily housing permits in October were little changed from pre-attack levels.

The story about Manhattan's commercial real estate market is really quite interesting because everybody was quite convinced until the 11<sup>th</sup> of September event that the commercial real

estate market was quite tight. About 7 percent of the office space was wiped out by the attack on the Twin Towers, but suddenly we don't have any shortage of available office space. So it became clear that some of the apparent tightness in commercial space reflected hoarding--a real estate version of the over-investing that seems to have been taking place, and not just in the tech sector.

There has been good news for the future of lower Manhattan. John Whitehead, who for four years was Chairman of the Board of Directors of the Federal Reserve Bank of New York, has been named by the governor to be Chairman of the Lower Manhattan Development Corporation. I think that will bring some necessary decisiveness to what is going to happen in the City, which is a very important factor in restoring both consumer and business confidence.

Nationally, based on the assumption that monetary policy will be eased and that the funds rate then would be held steady through a good portion if not all of next year, we have forecast economic growth of 3 percent Q4 to Q4 in 2002 and of 3.4 percent in 2003. We see the core PCE deflator at 1.7 percent next year and 1.6 percent in 2003. The unemployment rate in our projection is quite benign. It reaches 5.9 percent by about the middle of next year and then gradually comes down to about 5.7 percent in 2003. We do assume in this forecast that about \$100 billion of fiscal stimulus will be passed by the Congress and that it will be reasonably effective. Should that not happen, our economic forecast would be somewhat weaker although obviously, depending on the nature of the fiscal stimulus package, how much effect it will have next year is very questionable.

The mood of business leaders in the District is extraordinarily glum. It's reaching the point where it seems to be becoming fashionable in New York business circles to show that one can be at a greater depth of despair than one's neighbor. In fact, I've given up trying to discuss rational forecasts with business leaders and now have shifted to asking this question: When you figure out that you're wrong, can you revise your business plan and do it quickly? The answer to that is yes, which I think is

far more pertinent than whether these business leaders have the right forecast. But the degree to which the spreading of gloom can be self-fulfilling I think is a downside risk to the forecast.

We are assuming that growth abroad will continue to be anemic and that, therefore, the current account deficit--what I view as the long-run weak point of the American economy--will continue at about 4-1/2 percent of GDP. We think that can be financed and probably financed with very little if any weakening of the dollar. But it is something that concerns me greatly over the longer run as an indication that the world economy simply isn't balanced well. Thank you.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. The conversation thus far has indicated that it is extraordinarily difficult to identify with great certainty turning points in the economic cycle. A number of people have already pointed to some of the positives that emerged in the intermeeting period, including retail sales, new orders of durable goods, auto sales, et cetera. I would only add to that by saying that even our appropriately cautious financial and forecasting gurus here at the Fed have looked at those data and produced a Greenbook that for the first time in several rounds does not feature a downward revision to the outlook. However, as others have noted, the fed funds futures markets and market participants in surveys are nearly uniform in their expectations of another easing move at this meeting. So why is that? I think the answer is because the turnaround implicit in the positive data and even in the forecast is still quite tentative. And some of the positives we have seen may reflect in large part a one-month bounceback from the shock of September 11<sup>th</sup> and may not necessarily prove to be a certain precursor to a sustained turnaround. I see the risks in the turnaround scenario to be quite clear and almost all to the downside.

Labor market conditions are continuing to deteriorate, which might have a negative effect on consumption by households and delay the expected turnaround. Second, I believe almost all

forecasts assume some form of fiscal stimulus and, as we've already discussed, the state of fiscal stimulus is very much in play and quite uncertain. Third, there is risk from the international environment where we have a synchronous global downturn. I think the turnaround internationally depends much more on whether or not our economy recovers as opposed to our looking to others to be the engine for recovery. Finally, financial markets could easily deteriorate if the expectations of a return to growth and profitability are not met. And if such a negative event to financial markets were to occur, that clearly would be a drag on consumer and business plans, not a support for them.

A number of issues have emerged with respect to policy. I, like President Stern, will restrain myself on that subject but not as much as he did. [Laughter] First, some people have suggested that we shouldn't move in expectation of a terrorist attack and I would think that is certainly true. We cannot inoculate the U.S. economy from potential or actual political threats. On the other hand, we can position policy in such a way that we can make the economy as robust as possible, even in its relatively weakened state. Secondly, I've heard at least one or two people refer to the risk that if we move today and then reverse our stance later, that might be surprising to the markets. I find that a little hard to understand because the markets have already built in an expectation of a turnaround in policy. So were we to move today and then turn, we would simply be validating what the markets expect.

Governor Gramlich stole my thunder with respect to the perfect foresight policy. I know I don't have it, but presumably a goal of having a Committee is that we approximate something like perfect foresight with the consensus-building that goes on here. So I would encourage all of us, before we get to the policy discussion, to look at pages 11 and 12 of the Bluebook if you haven't done so.

And finally, Harvey Rosenblum's name was mentioned as a superb economist. I will not try to bring the views of another economist to the table, but I would bring Samuel Johnson to the table.

Samuel Johnson demonstrated his wit on hearing that an acquaintance was planning to remarry by describing that as a triumph of hope over experience. When we get to our policy discussion, I would certainly expect that this Committee, with perfect foresight, would not let hope triumph over its wisdom and experience. [Laughter]

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. Recently at FOMC meetings, one of the key issues that has weighed on the policy decision is whether or not the forecast is stabilizing. In fact, as Governor Ferguson just noted, in each of the previous FOMC meetings this year there has been some meaningful downward revision in the Greenbook forecast. And these revisions have been followed by further easing. So it seems that a precondition for an end to the cycle of easing is a stabilization in the Committee's forecast. This Greenbook delivers such a stabilization. Indeed, it has a small upward revision in projected growth for next year. My forecast has the same property and a number of you around the table have reached the same conclusion. This at least puts on the table the possibility of holding the line on the funds rate, if not today then perhaps after today.

Of course, we face a tension between the forecast and the incoming data on production and employment. The incoming data reflect the projected decline in output this quarter, and over the next several months we're likely to see further increases in the unemployment rate until economic growth comes back to trend. In my view, prudent monetary policy would call for an end to the policy easing cycle before an end to the rise in the unemployment rate. Nevertheless, the sharpness of the increase in the unemployment rate in November and the uncertain effects of that on sentiment and spending at least put back on the table the possibility of a little further easing at this meeting.

One way of thinking about monetary policy is in terms of the path of the funds rate. A second way that I sometimes find useful is in terms of the desired path of real GDP growth, as if that

were the instrument under control. Given the lags in the response of monetary policy and the preference with regard to moving interest rates, when I play this game I don't adjust GDP growth for a couple of quarters. The question I ask as I look at the Greenbook is whether the strength of the rebound as we get to the middle of next year is about right or, for example, would be better scaled up. I view that as a way of gauging whether or not there is room for further easing. That room depends on three considerations: the rate of employment in mid-2002, when growth moves above trend in the Greenbook forecast; the inflation rate at that time relative to the Committee's long-run objective; and how much projected growth is above trend in the following year or two. The Committee does not have an explicit long-run inflation objective, so I do the exercise in terms of my own long-run objective for inflation, which is 1-1/2 percent for the PCE core inflation rate.

It seems to me that these considerations reinforce each other and suggest relative to the Greenbook forecast some room for further easing. The unemployment rate peaks just above 6 percent and is still 5-3/4 percent at the end of 2003, as compared to my estimate of the NAIRU at that point of 5-1/4 percent. And the inflation rate is almost 1/2 percentage point below my long-run objective at the end of the period. A number of people, Governor Ferguson and Governor Gramlich both, mentioned the perfect foresight simulation, and this is the message that comes through in that particular forecast.

On the other hand, just to keep it close, I expect that growth might be stronger by mid-2002 than projected in the Greenbook and I'm slightly more pessimistic than the Greenbook about inflation. First, I expect a sharper cyclical rebound in equities and therefore I start with the staff's alternative simulation with a stronger stock market. The Greenbook equity path is predicated on further earnings disappointments and a perception that there is some overvaluation today, given the excessively optimistic earnings expectations. There's good logic in this assessment, to be sure. But I suspect that this logic will be overwhelmed by a more normal cyclical rebound if the economy performs as

projected in the Greenbook. Down the road, we'll face the implications of any resulting overvaluation.

Second, I believe we may be at an inflection point. We are shifting from progressive downward to upward revisions to the forecast. And this reflects a tendency toward a coincidence of positive errors or smaller negative errors in spending equations during recovery periods.

With respect to inflation, the Greenbook focuses on the effects of declining oil prices and the emerging slack in labor markets. I would put more weight than the staff does on the implications of what looks like a significant adverse supply shock. The staff estimate of structural productivity growth has declined from a bit above 2-1/2 percent in 1998 and 1999 to about 2 percent this year and about 1-1/2 percent next year. We, or at least I, placed a lot of emphasis on the effect of the productivity acceleration on both demand and inflation to explain the exceptional performance of the economy in the second half of the 1990s. Now, the deceleration is different in character from the acceleration, and perhaps this will matter. It reflects a move from overshooting in 1999 and into 2000, relative to some longer-run sustainable growth rate for productivity, to undershooting next year. In addition, it reflects some effect from increased spending on security. But it seems to me that this swing could damp the projected disinflation. To be sure, the staff has taken this into account in their forecast but not with the weight I would have given it. As a result, I view the negative supply shock as at least a risk factor relative to the Greenbook forecast.

The bottom line is that there appears to be a little room for further easing, but we are rapidly approaching the point where it may be prudent to hold the funds rate stable for a while. Even at this point, the Committee will still be able to adjust the degree of stimulus going forward by its decision on how long to remain at the low prevailing funds rate and how gradually to return to neutrality.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. Well, given my long tenure of a long weekend and a day to look at this information, I won't pretend to be as up-to-date on many of the series as the experts around the table. But I wanted to bring to the table some observations I've noted, which are more from an anecdotal perspective of the business community and the banking community.

First, my main concern regarding where we are in this business cycle is where we are on the business investment side. The reason is that I believe what got us into the recession was the drastic drop in investment in certain key technology sectors. I feel optimistic that inventory corrections are well under way in that sector and that we may actually begin to see some stabilization in sales.

The consumer has really kept the economy going in this cycle. We can see that both in housing and in auto sales, even though I believe a lot of the recent auto sales represent a timing difference due to the attractive financing programs. But the consumer has been using the refinancing of homes as a way to increase disposable income every month, and we know that the pool of mortgages that can be profitably refinanced by consumers is dwindling. In fact, I would argue that the recent uptick in refinanced mortgages is what we normally see when long-term mortgage rates begin to go up, as the astute refinancers jump in and lock in rates that they believe have hit their lows. So, I don't believe we're going to see much more of an increase in spendable income coming from the consumer. And obviously, as many others have said, the threat of terrorism may put a damper on the consumer, as will unemployment worries.

The other sector that concerns me--and I say this in light of recent personal experiences--is state and local governments due to the financial stress currently being placed on them, particularly in areas that depend a great deal on sales tax revenues and on revenues tied to the employment situation. Those entities are having to spend substantial sums to support responses to potential terrorism activities.

Finally, most corporate executives I talk with feel that they have very little ability to raise prices at this time. In fact, they're feeling more pressure to cut prices, as has already been discussed, to deal with inventory accumulation and excess capacity. So I find very little pressure on inflation at the moment.

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. First, I'd like to associate myself with Governor Bies's preamble. I share the same view. I would like to make one observation on the subject of fiscal policy and the stimulus package, which has been discussed by a number of people. I do so from the standpoint of having spent much of the last 30 years being very closely involved in the public policy formation process.

Congress functions best or most rationally in two environments, either a crisis or a consensus. That's not because members of Congress are necessarily weak people but because the system was designed that way. We reelect the entire House and a third of the Senate every two years, and that is not a circumstance that lends itself to creating statesmen or women or to fostering long-term thinking. As we move away from a sense of crisis, we move into an environment where I think the stimulus package is in some jeopardy. That is not, as President Jordan suggested, because it involves a conscious rejection of discretionary countercyclical fiscal policy but because we find members of Congress, particularly in an election year, tugged by their core constituencies. Where that leaves us now is that to the extent there is a growing sense of confidence in the economy--despite that confidence being based in part on the assumption of a fiscal stimulus package--it will in fact have jeopardized the possibility of a stimulus package being passed. It's a bit of a Catch-22. So in that very narrow component of the outlook, I think the probability of an economic impetus package is less than it was 30 days ago. Thank you.

CHAIRMAN GREENSPAN. We move on to Don Kohn.

MR. KOHN. Thank you, Mr. Chairman. As many of you have remarked, perhaps the most striking--and certainly welcome--aspect of this intermeeting period has been the mixed character of the incoming economic data. For the first time in many months, data have *not* pointed to further downward revisions to current and prospective economic activity. Importantly, although measures of aggregate employment and output show the economy overall continuing to contract appreciably, key elements of private final demand have firmed, and by somewhat more than expected. This latter development would seem to provide the first concrete indication that further contraction in the economy could well be limited, and some tentative support for the projected turnaround beginning early next year. The key issue for you today would seem to be whether, with the economic outlook perhaps stabilizing, the monetary stimulus already in place is sufficient to foster an adequate rebound, thus arguing for keeping policy unchanged at this meeting, or whether the persisting softness in activity and prices, along with the possibility that you are seeing a false dawn and the recovery may be damped, justifies a further slight easing of policy of 25 basis points.

In practical terms, the differential effects of either standing pat or easing by 1/4 point may not be that great. Because both represent a step-down from the recent pace of easing, either will reinforce perceptions in the market that the FOMC believes that the end of the easing cycle is near. With such an expectation already largely embedded in the term structure of interest rates, long-term interest rates should not change much under either alternative. Still, the choice will matter to some degree. In addition to its effect on the cost of short-term finance, it could have some small influence on longer-term rate expectations, especially if you do not ease as markets anticipate. Perhaps more importantly, the inferences market participants draw about your own economic outlook and your weighing of risks and costs in policy decisions will help them to shape how asset prices respond to new information going forward.

A decision to leave rates unchanged at this meeting would seem to rest mainly on the combination of a more stable outlook and the extent of previous policy easing. Policy has eased more rapidly than in most economic downturns, in part reflecting your efforts to take account of the implications of new information not only for the current situation but also for the path of the economy into the future. In this regard, you may see the degree of stimulus in the stance of policy at the end of your last meeting as already based on expectations of further weakening in the economy and as sufficient to foster a satisfactory recovery beginning next year from the lower level of resource utilization in train. Indeed, to some extent, the aggressiveness of policy easing may have reflected your attempt to protect against downside risks, as well as to address the central tendency of the outlook. This seemed especially the case at your last meeting when several of you remarked that the choice between 25 and 50 basis points was a close call. If you thought you had policy positioned about right at the end of your previous meeting for the forecast and the balance of risks

you saw at that time, the information you have received since then--which suggests smaller downside risks and no more contraction than expected--could be seen as supporting a decision to keep policy unchanged.

In addition, if you believe that the staff has been relatively conservative in its interpretation of the recent news in its assessment of final demand, you may see some greater upside risks to the staff forecast than perceived earlier. Judging from the rise in bond yields and equity prices, the private sector has become considerably more optimistic about the prospective pickup in the economy--accentuating the disparity with most economic forecasts that has existed for some time. The persistence of the steep upward slope of the yield curve for so long may mean that optimism extends beyond bond traders and financial intermediaries to savers and spenders. One piece of evidence in support of this possibility has been the surprising resilience of consumer confidence in the Michigan survey--notably in expectations about the future. Even if the staff has the fundamentals right, they could be trumped by animal spirits for some time as the economy turns around, bolstering equity prices and spending for a while.

Moreover, as a number of you remarked, some of the important downside risks to the staff forecast may not readily lend themselves to being incorporated as an influence on the current stance of policy. Stock price misvaluations could last a long time, and in the interim policy that adjusted out of concern about the effects of a future sharp drop in prices will have been promoting suboptimal economic outcomes. And, in the case of equity prices, easing a little now to protect against a future major decline might only feed the current perceived disequilibrium. The possible effect of a second major downside risk--another terrorist attack--would also be equally difficult to build into policy today, given the wide range of possibilities. Altogether, the Committee may see the practical policy risks around a central tendency forecast as much more balanced than at your previous several meetings, supporting the argument to hold rates unchanged at this meeting.

However, although the outlook seems to have stabilized and the risks around the forecast seem to have become better balanced, the recent data are preliminary and tentative. And, as yet, they are inconclusive as to whether a reasonably strong and prompt rebound is in process or the economy is likely to remain weak for some time and the recovery delayed and tepid. Economic activity continues to contract, and, while the current stance of policy means that the Committee will need to stop easing well before growth picks up substantially, you might want some greater assurance that a turnaround is in process before pausing. If so, you should consider easing policy slightly further at this meeting.

Moreover, the Greenbook forecast, itself, may not point to an entirely satisfactory economic outcome. In that forecast, with the federal funds rate at its current level through 2002, growth is not strong enough next year or the year after to cut very substantially into the excess margin of underutilized resources

that is coming to prevail. Persisting excess production capacity and relatively modest profit growth hold back the upswing in investment and repress consumption growth by weighing on equity prices. These forces of restraint erode only gradually, and to promote recovery they must be countered by maintaining an accommodative stance of policy for some time. The perfect foresight simulation in the Bluebook showed that, with inflation already low and likely to decline further in the staff forecast, policy can be eased even further to promote a more vigorous recovery, without sacrificing the Committee's longer-run price stability objective. And, as Dave pointed out, the staff forecast is not without its major downside risks, in addition to those posed by a sharp correction in equity markets and another terrorist incident--notably the potential influence of increases in unemployment on consumer confidence and spending and the possibility that fiscal stimulus could be considerably smaller than assumed. Easing policy today by 1/4 point might have little immediate effect on financial asset prices, as it is fully anticipated by the markets. But it would encourage and give greater scope for a later downward adjustment of long-term interest rates and, hence, support for asset prices and spending, as investors confront the disappointing reality embodied in the staff forecast--or something even weaker.

Even if you suspect that the staff may be unduly pessimistic about demand and activity next year, you might still favor an easing at this meeting. Such an action could be seen as providing greater protection against the possibility that the economy could remain weak for a while or that the upturn could turn out to be insufficient, without incurring much inflationary risk. To be sure, the more you ease, the sooner and by more you may have to tighten, and that reversal could need to begin next year, especially if the economy does turn out to be more vigorous than in the staff forecast. Such a pattern was another feature of the "perfect foresight" model, and it is built into market expectations. But, if the Committee is willing to stop easing when a turnaround is seen as more definitive, and to tighten preemptively as strength becomes evident, the level of resource utilization that seems likely to prevail, even under more optimistic outlooks, should keep downward pressure on inflation for long enough to allow such a policy reversal to forestall inflation pressures from emerging.

Financial market participants seem confident that you will carry it off, judging from the combination of low inflation compensation and a sharp turnaround in expected short-term interest rates after further easing today that is built into the structure of interest rates. Such market confidence, itself, provides a safety margin for the Committee, because it keeps inflation expectations damped and raises real longer-term interest rates promptly in response to surprisingly strong economic news. In effect, a further easing could be seen as taking advantage of the credibility growing out of your past actions and good inflation outcomes to provide a margin of protection against the possibility that, at the current stance of policy, the economy will turn out to be weaker than is consistent with fostering the Committee's objectives of maximum employment and stable prices.

Whichever policy you chose at this meeting, you might still see the risks to achieving those long-term goals as tilted toward economic weakness for the foreseeable future. Even if you thought that the economy might be stronger than in the staff forecast, output is likely to grow more slowly than the rate of growth of potential for a while and inflation should be moving lower. At some point, the prospect of higher output gaps in the short run could be balanced by expectations that growth will pick up sufficiently over a longer period to raise questions about inflation pressures at the prevailing policy setting. But given the very tentative nature of the indications of future economic recovery, that point would not seem to have been reached yet.

CHAIRMAN GREENSPAN. I have a couple of questions about this “perfect foresight” model. It’s an ideal way to make monetary policy, if we have a perfect foresight or even some foresight! [Laughter] I’m just curious about it from a technical standpoint. With reference to the model, there’s a sentence in the Bluebook that says, “The policymaker is assumed to view both the output and inflation gaps with equal distaste, and the penalty on interest-rate changes was selected to deliver policy predictions that make the funds rate about as volatile as it has been over the past ten years.” I’m a little curious as to why that constraint in the forecast is required if the model fully determines what the economy is going to do. It’s a fully deterministic model, but there has to be an optimum path for short-term interest rates that does not require that sort of tradeoff. Why is it there?

MR. KOHN. If you didn’t have it there you would have some much sharper declines in interest rates. It’s a tradeoff. By putting in that constraint you are deviating from the optimum possible economic performance.

CHAIRMAN GREENSPAN. I understand that. Why do we want to? If in fact you’re getting the sort of result that you find distasteful, are you not suggesting that the model may be at fault, rather than the assumptions?

MR. KOHN. For one thing, if that constraint weren’t there we would be dealing with a zero bound situation, given the staff forecast. That’s not a reason not to show it.

CHAIRMAN GREENPAN. I think we all know what's happening here. Let me see if I can rephrase my question in defense of my position that the constraint undercuts part of the point of this exercise. You have a set of fixed coefficients here. In any econometric model there is a rigidity that probably does not exist in the real world, and there are second-order and third-order coefficients that tend to stabilize instead of producing distinct, exact effects; they smooth everything out. And that I presume is what you're doing.

MR. STOCKTON. This experiment requires in essence the specification of the policymaker's preference function. If you're telling us that you really don't care about fluctuations in interest rates, then this isn't the optimal or perfect foresight policy for you. The reason that in some sense the constraint is in there for this particular exercise is that one could infer from the data and your past behavior some preference for limiting movements in interest rates. And this is a policy that is predicated upon not just a constraint on movements in interest rates but also on some notion of what your distaste is for output and inflation gaps.

CHAIRMAN GREENPAN. I think the issue is not about our feelings or our tastes; this is a question of fact. If you have a perfect foresight model that is wholly deterministic, then any action you take should exactly replicate what is going to happen in the real world. That's the presumption. But if you are putting additional constraints into the model, of necessity you must be overriding the deterministic nature of the model because the model solves in the sense that you have as many unknowns as you have basic inputs. Consequently, you're over-determining the model on the basis of judgments that essentially say that you don't want an optimum conclusion or, which is more likely and is obviously a fact of life, that the model itself is not a true replication of reality in all respects.

MR. REINHART. There are two aspects to what you said. The first is, yes, the model represents an average behavior over the historical period that was estimated. That by itself smoothes

the reaction of households and businesses to changes in financial market prices. It smoothes the reaction in financial market prices to changes in behavior. Putting all that smooth behavior into the model would, as your intuition suggests, allow short-term interest rates to move a lot in order to stabilize the results. But the second aspect is the word “deterministic.” This really is a perfect foresight path. It assumes that you know the whole future path of the outlook and you know what the coefficients are precisely. If you just had uncertainty about the coefficients in the model, and depending on which coefficients they were, you might attenuate; you might not react as strongly to that news. So it is possible to construct an optimal path in the presence of uncertainty about both the model and the shocks that, depending on the objective function, potentially will have the property of moving the funds rate in the outlook period by less. The shorthand way of capturing that without working out the very hard problem of specifying the uncertainty about the coefficients and the shocks in the model is to say, well, find the solution under perfect foresight but put a penalty on movements in interest rates.

CHAIRMAN GREENSPAN. I don't want to pursue this at length here, but I do want to determine precisely what you're suggesting. It involves a very complex mathematical solution. You just can't say that smoothing creates this result and that the constraints that you're imposing with respect to the exercise, including equal taste--

MS. MINEHAN. Distaste.

MR. REINHART. Equal distaste.

CHAIRMAN GREENSPAN. It's equal distaste; that is the better term, which is a mathematical term. The problem is that it's a very useful concept if only we could apply it! And I'm just trying to ferret that out, which gets me to the real question I wanted to ask. Granted that the presumptions with respect to policy are what you stipulate, namely that in effect there's equal distaste,

that there's an objective function endeavoring to limit volatility, and there's a constraint, which is really part of the model, that the federal funds rate has to be greater than zero. Assuming all of that, how significant are the effects of alternate economic assumptions on the path of the federal funds rate? Is this a model in which the input specifications for the economy, not the policy they are imposing, create a very sensitive, fluctuating funds rate? Or are the policy restraints such and the nature of the long-term structural outcome of the economy such that, almost independently of what some of the input variables are in the economy, the path is essentially robust?

MR. KOHN. The model used for this is the same model used in the alternative simulations in the Greenbook.

CHAIRMAN GREENSPAN. I assumed that, right.

MR. KOHN. So you do get a sense of how sensitive the economic outcomes are to different policy assumptions. For example, the fiscal policy assumption that Governor Gramlich mentioned produces a somewhat different outcome for the economy, and that would feed back through the policy path. And importantly, because this is a perfect foresight model, even if you anticipate something happening or not happening, say, out a year or two, that feeds back into your current policy stance.

CHAIRMAN GREENSPAN. That's the reason why I'm raising it.

MR. KOHN. The Committee is assumed to choose a whole path for the federal funds rate that minimizes the squared deviations of the output and inflation gaps at every point in time, taking account of all the information you have way out into the future.

CHAIRMAN GREENSPAN. Yes. The reason I'm raising these issues is that I think this is a very interesting, original addition to the various vehicles that we're employing in making monetary policy. And despite the presumption, which is obviously factually true, that all we ever set is the funds rate for the next 15 minutes, there is nonetheless a path that we should have in the back of our

minds. Granting all the weaknesses in this type of approach, it is conceptually the way we really ought to be going about policy issues. It gets to the kinds of notions President Broaddus was raising in earlier periods about the optimum inflation rate--where we should be, how we should get there, and what is the path of the funds rate that stabilizes inflation and therefore presumably long-term real growth. So I'm merely saying that this is a worthwhile endeavor to pursue. It's just that I'm trying to understand it.

MR. REINHART. Just to underscore what Don said in terms of the robustness of alternatives, it really depends on the duration of the other alternatives. Some of the types of shocks in the Greenbook alternatives, which are relatively temporary, don't perturb this path all that much. But one can imagine other types of shocks, including different assumptions about productivity growth, that could displace the path by much more because you are choosing an entire path. And here comes our part of the presumption of putting this in the Bluebook: We had to make an assumption about the Committee's long-term inflation goal. These simulations were constructed using the assumption that it was 1 percent. But if you move that a bit, it will have marked consequences.

CHAIRMAN GREENSPAN. But the optimum long-term inflation goal should be determined by the model if you believe the model. There is a level of inflation that maximizes long-term economic goals. It shouldn't be an input to the model. President Poole.

MR. POOLE. I have a different subject to raise.

CHAIRMAN GREENSPAN. Okay, go ahead.

MR. POOLE. A very quick question: On page 8 of the Bluebook there is a statement to the effect that investors currently believe that our decision at this meeting will include a balance of risks weighted toward weakness. Is that conclusion from talking with people, from surveys, or is it extracted from the fed funds futures market, or what?

MR. KOHN. It's from several surveys that show a universal expectation among economists and market observers about the balance of risks. You can't infer anything about the balance of risks from financial prices per se. So it is survey based.

MR. REINHART. One, for instance, is the Money Market Services survey. In last Friday's survey, twenty out of twenty respondents said the balance of risks would be tilted toward weakness. For the January meeting it was three out of twenty who thought it would go back to the neutral. By the time you get to their expectations for the March meeting, it is half toward weakness and half toward neutral.

MR. HOENIG. Don, let me see if I can ask a question on interest rate volatility. I observed that after we moved the last time, futures funds rates actually went up.

MR. KOHN. I think the immediate reaction to our move was that the Eurodollar futures rates went down by 10 to 15 basis points.

MR. HOENIG. Right.

MR. KOHN. And then there was the new information--

MR. HOENIG. New information that brought it up, okay. But they are now higher. Secondly, assuming that we have an easy policy now and also assuming that if we have an easy policy, it would be better to have less volatility in interest rates than more volatility, are we not risking, by moving the funds rate down, increasing the volatility of interest rates?

MR. KOHN. I think if you move down and then up, in some definitional sense that increases the volatility of interest rates over the period of time. But I don't think it necessarily would increase the volatility of interest rates in the short run because moving down now is exactly what the market expects. In some sense not moving would increase the short-run volatility of rates because you would be doing something unexpected. That's not necessarily good or bad. You ought to do what you

think is the right thing to do. But I don't see that an easing today would have a material effect on the volatility of interest rates other than in the definitional sense that at some point next year or the year after you'll have to raise them again in order to further--

MR. HOENIG. Raise them more than you otherwise would.

MR. KOHN. More than you otherwise would.

CHAIRMAN GREENSPAN. Further questions for Don? If not, let me get started.

Prior to September 11, I think there was clear evidence of stabilization in some sectors of the economy. That pattern was broken decisively on September 11. Not only did the quite intense forces that were causing deflation in asset prices and economic activity prior to September 11 subsequently gather momentum, but new forces of a similar nature began to press down quite significantly on the economy. Frankly, that was one of the reasons why I was concerned that the Greenbook forecast prepared for this meeting would be revised downward. I was delighted to find out that I was wrong. And I suspect the reason I was wrong is that something is going on in the economy, even in the world economy, that was not evident earlier, namely that we are seeing a greater synchronousness of activity within this economy and worldwide. There is far greater synchronization, for example, among the twelve Districts, among different types of companies and products, and clearly among the world economies. That has generally been read as an indication that the world is becoming more vulnerable to cumulative downturns because if every economy is moving in the same direction, it becomes a self-feeding, self-reinforcing process that can induce volatility in the economic system.

I suspect that that view has to be tempered at least in part. And I think the evidence we have seen in the last couple of months, especially since September 11, is that to a large extent the synchronousness in world economic activity is due to the availability of very substantially improved

information. Thirty years ago we used to see companies and industries moving in quite different directions. One of the reasons was that the information available to individual firms was distinctly different because, unlike the situation today, a real-time data system that permits everyone to look at the same database did not exist. What that means in today's environment is that imbalances that emerge can be more readily resolved, but the resolution can create contraction or expansion in economic activity. If everyone is looking at the same data and is subject to somewhat the same imbalances, we get synchronisness, but it is not a synchronisness that is necessarily self-cumulating on the downside.

One can very readily argue that the evidence of the last two months is indeed a fascinating test of whether the latter is the case. If there ever were a situation in which the fabric of confidence was going to be breached throughout the business and consumer sectors, September 11 would have done that. Indeed, for a couple of days the economy came to a very dramatic halt. What we are now observing, however, is not cumulative weakening but the emergence of mixed signs in the economy. We're seeing some evidence of stabilization, and the question is basically whether we are looking at the emergence of forces that are engendering not only stabilization but an actual recovery from here. The markets are obviously saying yes. The stock market is difficult to understand, especially in terms of what we know about earnings, and the bond market is even more difficult to understand. But there are well-informed people in those markets who are trying to maximize their asset positions. So it's not a roulette game out there.

If the very considerable and continuing overhang of deflationary forces, which we discussed at considerable length at the last meeting, is still there--and all of the evidence suggests to me at least that it is--then the question is what is going to reverse this contraction in economic activity. Well, one of the elements that have been discussed around the table is the inventory situation. And indeed the

inventory numbers are simply awesome. My recollection is that October motor vehicle inventories went down at an annual rate of \$100 billion on a national income and product accounting basis. We're seeing very significant liquidations, which essentially means that as soon as final demand stabilizes, days' supply in an operational sense will go down very rapidly. When that occurs, business firms will suddenly start to find themselves short, and orders will turn up. Well, we are not quite there yet, but we are getting a few very early signals of some firming of demand. They are occurring mainly in the commodity markets, which tend to be reflective, especially the metals, of the base of the durable goods economy, the most volatile and inventory-laden part of the economy. Prices are beginning to move up in commodities markets, suggesting that demand is beginning to pick up there because inventory liquidation has probably reached a maximum. That means that the rate of production will start to rise relative to the rate of consumption of materials and products.

That inventories may now be closer to the point where firms will start to taper off the rate of liquidation is evidenced by the responses to the National Association of Purchasing Managers question on customer inventory positions. Since by definition all inventories are manufactured goods, the people who know what's happening are those who sell such goods. So, the purchasing managers of manufacturing or industrial concerns are in the best position to get a sense of the current status of inventories. A full survey of all those who actually hold inventories is a very difficult undertaking, the data collection process is lengthy, and when such a survey has been tried the results have not been satisfactory. This survey, which is relatively new, seems to be capturing a goodly part of what is going on in the marketplace.

Contrary to what outside estimators are suggesting with regard to the industrial production index for the month of October, we are beginning to see a very dramatic slowing in the rate of decline. The reason we are seeing a smaller negative than the markets is that there is a lot more current

productivity growth--or more exactly growth in output per hour--in the manufacturing area than outside observers are assuming. That slower rate of decline is also reflected in the very rough weekly series that's supposed to replicate the industrial production index; it shows that most of the decline in October occurred in the first two weeks of the month. Production started to come back in the last half of October, but it couldn't come back enough to prevent the average for November from being below the average for October. These figures, if we can believe them, essentially are saying that the level at the end of November is above the average level for November or at worst about equal to it. That would suggest that production levels are beginning to support a reduction in inventory liquidation.

If this is indeed happening, then final demand clearly is where the uncertainties are. The crucial sector is personal consumption expenditures where there are a number of forces at play. One is motor vehicle sales, which have been startlingly high in October and November and in fact have been engendering a good part of the liquidation in inventories for that part of the economy. However, as best we can judge, motor vehicle sales slumped very sharply in the first 10 days of December. They were really quite weak, and one would assume that they were close to the average level projected in the Greenbook for the month of December; but they seemingly are on the way down. So motor vehicles no longer seem to be a positive force.

Another positive force that has been removed stems from the rise in mortgage interest rates. They obviously are up quite significantly. Indeed, the 10-year Treasury yield, which usually is a good proxy for mortgage rates, has gone up almost a full percentage point. And as best I can gather, that's pretty much what has happened to mortgage rates. Low mortgage rates have been a key factor in the turnover of existing homes from which realized capital gains are engendered. And since those realized capital gains are a major part of the extraction of home equity for consumption purposes, one would assume that higher mortgage rates will foster some weakness in existing home sales and, indirectly,

some weakness in consumption expenditures. It is certainly the case that the cash-outs in refinancings mentioned earlier also would be affected, largely because the absolute level of refinancings is already declining significantly, and there is no evidence that the cash-out proportions have changed enough to offset that. So we are beginning to see some softening after a prolonged period when the extraction of funds from home equity has fostered consumption expenditures.

On the positive side, obviously, we've seen a significant decline in the prices of fuel oil and gasoline. The effects can be quite substantial, as a number of you have indicated. But remember that these are one-shot effects and that in order for those effects to continue we have to get still further declines in crude oil or natural gas prices. That's not likely to happen, but it is certainly the case that we are now getting the full impact of the declines. What we used to call an oil tax cut probably exerts its effects with very little lag. It has been a major factor in the markets and it may well be a factor holding up Christmas sales. But we don't know that quite yet.

The major uncertain negative is the further rise in the unemployment rate. I am not referring primarily to its eventual level because if the rate went to a higher level and adjusted there, the markets would also adjust and we would pretty well know what consumption expenditures were associated with that level of unemployment. But when the rate of change is as great as it has been in recent months, and when the rate of layoffs is as high as it has been, we are getting a whole new set of consumers that are shocked by uncertainty. The impact on consumption is indeterminate at this stage. The sign is pretty clear. It has to be negative but we don't know how negative. So at this point we're not clear as to how to view this weakening employment situation or we shouldn't be clear because I don't think there is any way in which we can know.

Fortunately, homebuilding per se has been holding up, and while the rise in mortgage rates may trim it some, the weather clearly has been positive in the areas where the major population centers

are located. As a consequence, weather is likely to give us somewhat better residential construction activity in the period ahead, and I presume that's also the case for some areas of nonresidential construction.

How the combination of final demand balances against the issue of inventory liquidation probably comes down at the end of the day to capital investment, as a number of you mentioned. And capital investment gets down to corporate cash flow. Here I think the uncertainty relating to the ongoing deflationary pressures is still very formidable. While we have had much better output per hour than we anticipated for this particular period and presumably wage increases and general worker compensation are decelerating, the ability of firms to pass through increasing costs is virtually nonexistent. This is another way of measuring the extent of the deflationary forces that are pressing on the economy. The evidence we have, both anecdotal and otherwise, is that it is very difficult to pass on cost increases to customers. Profit margins have come down very sharply. Indeed, if we look strictly at the nonfinancial, nonenergy corporate sector, profits are down to levels that are as low as I remember them and the inability to raise prices is really crippling cash flows. What that suggests is that the outlook for profitability is very important to the general outlook and that's where final demand is going to be financed.

It's certainly the case that security analysts, as I have mentioned to you previously, are not terribly good as forecasters but they are not bad as reporters. And they are reporting that the high-tech earnings outlook has stabilized in the last three or four weeks. The non-high-tech area, however, continues to deteriorate though at a lesser pace than it was. This clearly is a pattern of earnings expectations that is inconsistent with what stock prices are doing if one believes current standard capital asset valuation models. But as Dave Stockton pointed out, it may very well be that the markets are displaying increased flexibility and that the ability of this economy to recover will differ from what

it was in the past. Analysts and stock purchasers may be looking beyond the current squeeze in profit expectations to a much better longer-term outlook and may perceive that the increased flexibility of the markets may itself enable lower equity premiums and the obverse higher price/earnings ratios to persist in the marketplace. But how all that will come out clearly relates to the outlook for capital investment. At this stage I would say it is just too early to make a judgment.

When we get to policy, it's pretty evident to me that the case for standing pat at this point requires that the stock market remain overvalued for a protracted period of time. Now, that's not an inconceivable event. It may be, as Dave says, not an overvaluation but possibly a new way of looking at the market. You didn't say exactly that, Dave; I'm just interpreting what you said in a somewhat different manner. Or it may be, as often happens, that the markets stay overvalued or undervalued for protracted periods of time. If that's the case, it is conceivable that the earnings outlook could stabilize, perhaps even improve, in which case capital investment can stabilize and consumption may still do well on the presumption that long-term mortgage rates do not keep going up and create additional problems. But it is a credible position.

I would only argue that the risk of doing nothing is too high because I think that the play-out of deflationary forces, at least looking at profit expectations, is not anywhere near complete. It may have an extended period to go; we don't know that. But so long as that is the case, I think we would probably be wise to move the funds rate down another 25 basis points, as the market expects, and retain the statement that suggests that weakness is the most likely risk in the outlook. I don't deny that our history--that is, the Federal Reserve's history--is one in which we've typically moved at least once more often than we probably should have on both ends of the cycle. I'm not sure that's all bad. First of all, we're not absolutely certain that had we not moved we would have gotten the outcome that we are looking at in retrospect. But we're always dealing with uncertainties and unknowns and we're

always tacking away from one place or the other. If I knew for certain that the economy was going to be moving up in the second half of 2002 as in the Greenbook, I would say it would be a grave mistake at this point to move the rate down. I don't know that and I don't think anybody can know that. As a consequence, I think that the least risky action is to reduce the rate because, as I've said in the past, one way of looking at these types of situations is to ask ourselves what are the consequences if we are wrong. And in this case I would suggest that if we move the rate down 25 basis points and that turns out to be wrong, I cannot conceive of the deflationary forces moving away sufficiently quickly to prevent us from moving the rate back up well before inflationary pressures rise. If on the other hand we stand pat and these deflationary forces are larger than we expect, we'll look back and find that standing pat was a mistake. I know it's a close call and I don't want to argue that this is a closed issue. I do think that the weight of the evidence at this stage suggests that the best solution is in fact to move down 25 basis points and stay asymmetric to the downside. Vice Chair.

VICE CHAIRMAN MCDONOUGH. I concur with your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, I support your recommendation but I do want to express a little uneasiness about the balance of risks statement. Let me explain. I ask myself the question: What difference does that sentence make? It's clear that the downward move of 25 basis points is built into the markets. And in my view long-term rates are going to go wherever they go, but this is not going to affect their direction in coming weeks. I think our task at this point is to start an orderly process toward a changed policy stance. That is, we seem to be close to a turning point in the economy. And what we would not want is a situation in which the market believes for some reason that we are pretty committed to additional cuts in the future even though the data might start to come in rather convincingly in the other direction. So that's my concern about the balance of risks. In other

words, the message that I personally would like to send--to put some probabilities on it--is that there may be a two-thirds chance that we will not change the funds rate at the next meeting and a one-third chance, if the data continue to come in weak, that we will reduce rates another time. What I would not like to do is to create an impression that we believe there's a high probability that we will be cutting rates again at the next meeting. That's my concern about the balance of risks statement.

CHAIRMAN GREENSPAN. I agree with that and I think there are two ways to handle that problem. One is in the balance of risks statement and the other is in the full press statement that we make. I would much prefer to put something in the full statement itself that recognizes that the situation has changed from an unmitigated set of negative forces to a more mixed environment now. I would prefer to do it that way because, as far as I'm concerned, it's too abrupt an adjustment to change to a balance of risks statement that says it is just as likely that at the next meeting we will raise rates as lower them. I just don't think that's credible. But it's certainly credible--in fact I agree with your probabilities that the chances are probably two to one--that we will not be changing the funds rate at our next meeting.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, the reduced size of the rate decrease, from 50 basis points several times in succession to 25 basis points, will in and of itself send the kind of signal that I think we're looking for. That's part of the message that comes from reducing the size of the cut.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, it seems fairly likely to me that economic recovery would occur next year without any further easing of monetary policy. However, that outcome is vulnerable to a number of negative shocks that could hit the economy at any time. With inflation well in hand and Federal Reserve credibility in good shape, I believe we have the flexibility to respond to these

risks. Therefore, I strongly support your recommendation of a 25 basis point reduction in the funds rate as some insurance against downside risks. I also prefer a balance of risk statement that emphasizes economic weakness.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. I support your recommendation and would like to associate myself with President Parry's view. The reason I support it is in large part because of the uncertainty about how to interpret the incoming data and the outlook. In those circumstances, as he suggested, insurance is probably a good thing to have.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, let me make a couple of comments that may make your recommendation look a little more moderate and restrained. [Laughter] There are certainly some differences in the situation we face today from the one we were looking at when we met last month. But I think there are a lot of similarities as well. At the November meeting I favored a 50 basis point reduction in the funds rate, which we eventually did, and I favored it very strongly and categorically. There were primarily two factors that conditioned my thinking. First, I didn't see any evidence of either inflation or rising inflation expectations anywhere. And second, given our high credibility, I thought we would have time to reverse course, if we needed to, and move the rate back up. After all, we did that in 1999, so we have had at least one recent experience when we were able to pull that off. Given these two preconditions, I thought we ought to use some of our credibility to ease policy aggressively and to reduce the risk that disinflation might undercut the stimulative impact of the reductions in the nominal funds rate we had engineered. I think those two preconditions are still in place and in my view the policy risks today are much the same as those we faced last month.

What I think we need to do above all is to avoid getting into a situation where inflation expectations are quite low and we have the nominal funds rate close to zero. That's the so-called zero bound problem. It's very difficult to get out of that, as I think we know. We don't want to go there. As we discussed earlier in the meeting, inflation expectations in the Michigan survey have dropped quite abruptly over the last several months as a whole. So I think that risk of a zero bound problem is still with us. For that reason I believe a persuasive case can still be made for another 50 basis point reduction today, using the current core PCE rate, which is about 1-1/2 percent, as our measure of inflation. That would take the real funds rate down roughly to zero. Now, granted, we've gotten into difficulty in the longer-term past when we have pushed the real rate below zero--and this was especially evident in the 1970s. We took the real funds rate to zero in 1992--which is where a 50 basis point reduction today would put it--and we did not get a subsequent increase in inflation. So I still think the case is persuasive and in my view a 50 basis point cut is the best option. I recognize though that the tone of the economic data is a bit stronger in some respects and in some places this time. Therefore the argument for a half point is a little less compelling today than it was last time. But if it were my choice, I think that is the way I would go.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I agree with the recommendation for a 25 basis point reduction in the rate. In my view it's appropriate this time because I think it will help to underpin the consumer while the inventory cycle completes itself and corporate profits and capital spending slowly return to more normal levels. I also believe that the balance of risks should be toward weaker economic growth. And I strongly support the idea of putting a signal in the wording of the press statement to the effect that the situation is not as bleak as we saw it last time. I don't want to encourage people to think that we continue to see only negative news on all fronts.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I would prefer to leave policy unchanged today. Let me quickly sketch out the elements of my reasoning. Part of it I touched on earlier. I do think that the story in the mainstream Greenbook forecast is a reasonably convincing one and I'm certainly more confident about the outlook than I have been for the past several meetings. Is it a done deal? Of course not, but that I think is too high a bar. We're not going to know that for quite some time. It does seem to me that the recent spate of data suggests that the economy is stabilizing. Not only do the data suggest that but a lot of market participants are expecting that, based on the way financial assets are being priced. And at least in my view our economy has a history of being resilient and largely self-correcting. Beyond that, I think policy has been very expansionary. I'm not talking just about aggressive reductions in interest rates, although we have done that. We have also had very rapid growth in the monetary aggregates and it would be a shock to me if we got deflation, given the kind of growth we've had in money for some time now. I don't know how fiscal policy will play out, but I would guess that we will get some added fiscal stimulus. And while it's certainly true that if this further reduction in rates turns out to be a mistake we can reverse direction when needed, it's possibly destabilizing--though I don't want to overstate this--to embark on that kind of policy path. So for that combination of reasons, recognizing that perhaps no one of them is convincing by itself, I would prefer to stay where we are.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. I support your recommendation. While I support a statement of unbalanced risks toward weakness, I also believe that the Committee should avoid encouraging an expectation of further easing at the next meeting. Given my recent experience in communicating with the markets, I'm not giving any advice on how to do so! [Laughter] I will

view with great interest the statement this time, as it tantalizes us with a possible way of accomplishing that goal.

I'm very pleased to see that the Committee will continue its practice of using its two-day meetings as an opportunity to have a wider discussion of key issues related to the strategy of monetary policy. Because this is my last FOMC meeting I will not have an opportunity to participate in these discussions or even to make suggestions for the agenda. So I thought I'd take this opportunity to unveil some recommendations--in this case for improving the transparency of monetary policy--in the hope that the Committee might find it worthwhile to discuss this topic in the future. Let me also note the excellent contribution to this topic from the recent conference at the Federal Reserve Bank of Philadelphia.

Transparency means, in my view, revealing to the public both the objectives that drive the policy decisions and the rationale for specific policy decisions. I see greater transparency as serving both to enhance the accountability of the Fed and to increase the effectiveness of monetary policy by improving the market's ability to anticipate future policy actions. In terms of transparency about objectives, I would urge the Committee to discuss again and to consider further setting an explicit numerical value on its long-run price stability objective. I stated my case on this recommendation in a paper earlier this year, so I'll focus today on recommendations related to the minutes and the role that document plays in conveying the FOMC forecast.

The Committee's press statements have become briefer and more repetitious this year and in my view less revealing. Moreover, some Committee members have expressed a preference for moving further in this direction. To be sure, it is a challenge to have more than a very brief statement and still represent the consensus of the Committee. In any case, as a consequence the minutes have become a more important vehicle for revealing the Committee's views on the outlook and policy

options. The minutes serve to illuminate the rationale of the recent action and in addition they recognize the diversity of views on the Committee.

The first change I would recommend is either to eliminate the discussion of recent indicators at the beginning of the minutes or to move it to an appendix at the end. This discussion is presented on page one, I presume, to set the context for the meeting, not to describe what we discussed. As it is today, it is the first substantial section in the minutes. To my mind at least it numbs the reader [laughter] and may even distract those who continue on and remain for the summary of the Committee's discussion that follows.

I had thought about recommending that the next section, which is the paragraph that summarizes the staff forecast, be expanded maybe to a full page. In the end, after some quite interesting and constructive discussion with the staff, I decided not to recommend this course of action out of concern that moving in this direction might interfere with the freedom the staff currently perceives in putting together its forecast. At the margin though, it still might be useful to expand the paragraph a little to better tell a coherent story about what underlies the staff forecast. Furthermore, particularly to the extent that the Committee's press announcement on the policy decision becomes less revealing, it would in my judgment be constructive to speed the release of the minutes--perhaps to the third Thursday following the meeting, or just over two weeks after the meeting.

My next set of recommendations relates to the FOMC members' own forecasts, now revealed twice a year in the testimony and report on monetary policy. My first concern is that these forecasts may not be developed as advertised. That is, the forecast is supposed to reflect appropriate monetary policy from the perspective of each member. This is a very weighty assignment, especially if the forecast extends out beyond a year--perhaps similar to the perfect foresight policy in the Bluebook this time. It might be helpful, therefore, if the Bluebook included such a forecast based on

perfect foresight in the policy-related material. I think the Committee members might want to discuss whether they're preparing the forecast under this type of model and if not, whether and how to do so.

Second, these forecasts in my view should always cover a period of at least one and a half to two years. In particular, the forecast prepared each January now extends only to the end of that year, while the forecast prepared in June extends one and a half years. The January forecast in my view should be extended to the end of the following year, a two-year period. Now, I appreciate that this recommendation was considered and rejected in 1994. Some members of the Committee were concerned at that time that such an extension could allow the public to infer the Committee's objectives! Should I repeat that? To my mind, this is an advantage. Publishing an extended forecast might require more discussion by the Chairman at his monetary policy testimonies and perhaps by other Committee members. That's what transparency is all about.

Third, the ability of the forecast to serve as a rationale for the Committee's decisions is limited today because the Committee does not reveal the assumptions underlying its consensus forecast and in particular the funds rate path. I understand that this is especially radical, but I would encourage the Committee to consider revealing the central tendency of the funds rate path that underlies its consensus forecast. I'd also suggest perhaps looking for other ways to reveal the key assumptions underlying that forecast.

Finally, I'd encourage the Committee to consider increasing the frequency of such forecasts from twice a year to four times a year. This forecast provides a rationale for the Committee's decision. And it is more important in this respect because of the absence of a full statement that otherwise provides that rationale. Just as a picture might be worth a thousand words, so might that be said of a forecast.

Let me conclude by repeating what I said during my very first meeting in June 1996. This has been even more fun than I expected it to be! It has been a privilege to serve on this Committee. I'm certainly fortunate to have served during a time that has been so interesting and challenging. I'm fortunate to have served on this Committee under the leadership of Alan Greenspan and with all of you. I'm fortunate also to have had the exceptional support of the staff, as I wrestled with the outlook and tried to make contributions to the policy discussion.

CHAIRMAN GREENSPAN. We will obviously be considering your notions and I'll appoint two or three people to be the proxy for you. It's going to require two or three people to do that! [Laughter] In any case, I'm sure that in the weeks ahead there will be a lot of statements about your contributions to this Committee. But I doubt that any of us has to say very much. I think we're all acutely aware of your accomplishments. [Applause] Governor Gramlich.

MR. GRAMLICH. I didn't necessarily want to follow in this order! Let me first say a word to my good friend, Larry Meyer. I don't always agree with him, but he always makes us think. And I believe he has done that today. I'm frankly a little too tired to think about disclosure and transparency at this particular moment, but I agree that perhaps we ought to consider that issue again. However, I would say that lately the Fed seems to me to have been very well understood by markets. When a data series comes out, everyone says here is what the Fed thinks about that and they're usually not far wrong. So I think somehow or other we are communicating fairly well already. That's not to say we can't do more, but I don't think communication is a huge problem at this point.

Now, back to the Chairman's recommendation. I agree with going down 1/4 point and with continuing the bias toward weakness. I think that's about the right policy in level terms. As I've said many times over the year, I'm not too worried about the reversibility issue. If we have to, we can do it. We have done it. Also, in line with what Bill Poole said, this small step paves the way for an

orderly repositioning of policy, which I think all of us want to do. The final thing I would say about the policy recommendation is that, if I'm not mistaken, going down 1/4 point today would be following exactly the strategy built into the Bluebook forecast in which the staff imputed the so-called perfect foresight policy. I think it would be pretty close to the way they've got us in their equation. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. Hopefully we don't all have to comment on transparency because I'm not going to! I am in agreement with your recommendation. Given the hard time I had with the 50 basis point reduction last time, some might ask how I could be and, frankly, on the case for standing pat I think President Stern has some good arguments. But as I view the data that have come out since the last meeting, there are not only glimmers of a turnaround but some enhanced downside risks as well. I thought you covered them well in your statement: the trajectory of the unemployment rate, the euphoria in the stock market, the potential for no fiscal policy or one that's not effective in any way like what is in our forecast, downturns in corporate profits, and so forth. So I see some new risks here. I agree with the statement that the risks are biased to the downside, certainly over the near term. So with that logic, I come down on the side of a 25 basis point decline in rates as you have suggested. In some ways I think it is a measure of insurance and in fact I'm hopeful that it is. I'm also hopeful that the positives we're now seeing do turn out to outweigh the potential for negative developments and that the next time we meet policy will be stable and the risks will be balanced.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I can accept your recommendation, but I have a preference for no change at today's meeting. I would like to associate myself with President Stern's comments.

It seems to me that after eleven months of very aggressive front-loaded easing and having been in an accommodative stance for some time now--the degree of which we could argue about--we have the latitude to pause today. That's not to say we can declare victory but I think we ought to pause and see how things play out. People around the table have made the point that we're very likely to see some more ugly data over the next couple of months or next couple of quarters. But I would argue that there is some considerable value in signaling several things. One is that we are seeing some first signs--I underscore first--of stabilization and that many of the further adjustments that still need to be made are not particularly interest rate sensitive. And finally, having done what we can to cushion the slowdown over the cycle, we can send the message that we have gotten back to--in fact have never gotten away from--a focus on the optimum long-term policy. Perhaps the statement that you have crafted will achieve much of that, but I think there is some significant value today in making some of those points to the people who watch what we do. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. I support your recommendation, Mr. Chairman. The recovery appears to be on track or at least visible in the distance. As you point out, the timing and magnitude of the recovery depend on consumer spending, which is still uncertain. And to counter the risk associated with that, I support further easing. I also support leaving the risk statement weighted toward economic weakness at least at this time. But I also feel that the wording of the press announcement is particularly important this time, so I look forward to seeing the craftsmanship.

CHAIRMAN GREENSPAN. I'm glad it's short! [Laughter] President Jordan.

MR. JORDAN. I agree with the views stated by Gary Stern.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I really think we ought to stay where we are. A 2 percent fed funds rate is stimulative. We've cut the rate 450 basis points this year, which is very aggressive for us, and 150 basis points of that has been done since September 11<sup>th</sup>. We are seeing some signs of improvement and not all of the stimulus has come into play yet. While I recognize that inflation is not an immediate issue, and I appreciate that, I still think we need to take a little longer-run view at this time. So, I have to say I agree with Gary Stern's comments.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I can support your recommendation, although I'd like to associate myself with the comments of Gary, Jerry, Jack, and Tom. I think this would have been a good time to pause and no real harm would have come from it. It seems to me that it would be a good time to signal to the markets that they can't get a cut every time they build one into the fed funds futures. On the risk statement, since we put it out we have to say that the risks are biased toward the downside because they clearly are. Nevertheless, I continue to feel that having such a risk statement at every meeting is not serving us all that well because I think it's almost always interpreted as one more easing move to go. So, eventually I think we ought to take another look at that practice. One additional way we might signal that we're winding down other than the language of the statement and the fact that the cut is 25 rather than 50 basis points, is to consider not reducing the discount rate.

CHAIRMAN GREENSPAN. I might note that in fact that issue did come up and the general consensus, at least among the staff, is that it probably would create more uncertainty than otherwise. But it's an interesting idea.

MR. MCTEER. Well, I've suggested it at the last two meetings as well.

CHAIRMAN GREENSPAN. I'm aware of that.

MR. MCTEER. It seems to me that our long-run plan is to reverse the positioning of those two rates and that we're missing a good opportunity to get a head start on doing that.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. I support the recommendation, but I do also support the comments that other people have made about beginning to signal that this may be one of our last easing actions.

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. I support the recommendation.

CHAIRMAN GREENSPAN. Will you read the directive wording?

MR. BERNARD. The directive wording is on page 14 of 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 1-3/4 percent." And the statement for the press release that goes with that reads: "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. Call the roll.

MR. BERNARD.

|                         |     |
|-------------------------|-----|
| Chairman Greenspan      | Yes |
| Vice Chairman McDonough | Yes |
| Governor Bies           | Yes |
| Governor Ferguson       | Yes |
| Governor Gramlich       | Yes |
| President Hoenig        | No  |
| Governor Meyer          | Yes |
| President Minehan       | Yes |
| President Moskow        | Yes |
| Governor Olson          | Yes |

President Poole

Yes

CHAIRMAN GREENSPAN. I'd like to ask that this Committee go into recess and that the Board of Governors congregate next door where we will address the issue of discount rate requests by the Reserve Banks. I hope that while we are doing that, the preliminary statement will be distributed to everybody.

[Recess]

CHAIRMAN GREENSPAN. The FOMC meeting is now back in session. The Board of Governors, much to everybody's surprise, voted as was contemplated in the first paragraph of the draft press release. Has everyone had a chance to read that statement? Are there comments or suggested alterations?

VICE CHAIRMAN MCDONOUGH. The statement captures it just fine. It's good.

CHAIRMAN GREENSPAN. I tried to capture what I thought would be the center of the Committee's views. If there are no objections, we will consider this the statement of the Committee.

I'd like to remind you all that our next meeting is a multiple-day meeting, to be held on Tuesday and Wednesday, January 29<sup>th</sup> and 30<sup>th</sup>. We can go to lunch. We have as our guest a prominent Treasury Department official whose name I won't mention until he arrives.

END OF MEETING