

**Telephone Conference Meeting of the Federal Open Market Committee on
April 8, 2003**

A telephone conference of the Federal Open Market Committee was held on Tuesday, April 8, 2003, at 2:00 p.m. Those present were the following:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
Mr. Gynn
Mr. Moskow
Mr. Olson
Mr. Parry

Mr. Hoenig, Mses. Minehan and Pianalto, Messrs. Poole and Stewart, Alternate Members of the Federal Open Market Committee

Mr. McTeer, President of the Federal Reserve Bank of Dallas

Mr. Reinhart, 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. K. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Goodfriend, Howard, Hunter, Judd, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Ms. J. Johnson, Secretary, Office of the Secretary, Board of Governors

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

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

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Clouse, 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, Division of Monetary Affairs, Board of Governors

Mr. Fuhrer, Ms. Mester, and Mr. Sniderman, Senior Vice Presidents, Federal Reserve Banks of Boston, Philadelphia, and Cleveland respectively

Mr. Rudebusch, Vice President, Federal Reserve Bank of San Francisco

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

**Transcript of the Federal Open Market Committee Conference Call on
April 8, 2003**

CHAIRMAN GREENSPAN. Good afternoon, everybody. As usual, we'll start off with Dino Kos.

MR. KOS. Thank you, Mr. Chairman. As I was last week, I can be rather brief. The markets have continued to function in an orderly way. There really have been no disruptions in any of the major markets that we follow. Liquidity reportedly has been normal and bid-offered spreads are also at normal levels. Let me say a few words about the fed funds markets. I mentioned at the last FOMC meeting that we would be on guard for any signs of increased demand for excess reserves. There have been no signs of that, so that was a non-event. The funds market has been functioning well, and if anything, the fed funds rate at times has been a little on the soft side. To the degree that we have had challenges at the Desk, they have involved forecasting the Treasury's balance and forecasting the weather and its effects on float. Float has been created because of bad weather the last two days here on the East Coast and the last week or two in the Midwest. The capital markets, as I think everybody knows, have tended to move on headlines related to the war. But on net both investment-grade and high-yield spreads are narrower, equities are higher, and implied volatilities among most asset classes are lower. So the signs of risk aversion or anxiety are pointing in the other direction—that is, there is less anxiety as some of the uncertainty that preceded the war has ebbed somewhat.

One thing that people have noticed is that to some degree markets have focused slightly more on the economic data than they did in the past few weeks, when all the markets were reacting to nothing but the headlines regarding the war. For example, the recent employment data were scrutinized closely by economists and other market observers. They had expected a bad number so that can explain to some degree the market's counterintuitive reaction, and at least the focus has begun to turn toward the economic statistics. The other thing that has been noted in the corporate market is a return of headlines regarding corporate governance issues. HealthSouth was one example, and there were one or two other, lesser situations. But the markets have actually absorbed that news and taken it in stride; it has not had the effect that Enron or other notable incidents had last year. So all in all the markets seem to be working fine. I think I'll leave it there, Mr. Chairman.

CHAIRMAN GREENSPAN. Questions for Dino?

MR. GRAMLICH. Yes, I had one. It's Ned. Dino, did you actually say that rainfall increases float? [Laughter]

MR. KOS. I'm sorry, I didn't hear that.

CHAIRMAN GREENSPAN. Repeat it.

MR. GRAMLICH. I thought I heard you say that rainfall increases float.

VICE CHAIRMAN MCDONOUGH. That really wasn't worth repeating!

CHAIRMAN GREENSPAN. Dino, you'll have a shot at him in person next month!

Further questions for Dino? If not, Vincent Reinhart.

MR. REINHART.¹ Thank you, Mr. Chairman. I'll be referring to the materials that were sent out to you about an hour or so ago. Once again, financial market quotes have mirrored the changing fortunes of war. As seen in the top panel of your first exhibit, through 11:00 this morning Treasury yields have risen about a dozen basis points since your conference call last week. That places the current yield curve (as shown in the middle left panel) about where it was just before the war began. Equity prices, the subject of exhibit 2, have moved in tandem with interest rates. The rally over the past five trading days implies that major indexes (shown in the bottom panel) are little changed on net since the onset of hostilities. I'd note that implied volatility on the S&P 500 (the middle panel) has edged off a bit.

As shown in the top panel of exhibit 3, near-term money market futures rates have risen in the past week, especially at further ahead maturities. On net, the path of expected futures rates (shown in the middle left panel) has apparently rotated down relative to what investors anticipated three weeks ago. In the very near term, a little less weight is being placed on policy ease. The solid line is a touch above the dotted line in the middle left panel, and the probability of a funds rate of 1 percent by the May 6 meeting (shown in the bottom panel) has fallen to that of a coin toss. Such a judgment, though, depends on the swing of just a couple of basis points. More evident is the decline in expected rates for next year, which are off about ¼ percentage point since March 19.

As shown in exhibit 4, credit spreads have narrowed a bit further, with swap spreads (the top panel) edging lower. For the key financial intermediaries (shown in the middle panel), share prices since March 19 are higher on net, and credit default premiums have fallen.

Your last exhibit, exhibit 6, provides an update on the behavior of the money and credit aggregates in March. As shown in the top left panel, M2 growth slowed in March to an annual rate of about 3 percent. Special factors, including prepayments of mortgage-backed securities, tax effects, and currency shipments pulled down M2 growth last month. I must admit, however, that tax effects are highly uncertain at this time of year. As shown in the top right panel, the performance in March continued the pattern observed for a while now, given sustained low short-term nominal interest rates: Liquid deposits are expanding, and small time and M2 money funds are

¹ The materials used by Mr. Reinhart are appended to this transcript (appendix 1).

running off. After a surge in February, currency growth, both domestically and abroad, seems to be returning to trend. As shown in the bottom left panel, bank credit expanded at an annual rate of 6½ percent in March, a bit below the pace in the first quarter as a whole. Total loan growth slowed, owing to an unusually large volume of residential mortgage securitizations. As can be seen by the dark portion of the bars at the far right, C&I loans ran off again in March, about in line with the pace of contraction that has prevailed for the past two years. This weakness continues to be concentrated in large domestic banks and in U.S. branches and agencies of foreign banks. Commercial paper, the hollow portion of the bars, declined once again last month. On net, though, the receptiveness of bond markets allowed nonfinancial firms to expand their debt last month, albeit at a lighter pace than in the previous couple of months. That's all I have, Mr. Chairman.

CHAIRMAN GREENSPAN. Questions for Vincent? If not, Karen Johnson, please.

MS. JOHNSON.² Thank you, Mr. Chairman. I'll be referring to the set of international charts distributed to you earlier. In chart 1, which shows a few bilateral exchange rates and indexes for the trade-weighted value of the dollar, you can see that the dollar continued to strengthen on balance over the past week. For the week, it is now up against the major currencies by a little more than 1 percent but less than 1½ percent. Notice that it has moved up and down, driven in large part by war news, so the absence of some good news today—the chart was updated this morning—has caused it to drop back a bit. But the dollar has been rising fairly steadily, as the news out of Iraq seems to have been favorable over the past two weeks. The pattern is similar for changes in the dollar's value against the European currencies and the yen. But the exchange rate against the Canadian dollar (the bottom line in green) has been quite flat.

Chart 2 depicts the outlook for short-term rates from which we infer market expectations about policy moves by the foreign central banks. Last week's yield curves are the dashed red line; this morning's are the solid black line. You can see that some of the expectation of monetary easing abroad that was priced into markets last week has been removed. That's particularly the case for sterling, where a bit of ease is still priced in; but of the probably 50 basis points in there last week, about 25 have come out as a consequence of recent favorable developments. I think those developments have led to the expectation that a global recovery is more likely than it seemed a week ago.

The third chart reports on stock prices in major foreign countries. Again, they have moved up on balance but took a bit of a step back today absent some positive news to which markets would have responded. Notice in particular that European stocks are outpacing the others; relative to other markets, European stocks are now further above the levels reached with the initial bounce that occurred after March 12. In contrast, share prices in Japan have not recovered to the extent they have in other markets. The index for total stocks is off its lows in Japan but not as much as

² The materials used by Ms. Johnson are appended to this transcript (appendix 2).

elsewhere, and in particular the bank sub-index of the TOPIX (the dotted blue line) has been underperforming very sharply. So it is the weakness of Japanese bank stock prices that is holding down overall stock prices in Japan, producing a rather different perspective in that country in terms of the optimism being reflected in share prices. To some degree those bank stock prices are down because of new share issuance, which is a way that some of the large banks that are in financial straits are raising capital. But that, of course, has had an effect on prices by diluting the value of the outstanding shares. Even so, I think one could say that the market is indicating as well that the situation in Japan is not really improving, particularly in the banking sector.

Consumer confidence in Japan remains very weak. We did see a couple of positive signs from the real economy that I mentioned last week. I think one could say that the recent past and the near term in Japan look flat. It's probably hard to believe that further contraction is inevitable but that the economy really is not recovering in any sense. On the other hand, in the rest of the major industrial countries, given a good war outcome and favorable stock price developments, I think we are going to see a mild but nonetheless positive expansion in the first half of this year.

That outcome, however, is heavily dependent on oil prices, which are shown in the last exhibit, chart 4. Oil prices have come down further today. The spot price is trading at about \$28 dollars a barrel, which is approximately the same as for the May futures contract. The whole futures curve has shifted down for the near term; but in the further-out timeline quotes, prices are about the same as in the March Greenbook. As a consequence, the futures curve is considerably flatter than it was at the time of the Greenbook, and much but not all of the backwardation is now gone. With respect to the risk imbedded in that futures curve, I would point out that currently we have reports of some fighting in Kirkuk and Mosul, which are near the northern oil fields of Iraq. In that region the Iraqis, on the one hand, and the Kurds and the U.S. troops, on the other, are beginning now to interact militarily. The risk of damage to the oil wells there I think is still an open question. At the moment there is no report of such damage, but securing those oil fields will require some military action first. I would say that that process has begun, but uncertainty about the fate of the oil wells in that region remains.

The low level of the current spot price and the shifting down of the futures curve have triggered a response from OPEC, which has called a meeting sooner than one would have been scheduled otherwise. Their basket of oil prices is now around the middle of their target range, and I think there is some concern among OPEC members that the price might continue to fall. A major concern is that the whole futures curve might shift down as opposed to what has happened so far, which is that the front end has moved down to a flatter position. It is the case that Saudi Arabia has been pumping more oil than is considered "normal," so to speak. A natural reaction might be for Saudi Arabia to cut back its production from this elevated level to something in the range of 8 million barrels a day or even less. That would be one way to sustain oil

prices near the midpoint of OPEC's target range and not allow those prices to go further below it. In Nigeria oil production appears to be coming back. There are now announced plans to resume pumping approximately half of the 800,000 barrels that were lost. That is, the security in Nigeria has improved in some places but not throughout the country, so some wells will be left unused—for a time anyway. But other parts of the Nigerian oil production sector are going to be restaffed, and the oil will begin to flow again. Oil inventories are still somewhat low, but we've noticed in the most recent U.S. data an indication that inventories are building and rather sharply so. All in all, the picture in the oil market is one of fairly well maintained quantities and lower prices, with prospects for still lower prices absent a sharp reaction from OPEC and Saudi Arabia in terms of production quantities. That's all I have, Mr. Chairman.

CHAIRMAN GREENSPAN. Questions for Karen? Governor Bernanke.

MR. BERNANKE. This is Ben. My question is actually more for Vincent, I think, but it follows on Karen's comments about oil. Since March 19, oil prices have come down quite a bit, interest rates have dropped a little, and there has been a reduction in volatility. The war news has been generally good, and stock prices are basically where they were on March 19. Has there been news on earnings or other medium-term or long-term news that would offset the benefits of those macro developments on stock prices?

MR. REINHART. Well, that would depend in part on how one interprets the economic data that have come out since March 19. Not to steal Dave Stockton's thunder, but I think on balance the data have been a bit negative. So one could imagine that stock prices are reflecting that. Another factor is that we're hard pressed to explain the run-up in stock prices just before the March 19 deadline to Iraq. As you can see in exhibit 2 of my package of charts, there was a very substantial rally—on the order of 8 percent—in that run-up before the onset of military action. So I think one might argue that this is one of those cases where markets did buy on the rumor and then moved sideways on the facts.

MR. BERNANKE. Thank you.

MR. OLSON. Karen, regarding the euro area stock market performance, can you elaborate on why that would be so much more positive?

MS. JOHNSON. Well, as you can see in my chart, which was benchmarked off March 12—a date chosen because that was a trough before the turning point in markets as opposed to war-related moves—they had fallen a lot further as well.

MR. OLSON. Yes.

MS. JOHNSON. So in some sense the question is why the euro area markets are more volatile in both directions. One explanation might be that stock capitalization relative to GDP is lower in Europe than it is in the United States and it is a smaller, more volatile component of corporate finance than in the United States. Now, when European stock prices were going down last month, somebody asked me a similar question, and I did a little digging and came up with a couple of reasons that those prices might have been particularly depressed in the middle of March. In part, there was a lot of distress in insurance stocks at that time, and the insurance and reinsurance industries in Europe were particularly hard hit. To be honest, I haven't checked on this in the last two or three days, but on at least one earlier day I was told by someone from New York—maybe Dino can confirm this—that insurance stock prices had been moving up. It may be that the insurance sector is reacting to both the good news and the bad news in a greater way—and that sector looms larger in the European indexes because those markets are smaller than the U.S. market to begin with. Another major piece in the European markets was the Ahold situation, which when it broke pushed stock prices down further. To the extent that there was sympathy selling at that time, that may have provided some room for stock prices to come back more as those correlations are coming undone now.

MR. OLSON. Thank you.

CHAIRMAN GREENSPAN. Further questions for Karen? If not, David Stockton.

MR. STOCKTON.³ Thank you, Mr. Chairman. I'm going to be referring to the package of nonfinancial charts that we updated this morning. The major piece of information that we received on the economy last week was the March labor market report, which is summarized in the first chart. In brief, the data in that report were very close to our expectations. Payroll employment (line 1) dropped 108,000 last month, pulled down by a decline of 38,000 in state and local employment, most of which was in local education. Private payrolls (line 2) were off 68,000, which was a bit smaller decline than we had anticipated. But owing to a net downward revision over the January/February period, we were very close on the level of employment in March. As you can see by scanning down the column of figures for March, the declines in employment last month were widespread. Only the construction sector posted a gain, and that came on the heels of a weather-related drop in February. Construction was also responsible for about half of the swing in the workweek (line 10), which dropped in February and bounced back in March. Still, that bounceback in the workweek was a little larger than we had projected, and aggregate production worker hours (line 11) were a touch ahead of our expectations. As seen in the middle left panel, there have been some rather big fluctuations in employment in recent months. But, on average, declines in private payrolls have been running about 100,000 per month, as shown by the red line in the panel. The unemployment rate, at 5.8 percent, was one-tenth lower than we had expected, but we really don't see that as a sign of good news about the labor market. It still looks to us as if a weak labor market is inducing some people to leave the labor force and others not to enter it.

As I said, the March report was very close to our expectations. Nonetheless, more-recent indicators suggest that the poor labor market conditions we've been seeing in the past few months could persist longer than we had expected in our March forecast. As shown in the bottom left panel, initial claims for unemployment insurance jumped to nearly 450,000 in the week of March 29, and the four-week moving average has been running a bit above 425,000. That reading is consistent with declines in payroll employment of roughly 75,000 to 100,000 per month. Survey readings that we're getting from both households and businesses also suggest that they perceive a fairly soft labor market. I've plotted in the bottom right panel the latest reading from the NFIB survey of small businesses. You can see that their hiring plans dropped sharply last month. Obviously, that is just yet another piece of information that could well be contaminated by the war fears of March. But it is broadly consistent, I think, with most of the readings that we're getting on the labor market, which continue to be rather dismal. So at this point we'd probably be inclined to mark down our employment forecast for the second quarter. Our expectation now is for continued sizable employment declines in the near term and for appreciable employment gains not to become evident until the second half of this year.

³ The materials used by Mr. Stockton are appended to this transcript (appendix 3).

Chart 2 presents some updates on the current indicators that we're following. The final count put light vehicle sales in March at 16.1 million units. That's well below the incentive-induced spikes that we saw over last year, but it's still a fairly solid figure and one that was above our forecast of a 15½ million unit sales pace that was incorporated in the Greenbook. But as I noted last week, this improvement isn't big enough to put much of a dent in the inventory situation in the automotive industry. And it's certainly not enough to forestall what we think will be some fairly substantial production cutbacks in the second quarter, which I've shown in the top right panel. The cutbacks in motor vehicle production, as well as some further drops in utility generation, are the principal causes for the decline in the aggregate weekly physical product data plotted in the middle left panel. These components make up about 20 percent of the initial estimate of industrial production. As you know, we rely heavily on production worker hours from the labor market report for the areas of industrial production where we don't have physical product information. Hours for manufacturing outside of the motor vehicle area, plotted at the right, dropped 0.2 percent last month. Given the productivity gains in the manufacturing area, that's consistent with probably some small increase in production in that particular component.

Putting these pieces together, we're expecting total IP to be down about ½ percent in March. Manufacturing output might be down 0.1 percentage point. Manufacturing, excluding motor vehicles, could be up a tenth or two. We're not very far along in that estimation process, but at this point we don't really have anything to suggest that big revisions are in the offing. But as I indicated, we'll have a great deal more information over the next week and a half, and as we process that, all of these figures could change to some degree. The picture of the industrial sector painted by last month's employment report is not quite as weak as the ISM survey might have suggested, but it's still weaker than the Greenbook projection that we had in March. We had expected a continuation of the modest increases that we'd been seeing since the turn of the year. But now it really looks to us as if the manufacturing sector outside of the motor vehicle area is pretty much flat and likely to stay that way for a time. The bottom left panel plots this morning's reading on chain store sales, which dropped further last week. Again, I wouldn't want to lean heavily on these data, but they continue to look quite soft. In the bottom right-hand panel, we've plotted a recent reading on consumer sentiment. We received, on a very confidential basis, a reading of the first 170 responses of the Michigan survey for April, and they suggest that the gains posted in the second half of March have held in the early part of this month. But still that level is no great shakes. Domestic energy markets are the subject of chart 3. Gasoline prices have continued to fall, and inventories remain tight. There's really not anything new on that front, and the same goes for the natural gas markets.

So in summary, I'd say that we're still projecting something in the neighborhood of 2 percent growth in real GDP for both the first and the second quarters of this year. As I noted last week, the composition of the increase in the second quarter is likely to involve stronger defense spending and weaker private spending than we had projected

in March. But there are some upside risks to that figure. Defense spending could be stronger than we've incorporated in this forecast. We're going to be quite anxious to see how that plays out over the next month or so. On the downside, I think the recently weaker labor market readings—from initial claims data and other surveys—and the chain store sales suggest that there's some greater potential for weakness in consumer spending than we've built into our forecast. So I see risks on both sides.

We'll be getting a retail sales report on Friday of this week. That should at least be somewhat informative about the trajectory of the economy as we move into the second quarter. Looking beyond the second quarter and barring any major innovations in the data, I suspect that we'll be pushing back a bit the timing of our projected pickup in activity, mirroring the adjustment we'll be making to our labor market forecast that I described earlier. Still, the underlying forces that will be operating in the economy do appear more favorable than we had incorporated in the last forecast. Oil prices fall sooner and stock prices are about 9 percent above the levels that we had in our baseline forecast in March. So with some customary lag we'd expect the impetus to acceleration to be greater down the road than we built into our last forecast. Working to temper that pattern of greater acceleration a bit is the fact that we're getting more defense impetus now, which is adding more to the near term and probably will be adding a bit less to the longer term. At this point, putting all that together, I don't see any reason to make a material change in our projection. We're still expecting economic slack to mount this year. We believe that next year there will be a gradual dissipation but not an elimination of that slack, and we'd expect inflation to be headed lower. I'll stop there, Mr. Chairman.

CHAIRMAN GREENSPAN. Thank you. Questions for Dave?

MS. MINEHAN. Dave, this is Cathy. We've talked a lot about uncertainty in our last several discussions about the economy and policy. Now that the war is proceeding, I think there's a little greater level of confidence built into people's assessments of the situation, though granted we don't know when the war will come to an end. But at least we know how the economy has been reacting while it has been going on. Do you feel that we've moved away from the edge of what everybody has called Knightian uncertainty into a more probabilistic form of uncertainty?

MR. STOCKTON. I would guess that we have probably cut off at least some of the tail ends of the probability distribution to the extent that they even existed previously. By that I mean that I'm not necessarily buying completely into the view that recently we have lived in a

totally Knightian world and now we have jumped from one universe to the next. I think we've probably cut off some of the tails of the probability distributions. Karen certainly showed some dissipation in the tails on the upside with regard to oil prices at least. So some aspects of the uncertainty have been eliminated. We've seen that reflected, too, in stronger equity prices, some declines in risk spreads, and some improvement in consumer sentiment. But I think one has only to look at the mood swings, if I can use that term, over the last two and a half weeks regarding the progress of the war to justify remaining a bit cautious. Given those ups and downs, it's hard to state with any confidence that we're now moving into a less risky or more certain world. In my view there are still a lot of uncertainties, especially about the underlying strength of the business climate. Maybe some of the uncertainty about the war and the consequences for oil prices has cleared up, but I think a lot of uncertainty remains with regard to the underlying strength of the economy.

MS. MINEHAN. Yes, but as I interpret the discussions that we've had, it seems to me that we've put a lot of emphasis—particularly since the last meeting—on being in a position where it was very hard to estimate probabilities. The reason it was so hard to do that was that there were so many one-of-a-kind situations facing us—a war, for example—about which there was great uncertainty. I'm not saying that I think the outlook looks better, but could we say that we're now in an environment in which we know more how to forecast?

MR. STOCKTON. The basic premise of your question—that the risks have diminished some—I think is correct.

MS. MINEHAN. Well, I'd say it's a different kind of risk. We're always dealing with risks. We're accustomed to trying to figure out where the probabilities are relative to the baseline forecast. We're used to trying to put together a number of different pieces of data and

the theories that underlie your models and so forth. I thought, though, that we were saying at the last meeting that we were in a realm where that was relatively hard to do.

MR. STOCKTON. That was exceedingly hard to do, and the world does look a little clearer to me today than it did at the time of the last FOMC meeting before the conflict with Iraq got started.

MS. MINEHAN. Thank you.

CHAIRMAN GREENSPAN. Further questions for Dave? Any general comments on any subject by any Committee member? If not, let me reiterate to those of you who are not up-to-date on this that the meeting scheduled for next Tuesday, April 15, has been shifted to Wednesday, April 16, and will start at noon. As you may recall, based on conversations we had last week, we plan to have a Committee roundtable discussion at our meeting next week. So I would request of the participants that you be prepared to outline what is going on in various areas if you wish to add anything to what you said at the March FOMC meeting.

MR. REINHART. Mr. Chairman, I might just point out that the reason we shifted the meeting from Tuesday to Wednesday of next week was a scheduling conflict for two Committee members. I've received a couple of inquiries about why the meeting date was changed, and that's the reason.

CHAIRMAN GREENSPAN. Is that a satisfactory explanation for everybody, or do you need to know who the two are? [Laughter] Not hearing any further comment, we'll call this meeting to a close. Thank you very much. We look forward to talking to you next week.

END OF MEETING