Prefatory Note

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Please note that some material may have been redacted from this document if that material was received on a confidential basis. Redacted material is indicated by occasional gaps in the text or by gray boxes around non-text content. All redacted passages are exempt from disclosure under applicable provisions of the Freedom of Information Act.

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[1] In some cases, original copies needed to be photocopied before being scanned into electronic format. All scanned images were deskewed (to remove the effects of printer- and scanner-introduced tilting) and lightly cleaned (to remove dark spots caused by staple holes, hole punches, and other blemishes caused after initial printing).

[2] A two-step process was used. An advanced optical character recognition computer program (OCR) first created electronic text from the document image. Where the OCR results were inconclusive, staff checked and corrected the text as necessary. Please note that the numbers and text in charts and tables were not reliably recognized by the OCR process and were not checked or corrected by staff.

Content last modified 5/26/2009.

Strictly Confidential (F.R.) **October 23, 2003**
Class II – FOMC

MONETARY POLICY ALTERNATIVES

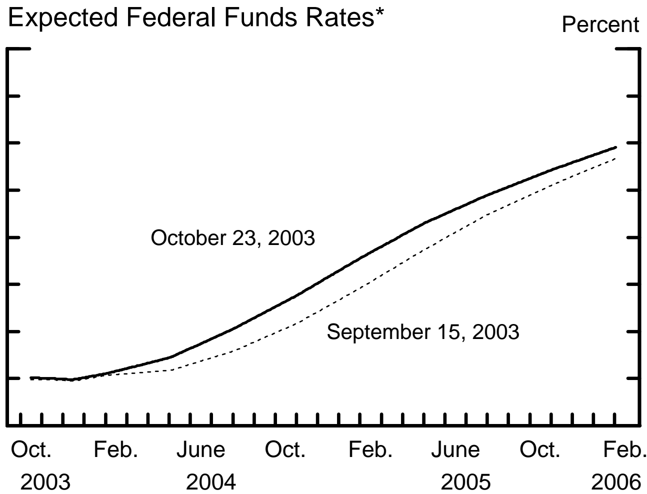
Recent Developments

(1) The FOMC's decision at its September meeting to keep the target for the federal funds rate unchanged at 1 percent and not to alter the assessment of risks to the economic outlook was widely anticipated, and rates on near-dated federal funds futures contracts held about steady after its announcement. The Committee's characterization of labor market conditions as "weakening" and reaffirmation that an accommodative policy can be maintained for a "considerable period" reportedly led investors to mark down rates on futures contracts covering next year by a few basis points. In recent weeks, though, longer-dated futures rates have risen sharply against the backdrop of better-than-expected economic data, positive corporate earnings announcements, and a pronounced weakening of the dollar. In addition, comments by some Federal Reserve officials last week were read by many as signaling that policy firming might commence sooner than had been previously expected, adding to the upward pressure on market rates. While short-term futures rates remained anchored near 1 percent throughout the intermeeting period, those at longer horizons increased about 25 to 30 basis points on net (Chart 1). (Further discussion of the recent stability of near-term policy expectations is provided in the box below.) Market participants seem certain that policy will remain on hold at this FOMC meeting, but they now place considerable odds on a 25 basis point tightening by the middle of next year.[1]

[1] The effective federal funds rate averaged close to 1 percent over the intermeeting period. The Desk purchased $922 million of Treasury bills from foreign official institutions and $742 million of Treasury coupon securities in the market. The outstanding amount of long-term RPs increased $2 billion, to a level of $20 billion.

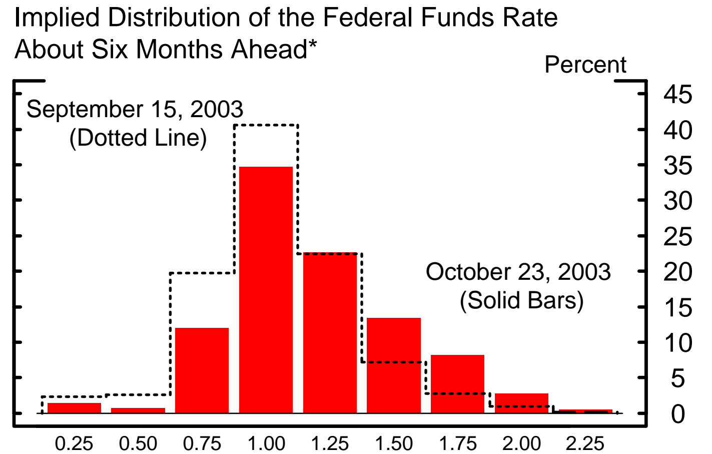
Chart 1
Interest Rate Developments

Expected Federal Funds Rates*



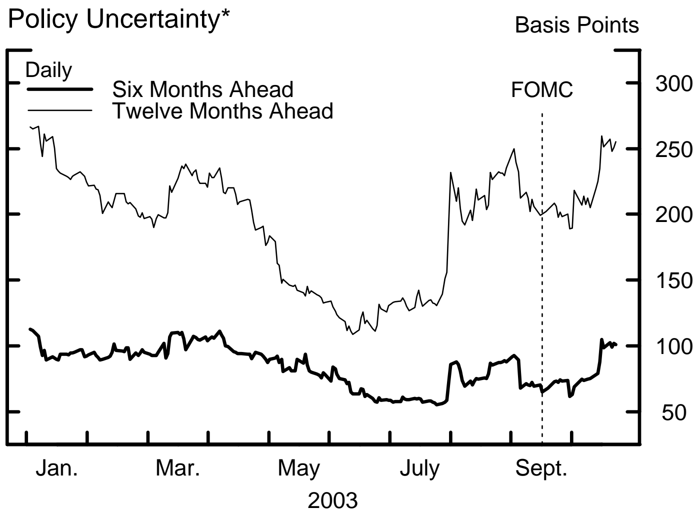
*Estimates from federal funds and eurodollar futures, with an allowance for term premia and other adjustments.

Implied Distribution of the Federal Funds Rate About Six Months Ahead*



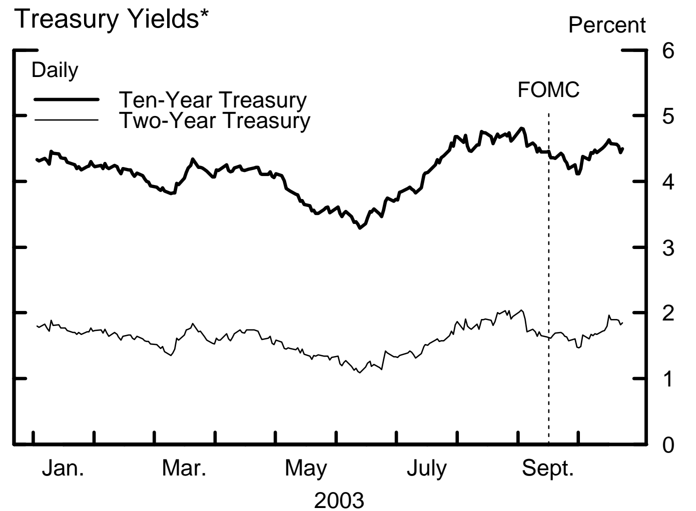
*Based on the distribution of the three-month eurodollar rate five months ahead (adjusted for a risk premium), as implied by options on eurodollar futures contracts.

Policy Uncertainty*



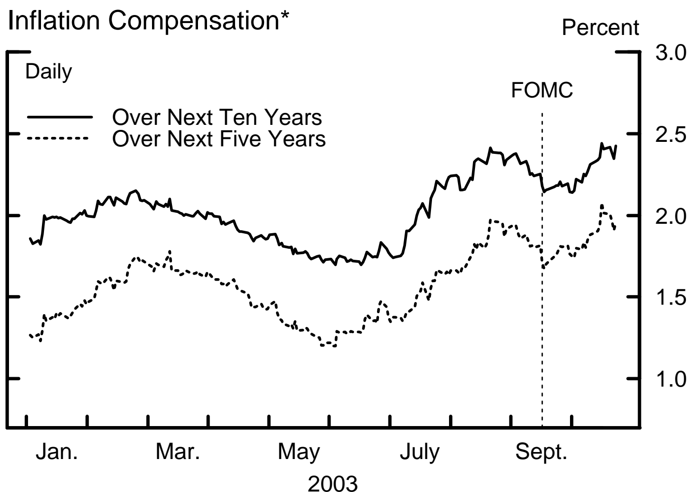
*Width of a 90 percent confidence interval computed from the term structures for the expected federal funds rate and implied volatility.

Treasury Yields*



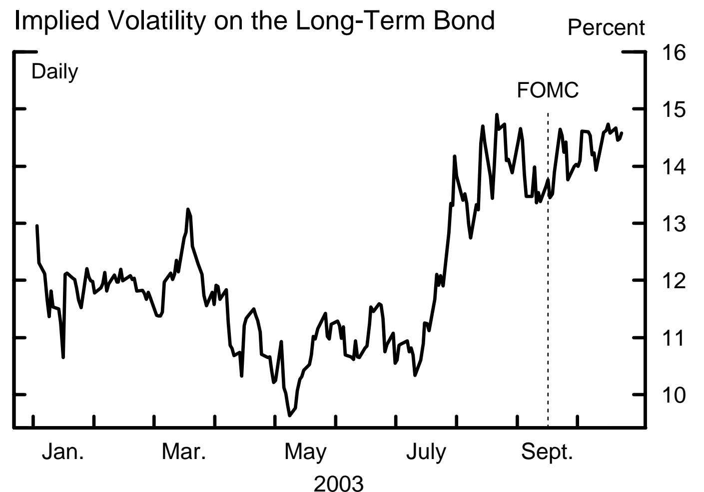
*Par yields from an estimated off-the-run Treasury yield curve.

Inflation Compensation*



*Based on a comparison of an estimated TIIS yield curve to an estimated nominal off-the-run Treasury yield curve.

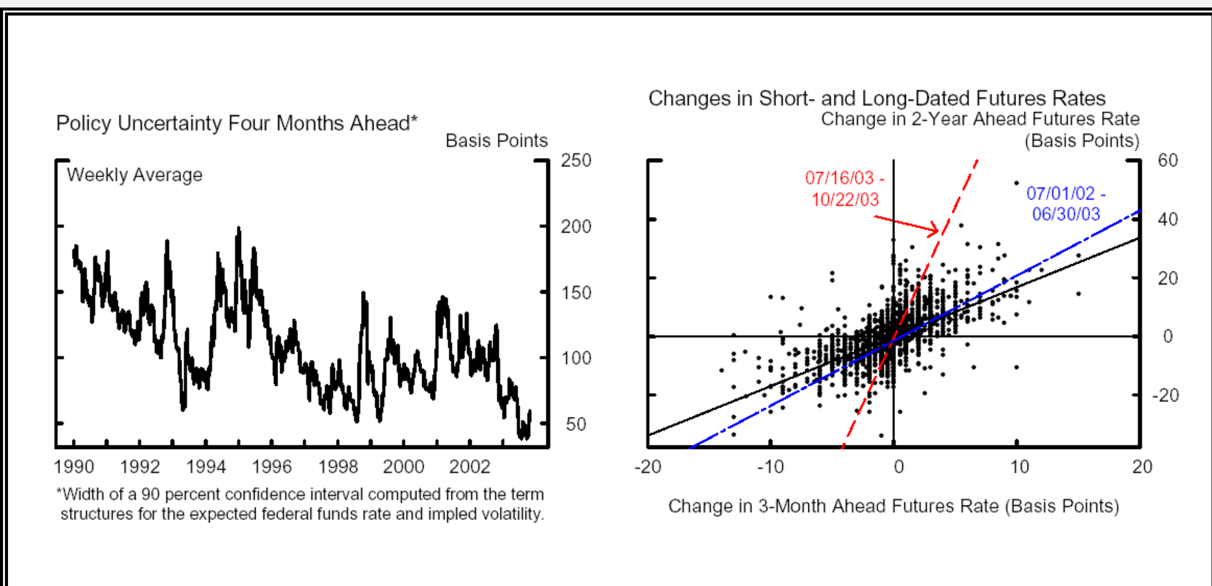
Implied Volatility on the Long-Term Bond



Note: Vertical lines indicate September 16, 2003. Last daily observations are for October 23, 2003 .

The Recent Stability of Near-Term Policy Expectations

The Committee's recent announcements as well as comments by Federal Reserve officials have hinted strongly–most explicitly in Chairman Greenspan's monetary policy testimony in July and in the concluding sentence of the August and September FOMC statements–that the stance of policy would remain accommodative for some time. These statements seem to have left investors quite confident that the target funds rate will remain near 1 percent for the next few months. For example, an estimate of uncertainty about the near-term policy path derived from options data–shown in the left panel of the chart–has fallen sharply over the summer and remains near historical lows. The efficacy of the Committee's statements in anchoring near-term policy expectations has also been suggested by movements of near- and longer-dated futures rates. The right panel plots daily changes in the eurodollar futures rate eight quarters ahead on the vertical axis



against the corresponding daily changes in the three-month-ahead federal funds futures rate. The solid black regression line shows the average relationship between these variables over the entire period from 1990 to the present. The red dashed line shows the regression line fitted with data since the Chairman's testimony in July; the significantly steeper slope of this line is consistent with the view that near-term policy expectations have been unusually stable over recent months. This conclusion holds even when a more recent period–the year ended June 2003 (the blue dot-dashed line)–is used as the basis for comparison.

(2) These changes in policy expectations showed through to short- and intermediate-term Treasury yields, which gained 10 to 20 basis points over the intermeeting period. Nominal yields on longer-term Treasury securities were about unchanged, while those on indexed debt fell about 10 basis points. As a result, implied inflation compensation edged higher, consistent with the uptick in the University of Michigan Survey's measure of long-term inflation expectations. Treasury yields remained volatile, but bid-asked spreads held near normal levels, and transaction volumes were in a typical range.[2] Continued debate about the appropriate regulatory structure for the GSEs, as well as reports of losses suffered by three Federal Home Loan Banks, left only a small imprint on agency spreads.

(3) Investors' improved economic outlook and perhaps some increased appetite for risk supported the prices of corporate debt and equity over the intermeeting period (Chart 2). While investment-grade yields moved about in line with Treasuries, lower-tier spreads registered further significant and broad-based declines. Major equity indexes rose roughly 2 percent, even as earnings reports for the third quarter came in about as strong as analysts had expected, and forward-looking measures of the volatility of the S&P 500 fell to their lows for the year. In addition, gross equity issuance jumped in September and even included a rise in initial public offerings.

(4) The foreign exchange value of the dollar fell almost 5 percent over the intermeeting period against major currencies, paced by a 6-1/2 percent drop against the Japanese yen (Chart 3). The dollar depreciated more than 4 percent against the euro and the Canadian dollar. The communique issued at the conclusion of the G-7 meeting in Dubai on September 20 was reportedly interpreted by market participants

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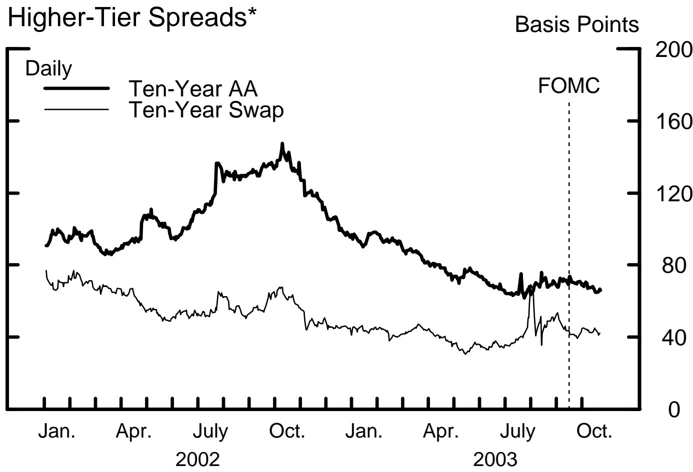
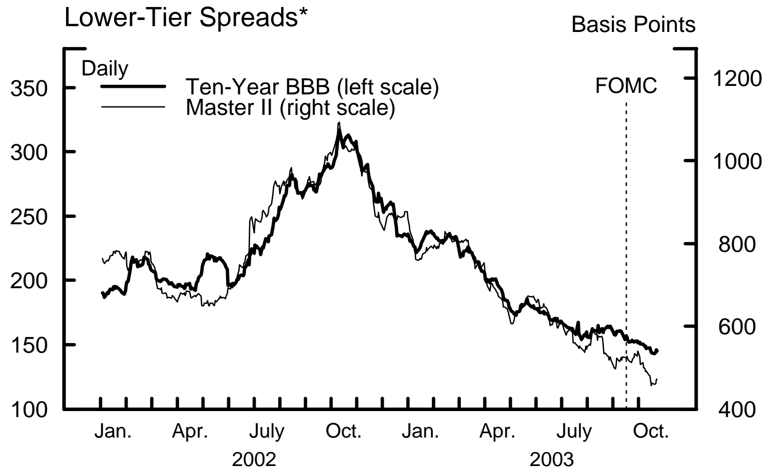
[2] Fails to deliver Treasury securities, especially of the once-off-the-run ten-year note, remained elevated–albeit well below their summertime peaks.

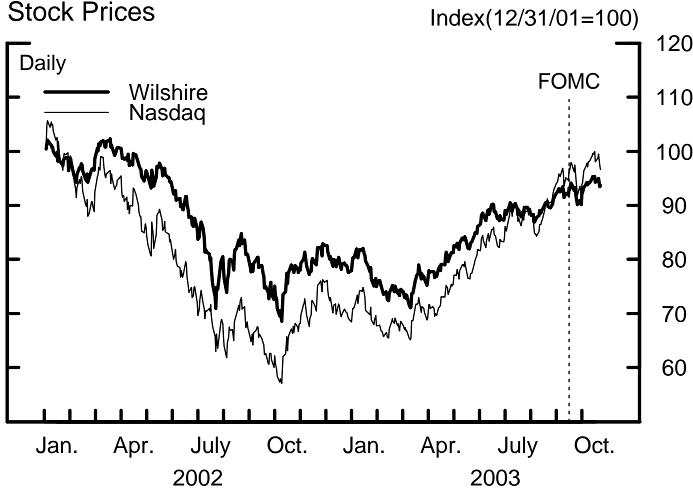
Chart 2
Financial Market Indicators

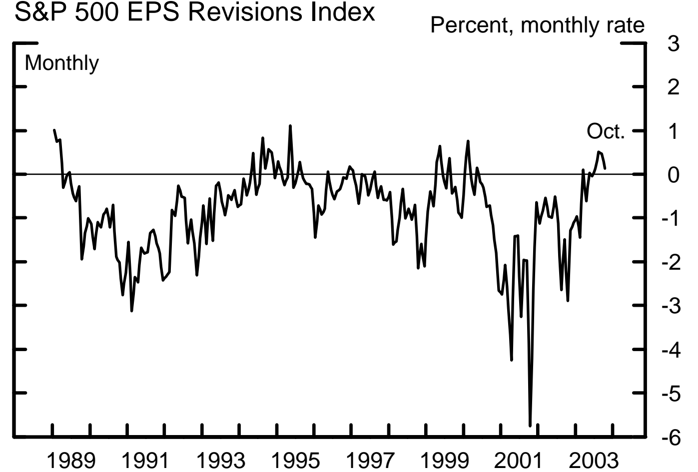


*AA spread measured relative to an estimated off-the-run Treasury yield curve. Swap spread measured relative to the on-the-run Treasury security.

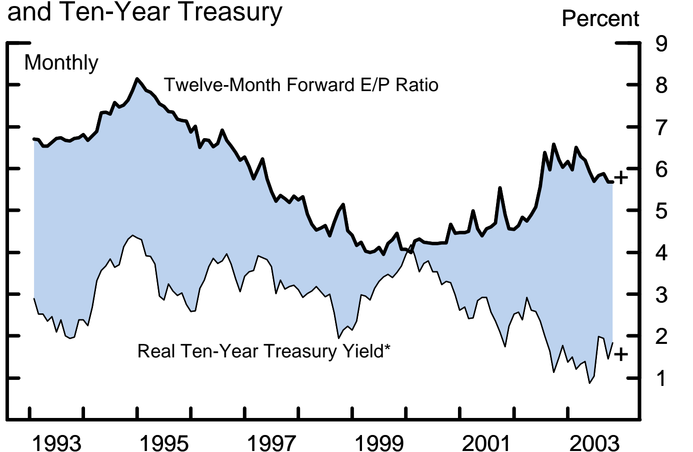


*Measured relative to an estimated off-the-run Treasury yield curve.

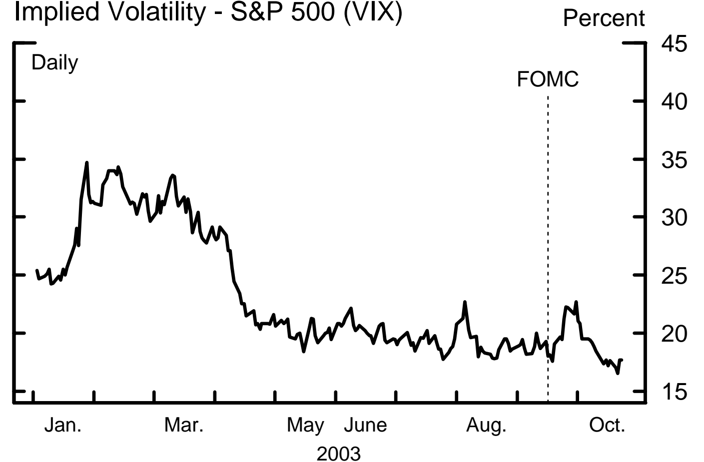




Note. Index is a weighted average of the percent change in the consensus forecasts of current-year and following-year EPS.

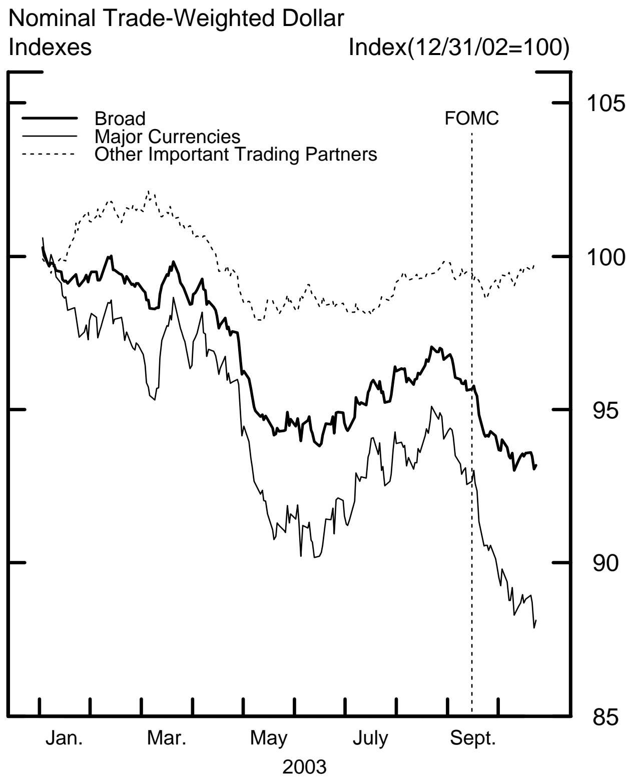


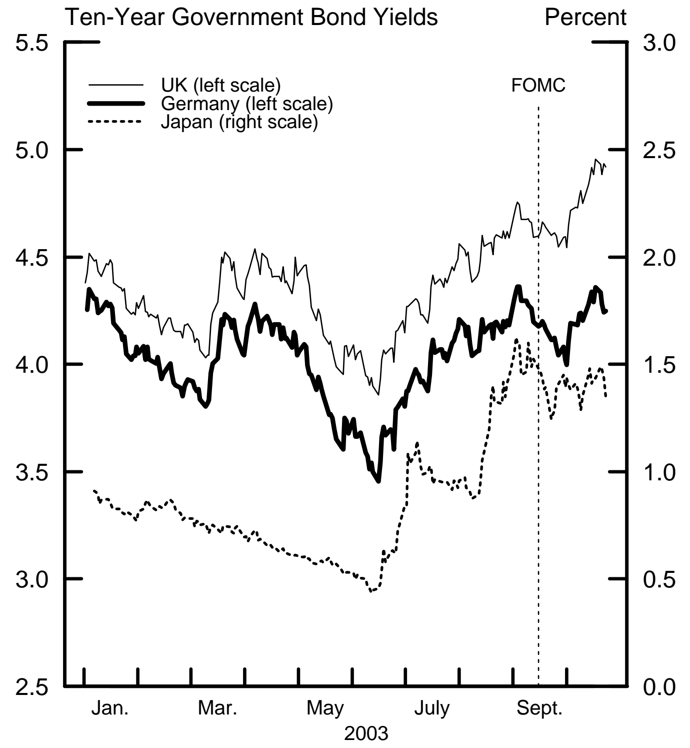
*End-of-month ten-year Treasury yield minus Philadelphia Fed ten-year expected inflation.
+ Denotes latest daily observation, October 23, 2003 .

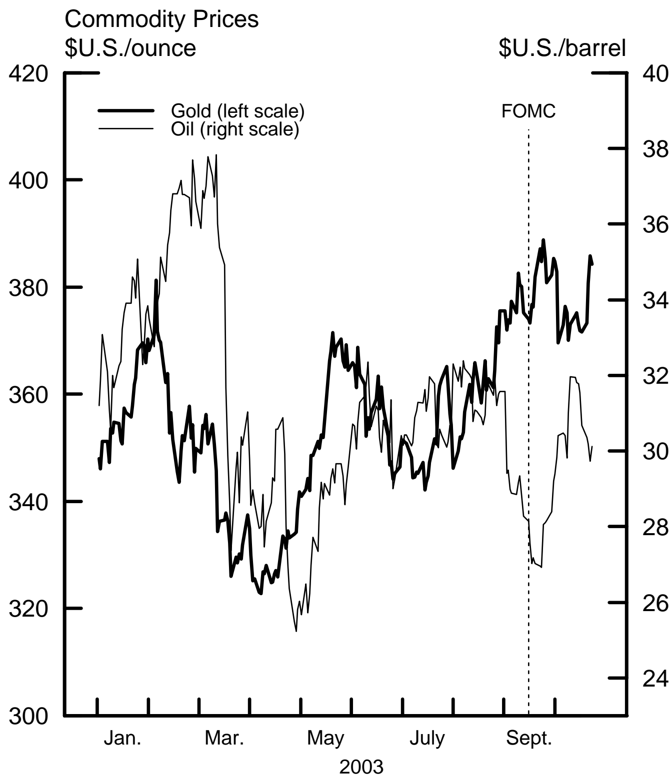


Note: Vertical lines indicate September 16, 2003. Last daily observations are for October 23, 2003.

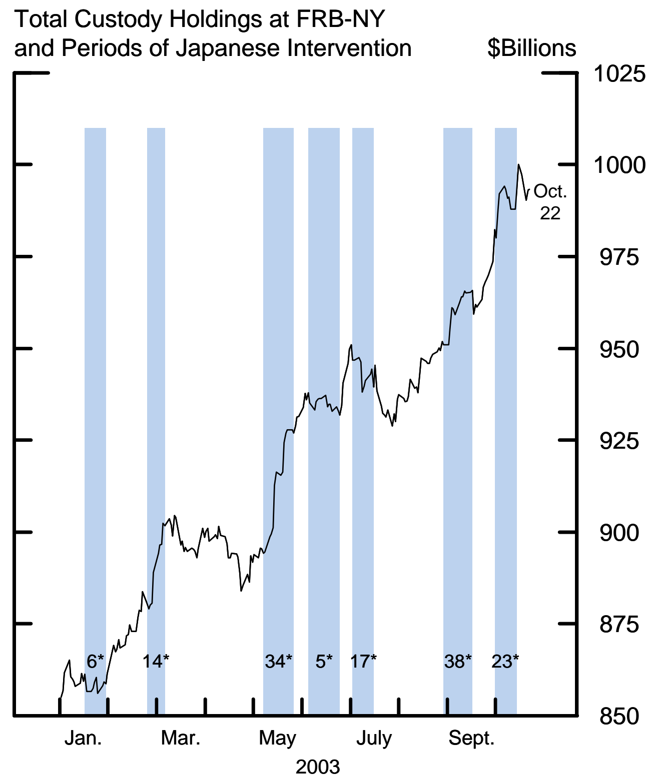
Chart 3
International Financial Indicators
(Daily Data)







Note: Last daily observations are for October 23, 2003, except as noted.



*Total purchases of U.S. dollars in billions per episode of intervention by Japanese monetary authorities. Cumulative total purchases in 2003: $136.6 billion.

as indicating official acceptance of further dollar depreciation. Subsequent statements by the Administration that the "strong dollar" policy had not changed and a resumption of significant intervention by Japanese authorities within ten days of the G-7 meeting did not halt the dollar's decline.[3] Long-term government bond yields in advanced economies showed mixed changes; the exception was in the United Kingdom, where yields jumped 32 basis points as market participants came to believe that the Bank of England would be the first major central bank to tighten policy. In contrast, announcements by the Bank of Japan regarding its monetary policy intentions supported equity prices and trimmed longer-term JGB yields.[4] Stock prices in other major foreign economies registered mixed changes on net over the intermeeting period.

(5) Against the currencies of our other important trading partners, the trade-weighted foreign exchange value of the dollar changed little on net, as a 2 percent rise against the Mexican peso was offset by declines against the currencies of Brazil and several Asian economies. The Mexican government lowered its growth forecast for the remainder of 2003, and Mexico's stock market index posted only minor gains,

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[3] . The Desk did not intervene for the accounts of the System and the Treasury over the intermeeting period.

[4] On October 10, the Bank of Japan announced an increase in the upper limit of its target range for reserve balances to 32 trillion yen, from 30 trillion yen, and an expansion of the scope of RP operations that amounted to an extension of the permissible term of RPs. A clarification of the conditions that would have to be met before the Bank of Japan would end its policy of quantitative easing may have led market participants to believe that low short-term interest rates would prevail for longer than had been previously expected.

while risk spreads widened somewhat. In contrast, Brazilian financial market indicators improved considerably on market speculation that Brazil's sovereign debt rating may be raised shortly. Although the Chinese authorities maintained the renminbi's peg against the dollar, rates on forward contracts suggest that market participants have marked up the odds on renminbi appreciation within the next year.

(6) Nonfinancial businesses appear to have pared their borrowing further on balance in September, as a pickup in net bond issuance was more than offset by further paydowns of short-term debt (Chart 4). For the third quarter as a whole, debt of the nonfinancial business sector is estimated to have grown at a 2-3/4 percent pace. Available data for October suggest that business borrowing remains weak. Bond issuance has been slowed by the recent rise in interest rates, and runoffs of C&I loans have continued unabated, despite the stabilization in banks' lending standards and terms reported in the most recent Senior Loan Officer Opinion Survey.[5] Commercial paper issuance, though, appears to be strengthening somewhat. In the household sector, consumer credit growth picked up earlier in the third quarter, buoyed by spending on motor vehicles. Data from commercial banks suggest that growth of households' mortgage debt has slowed as the pace of mortgage refinancings has stepped down. Overall, debt of the household sector is estimated to have risen at a 9-1/2 percent pace in the third quarter. With debt in the federal sector expanding less rapidly, total domestic nonfinancial debt is estimated to have grown at a 7 percent

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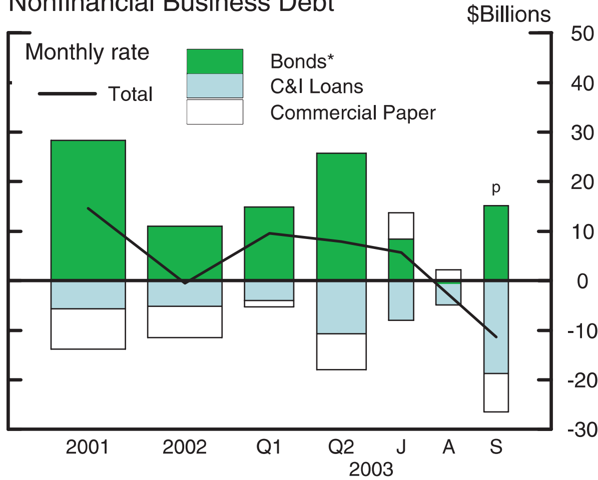
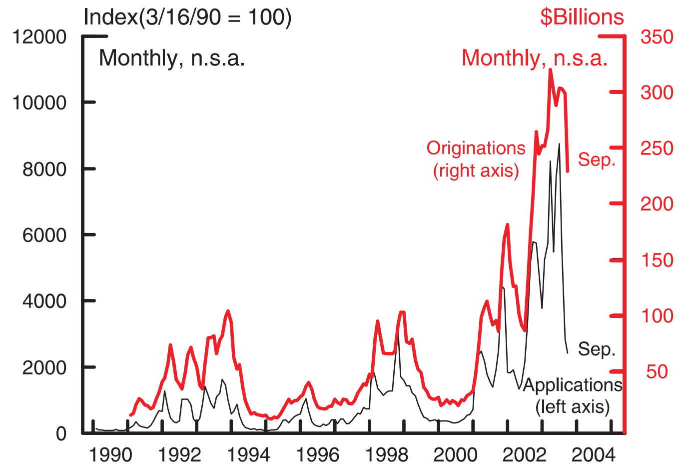
[5] Data on business loans presented in this Bluebook have been adjusted to remove the estimated effects of the adoption by some banks of Financial Accounting Standards Board (FASB) Interpretation 46 (FIN 46). This accounting change, which was issued in January, originally required institutions to consolidate some variable interest entities onto their balance sheets in the third quarter. During the intermeeting period, however, FASB announced that institutions could delay implementation of the new accounting treatment until the fourth quarter, reducing its impact for now.

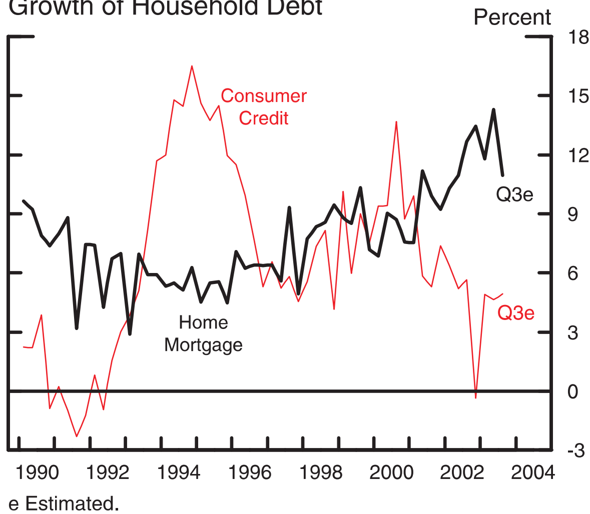
Chart 4
Debt and Money Growth



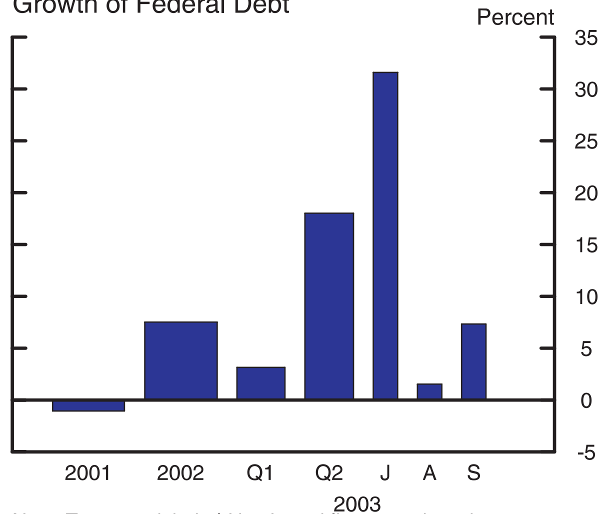
* Not seasonally adjusted. p Preliminary.
Note. C&I loans are adjusted for the estimated effects of FIN 46.



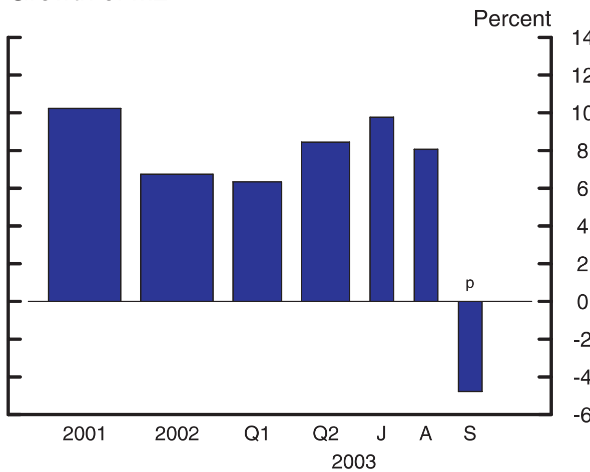
Source. Staff estimates.



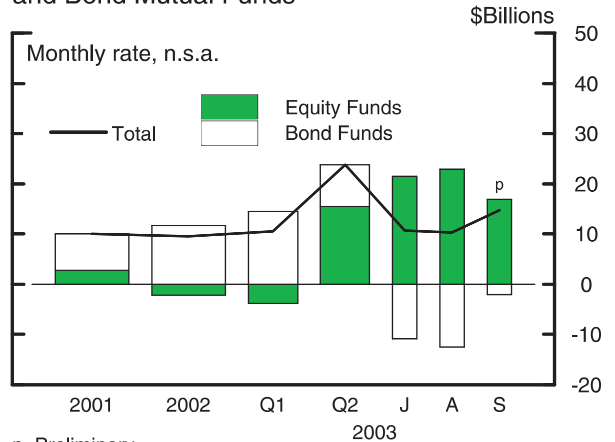
e Estimated.



Note. Treasury debt held by the public at month-end.



p Preliminary.



p Preliminary.
* Excluding reinvested dividends.

pace last quarter, down significantly from the second quarter.

(7) M2 contracted at a 4-3/4 percent annual rate in September after surging over the prior several months, and the weakness appears to be carrying into October. The steep falloff in mortgage refinancing seems to have played an important role in this reversal.[6] The temporary effects of the multi-day power blackout in August, which had immobilized large amount of funds in demand deposits, elevated the level of M2 in that month relative to September. In addition, some portion of the child tax credit refunds received by households in late July and early August may have been initially placed in M2 accounts and then spent last month. Lastly, net inflows to equity and bond mutual funds picked up in September and early October relative to recent months, perhaps damping M2 growth.

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[6] Some pre-paid mortgage balances are required to be held temporarily in liquid deposits before those funds are disbursed to holders of mortgage-backed securities. The resulting effect on M2 growth for a given month depends on the dollar amount of mortgage refinancings in that and the previous month as well as the length of time those funds remain in M2 deposits. Estimates of those factors are subject to considerable uncertainty. Nevertheless, it appears that refinancing effects accounted for a large share of the deceleration of M2 in September.

Policy Alternatives

(8) Stronger-than-expected incoming data on spending have led the staff to mark up its estimate of third-quarter growth, and the resulting higher level of real GDP is carried forward with the general contours of the forecast little changed. Monetary policy is still assumed to be on hold until mid-2005 and to firm only gradually thereafter. Longer-term interest rates are projected to be about flat for a few quarters and then to drift a bit lower as investors conclude that monetary policy will not need to tighten as quickly as they had thought. The levels of equity prices and the foreign exchange value of the dollar in the fourth quarter have been marked up and down, respectively, to reflect their changes over the intermeeting period. Over the forecast interval, equity prices are again assumed to rise enough to yield risk-adjusted returns in line with those on fixed-income instruments, while the dollar is still assumed to edge lower at about the same rate as in the last Greenbook. With these accommodative financial conditions, expansionary fiscal policy, and inventory dynamics supporting growth, real GDP is projected to expand at about a 5-1/4 percent rate over the second half of 2003 and at nearly that pace in 2004. A swing in fiscal policy toward restraint in 2005 contributes to a moderation of GDP growth to about 4 percent–still somewhat above the estimated growth rate of potential output. With output growth exceeding that of its potential, the civilian unemployment rate is projected to fall to nearly 5 percent–the staff's estimate of the natural rate–by the end of 2005. Cumulative slack in product and labor markets puts a bit of downward pressure on core PCE inflation, which ends the projection period at 1 percent. The recent rise in oil prices is assumed to unwind gradually, causing headline inflation to run a bit below core inflation in 2004 and 2005.

(9) If the Committee, like the staff, sees output growing briskly with inflation staying near 1 percent for an extended period, it might choose an

unchanged target for the federal funds rate at this meeting. The recent strength in spending may have led the Committee to trim its assessment of the possibility of a significant decline in inflation and, perhaps, the risk of adverse feedback to aggregate demand should such a decline eventuate. Moreover, financial conditions would now seem to be providing more support for spending than at the time of the September meeting, and possibly enough to lead the Committee to see more robust growth in aggregate demand going forward than the staff projects. Indeed, current estimates place the real federal funds rate below the range of equilibrium values derived from various staff models (Chart 5).[7] Even if the Committee is concerned that economic slack could persist for a substantial time, it might think that any additional easing undertaken at this meeting would not–given the lags with which policy affects spending–have a noticeable impact until the economic expansion was far enough along to make additional stimulus undesirable. Alternatively, Committee members–like many private forecasters–may expect inflation pressures to emerge faster than in the staff projection. For instance, relative to the Greenbook, the Committee may see less resource slack currently or be more worried that very rapid output growth could put pressure on prices even as some slack in resources remained. Given these possibilities, the Committee may feel that it is best to await additional

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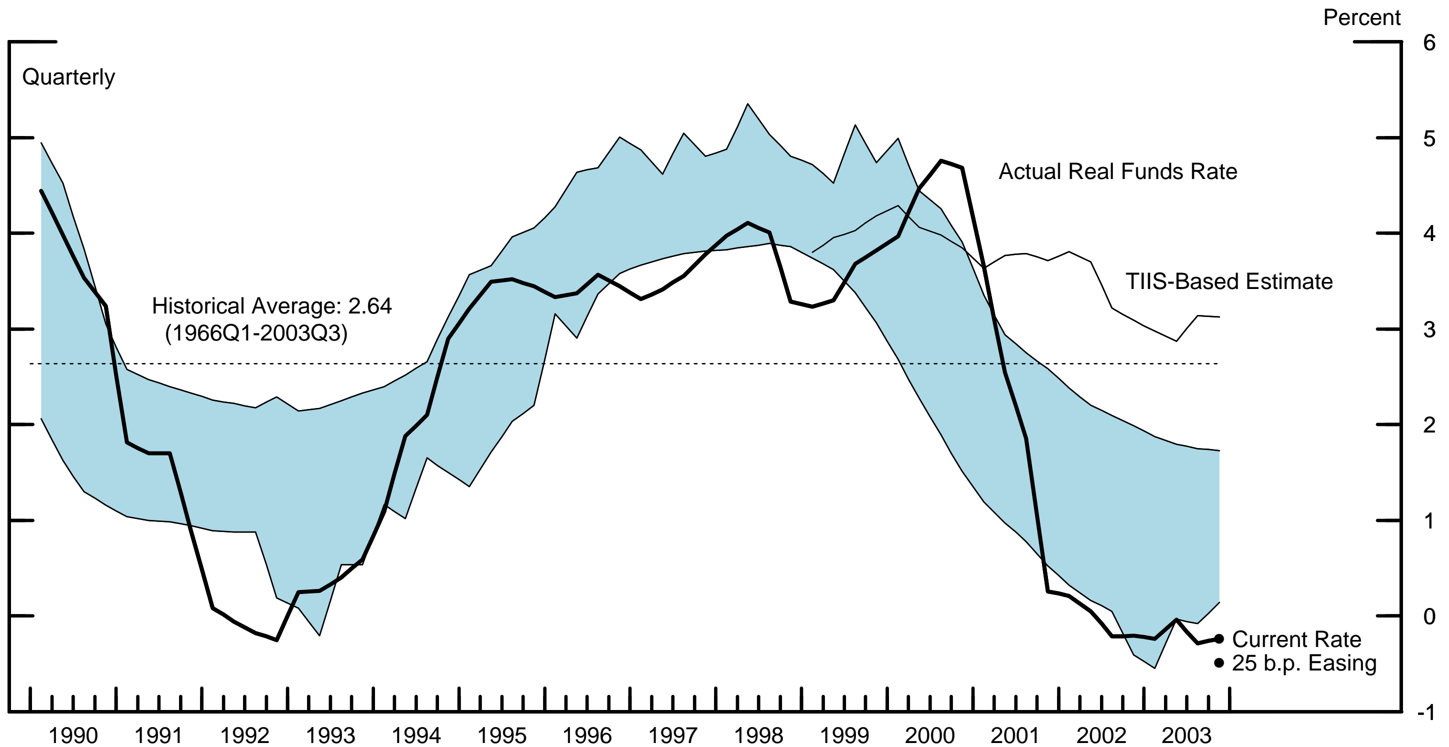
[7] In the September Bluebook, the staff estimated that the real federal funds rate in the third quarter was about 20 basis points above the bottom of the range of estimates of its equilibrium value. In the current Bluebook, the staff now estimates that the real funds rate in the third quarter was about 20 basis points below the bottom of the range. This relative shift largely reflects two factors. First, the staff's estimate of four-quarter core PCE inflation for last quarter has increased about 10 basis points since the last Bluebook, reducing the estimated level of the actual real federal funds rate. Second, the level of third-quarter GDP was revised higher, and some of this strength is projected to carry over to the fourth quarter. The resulting decline in the estimate of the output gap in these two quarters boosts the estimate of the equilibrium funds rate produced by the one-sided statistical filter (the measure at the bottom of the range) by 34 basis points.

Chart 5
Actual Real Federal Funds Rate and Range of Estimated Equilibrium Real Rates



Note: The shaded range represents the maximum and the minimum values each quarter of four estimates of the equilibrium real federal funds rate based on a statistical filter and the FRB/US model. Real federal funds rates employ a four-quarter moving average of core PCE inflation as a proxy for inflation expectations, with the staff projection used for 2003Q4.

Equilibrium Real Funds Rate Estimates (Percent)

	2002	2003H1	2003Q3	2003Q4
Statistical Filter				
- Two-sided:				
Based on historical data and the staff forecast	0.2	0.2	0.4	0.4
September Bluebook	*0.0*	*0.0*	*0.1*	--
- One-sided:				
Based on historical data*	0.5	-0.3	-0.1	0.1
September Bluebook	*0.4*	*-0.6*	*-0.4*	--
FRB/US Model				
- Two-sided:				
Based on historical data and the staff forecast	2.2	1.8	1.7	1.7
September Bluebook	*2.2*	*1.9*	*1.8*	--
- One-sided:				
Based on historical data**	1.3	0.2	0.3	0.4
September Bluebook	*1.4*	*0.4*	*0.4*	--
Treasury Inflation-Indexed Securities	3.5	2.9	3.1	3.1
September Bluebook	*3.5*	*2.9*	*3.1*	--

* Also employs the staff projection for the current and next quarters.

** Also employs the staff projection for the current quarter.

Note: The estimates of the equilibrium real funds rate based on Treasury inflation-indexed securities have been revised to cover a period from five to ten years ahead rather than ten to thirty years ahead. The estimates based on the FRB/US model have been revised to take account of changes to the model and to the details of the method used. In all of these cases, the values shown for the September Bluebook are on the new basis, and so they differ from the value actually shown in that Bluebook. The effect of these restatements is never larger than 0.2 percentage point.

information on aggregate demand and supply before adjusting policy further.

(10) If, however, the Committee is concerned that growth may not remain rapid enough to return output to its potential reasonably promptly and so limit any further decline in inflation, then it might choose to **cut the target for the federal funds rate by 25 basis points** at this meeting. While the Committee may be convinced that the economy has been growing robustly and will continue to do so over the remainder of this year, it may fear that the expansion could sputter in 2004. In particular, firms may remain cautious in their spending, hiring, and inventory control, implying continued restraint on aggregate demand growth as the impetus from this summer's tax cuts ebbs. Even if the Committee thinks that the most likely outcome is one in which output growth is sufficient to reduce resource slack at an acceptable pace, it might want to err on the side of more accommodative policy given that inflation is low, inflation expectations are apparently well anchored, and the costs of a further decline in inflation likely outweigh those of a modest increase. Indeed, Committee members may see the current level of inflation as near the bottom of the range that they would like to achieve in the longer term, given the asymmetries caused by the zero lower bound on nominal interest rates and other possible nominal rigidities.

Policy Announcement, Directive, and Assessment of Risks[8]

(11) The wording of the second paragraph of the policy announcement–the portion of the announcement that provides a rationale for the Committee's decision–should presumably reflect the judgments about the stance of monetary policy and economic conditions that the Committee makes in arriving at its policy decision. If

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[8] As discussed on September 15, the drafting of the announcement would be facilitated if Committee members conveyed their views about the possible wording of the second paragraph of the statement to the Secretary in advance of the meeting. The September 16 policy announcement is provided in the Appendix.

the Committee decides to make no change in policy, then it may well want to employ language similar to the statement issued following the September meeting. Such a statement would note that the accommodative stance of policy and vigorous growth in productivity are providing ongoing support to economic activity and that incoming data continue to show a firming of spending. In light of the small rise in employment in September and the somewhat lower levels of initial claims posted in recent weeks, the Committee may want to note some evidence of stabilization in labor markets rather than retaining the language that "the labor market has been weakening."

(12) Even if the Committee is persuaded by the arguments for easier policy, it may still want to start the "rationale" paragraph by noting that the accommodative stance of policy and robust underlying growth in productivity are providing support to economic activity and by acknowledging the recent strength in spending. The statement could then justify a rate cut by pointing to concerns about the sustainability of brisk growth or the effects of faster structural productivity growth on estimates of economic slack. The statement might also note that the costs of a significant further decline in inflation could be large whereas upside inflation risks seem small, helping to tilt the balance in favor of easier policy.

(13) This Bluebook assumes that the structure of the third paragraph of the statement summarizing the risks to the outlook follows that selected at recent FOMC meetings–with the possible exception of the final sentence, which will be discussed in paragraph 16.[9] The first two sentences summarize the risks to the outlook for economic growth and for the rate of inflation over the next few quarters, which correspond to the rows and columns, respectively, of Table 1. If the Committee, like the staff, sees output growth as likely to trim the slack in goods and factor markets

[9] "Committee Discussion of the Wording of the Announcement," memorandum to the Committee from Vincent Reinhart, dated October 22, 2003.

Table 1

Possible configurations of the risks to economic growth, the risks to inflation, and the balance of risks

	Risks to inflation			
Risks to sustainable economic growth		*Unwelcome fall*	*Balanced*	*Unwelcome rise*
	Weighted to the downside			
	Balanced	Inflation undesirably low	Balanced	
	Weighted to the upside	Inflation undesirably low -or- balanced	Upside risks to sustainable growth	

fairly slowly in coming quarters, then it may again judge that "... *the risks to the attainment of sustainable economic growth over the next several quarters are balanced.*" Such an assessment might reflect a view that the phrase "sustainable economic growth" is consistent with above-trend expansion over the next several quarters so long as it only gradually closes the output gap. Retention of this risk assessment might also follow from an interpretation of the phrase that focused on whether or not the growth process appeared to be self-sustaining, especially if the Committee harbored reservations that the expansion could falter early in 2004. However, if the Committee views "sustainable economic growth" as denoting the growth rate of the economy's potential to produce, then it might be inclined to indicate that the risks are tilted toward the upside at this meeting. Since such a statement might be misread by the markets, the Committee may want to make clear in the announcement that growth above potential would not necessarily trigger tighter policy in the near term.

(14) If the Committee remains concerned that substantial downward pressures on prices could accumulate and that significantly lower inflation could prove very costly, then it would likely indicate that, *"...the probability, though minor, of an unwelcome fall in inflation exceeds that of a rise in inflation from its already low level."* However, such concerns may have eased considerably given the tenor of the spending data since summer, and, if the Committee believes that the more rapid growth is not likely to prove transitory, then it might be ready to report that the risks to the outlook for inflation over the next several quarters are about balanced.

(15) The alternatives just discussed for the first two sentences admit four possible configurations, as shown in Table 1. As it did at the September meeting, the Committee might see the risks to sustainable economic growth as balanced and the risk of an unwelcome fall in inflation as outweighing that of a rise in inflation (the blue diagonally hatched box in the table). In that case it would presumably conclude that

"... the risk of inflation becoming undesirably low remains the predominant concern for the foreseeable future." Alternatively, the Committee might assess the risks to sustainable growth as to the upside but remain concerned about an unwelcome fall in inflation (the yellow horizontally hatched box). With the level of output currently below estimates of its potential and inflation quite low, the Committee might believe that its dual goals are more likely to be jeopardized by a further decline in inflation than by plausible outcomes for growth in output. In that case, it might continue to indicate that the risk of undesirably low inflation was predominant. However, if the Committee feels that the prevailing degree of economic slack is relatively modest and thinks that output growth could well pick up to a very rapid pace, then it might want to report a neutral balance of risks. Conversely, the Committee might still view the risks to sustainable growth as balanced, but now believe that the risks to inflation are balanced as well (the red vertically hatched box). In that case, it seems likely that the overall assessment also would be balanced. Lastly, if the improvement in growth prospects is seen as sufficiently large, the Committee might believe that the risks to sustainable output growth are tilted to the upside, while the risks to inflation are balanced (the green cross-hatched box). If so, it would presumably indicate that the balance of risks is weighted toward unsustainably rapid growth.

(16) The final issue relating to the policy announcement is whether to modify or delete the sentence *"In these circumstances, the Committee believes that policy accommodation can be maintained for a considerable period."* This choice presumably depends upon the same considerations that underlie the Committee's selection of the balance of risks statement. If the Committee believes either that the growth of aggregate demand may slow next year from its second-half pace or that the degree of slack in the economy is currently considerable and will take time to work off, then it might choose to repeat its earlier statement. Such a decision might be especially favored if the Committee

viewed the firm anchoring of near-term policy expectations that appears to have been the case of late as helpful in preventing market participants from anticipating substantial policy tightening in short order. However, with the recovery seemingly gaining traction, the Committee might feel that tighter policy may well be needed relatively soon to avoid a build-up in inflation pressures. Since the Committee presumably will want to remove the statement in its current form from the announcement in advance of any policy tightening, it may judge that the time has come to alter or drop it. Relatively few market participants reportedly expect the latter development at this meeting. As a result, simply dropping the sentence might well lead investors to move up the expected timing of policy tightening considerably, prompting a sizable reaction in financial markets.

(17) Even if the Committee does not see current market expectations for policy as unreasonable, it might be concerned that, as time goes by, repetition of the sentence would lead investors to push back the date at which they expect tightening to begin beyond the range that seems plausible to Committee members. To avoid this possibility, the statement could be made more clearly conditional on future economic developments. For example, the Committee could indicate that *". . . policy accommodation can be maintained for the considerable period it currently assesses will be required to foster the moderation of disinflationary pressures."* Even with this modest change in wording, interest rates would presumably rise some, since investors would see the change as increasing the likelihood of a tightening move in the not-too-distant future.

(18) Should the Committee wish to follow the same procedure as at the last two meetings, it could vote on the directive and on language providing guidance to the drafters of the announcement regarding the risk assessment. Draft language with a range of options is provided below.

(1) Directive Wording

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 maintaining/INCREASING/REDUCING the federal funds rate at/TO an average of around ___ + percent.

(2) Risk Assessment

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes the risks to its outlook for sustainable economic growth over the next several quarters [ARE WEIGHTED TOWARD THE DOWNSIDE] [are balanced] [ARE WEIGHTED TOWARD THE UPSIDE]; the risks to its outlook for inflation over the next several quarters [are weighted to the downside] [ARE BALANCED] [ARE WEIGHTED TOWARD THE UPSIDE]; and, taken together, the balance of risks to its objectives [are weighted toward the downside] [ARE BALANCED] [ARE WEIGHTED TOWARD THE UPSIDE] in the foreseeable future.

Market Reaction

(19) Market participants expect no change in the stance of monetary policy at this meeting, and generally do not foresee an alteration in the three-sentence assessment of risks. Thus, an announcement that closely followed the content of the September statement–that is, an announcement that the target federal funds rate was being left at 1 percent, that the risks to sustainable growth were balanced, that the probability of an unwelcome fall in inflation exceeds that of a rise, and that the risk of

undesirably low inflation remained the predominant concern–would presumably have minimal effects in financial markets. Given the focus of market participants on the overall assessment of the balance of risks, market reactions would likely be quite modest so long as the Committee continued to point to undesirably low inflation as the predominant concern, even if the announcement indicated that the risks to sustainable growth were now to the upside. If, however, the Committee chose an unchanged policy stance but suggested that the risks to its goals of sustainable economic growth and price stability were about equal, investors would likely move up their expected timing of policy tightening, pushing interest rates higher and trimming stock prices.

(20) A decision to ease policy at this meeting would surprise investors. Short-term interest rates would follow the federal funds rate lower, and intermediate-term rates should also decline. If investors interpreted the easier policy as reflecting a higher desired level of long-run inflation on the part of the Committee than they had previously believed, then they would likely foresee an easier policy stance in the near term, but higher nominal interest rates in the longer run. In that case, long-term yields could increase, and the foreign exchange value of the dollar would likely fall. Alternatively, market participants might see the change in policy as reflecting a deterioration in the outlook that they had not yet observed. If so, longer-term yields would presumably decline, as would stock prices and the dollar.

Monetary and Credit Aggregates

(21) M2 is projected to accelerate gradually in coming months under the assumptions of the Greenbook forecast. The effects of the substantial drop-off in mortgage refinancing activity on liquid deposits, which have trimmed M2 considerably of late, are expected to diminish gradually. Nonetheless, with the boost to M2 from past monetary policy easings tailing off, and lower stock price volatility perhaps

encouraging some households to shift funds from M2 assets back into equities, the expansion of M2 is expected to remain modest. M2 is projected to be about flat from September through December, bringing its increase for 2003 as a whole to around 5-3/4 percent. With a small further drag from the slowing of mortgage refinancing flows and no change in opportunity costs, M2 growth in 2004 is forecast at 5-1/2 percent, a bit below the pace of expansion in nominal income. The resulting increase in M2 velocity would be the first in seven years. M2 is projected to slow slightly further in 2005, reflecting smaller gains in nominal income and the effects on opportunity costs of the tightening of policy in the second half of the year.

(22) The growth rate of domestic nonfinancial sector debt is expected to decline over the Greenbook period. Household sector debt is projected to slow noticeably in the current quarter, and then to decelerate a bit further in 2004 and 2005, though it continues to expand at a slightly faster rate than disposable personal income. A reduction in the pace of mortgage refinancing, and a consequent fall in the volume of cash raised from such transactions, is associated with a slowing in mortgage debt that is only partly offset by an acceleration in consumer credit. In the corporate sector, the pickup in investment spending in coming months is nearly matched by rising profits, limiting business borrowing. However, the rise in investment outlays subsequently outstrips profits, and business debt growth picks up. Federal borrowing remains considerable through 2004, but it is projected to slow in 2005 as the budget deficit narrows. All told, debt of the domestic nonfinancial sectors is projected to expand 8-1/4 percent in 2003 and then to slow to 7 percent and 6-1/4 percent in 2004 and 2005, respectively.

Alternative Growth Rates for M2

		Ease 25 bp	No change	Greenbook Forecast*
Monthly Growth Rates				
	Aug-03	8.1	8.1	8.1
	Sep-03	-4.8	-4.8	-4.8
	Oct-03	-4.6	-4.6	-4.6
	Nov-03	1.9	1.5	1.5
	Dec-03	4.6	3.8	3.8
	Jan-04	5.3	4.5	4.5
	Feb-04	5.2	4.5	4.5
	Mar-04	5.5	5.0	5.0
Quarterly Growth Rates				
	2003 Q3	8.6	8.6	8.6
	2003 Q4	-0.8	-1.0	-1.0
	2004 Q1	4.8	4.1	4.1
Annual Growth Rates				
	2002	6.8	6.8	6.8
	2003	5.7	5.7	5.7
	2004	6.0	5.6	5.6
Growth Rates				
From	**To**			
2002 Q4	Sep-03	7.1	7.1	7.1
Sep-03	Dec-03	0.6	0.2	0.2
Sep-03	Mar-04	3.0	2.5	2.5

* This forecast is consistent with nominal GDP and interest rates in the Greenbook forecast.

Appendix: The September FOMC Announcement

Paragraph	**Text**
1. Policy decision	The Federal Open Market Committee decided today to keep its target for the federal funds rate at 1 percent.
2. Rationale	The Committee continues to believe that an accommodative stance of monetary policy, coupled with robust underlying growth in productivity, is providing important ongoing support to economic activity. The evidence accumulated over the intermeeting period confirms that spending is firming, although the labor market has been weakening. Business pricing power and increases in core consumer prices remain muted.
3. Assessment of risks	The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. In contrast, the probability, though minor, of an unwelcome fall in inflation exceeds that of a rise in inflation from its already low level. The Committee judges that, on balance, the risk of inflation becoming undesirably low remains the predominant concern for the foreseeable future. In these circumstances, the Committee believes that policy accommodation can be maintained for a considerable period.
4. Vote	Voting for the FOMC monetary policy action were: Alan Greenspan, Chairman; Ben S. Bernanke; Susan S. Bies; J. Alfred Broaddus, Jr.; Roger W. Ferguson, Jr.; Edward M. Gramlich; Jack Guynn; Donald L. Kohn; Michael H. Moskow; Mark W. Olson; Robert T. Parry; and Jamie B. Stewart, Jr.

SELECTED INTEREST RATES
(percent)

	Short-term						Long-term									
	Federal funds	Treasury bills secondary market			CDs secondary market	Comm. paper	Off-the-run Treasury yields				Indexed yields		Moody's Baa	Municipal Bond Buyer	Conventional home mortgages primary market	
		4-week	3-month	6-month	3-month	1-month	2-year	5-year	10-year	30-year	5-year	10-year			Fixed-rate	ARM
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
02 -- High	1.92	1.82	1.88	2.16	1.98	1.81	3.75	4.99	5.73	6.04	3.33	3.56	8.23	5.67	7.18	5.26
-- Low	1.15	1.07	1.16	1.23	1.31	1.26	1.59	2.72	3.94	4.85	1.54	2.19	7.30	5.02	5.93	4.01
03 -- High	1.45	1.26	1.22	1.28	1.32	1.28	2.04	3.60	4.80	5.61	1.84	2.48	7.48	5.50	6.44	4.06
-- Low	0.86	0.79	0.81	0.82	0.93	0.91	1.09	2.06	3.29	4.37	0.77	1.56	6.01	4.78	5.21	3.45
Monthly																
Oct 02	1.75	1.62	1.61	1.59	1.73	1.72	1.92	3.02	4.25	5.13	1.86	2.44	7.73	5.16	6.11	4.27
Nov 02	1.34	1.26	1.25	1.30	1.39	1.34	1.94	3.13	4.33	5.16	1.99	2.49	7.62	5.25	6.07	4.16
Dec 02	1.24	1.20	1.21	1.27	1.34	1.31	1.84	3.09	4.31	5.12	1.90	2.46	7.45	5.20	6.05	4.12
Jan 03	1.24	1.17	1.19	1.22	1.29	1.25	1.76	3.07	4.30	5.14	1.68	2.32	7.35	5.19	5.92	3.99
Feb 03	1.26	1.20	1.19	1.20	1.27	1.24	1.64	2.92	4.14	5.01	1.28	2.03	7.06	5.15	5.84	3.86
Mar 03	1.25	1.18	1.15	1.16	1.23	1.21	1.59	2.81	4.04	4.98	1.13	1.99	6.95	5.12	5.75	3.76
Apr 03	1.26	1.16	1.15	1.17	1.24	1.22	1.65	2.94	4.16	5.07	1.39	2.21	6.85	5.17	5.81	3.80
May 03	1.26	1.08	1.09	1.10	1.22	1.21	1.41	2.53	3.74	4.70	1.19	1.94	6.38	4.92	5.48	3.66
Jun 03	1.22	0.98	0.94	0.94	1.04	1.06	1.23	2.27	3.51	4.56	0.95	1.75	6.19	4.87	5.23	3.52
Jul 03	1.01	0.89	0.92	0.97	1.05	1.01	1.50	2.84	4.14	5.06	1.33	2.12	6.62	5.14	5.63	3.57
Aug 03	1.03	0.95	0.97	1.05	1.08	1.03	1.89	3.36	4.64	5.46	1.53	2.32	7.01	5.43	6.26	3.79
Sep 03	1.01	0.91	0.96	1.03	1.08	1.02	1.70	3.16	4.45	5.30	1.34	2.19	6.79	5.30	6.15	3.86
Weekly																
Aug 22 03	1.09	0.96	0.97	1.05	1.08	1.04	1.91	3.38	4.66	5.45	1.48	2.27	7.02	5.41	6.28	3.84
Aug 29 03	1.01	0.99	1.00	1.06	1.09	1.02	1.98	3.47	4.68	5.43	1.52	2.30	6.97	5.40	6.32	3.88
Sep 5 03	1.00	0.97	0.97	1.05	1.10	1.04	1.92	3.47	4.71	5.48	1.55	2.33	6.96	5.41	6.44	3.98
Sep 12 03	0.98	0.94	0.96	1.03	1.08	1.01	1.70	3.20	4.51	5.36	1.36	2.21	6.86	5.32	6.16	3.87
Sep 19 03	1.01	0.90	0.95	1.02	1.08	1.02	1.65	3.08	4.40	5.28	1.35	2.19	6.77	5.24	6.01	3.81
Sep 26 03	1.02	0.88	0.95	1.03	1.07	1.01	1.65	3.05	4.33	5.20	1.26	2.12	6.68	5.22	5.98	3.77
Oct 3 03	1.06	0.86	0.95	1.01	1.10	1.01	1.54	2.92	4.21	5.11	1.13	2.02	6.60	5.20	5.77	3.72
Oct 10 03	0.99	0.87	0.92	1.00	1.10	1.02	1.66	3.11	4.42	5.30	1.27	2.14	6.76	5.34	5.95	3.69
Oct 17 03	1.03	0.90	0.93	1.02	1.11	1.01	1.85	3.29	4.58	5.42	1.30	2.17	6.85	5.34	6.05	3.79
Oct 24 03	--	0.92	0.95	1.04	1.11	1.02	1.86	3.26	4.51	5.34	1.30	2.10	--	--	6.05	3.76
Daily																
Oct 7 03	0.98	0.84	0.92	1.01	1.10	1.02	1.67	3.13	4.43	5.30	1.28	2.16	6.76	--	--	--
Oct 8 03	0.99	0.87	0.91	1.00	1.10	1.03	1.65	3.11	4.43	5.32	1.30	2.17	6.78	--	--	--
Oct 9 03	1.02	0.90	0.91	1.00	1.09	1.02	1.69	3.16	4.48	5.36	1.30	2.19	6.82	--	--	--
Oct 10 03	1.00	0.88	0.92	1.00	1.09	1.01	1.67	3.13	4.44	5.33	1.23	2.10	6.77	--	--	--
Oct 13 03	1.00	--	--	--	--	--	--	--	--	--	--	--	--	--	--	--
Oct 14 03	1.08	0.88	0.93	1.01	1.09	1.00	1.73	3.21	4.53	5.41	1.29	2.17	6.85	--	--	--
Oct 15 03	1.09	0.90	0.93	1.01	1.10	1.00	1.80	3.27	4.58	5.44	1.32	2.20	6.87	--	--	--
Oct 16 03	1.04	0.90	0.93	1.03	1.11	1.02	1.96	3.38	4.64	5.45	1.29	2.17	6.87	--	--	--
Oct 17 03	0.98	0.90	0.93	1.02	1.12	1.02	1.90	3.32	4.57	5.41	1.29	2.14	6.79	--	--	--
Oct 20 03	1.02	0.90	0.95	1.04	1.12	1.03	1.90	3.32	4.56	5.38	1.30	2.12	6.77	--	--	--
Oct 21 03	0.99	0.92	0.93	1.04	1.11	1.02	1.89	3.29	4.54	5.37	1.32	2.13	6.77	--	--	--
Oct 22 03	0.99	0.92	0.96	1.03	1.11	1.02	1.82	3.20	4.44	5.30	1.28	2.07	6.72	--	--	--
Oct 23 03	--	0.92	0.96	1.03	1.11	--	1.85	3.24	4.49	5.33	1.27	2.04	--	--	--	--

NOTE: Weekly data for columns 1 through 13 are week-ending averages. Columns 2 through 4 are on a coupon equivalent basis. Data in column 6 are interpolated from data on certain commercial paper trades settled by the Depository Trust Company. Column 14 is the Bond Buyer revenue index, which is a 1-day quote for Thursday. Column 15 is the average contract rate on new commitments for fixed-rate mortgages (FRMs) with 80 percent loan-to-value ratios at major institutional lenders. Column 16 is the average initial contract rate on new commitments for 1-year, adjustable-rate mortgages (ARMs) at major institutional lenders offering both FRMs and ARMs with the same number of discount points.

Money Aggregates

Seasonally adjusted

Period	M1	M2	nontransactions components: In M2	nontransactions components: In M3 only	M3
	1	2	3	4	5
Annual growth rates(%):					
Annually (Q4 to Q4)					
2000	-1.7	6.1	8.5	17.3	9.2
2001	6.8	10.2	11.2	18.5	12.7
2002	3.2	6.8	7.7	5.5	6.4
Quarterly(average)					
2002-Q4	4.9	7.0	7.6	9.5	7.8
2003-Q1	7.5	6.4	6.0	3.9	5.6
Q2	9.2	8.4	8.2	1.8	6.3
Q3 p	8.9	8.6	8.6	12.1	9.7
Monthly					
2002-Sep.	6.8	5.4	5.1	7.2	6.0
Oct.	11.5	8.0	7.1	-12.0	1.6
Nov.	-0.4	8.3	10.7	38.1	17.7
Dec.	8.2	3.2	1.9	17.9	7.9
2003-Jan.	2.6	6.0	6.8	-12.7	0.0
Feb.	20.2	10.9	8.5	-2.8	6.5
Mar.	3.5	2.5	2.3	6.4	3.7
Apr.	0.4	4.6	5.8	-2.2	2.5
May	20.3	17.8	17.2	2.2	12.9
June	13.3	9.5	8.5	8.2	9.1
July	5.5	9.7	10.9	34.9*	17.6*
Aug.	7.3	8.1	8.2	-7.6	3.1
Sep. p	2.0	-4.8	-6.6	0.2	-3.2
Levels ($billions):					
Monthly					
2003-May	1258.3	5996.2	4737.9	2709.9	8706.0
June	1272.2	6043.6	4771.4	2728.5	8772.1
July	1278.0	6092.7	4814.7	2807.8†	8900.5†
Aug.	1285.8	6133.6	4847.8	2790.1†	8923.6†
Sep. p	1287.9	6109.1	4821.2	2790.6†	8899.7†
Weekly					
2003-Sep. 1	1277.5	6122.1	4844.6	2765.9†	8888.0†
8	1277.3	6119.1	4841.8	2782.2†	8901.3†
15	1284.0	6116.0	4832.0	2803.8†	8919.8†
22	1294.3	6106.6	4812.3	2788.5†	8895.1†
29	1290.5	6092.6	4802.2	2796.2†	8888.8†
Oct. 6p	1289.7	6087.1	4797.4	2763.0†	8850.1†
13p	1271.3	6082.9	4811.6	2753.1†	8835.9†

p preliminary
* FIN 46-adjusted growth rates for non-M2 M3 and M3 in July are 12.9 and 10.7, respectively. FIN 46 has had no material impact on M2 as yet.
† As of July 7, includes $50 billion due to FIN 46 effects.

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Class II FOMC

Changes in System Holdings of Securities [1]
(Millions of dollars, not seasonally adjusted)

October 23, 2003

	Treasury Bills			Treasury Coupons						Federal Agency	Net change total outright holdings [4]	Net RPs [5]		
	Net Purchases [2]	Redemptions (-)	Net Change	Net Purchases [3] < 1	1-5	5-10	Over 10	Redemptions (-)	Net Change	Redemptions (-)		Short-Term [6]	Long-Term [7]	Net Change
2000	8,676	24,522	-15,846	8,809	14,482	5,871	5,833	3,779	31,215	51	15,318	-2,163	7,133	4,970
2001	15,503	10,095	5,408	15,663	22,814	6,003	8,531	16,802	36,208	120	41,496	3,492	636	4,128
2002	21,421	---	21,421	12,720	12,748	5,074	2,280	---	32,822	---	54,242	-5,366	517	-4,850
2002 QIII	6,117	---	6,117	2,835	3,676	1,318	143	---	7,972	---	14,089	-3,067	-5,225	-8,291
QIV	250	---	250	---	339	314	---	---	653	---	903	4,892	-304	4,588
2003 QI	6,024	---	6,024	1,796	2,837	1,291	50	---	5,974	---	11,998	1,957	3,770	5,727
QII	6,259	---	6,259	2,209	1,790	234	---	---	4,232	---	10,491	-2,578	1,056	-1,522
QIII	2,568	---	2,568	---	---	1,232	150	---	1,382	---	3,950	1,712	-554	1,158
2003 Feb	4,161	---	4,161	478	2,127	769	---	---	3,374	---	7,534	1,736	-2,262	-526
Mar	1,863	---	1,863	1,318	710	522	50	---	2,600	---	4,463	-2,254	520	-1,734
Apr	3,543	---	3,543	1,422	733	---	---	---	2,155	---	5,699	-265	816	551
May	1,684	---	1,684	786	1,057	234	---	---	2,077	---	3,761	-515	346	-170
Jun	1,032	---	1,032	---	---	---	---	---	---	---	1,032	-3,302	1,354	-1,948
Jul	808	---	808	---	---	---	---	---	---	---	808	2,486	-1,548	938
Aug	981	---	981	---	---	---	---	---	---	---	981	3,195	-935	2,259
Sep	780	---	780	---	---	1,232	150	---	1,382	---	2,162	-1,562	1,817	256
2003 Jul 30	34	---	34	---	---	---	---	---	---	---	34	-632	-3,000	-3,632
Aug 6	166	---	166	---	---	---	---	---	---	---	166	4,612	-2,000	2,612
Aug 13	250	---	250	---	---	---	---	---	---	---	250	-5,438	---	-5,438
Aug 20	235	---	235	---	---	---	---	---	---	---	235	11,850	4,000	15,850
Aug 27	152	---	152	---	---	---	---	---	---	---	152	-11,581	3,000	-8,581
Sep 3	257	---	257	---	---	---	---	---	---	---	257	8,022	1,000	9,022
Sep 10	235	---	235	---	---	1,232	150	---	1,382	---	1,617	-9,930	-1,000	-10,930
Sep 17	347	---	347	---	---	---	---	---	---	---	347	5,972	-2,000	3,972
Sep 24	47	---	47	---	---	---	---	---	---	---	47	-4,707	-1,000	-5,707
Oct 1	187	---	187	---	---	---	---	---	---	---	187	8,983	---	8,983
Oct 8	71	---	71	---	---	---	---	---	---	---	71	-8,795	-2,000	-10,795
Oct 15	207	---	207	---	---	---	---	---	---	---	207	6,370	1,000	7,370
Oct 22	252	---	252	---	---	---	---	---	---	---	252	-5,360	4,000	-1,360
2003 Oct 23	---	---	---	---	462	280	---	---	742	---	742	-14	---	-14
Intermeeting Period														
Sep 16-Oct 23	922	---	922	---	462	280	---	---	742	---	1,664	-6,234	2,000	-4,234
Memo: LEVEL (bil. $)														
Oct 23			242.1	108.9	177.4	52.0	77.1		415.4	0.0	657.5	-12.6	20.0	7.4

1. Change from end-of-period to end-of-period. Excludes changes in compensation for the effects of inflation on the principal of inflation-indexed securities.
2. Outright purchases less outright sales (in market and with foreign accounts).
3. Outright purchases less outright sales (in market and with foreign accounts). Includes short-term notes acquired in exchange for maturing bills. Excludes maturity shifts and rollovers of maturing issues, except the rollover of inflation compensation.
4. Includes redemptions (-) of Treasury and agency securities.
5. RPs outstanding less reverse RPs.
6. Original maturity of 13 days or less.
7. Original maturity of 14 to 90 days.

MRA:HAW