

**Meeting of the Federal Open Market Committee on  
September 16, 2008**

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, September 16, 2008, at 8:30 a.m. Those present were the following:

Mr. Bernanke, Chairman  
Ms. Duke  
Mr. Fisher  
Mr. Kohn  
Mr. Kroszner  
Ms. Pianalto  
Mr. Plosser  
Mr. Stern  
Mr. Warsh

Ms. Cumming, Messrs. Evans, Lacker, and Lockhart, and Ms. Yellen, Alternate Members of the Federal Open Market Committee

Messrs. Bullard, Hoenig, and Rosengren, Presidents of the Federal Reserve Banks of St. Louis, Kansas City, and Boston, respectively

Mr. Madigan, Secretary and Economist  
Ms. Danker, Deputy Secretary  
Mr. Skidmore, Assistant Secretary  
Ms. Smith, Assistant Secretary  
Mr. Alvarez, General Counsel  
Mr. Sheets, Economist  
Mr. Stockton, Economist

Messrs. Connors, English, Kamin, Rolnick, Rosenblum, Slifman, Tracy, and Wilcox, Associate Economists

Mr. Dudley, Manager, System Open Market Account

Mr. Cole, Director, Division of Banking Supervision and Regulation, Board of Governors

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

Mr. Parkinson, Deputy Director, Division of Research and Statistics, Board of Governors

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

Mr. Struckmeyer, Deputy Staff Director, Office of Staff Director for Management, Board of Governors

Mr. Gagnon, Visiting Associate Director, Division of Monetary Affairs, Board of Governors

Messrs. Reifschneider and Wascher, Associate Directors, Division of Research and Statistics, Board of Governors

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

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Carlson, Economist, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors

Mr. Moore, First Vice President, Federal Reserve Bank of San Francisco

Mr. Judd, Executive Vice President, Federal Reserve Bank of San Francisco

Mr. Altig, Ms. Baum, Messrs. Rasche, Schweitzer, Sellon, and Tootell, Senior Vice Presidents, Federal Reserve Banks of Atlanta, New York, St. Louis, Cleveland, Kansas City, and Boston, respectively

Mr. Krane, Vice President, Federal Reserve Bank of Chicago

Mr. Chatterjee, Senior Economic Adviser, Federal Reserve Bank of Philadelphia

Mr. Wolman, Senior Economist, Federal Reserve Bank of Richmond

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CHAIRMAN BERNANKE. Good morning, everybody. Sorry for the late beginning. The markets are continuing to experience very significant stresses this morning, and there are increasing concerns about the insurance company AIG. That is the reason that Vice Chairman Geithner is not attending, and Chris Cumming will sit in his place.

I want to turn in a minute to Bill Dudley for his usual report, and he will be able to give you more information about the situation. There is another action item I would like to add, given what is happening, which is that there are very significant problems with dollar funding in other jurisdictions—in Europe and elsewhere. After Bill makes his presentation and we have our discussion, I would like to put on the table a request for authorization for swap lines. I prefer not to put a limit on it, so I know I've got my own bazooka here. [Laughter] There is a Foreign Currency Subcommittee that consists of myself, the Vice Chairman of the FOMC, and the Vice Chairman of the Board. Again, after Bill's discussion, I would like to discuss the possibility of giving us a temporary authority to use swap lines as needed.

Before I turn to Bill, let me say one other thing. Obviously, we started late. We have a lot to talk about. I would like—just for today, if you would indulge me—to condense our discussion to one round. In your discussion, please include your tentative views on the policy decision. Obviously, that is not ideal because you will not have heard everyone else's views, but we will have an opportunity afterward for people to amend, revise, and give additional thoughts. But in the interest of time, I think it would be more efficient at this time just to do it that way. Without further ado, let me turn to Bill and ask for a report.

MR. DUDLEY. Thank you, Mr. Chairman. I am not going to go through this in great detail. You can look at these charts at your leisure.<sup>1</sup> I am going to focus on

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<sup>1</sup> The materials to which Mr. Dudley refers are appended to this transcript (appendix 1).

what is going on right now, how we have responded to it, and what I think the issues are. Just to give you a snapshot of what has happened since Sunday evening, stocks are down worldwide—4 percent plus everywhere. Yesterday, the U.S. stock market was down about 4½ percent, and S&P futures indicate a lower opening today. As you might expect, there has been a big flight to quality, especially into the Treasury bill market. Ten-year Treasury note yields fell about 30 basis points yesterday, and there has been a big rally throughout the Treasury curve. The big thing, where there has probably been the most severe stress in the market, is in dollar liquidity for foreign banks. As you remember, foreign banks, especially in Europe, have a structural dollar funding shortfall, and they look to execute foreign exchange swaps or borrow in the dollar LIBOR market to fund that. There was significant upward pressure in that market—overnight LIBOR rates today were 6.44 percent—and that pressure in Europe is leaking over into our market. Yesterday the federal funds rate opened at 3 to 3½ percent. Despite our doing a \$20 billion repo at our normal 9:30 a.m. time, the upward pressure on the funds rate yesterday continued. It rose to as high as 6 percent in the late morning, and that is why we came in with a second operation of \$50 billion around noon yesterday.

To try to have more effect on this issue, this morning we came in much earlier than we normally do—around 8:00 a.m. We did a \$50 billion overnight repo. The funds rate at the time was trading at 3¼ percent. I think this means that we are obviously adding way too many reserves for the current maintenance period; but the good news is that, when this maintenance period is over a week from tomorrow, we get a fresh start. So at the current time I think we will see essentially a lot of firmness in the funds rate in the morning and then the funds rate trading down to zero late in the day. Where the funds rate averages relative to the target is going to be somewhat difficult to say. Yesterday, despite the collapse in the funds rate to essentially zero at the end of the day, the funds rate was quite firm relative to the target. I don't remember the numbers, but it was in the 2½ percent range. We are going to try to hit the target on average, but it is going to be very difficult. In the current circumstances, it probably is more sensible—at least my advice would be—to err on the side of providing enough liquidity to the market rather than trying to be cute and worrying just about the target federal funds rate.

Now, the Lehman filing has also intensified the pressure on Morgan Stanley and Goldman Sachs in a number of respects. The Lehman failure means that investors now view the debt of Morgan Stanley and Goldman Sachs as having much more risk than it did on Sunday. This means that these firms need bigger liquidity buffers than they had before, and it does have implications for long-term profitability. As a consequence, their share prices fell very sharply yesterday. Morgan Stanley was down about \$5 a share, to \$32, and Goldman Sachs's stock was off 18 points, to \$135. Morgan Stanley experienced a modest, but not insignificant, pulling back of their counterparties and ate into their liquidity buffer by a measurable degree. The Lehman problems also were evident in some other areas. This is very incomplete, but the ones that came to my attention were money market funds—especially, the Reserve Fund that had large withdrawals, and they encountered a significant liquidity

problem. I am actually not sure how that was resolved, but I think that State Street was in the situation of having to cover a very large shortfall of the Reserve Fund last night. The risk here, of course, is that, if AIG were to fail, money funds have even a broader exposure to them than to Lehman, and so breaking the buck on the money market funds is a real risk. The capital resources of the entities that are associated with the money market funds often are quite modest, so their ability to top up the money funds and keep them whole is quite limited. Thus the money market funds are definitely one important issue in how this contagion could be broader.

The second issue is the people who are dealing with Lehman and who have positions with Lehman as their counterparty and how they wind up those positions. As you know, the parent filed for bankruptcy, but the U.S. broker-dealer is still in operation. But being in operation doesn't mean that they are necessarily conducting business in a normal way. One issue that has received a lot of attention is from some of the asset managers on their mortgage TBA positions with Lehman. Apparently, the sell side can net these up pretty easily through the FICC (Fixed Income Clearing Corporation), but the asset managers have positions with Lehman to either take on mortgage-backed securities or to sell mortgage-backed securities on a forward basis, and they are not really sure what those positions are going to be when we get to that date. Lehman was not executing those trades yesterday, and so these asset managers are in the very unfortunate position of not knowing what to do. Do they offset their Lehman position with a trade elsewhere or not? So that has been another very open-ended issue for the market. In terms of market function yesterday, it was manageable in the sense that markets did trade. But I think it is much too soon to think that we are going to make it through just based on yesterday's move because that move, even though it wasn't particularly severe in terms of, for example, the share price movement, did cause quite a bit of damage, and people are still pulling away.

Of course, we also have the issue of AIG. The AIG problem is at least starting as a liquidity crisis. The problem with AIG is that the parent company doesn't have a lot of liquidity resources and doesn't have easy ability to funnel liquidity up from their subsidiaries because most of the subsidiaries are regulated entities. So AIG is running into two problems: One, they are unable to roll their commercial paper and, two, as their ratings are downgraded—they were downgraded by Moody's yesterday, I think from AA minus to A minus, but don't quote me on that—they have to post a lot more collateral against their derivatives exposures and also with respect to their GIC (guaranteed investment contract) business. So AIG is in a situation in which the parent is basically going to run out of money—today, tomorrow, Thursday, or very, very soon. Now we say it's a liquidity thing, but a lot of times when people look closer at the books they find out that the liquidity crisis may also be a solvency issue. I think it is still a little unclear whether AIG's problems are confined just to liquidity. It also may be an issue of how much this company is really worth.

Finally, let me talk a bit about the facilities that we introduced over the weekend. Basically, we did two things. We broadened the Primary Dealer Credit Facility (PDCF) significantly in terms of collateral eligibility. Whereas, before, the PDCF

took investment-grade securities only, we broadened it to include basically everything that is in the tri-party repo system. We felt that, by backstopping the tri-party repo system completely, we would reassure tri-party investors that they didn't face rollover risk, and so we would keep tri-party investors investing with the banks. That seems to be mostly what happened, at least yesterday. We did get quite a bit of PDCF borrowing yesterday evening, but it was predominantly Lehman. It was about \$28 billion of Lehman borrowing. I think the total borrowing was something on the order of \$42 billion. That is telling you that most of the borrowing we had was associated with Lehman's not being able to roll over their tri-party repo positions with their investors. We don't really know the reasons for the other borrowing, but it probably was mostly to test the facility as opposed to actual need. So broadening the PDCF collateral eligibility does seem to be working, so far at least, in keeping tri-party investors in the game and continuing to provide funds to the other primary dealers.

The second thing we did was to the Term Securities Lending Facility (TSLF). In terms of the collateral requirements, that had been AAA-rated RMBS, CMBS, and asset-backed securities. We broadened that collateral, so the terms are now the same as the old Primary Dealer Credit Facility. We think that there is quite a bit of collateral that the primary dealers have in those AA, A, and BBB classes of asset-backed securities, CMBS, and RMBS. So we think that is going to provide more support to the primary dealers in terms of funding their liquid collateral in this environment. We also increased the size. The original authorization was for \$200 billion. Our auction schedule had been \$175 billion, and we put that \$25 billion increase into schedule 2. Remember, there are schedules 1 and 2. Schedule 1 is Treasuries and agencies. Schedule 2 is Treasuries, agencies, and this other stuff. So the schedule 2 auctions are going to go up in size, and we frontloaded that increase because the TSLF has not been fully subscribed. We are actually going to be able to do two TSLF schedule 2 auctions this week of \$35 billion, so we are going to get quite a bit of TSLF liquidity into the market this week, which we think will also be helpful.

So that is where things stand. Otherwise, I think things in the market are doing what you would expect. There is a flight to quality. The Japanese yen and the Swiss franc are outperforming. The dollar is sort of in the middle, and the high-yielding currencies continue to be under pressure. But that is just what we have seen for the last year underlying these risk trades. I have a lot more material, so if you ask questions I can get into that. But I think I will just leave it there.

CHAIRMAN BERNANKE. Questions for Bill? President Rosengren.

MR. ROSENGREN. Just an amplification on the State Street situation. My understanding is that no money actually went out. There was \$20 billion in withdrawals that came in late in the day. They had a \$7½ billion credit line. State Street had enough collateral to

do \$7½ billion. They were unwilling to do \$20 billion. They asked us what our position was, and we told them that they needed to make their own business decision in this case. I haven't heard what has happened this morning. I assume that they are scrambling for funds. But I would emphasize that a real concern is that there will be a run this week on money market funds because they may have to freeze the funds. It is possible that they will break the buck, and this will be at organizations that don't have sufficient capital to make people whole. So I think that is a real concern.

CHAIRMAN BERNANKE. President Plosser.

MR. PLOSSER. Just a question on the PDCF, about the expansion of the collateral base. You said there was \$42 billion, \$28 billion of it was Lehman. Do we know what kind of collateral Lehman posted? Did they actually make use of the expanded options or not? What was the nature of it, do you know?

MR. DUDLEY. That was not actually even known until late yesterday evening. It takes a while for us to get the reports from the clearing bank to be able to go through and tell you what the collateral is. In terms of the Lehman collateral, they are not allowed to broaden the PDCF—they are basically bringing us the stuff they had on Friday. It is also important to recognize that for Lehman we are demanding a lot higher collateral requirements on the non-Treasury and non-agency securities. Their collateral haircut for those is 20 percent. So the Fed is taking some credit exposure there, but we put in place on Friday—and we are continuing that—a 20 percent collateral haircut on the non-Treasury and non-agency stuff that is in the PDCF for that exposure to Lehman. We think that's about roughly three times the market level that investors had been charging previously, so I think that gives us a fair degree of protection.

CHAIRMAN BERNANKE. President Lacker.

MR. LACKER. Thank you, Mr. Chairman. The higher collateral requirement, is that just Lehman?

MR. DUDLEY. At this time, I believe that is right.

MR. LACKER. Okay. I know there was a lot of concern going in yesterday about the tri-party repo market, and I envisioned two scenarios and anything in between them. One is tri-party lenders pulling away from particular names and moving their funds to other names. Another, at the other extreme, would be tri-party repo lenders pulling away from the market as a whole. If you look at the tri-party repo market from the point of view of the borrowers, that is a frightening scenario. Then the lenders are going to do something with that money. I have been curious about what they would do. My understanding is that cash balances, in essentially deposit accounts, piled up at State Street and BONY yesterday and that they were able to do tri-party repos with some institutions that had been pulled away from. Is that a valid observation? What are the prospects for that providing some kind of resilience for the tri-party market?

MR. DUDLEY. Well, I guess the first thing I would say is that you are absolutely right. If investors pull away, they have to take their money somewhere. It doesn't disappear. I think that the Primary Dealer Credit Facility has been shown to be pretty significant in providing support to this market. If you look at what happened to Lehman, for example, even though Lehman was under extreme pressure on Friday, the tri-party repo investors stayed with Lehman on Friday night, which actually surprised me. I think the reason that they stayed is that they knew they didn't really have a lot of rollover risk. As long as the broker-dealer didn't file for bankruptcy over the weekend—and that was the risk they really were taking—the Federal Reserve and the PDCF would be there as the tri-party repo investor of last resort. Lehman's experience suggests to me that, if we can contain the broad parameters of this crisis so that it



doesn't spread much further, then we can keep the tri-party repo investors from bolting because they don't really have a huge amount of risk as long as we are there behind them to take them out when their overnight obligation comes due the next day.

MR. LACKER. So, if I can just follow up, my understanding is that tri-party repos are exempt from the automatic stay, so it is not filing per se that is the risk. It's the risk that they don't have the cash, right?

MR. DUDLEY. Well, I'm not sure about that. I thought that there was an issue about broker-dealer filing. I know that the clearing banks are certainly quite nervous about that eventuality, but I'm not a lawyer.

MR. PARKINSON. The repos are exempt from the automatic stay provisions of the bankruptcy code. But if Lehman had gone into SIPA liquidation, they could have been subject to a SIPA stay.

MR. LACKER. All right. Then a question about the TSLF. Is it this program in which we provide Treasuries?

MR. DUDLEY. We give them Treasuries, and they give us other stuff. You know, this will also probably be helpful this week in providing more Treasuries to the market. There was a tremendous amount of Treasury fails yesterday. So this mechanism does two things. It takes illiquid collateral from the dealers, and it also supplies a lot of Treasuries to the market, which should help improve the market function in Treasuries.

CHAIRMAN BERNANKE. Other questions? Bill, would you be able to talk a bit about the need for swaps?

MR. DUDLEY. I have just sketchy details based on a phone call, so this may not be quite right. But my understanding is that this morning Norway put in place a facility by which

they are going to offer their banks dollars, up to \$5 billion, on a one-week term—sort of an open facility. The fact that Norway is doing this suggests that the situation has broadened quite a bit further because this is the first time that we have heard about Norway in this story, except for maybe some exposures to the Icelandic banks.

I have had some conversations with my counterparts at the ECB this morning—this is at a staff level, so I can't really say what would happen if you were to take this up the chain of command. But certainly, at least on a preliminary basis, there is quite a bit of interest in having a similar facility for the ECB, which would not be a TAF loan type of facility but more of an open facility where European banks could come and get dollars. This would reassure people that dollar liquidity was available in Europe throughout the European day. My advice to you is that this is probably a good idea in this environment because we are seeing that the lack of dollar liquidity in Europe is really having a feedback effect on people's willingness to do business with one other in the broader markets. I think we should be open to doing this with the ECB and perhaps with the Bank of England and the Bank of Japan as well—at least have the ability to do it should it prove necessary.

CHAIRMAN BERNANKE. You had a two-hander, Governor Kohn?

MR. KOHN. Just to note that we did have a discussion of foreign exchange swaps in the Committee on the Global Financial System a week and a half ago, and the general consensus was that these had been very handy in damping pressures in money markets—dollar funding markets in particular—when the foreign exchange swap market isn't working very well in Europe and in Switzerland. The central banks around the table, which are all the major central banks, are quite supportive of expanding the facility. We were talking about putting something on a standby

basis for use in situations just like this. So the other central banks view this as very helpful to them in containing pressures in their own markets.

MR. DUDLEY. The Bank of Japan has requested at the staff level to set up a facility that would be on the shelf for year-end because the Japanese are quite worried that their banks are going to face a dollar funding problem at year-end. Now, this preceded the recent crisis, so even before this last week they were concerned that the Japanese banks could potentially have problems, and they were interested in exploring with us having a facility in place. We were actually going to pursue this, and I hope we will have more at the October FOMC meeting if not sooner.

CHAIRMAN BERNANKE. Bill, if we were going to take action today, what would you recommend in terms of counterparties? Should we say an unlimited amount? Should we specify an amount? Can we leave the time open? What are your recommendations on all those dimensions?

MR. DUDLEY. Certainly you want to make it pretty broad. You want to make it to the Bank of England, Switzerland, the ECB, the Bank of Japan, potentially Canada. I would leave it to their discretion if they would like to participate. I would make the offer to them; and if they want to participate, then we should be willing to do that. In terms of size, I think it is really important that you don't create notions of capacity limits because the market then can always try to test those. Either the numbers have to be very, very large, or it should be open ended. I would suggest that open ended is better because then you really do provide a backstop for the entire market. As we've seen with the PDCF, if you provide a suitably broad backstop, oftentimes you don't even actually need to use it to any great degree. So I think that should be the strategy here.

CHAIRMAN BERNANKE. President Lacker.

MR. LACKER. Remind me again how big the European system of central banks' own outright holdings of dollar balances are.

MR. DUDLEY. European banks?

MR. LACKER. Yes.

MR. DUDLEY. I don't know.

MR. LACKER. Central banks.

MR. DUDLEY. Do you mean in terms of their dollar foreign exchange reserves?

MR. LACKER. Right. The ECB—they all have their own dollar reserves.

MR. DUDLEY. I don't have the numbers.

MR. SHEETS. I believe that number is about \$180 billion of dollar reserves in the euro system. The ECB itself has control of only a fraction of that.

MR. LACKER. These are held at individual national central banks, so our swap lines to them aren't approaching that level yet, right?

MR. DUDLEY. No.

MR. LACKER. Note here a sense of discomfort with our lending them dollars that they already have and so our serving as a substitute for their mobilizing their own dollar reserves for this purpose. Obviously, the demand could swamp their own reserves, and at that point I would feel differently about this. But my understanding is that the distribution within the European system of central banks is uneven, and in some sense this just provides them with a way to circumvent negotiating how those dollars would be distributed from different central banks to different private-sector banks within their own system. Broadly, I'm uncomfortable with our playing that role.

CHAIRMAN BERNANKE. Whether it's sensible or not, the ECB has made a pretty strong distinction with us between their foreign exchange reserves and their dollars that they use in these operations. They really want to keep those segregated. They want, to some extent, to represent this as being a collaborative effort with the United States as opposed to something they are taking on their own behalf. From their perspective—actually President Poole raised the same issue earlier on, and we had this discussion—they seem to put a lot of value on having a distinct swap line, which symbolizes the cooperation and coordination of the two central banks as opposed simply to using their own reserves. President Fisher.

MR. FISHER. Mr. Chairman, I was going to say that we had this discussion before. We did approve the swap lines. I wonder if you could just summarize for us what you view as the downside risk to our doing this.

CHAIRMAN BERNANKE. Well, I don't think there are any significant downside risks. There are operational issues that Bill Dudley and his team have to worry about. If we extend funds to the Europeans, which they then relay to their banks, it affects our reserve positions and affects the management of the federal funds rate and requires sterilization. That's an operational issue. I suppose, if there were really very large draws, it would begin to affect some of these balance sheet constraint concerns that we have. I think that is not an entirely separate issue, but it is certainly one that we are looking at in terms of trying to get interest on reserves and those other kinds of measures.

Again, my expectation is that having the facility would in part provide some confidence over and above how much we actually extend. So I guess the operational issues and the further draw on the balance sheet would be the downside, but to me, it seems to be a relatively

straightforward step—one we've done in the past and one that has the additional benefit of indicating global cooperation on these issues.

MR. DUDLEY. In principle, we could talk to the ECB and other central banks about having the rate on these swap lines be at a slight penalty relative to normal times to try to mitigate the potential reserve impact. I mean, it doesn't have to be at 2 percent or 2¼ percent for overnight funds—it could be somewhat north of that. But if we have a credible backstop, then it should calm the markets, and then the backstop should not be used. If we have a backstop and it actually is used, that is presumably because market conditions are horrific. So in that environment, you could argue that the reserve-management things are very second order concerns in some sense.

CHAIRMAN BERNANKE. Other comments? All right. Then I'd like to propose that the FOMC delegate to the Foreign Currency Subcommittee an unspecified authority, in terms of amount, to offer swaps to foreign central banks as needed to address liquidity pressures in those other jurisdictions. Those decisions will be made, again, by the Foreign Currency Subcommittee in consultation with the Open Market Desk. We would keep the FOMC closely informed, and we would revisit and discuss this issue again in October. Is that an acceptable resolution? Any amendments to that? Further discussion, comments, or concerns? President Stern.

MR. STERN. Yes. I am in favor of this. I just wonder how the marketplace will look at the open-ended nature of this because typically we have dollar magnitudes associated with swaps. It may all go relatively smoothly; on the other hand, it may raise questions about exactly what we think the issues are here.

MR. DUDLEY. Well, I think we are going to have discussions with our foreign counterparts to decide what the right strategy is. I think right now it is better to have it open ended.

MR. STERN. That's fine.

CHAIRMAN BERNANKE. Why don't we have discussions with our counterparties—we won't announce anything today, I would assume?

MR. DUDLEY. No, I think they have to take it up the chain of command, just as we do here. So it's going to take probably a day.

MR. KOHN. This would come out in the minutes for this meeting.

CHAIRMAN BERNANKE. Right. We'll announce something.

MR. STERN. But I assume there will be an announcement at some point.

CHAIRMAN BERNANKE. Of course. When would we announce this measure?

MR. DUDLEY. I think it would be after we've had a chance—I mean, I think we have a lot of work to do with our foreign counterparties. This was basically raised to me this morning.

CHAIRMAN BERNANKE. All right. So this is all conditional on agreements and discussions with other counterparties. We will come up with a joint communication announcement strategy. President Plosser.

MR. PLOSSER. I just have one clarification. I have no basic objection to this. I wonder whether or not, if the FOMC is going to delegate the decision to this group, it is sort of an open-ended delegation to do this on an ongoing basis. Does it make sense to define a period of time for which this open-ended delegation is appropriate—that it would expire and would have to be renewed?

MR. DUDLEY. Yes. We have authorities extending right now to January 30 for a lot of these facilities, so that would certainly be a reasonable time frame, I think.

CHAIRMAN BERNANKE. Existing facilities go to January 31, is that right?

MR. MADIGAN. January 30.

CHAIRMAN BERNANKE. January 30. Would that be acceptable?

MR. PLOSSER. Yes. I think it ought to have a termination point so that, if we wanted to renew it, we would be free to do so, but it wouldn't last forever.

CHAIRMAN BERNANKE. Of course.

MR. KOHN. One more clarification, Mr. Chairman—this is intended for G-10 central banks, to include the ECB. Just to be clear, if somebody asks, this is not to give to central banks of emerging-market economies.

MR. DUDLEY. I presume so.

MR. KOHN. I think we should presume so. If the other were to happen, we would come back to the Committee.

MR. DUDLEY. Yes, this is about the major financial centers and the ability of large banks that operate globally to obtain dollar funding.

CHAIRMAN BERNANKE. Okay. So I amend the proposal to terminate on January 30. President Lacker.

MR. LACKER. Could I hear a little more about the benefits of an open-ended commitment? All of our programs have been capped at a certain size. You said something about "test the limits," and it makes me think of foreign exchange regimes. What kind of scenario do you have in mind?



MR. DUDLEY. I think a lot of the programs that we have are actually open ended. The discount window is open ended in the sense that it's limited only by the amount of collateral that the banks post there. The Primary Dealer Credit Facility is open ended in that it is limited only by the size of the tri-party repo system. My point here is that, if foreign banks worry about capacity limits, even having a large program could in principle not be sufficient in extremis. But if the program is open ended, the rollover risk problem goes away. If I lend you more dollars today, I don't have to worry about getting those dollars back because I always know that the facility is there. So it's really the elimination of the ability to flatten out your position if you need to in terms of your dollar exposures.

CHAIRMAN BERNANKE. It's not open ended in the sense that it is not an open window that anybody can come to and take. It just gives us the authority to adjust the amount.

MR. LACKER. So you will set a definite amount?

CHAIRMAN BERNANKE. We will certainly negotiate with the other central banks and tell them what we're doing now. But we want to have the flexibility in case of an emergency to respond, and we also don't want to communicate to the markets somehow that we have a hard limit that is not going to be changed. That would be potentially bad for confidence.

MR. LACKER. But we will communicate a program size?

MR. DUDLEY. I think that remains to be discussed with our counterparties. I think we need to have discussions about what would be most effective. Would a big size that's fixed in quantity be most effective? Would an open limit be most effective? I think we have to have those discussions. I think the important thing here—and what we're going for—is credibility. In a crisis you need enough force—more force than the market thinks is necessary to solve the problem—and we're going to have to have discussions to determine how much is enough force.

CHAIRMAN BERNANKE. I think it is mostly a communication issue. Anything else?

All right. Do you want to call the roll on this one?

MR. KOHN. So move.

CHAIRMAN BERNANKE. We need a second.

MR. FISHER. Second.

CHAIRMAN BERNANKE. All right. Thank you.

MR. PLOSSER. Can we read the resolution?

CHAIRMAN BERNANKE. The resolution is to provide to the Foreign Currency Subcommittee the authority to enter into swap agreements with the foreign central banks as needed to address strains in money markets in other jurisdictions. This will be done in cooperation with the Open Market Desk and in consultation with those other central banks. The amounts are unlimited in principle, but the decisions will be made by the Foreign Currency Subcommittee as needed and as appropriate for the particular circumstances. The FOMC is providing this authority through January 30. It will, of course, be open to discussion at any meeting.

MR. PLOSSER. As actions are taken, presumably you'll circulate the outcomes of these decisions to this Committee in advance of any announcements?.

CHAIRMAN BERNANKE. Of course. All right. Let's take a vote.

MS. DANKER.

Chairman Bernanke	Yes
First Vice President Cumming	Yes
Governor Duke	Yes
President Fisher	Yes
Governor Kohn	Yes
Governor Kroszner	Yes
President Pianalto	Yes
President Plosser	Yes
President Stern	Yes
Governor Warsh	Yes

CHAIRMAN BERNANKE. Thank you. Brian, have you circulated the statement?

MR. MADIGAN. Yes, Mr. Chairman. Everybody should have it.

CHAIRMAN BERNANKE. Has everyone a copy of that? Good. Before we get started on that, I just want to comment that we may want to say something in the statement about financial conditions, but we'll come back to that later. We need also now a vote to ratify the domestic open market operations.

MR. KOHN. So move.

CHAIRMAN BERNANKE. Any objections? Okay. Thank you. Let's turn now to the economic situation. Dave Stockton and Nathan Sheets.

MR. STOCKTON. Thank you, Mr. Chairman. In response to your request for some economy in our remarks this morning, I'm going to set aside my prepared remarks and just hit some of the highlights here. We did receive a great deal of macroeconomic data since we closed the Greenbook last Wednesday. We didn't seem to get any of it right, but it all netted out to just about nothing. [Laughter] Retail sales came in considerably weaker than we had anticipated, enough by themselves to have knocked about ½ percentage point off third-quarter GDP growth. But some of that was offset in higher retail inventories, and the rest was offset by a stronger-than-expected merchandise trade report for July. It all left us still feeling very comfortable with our forecast because it looks to us as though economic growth is going to drop below 1 percent on average in the second half of the year.

In terms of the things that really have stood out over the intermeeting period, at least to my mind, one has been the weakness in consumption. As I indicated, the retail sales report was weak; and now with that report in hand, we'd probably mark down our current-quarter consumption forecast to a decline of 1½ percent at an annual rate. What I think is really remarkable about that is that this weakness is occurring even though we still think spending is probably receiving some boost from the rebates. So excluding that effect, we'd be looking at something even weaker. Now, as you know, we've been head-faked a number of times by the retail sales data, which are subject to some pretty substantial revisions. So I wouldn't necessarily take that report at face value. But the drop we've seen in motor vehicle purchases pretty much mirrors in size and timing the kind of falloff that we've seen in overall consumption spending. So it looks like a very weak picture for consumption.

The other notable development over the intermeeting period has been the weakness in the labor markets—now not principally in the payroll employment figures. Private payroll employment has been falling pretty sharply but not any faster than we would

have thought. But the rise in the unemployment rate is remarkable. Now, some of the 0.4 percentage point increase in the unemployment rate last month could be statistical noise. It wouldn't be entirely surprising to see it fall back some. But the more than 1 percentage point rise that we've had since April is not going to be statistical noise. Some of that increase probably reflects a bigger response to the emergency unemployment compensation program than we previously thought, and we've upped our estimates for that to a little less than 0.3 percentage point on the level of the unemployment rate. But even putting that aside, we have experienced a more significant rise in the unemployment rate, and I think that's consistent with other things that we're seeing in terms of the labor market data. We've seen another appreciable jump in initial claims. Announced job cuts are up. Job openings are down. Survey hiring plans have softened.

Now, this sharp rise in the unemployment rate is a bit difficult to square with a GDP figure that looks as though it was running above 3 percent in the second quarter and even 2 percent if you want to average the first and second quarters together. There are occasionally large errors in Okun's law, as I think I've noted in the past. It seems as though Okun's law gets obeyed about as frequently as the 55 mile an hour speed limit on I-95. [Laughter] But still, one of the things that we should probably be considering is that perhaps the economy has not been as strong as suggested by the real GDP figures. Real gross domestic income, which is output measured on the income side of the accounts, has risen about 2 percentage points less than GDP over the past year. And if we look at industrial production and compare that with the components of GDP that are, in essence, goods production, there's about a 1 percentage point discrepancy there, with industrial production suggesting weaker figures than GDP.

We see no reason to discount the rise in the unemployment rate as suggesting that we're entering the second half with more labor market slack than we had previously thought. Furthermore, on net, we've revised down our projected growth in GDP over the next two years—admittedly just a bit—and that was in response to two pretty strong crosscurrents. One was the significantly lower oil prices that we have in this forecast. We do think they're going to provide some support to underlying disposable income and spending. But the positive effect of that on our forecast going forward was more than offset by a significant marking down in our forecast for net exports—which Nathan will be discussing—in response to an appreciation of the dollar and a further downward revision to our outlook for foreign activity. On net, that left us with a little lower growth rate and carrying forward a noticeably higher unemployment rate over the forecast period. Now, those were pretty small adjustments. I don't think we've seen a significant change in the basic outlook, and certainly the story behind our forecast is very similar to the one that we had last time, which is that we're still expecting a very gradual pickup in GDP growth over the next year and a little more rapid pickup in 2010.

The three things that are absolutely central to producing that outcome are our projection that we're going to get a stabilization in housing in 2009—and early in 2009; that there will be some diminishment of the drag on growth from the financial turbulence; and that oil prices flatten out. Of those three, to my mind, the component

that probably is most central and most important would be seeing some stabilization in the housing market, not only because this has been a big drag on growth and will also have consequences for household wealth but also because if there's going to be some clarity and reassurance to financial market participants, it seems as though some end to the housing debacle has to be in sight. We think we are seeing a few glimmers of hope there—however, we thought that on occasion in the past and have been proven wrong. But sales of existing homes have been flat since the turn of the year. Sales of new homes have been flat for several months now. We've had a drop in mortgage interest rates that followed the takeover of Fannie and Freddie. Starts have fallen so much now that, in fact, builders are making significant progress in working down the inventory of unsold new homes and even months' supply has tipped down of late. So we think that some things are looking a little better for us there. As a consequence, we're expecting to see some bottoming-out near the end of this year or the beginning of next year—but not a sharp recovery. Overall residential investment actually is still a negative for 2009 but less of a negative than it has been this year. As you know from the Greenbook, our estimates suggest that the financial restraints on overall activity—actually on the level of GDP—will increase between 2008 and 2009, but their effects on the growth rate of GDP are diminishing somewhat. Finally, with regard to oil prices, by our assessment the rise in crude oil prices since the beginning of 2006 is probably knocking about ½ percentage point off growth in 2008; and with a flattening out of oil prices, we expect that to be more of a neutral factor over the next two years. That's providing some impetus. A lot of what's going on in our forecast is bad things not worsening any more quickly next year than they did this year, rather than things actually getting better. I guess it's a sad comment that we're relying on second derivatives turning positive to be the main force generating some upward impetus to economic growth. But we are projecting a gradual pickup.

Now, on the inflation side, this morning's CPI report for August actually came in a little better than we were expecting. The CPI in August fell 0.1 percent. We had been expecting an increase of 0.1 percent. That surprise was all in the energy component, but we at least did see some moderation in the retail food price side that we were looking for, and the change in core CPI fell back to 0.2 percent after a string of 0.3 percent increases. I don't think these data will do much to change our basic forecast, which is for total PCE prices to be up somewhere in the neighborhood of a 5 percent rate in the third quarter, and core prices up 3 percent. Still, if one looks back at the last few CPIs and PCEs, things have come in a little higher on the core side. The projected 3 percent increase is up about ¼ percentage point from where we were in our August forecast, and our interpretation of this is that we're probably seeing more upward impetus and pass-through from the higher energy prices, other commodity prices, and imports than we had previously expected. That certainly squares with what we're hearing from our business contacts. It also squares with what we saw last week in the PPI, which was another very sharp increase in prices of intermediate materials. At least going forward, for the first time since this process got under way, we are seeing more than just a futures price forecast flattening out. Some easing in the prices of both oil and other commodities and the appreciation of the dollar are giving us at least a little more confidence that some of these cost pressures are going to abate going forward and that we will get the disinflation

that we have been forecasting. We continue to see reasonably encouraging signs on inflation expectations. The medium-term and long-term inflation expectations in the preliminary Michigan report last week dropped 0.3 percentage point, to 2.9 percent. TIPS haven't really done very much, and hourly labor compensation continues to come in below our expectations. So based on our assessment, once these cost pressures work their way through the system—and we still think that the process will take place over the second half—we think that we'll get some receding of core inflation from the 2.4 percent that we're projecting for this year to 2.1 percent next year and 1.9 percent in 2010.

Just a couple of final remarks on current events. Hurricanes Gustav and Ike obviously created an enormous amount of devastation for a whole lot of people, but they don't really appear to us to have significant macroeconomic consequences. There will be some temporary disruption to oil and gas extraction and refining, but it looks as though the basic infrastructure has largely been spared. I'll be interested to hear President Fisher's report. Retail gasoline prices have jumped in the last few days, but wholesale prices for delivery in October are actually lower than they were before the storms were on the horizon. I think that suggests that this is not going to be a major negative event. Undoubtedly, industrial production is going to fall like a stone in September, reflecting these two hurricanes as well as the Boeing strike, but we're expecting that to bounce right back again. I don't really have anything useful to say about the economic consequences of the financial developments of the past few days. I must say I'm not feeling very well about it at the present, but I'm not sure whether that reflects rational economic analysis or the fact that I've had too many meals out of the vending machines downstairs in the last few days. [Laughter] But in any event, we're obviously going to need to wait a bit to see how the dust settles here, but I think the sign would be obviously in a bad direction. I'll turn over the floor to Nathan.

MR. SHEETS. I also will be very brief in summarizing economic developments abroad. Indeed, I would just like to make six very brief points. The first one is that the incoming data we've received since the last Greenbook for the foreign economies have been extraordinarily soft. Indeed, we've marked down our forecast or projection of the second quarter by a full percentage point. The data also suggest that we should carry forward a fair amount of that softness at least through the next year. So our foreign outlook is much softer than it was before.

The second point is that this softening outlook in our view has been a key factor that has contributed to further sizable declines in oil and commodity prices. This morning, oil prices were trading around \$92 a barrel, which was down another \$25 a barrel from where we were at the time of the last meeting.

The third point is that this deteriorating foreign outlook also seems to have triggered something of a reassessment in currency markets. Since your last meeting, the dollar has strengthened nearly 5 percent in broad nominal terms. In our view, what happened in currency markets was that the markets had priced in the expectation that the foreign economies would remain quite resilient in the face of a slowing in the United States.

Now with the incoming data over the past couple of months, it is becoming clearer and clearer that the U.S. slowing is going to have a marked effect on these foreign economies, and this has shifted the relative attractiveness of the dollar and supported the appreciation that we've seen over the last couple of months.

The fourth point is that, in a number of emerging market economies, we've seen a resurgence of certain sorts of financial vulnerabilities. We've seen across really a broad array of these economies rising external debt spreads and rising CDS spreads. We've seen falling equity prices and, for a number of these economies, downward pressures on their currencies. On that last point, a number of the Asians have been intervening in the foreign exchange market over the intermeeting period but have actually been intervening to try to prevent their currencies from depreciating, which is a marked change from what we've seen in the last couple of years.

The fifth point is that the surprisingly strong performance of U.S. exports that we've seen appears to have continued through July. After the Greenbook went to bed, we got the July trade data, and they continue to point to a fair amount of strength in the export sector. It was particularly strong in the auto sector, but it was a broad-based strength through July. Nevertheless, our view is that, given the rise in the dollar and the softening outlook for foreign growth, we're very likely to see some slowing in export growth going forward.

The final point I'd like to mention is that, also late last week after the Greenbook went to bed, we received data on import prices. These data, really for the first time in a long time, showed a marked deceleration in both material-intensive goods import prices and finished goods import prices. Our forecast for a long time has called for a deceleration in import prices in line with the projected flattening out of commodity prices and a projected flattening out of the dollar.

Now it seems that we're at a point at which all those things that have been incorporated into our forecast but we haven't had a lot of evidence for are starting to materialize. We have the dollar flattened out and, indeed, somewhat stronger than in the last Greenbook. We have lower paths for commodity prices, and then the data that we recently received showed an actual deceleration in core import prices, which gives us some confidence that perhaps the rise in those import prices has peaked. I'll stop there.

CHAIRMAN BERNANKE. Thank you. Are there questions for Dave and Nathan?

MR. FISHER. Could I ask just one question, Mr. Chairman?

CHAIRMAN BERNANKE. President Fisher.

MR. FISHER. Could you interpret for us the Bank of China's cut in the bank lending rate?

MR. SHEETS. Yes. Yesterday the PBOC cut its main policy rate 27 basis points. I guess they felt that 26 would not have been enough and 28 would have been too much. [Laughter] And 27 was just the right number. I'd say a couple of thoughts were there. One important point is that inflation in China has decelerated significantly. In the spring they were looking at twelve-month inflation rates of around 8.3 percent. The latest reading for August was 4.9 percent. So it's clearly on a decelerating trajectory. That has been driven by a marked decline in food prices. Earlier this year, food prices were moving up at over a 20 percent rate, and now it is about 10 percent. So the deceleration in prices; some concerns about where activity is going, particularly in the aftermath of the Olympics; and signs of slowing external demand have given them the scope they need to cut policy rates. Besides the cut in monetary policy, we're also hearing reports that the authorities are poised to implement fiscal stimulus if that's necessary.

MR. FISHER. Thank you.

CHAIRMAN BERNANKE. Three is a lucky number in China. Don was going to tell you that 3 cubed is 27. [Laughter].

MR. KOHN. He was also going to wonder, Mr. Chairman, whether we needed to harness the mystical powers. [Laughter]

CHAIRMAN BERNANKE. I think we have good feng shui here.

MR. SHEETS. The science of monetary policy.

CHAIRMAN BERNANKE. Any other deep questions for our colleagues? I'm a little surprised.

MR. PLOSSER. We're all trying to be brief, Mr. Chairman.

CHAIRMAN BERNANKE. Everyone has been very brief. I'm shocked. [Laughter] My proposal, which I can be argued out of, is to do one round, if that's acceptable. Please indicate your



preliminary view on policy, and you will have another opportunity to refine and extend your views.

Is that acceptable with everybody?

MR. KROSZNER. Should we have Brian's presentation?

CHAIRMAN BERNANKE. Yes, of course. I was about to turn to that. If that's acceptable, let's turn to Brian and have your discussion.

MR. MADIGAN.<sup>2</sup> I will be referring to the package labeled "Material for FOMC Briefing on Monetary Policy Alternatives and Trial Run Survey Results." The results of the survey are shown in exhibit 2. In the interest of time, I will not cover them this morning. The Subcommittee on Communications plans to be in touch with the Committee on this issue over the upcoming intermeeting period.

The first page of the package reproduces the version of table 1 that you received yesterday afternoon. This version includes three policy alternatives. As in the Bluebook, alternative B would leave the stance of policy unchanged at this meeting, and alternative C would involve a 25 basis point firming today. However, alternative A now entails a 25 basis point policy easing rather than the unchanged funds rate that was specified in the Bluebook version of this alternative.

I will begin by discussing alternative C. The discussion at your last meeting suggested that you generally saw the next move in policy as likely to be a firming, a point that was explicit in the minutes of the meeting. Even though market volatility and financial strains have increased notably in recent weeks, you might view those developments as having only limited implications for the economic outlook and hence see economic fundamentals as continuing to suggest that policy should soon be firmed. Inflation has been well above the rates that Committee members judge as appropriate for the longer run, and despite lower oil prices and greater slack in labor markets, there remains considerable uncertainty about how soon and how much core inflation will slow. In these circumstances, you may believe that a firming of policy is appropriate.

Under the version of alternative B distributed yesterday evening, the Committee would hold the target funds rate constant at this meeting, and the statement would suggest that the Committee sees the risks to growth and inflation as roughly balanced. You may believe that this combination is appropriate for this meeting if your modal outlook for the economy has not changed much since the last meeting and if you judge that the upside risks to inflation have diminished, given the sharp drop in energy prices, the decline in indicators of inflation expectations, and the greater economic slack implied by the recent unexpectedly sharp jump in the unemployment rate. You might also believe that the downside risks to growth have increased as a result of the recent increase in financial strains. But at the same time, you may want

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<sup>2</sup> The materials used by Mr. Madigan are appended to this transcript (appendix 2).

to let the dust settle a bit before concluding that these developments warrant an adjustment in your policy stance. In particular, you may think there is a good chance that the latest enhancements to the Federal Reserve's special liquidity facilities will help keep markets functioning and mitigate the risks to growth.

Relative to the Bluebook version, the language of alternative B has been revised in three material ways. First, B2 now notes that "strains in financial markets have intensified." Second, the clause "some indicators of inflation expectations have been elevated" has been dropped from B3 in view of the recent declines in inflation compensation and survey measures of inflation expectations. Finally, the first sentence of B4 has been revised to suggest that the Committee now sees the significant risks to growth and inflation as roughly balanced. Given market participants' expectation that the funds rate could trade soft to the target for a time in light of recent developments, gauging exactly what is built into markets for the outcome of today's meeting is difficult. But earlier this morning, market prices appeared to incorporate high odds of at least a 25 basis point easing today or possibly more. Thus markets might well see a decision to keep the funds rate constant and to make no appreciable change to the language of the statement as signaling less concern about financial developments than they anticipated.

If you saw recent developments as significantly boosting the downside risks to growth or noticeably lowering the modal outlook, you might consider easing the federal funds rate 25 basis points at this meeting, as in alternative A. The rationale language for this action would begin by noting that strains in financial markets have increased significantly and would go on to indicate that the policy action should help to promote moderate growth over time. The Committee would cite the recent decline in energy and other commodity prices and the increased slack in resource utilization as factors that are expected to foster a moderation of inflation. The risk assessment would indicate that "the downside risks to growth have intensified, but the upside risks to inflation remain a concern to the Committee." With a policy easing largely built into markets, shorter-term interest rates would likely decline modestly in response to such an action, depending on how much is built in, or they might be little changed. As the Chairman indicated earlier in the meeting, adjustments to the statement could be considered in light of the further volatility in markets over the past day. Thank you, Mr. Chairman.

MR. DUDLEY. If I could add a few thoughts on market expectations about this meeting—I think it looks as though easing is priced in for two reasons. One, dealers do expect the federal funds rate to trade soft as we add excess reserves, so I would not take the softness in the September federal funds futures contract as indicative of necessarily expecting an easing. Two, I think it is important to recognize that the rates embodied in those fed fund futures contracts are means not modes. So I

would characterize the market expectation as either that things get very, very bad and the FOMC cuts rates significantly or that the FOMC does nothing.

I think that actually a 25 basis point cut is probably the least likely outcome that the market anticipates. As evidence of this, a couple of dealers yesterday did change their forecast to a 50 basis point rate cut. I'm not aware of anybody who has changed to 25. Probably people like that are out there. I know that my colleagues at Goldman Sachs, where I used to work, are saying that they think the FOMC is going to keep rates unchanged today but, if they were to move, it would be 50. That gives you a sense that it's really a bimodal kind of view and that putting different probabilities on 50 and zero gives you some easing priced into the federal funds rate futures market. So I think the consensus view still in the marketplace is that the Fed probably will not cut rates today. That would be a disappointment to a degree because there's some probability placed on the idea that the Fed might do 50, but that's how I would interpret what's priced into the markets today.

CHAIRMAN BERNANKE. President Fisher.

MR. FISHER. Could I ask for a little clarification here? The indication of sentiment is important, is it not, in terms of expectations from the population that you're talking about? The signaling of our direction would be important here?

MR. DUDLEY. Well, I think the market participants would gain some comfort to the extent that the Federal Reserve as an institution indicates concern about what's going on in the financial markets. But in some ways the Desk has already signaled that concern by its intervention, so I'm not sure that additional indications are needed. But in the language you might want to indicate to market participants that, if things were to materially worsen in the financial markets, the Committee might revisit the issue of where the federal funds rate should be.

CHAIRMAN BERNANKE. Just on the issue of trading soft, though, the October-December has also come down, and there is certainly some shift in the actual policy expectation.

MR. DUDLEY. That is true. I think on Friday the mood was basically that the funds rate was going to be flat for a long time. Probabilities placed on either easing or tightening were quite low, and since then the probability of easing has gone up fairly significantly. But I think it's hard to interpret because it's really not about 25 versus zero. It's really about zero versus 50 or maybe even 100 as you look out longer term. Either the financial system is going to implode in a major way, which will lead to a significant further easing, or it is not.

CHAIRMAN BERNANKE. Other questions? All right. If not, let's begin with President Lockhart.

MR. LOCKHART. Thank you, Mr. Chairman. I finalized the thinking that went into my prepared remarks late last week, which seemed like a good idea at the time. But I should follow the philosophy of Charlie Brown, who I think said, "Never do today what you can put off until tomorrow." [Laughter] Obviously, we can't ignore the events of the weekend and yesterday's financial markets. So late yesterday I reviewed the views that I shaped last week and tried to ground them in an assessment of whether the outlook for the real economy has changed materially, whether the balance of risks has been altered, and whether, in my opinion, we must reintroduce a risk-management approach and consider taking out more insurance.

With that as prologue, let me make just a couple of comments on regional soundings from the last couple of weeks. Anecdotal reports from the Sixth District support the view that the economy is quite weak but not deteriorating markedly. The CFO of a large retailer of housing-related goods said that they think they see a bottom forming. I am also starting to hear some reports that housing markets feel as though they are beginning to stabilize; but, really, it is

a little too early to say that a bottom has formed in any of our housing markets. My overall sense from District contacts and our surveys is of an economy that is quite weak, with no clear trend evident.

Turning to the national outlook, like most forecasts, my view on the likely path for the economy has not changed materially since our August meeting. I see nothing in the data and hear nothing from District reports that alters my views that the second half will be very weak. I expect this weak period to be followed by a slow recovery gathering in 2009, but the foundation of a recovery starting around year-end or early 2009 may be far from solid. The contraction of credit availability that is confirmed by both surveys and anecdotal evidence could deepen as financial institutions face tight liquidity and difficulty recapitalizing. A protracted credit crunch would likely operate as a substantial drag on the economy.

Consistent with the Greenbook, I expect some near-term improvement in headline inflation, as we saw this morning, some near-term deterioration of core inflation measures, and inflation moving in the right direction later this year and into next year. That said, one director said that he and his particular industry had seen no moderation of price increases up to this date. I am comforted somewhat that the upward drift in some inflation expectation measures appears to have been reversed. In addition, my staff has been monitoring revisions to inflation forecasts of professional forecasters, which also seem to suggest that concerns about accelerating inflation have abated somewhat.

Regarding the balance of risks in the economy, I am concerned that the downside risks to growth may be gathering force, as evidenced by the weakening personal consumption and retail sales data, the weakening economies of export partners, and the delicate state of the financial markets. At the same time, I perceive that there is significant risk that the current disinflationary

environment may fail to bring core inflation down to anything resembling acceptable levels for the longer term. Adding up all of this, I perceive a very rough balance of risks that could break either way in coming months.

My view of the appropriate policy path is consistent with the Greenbook—that the fed funds rate target will remain stable at or close to the current level for several months going into 2009. My preference is to hold the fed funds rate at the current level of 2 percent. Among the reasons is that a  $\frac{1}{4}$  percentage point drop, as suggested by alternative A, is really not clearly called for by a changed outlook for the real economy. Inflation risks are still in play, and I think we should give credit markets more time to digest events and sort out rate relationships.

As regards the statement, my preference is alternative B. However, I am concerned that the reference to the recent financial turbulence is not quite strong enough, so I took a shot at rephrasing just the beginning of the rationale section to read as such: “Economic growth appears to have slowed recently, and labor markets have weakened further. In addition, strains in financial markets have increased significantly”—basically taking the slightly stronger expression in the alternative A rationale and putting it in alternative B. So my position, Mr. Chairman, is to hold at this meeting. Thank you very much.

CHAIRMAN BERNANKE. Thank you. President Rosengren.

MR. ROSENGREN. Thank you, Mr. Chairman. I will be brief. This is already a historic week, and the week has just begun. The labor market is weak and getting weaker. The unemployment rate has risen 1.1 percentage points since April and is likely to rise further. I am not convinced that the unemployment rate will level off where the Greenbook is assuming currently. The failure of a major investment bank, the forced merger of another, the largest thrift and insurer teetering, and the failure of Freddie and Fannie are likely to have a significant impact

on the real economy. Individuals and firms will become risk averse, with reluctance to consume or to invest. Even if firms were inclined to invest, credit spreads are rising, and the cost and availability of financing is becoming more difficult. Many securitization vehicles are frozen. The degree of financial distress has risen markedly. Deleveraging is likely to occur with a vengeance as firms seek to survive this period of significant upheaval. Given that many borrowers will face higher interest rates as a result of financial problems, we can help offset this additional drag by reducing the federal funds rate. I support alternative A to reduce the fed funds rate 25 basis points. Thank you.

CHAIRMAN BERNANKE. President Hoenig.

MR. HOENIG. Mr. Chairman, I see no reason to focus on the details of the forecast. Clearly, the economy is under stress, both as we look at the economic growth forecast and as we look at the inflation forecast. So I recognize the amount of stress we are under here. I would say to you, in dealing with that stress, I am fully supportive of the actions that we take in terms of liquidity—the TAF and the other efforts to provide liquidity into the market. These are tools that we can and should use for these kinds of shocks in a short-term context. On the other hand, I would encourage the Committee to resist the impulse to ease policy in a sense of doing something. The issue is not the level of our policy rate at this time. It is the dysfunctioning of the markets that we hope our liquidity efforts will help address. To begin to talk about easing or even to put language in there that suggests easing is to cause people, on the expectation that we might ease at some point even if we hold off now, to delay decisions that they would otherwise make that would benefit the economy.

I also encourage us to look beyond the immediate crisis, which I recognize is serious. But as pointed out here, we also have an inflation issue. Our core inflation is still above where it

should be. Headline inflation has been up, even though there are some signs that commodities and energy are backing off. But the businesses themselves are saying, "How do I recover my margin?" So there is no impulse to pass along those reductions. We talk about wages and labor backing off. But they are holding off, they are not backing off, and in negotiations they are much more antagonistic. Those kinds of pressures will emerge at some point. Those are the longer-run issues that I think we need to keep in mind as we deal with this immediate crisis. So I would strongly encourage us to leave rates where they are, to be very careful with our language, not to encourage the expectation of further rate decreases, and to continue to be aggressive in our liquidity provisions as we have been the last several weeks and months. Thank you.

CHAIRMAN BERNANKE. Thank you. President Yellen.

MS. YELLEN. Thank you, Mr. Chairman. During the past several weeks, my head office and Branch directors have become decidedly more pessimistic about the economic outlook. My own assessment of incoming data coincides with theirs. My contacts also report that their businesses are still raising prices in response to past increases in commodity and import prices that boosted their costs. I expect as a consequence that core inflation will remain uncomfortably high for a while longer, but the marked decline in commodity prices since June reinforces my conviction that there is light at the end of this inflation tunnel.

With respect to growth, our forecast is similar to the Greenbook's, with a little more weakness in the second half of this year and a little more strength in 2009. I think the risks to this forecast are decidedly skewed to the downside. I agree with the Greenbook's assessment that the strength we saw in the upwardly revised real GDP growth in the second quarter will not hold up. Despite the tax rebates, real personal consumption expenditures declined in both June and July, and retail sales were down in August. My contacts report that cutbacks in spending are



widespread, especially for discretionary items. For example, East Bay plastic surgeons and dentists note that patients are deferring elective procedures. [Laughter] Reservations are no longer necessary at many high-end restaurants. And the Silicon Valley Country Club, with a \$250,000 entrance fee and seven-to-eight-year waiting list, has seen the number of would-be new members shrink to a mere thirteen. [Laughter]

Exports were a huge source of strength in the second quarter, but I am concerned that we cannot count on very large contributions to growth from exports going forward, now that the dollar has begun to rise and economic growth abroad has slowed, even turning negative in some important trade partners. Indeed, the growing weakness of the global outlook appears to be an important explanation for the reversion in commodity prices, and this adds a dimension of gloom to what would otherwise be a decided plus for both inflation and demand.

Recent data also suggest that labor markets are weakening across the board—a development that will cast a pall on household income and spending. The interaction of higher unemployment with the housing and financial markets raises the potential for even worse news—namely, an intensification of the adverse feedback loop we have long worried about and are now experiencing. Indeed, delinquencies have risen substantially across the spectrum of consumer loans, and credit availability continues to decline. One ray of hope is that the changes at Fannie and Freddie have caused a notable drop in mortgage rates. Another is that the decline in home prices has become somewhat less steep, and we have seen an outright improvement in home inventories relative to sales. But my contacts are very pessimistic about the prospects for nonresidential construction. They note that construction is continuing on projects in the pipeline with committed funding, but new projects are all but impossible to finance.

Turning to inflation, I have long anticipated and still expect that inflation will fall to more-reasonable levels in 2009. However, developments since our August meeting diminish the upside risks to this projection. The drop in oil and other commodity prices, along with the appreciation of the dollar, should work to moderate the current inflation bulge and diminish the potential for a wage-price spiral to develop. Import inflation has already begun to ease. Furthermore, we have seen a remarkable decline in inflation compensation for the next five years in the TIPS market. I would not rely heavily on this decline to support my view, but I do have to say that the decline is a lot more reassuring than the alternative. I was also encouraged by the 30 basis point drop in long-term inflation expectations in the most recent Michigan survey. I anticipate that the recent jump in the unemployment rate will place some additional downward pressure on growth in labor compensation, which has been quite low, and in core inflation. Although the jump in the unemployment rate probably partly reflects the extension of unemployment insurance coverage, a back-of-the-envelope calculation suggests that the upper bound on this effect is just a few tenths of a percent. I would agree with the Greenbook estimates. We have also examined the possibility that the increase in unemployment reflects a rise in the NAIRU due to sectoral employment shifts out of construction and finance and into other industries. Ned Phelps has argued that the sectoral shift story implies a sizable dispersion of employment growth across industries and states. But we looked at these data and found no significant increase, so I don't find this Phelps argument particularly convincing. Considering all of these factors, I expect both headline and core PCE price inflation to fall to about 2 percent for 2009 as a whole, and I see the risks to this projection as roughly balanced.

With respect to policy, I would be inclined to keep the funds rate target at 2 percent today. For now, it seems to me that the additional liquidity measures that have been put in place

are an appropriate response to the turmoil. I am fine with the wording of alternative B and would support President Lockhart's suggestion for change. That would seem fine to me, too. In view of the intensified financial stress and the potential for more turmoil, obviously I think we will need to be flexible in setting policy going forward, and I am very concerned about downside risks to the real economy and think that inflation risk is diminished.

CHAIRMAN BERNANKE. Thank you. President Bullard.

MR. BULLARD. Thank you, Mr. Chairman. I am going to start with the national economy in the interest of brevity here. Concerning the national outlook, it is difficult and probably unwise to try to assess growth and inflation prospects in the immediate aftermath of an event like the Lehman bankruptcy. I expect to see more failures among financial firms, and I expect those failures to continue to contribute to market volatility. This is part of an ongoing shakeout among financial market firms, following some of the worst risk management in a generation. I expect sluggish growth in the second half of 2008, in part due to labor markets that are somewhat weaker than expected. Financial market turmoil is certainly a key concern, but the U.S. economy still outperformed expectations in the first half of 2008, despite the demise of Bear Stearns—an event not too different in some respects from the current episode.

My sense is that three large uncertainties looming over the economy have now been resolved—the GSEs and the fates of Lehman and Merrill Lynch. Of these, the resolution of GSE uncertainty seems to be the most pivotal, even though it is not the one leading the news today. Normally, the elimination of key uncertainties is a plus for the economy. As is typical in this type of situation, safe interest rates have fallen dramatically across the board.

A second macroeconomic shock stemming from the dramatic rise in oil and other commodities prices has been an unwelcome development during the past six months. The retreat

of West Texas intermediate prices to \$94 a barrel, and today down to \$92 a barrel, should improve second-half growth prospects.

Meanwhile, an inflation problem is brewing. The headline CPI inflation rate, the one consumers actually face, is about 6¼ percent year-to-date. That does not include today's report. This is against the federal funds target of 2 percent. While it makes sense to focus on financial markets for the time being, it is essential that we keep in position to put downward pressure on inflation going forward. The financial crisis threatens to roll on for such a long time and to demand so much attention that the private sector may rationally conclude that we have lost all sight of our inflation objective. In such a case of unmoored expectations, outcomes could be far more severe than those envisioned in the Greenbook.

My policy preference is to maintain the federal funds rate target at the current level and to wait for some time to assess the impact of the Lehman bankruptcy filing, if any, on the national economy. In uncertain circumstances like these, I think it would be unwise to react too hastily to a fluid situation. Any immediate effects may not be the ones that are intended, and further down the line—that is, once more data have accumulated—a hasty action may leave the Committee out of position relative to the incoming data. By denying funding to Lehman suitors, the Fed has begun to reestablish the idea that markets should not expect help at each difficult juncture. Changing rates today would confuse that important signal and take out much of the positive part out of the previous decision. In addition, a rate move would be poorly targeted toward mitigation of difficulties at particular financial firms. The FOMC has already done a great deal to create a low interest rate environment in order to shepherd the economy through a substantial shock to the financial and housing sectors. The Committee now needs to allow the financial

sector shakeout to occur using liquidity facilities to the extent possible to help navigate the resulting turbulence. Thank you.

CHAIRMAN BERNANKE. Thank you. President Plosser.

MR. PLOSSER. Thank you, Mr. Chairman. New data and survey and anecdotal information in the Third District suggest that the economy in our District continues to be weak. There have been further declines in some industries and deceleration of growth in others, but generally data are coming in as expected. Employment growth was flat over the three-month period ending in July, and I expect that unemployment rates in our three states will tick up in August, when the regional data come out, much as it did in the national data.

Overall, the activity in our region, as I said, has remained weak since the last meeting. Housing construction continues to be weak. Sales of existing homes remain sluggish, and inventories remain high. One builder said, “Things don’t feel very good. I feel as though I am in a tar pit. My feet are maybe now on the bottom; my nose is still above the level of the tar; and while I may feel the bottom, it still doesn’t feel very good.” On the commercial real estate side, we saw a slight uptick in the value of July contracts, but they are not very high. In fact, they really remained at the average level of the last seven years. Retailers remain pessimistic in the latest Beige Book. District banks saw loans rise slowly but steadily in August. The Beige Book reports from them see slight gains in consumer and real estate lending and C&I loans essentially flat.

The good news is from our business outlook survey for September, which will be released to the public on Thursday at 10:00 a.m., but the results are in. The survey is from the first two weeks of September. The general activity index has been negative, if you recall, for the last nine months—since December 2007. The last value was minus 12.7. The September

number, not to be released until Thursday, is a positive 3.4, so that's a swing of 15 points to the good. This is clearly somewhat encouraging, although we don't want to get too excited about one month—but it is good news. Furthermore, both the new orders and shipment indexes in the survey improved in September. Price pressures have abated somewhat with the fall in commodities and oil, but they remain. The six-month-ahead outlook indexes also improved substantially in the new survey. This is the best picture that the survey has painted in certainly quite a while—about the last six or eight months. In summary, the economic conditions of the Third District remain weak and sluggish but are not materially different from what we and our business contacts had been expecting over the near term.

While a lot of attention in the short run is being paid to financial markets' turmoil, our decision today must look beyond today's financial markets to the real economy and its prospects in the future. In this regard, things have not changed very much, at least not yet. Indeed, the Greenbook forecast has changed only modestly since the last Greenbook. The economy remains weak but not appreciably different from what I anticipated or even what the Greenbook anticipated at the last meeting. I agree that the recent financial turmoil may ultimately affect the outlook in a significant way, but that is far from obvious at this point. We also need to acknowledge the long lag times associated with the effect of monetary policy actions on the real economy. Actions today will not help us very much in the very, very near term where the real economy is concerned.

On the inflation front, there has been some good news. The decline in the retail price of gas has contributed to a decline in headline inflation in August. In my view, the price declines in commodities and oil have mitigated somewhat the upward pressure on expectations and have reduced the likelihood that inflation expectations will become unanchored, at least in the near

term. Nevertheless, I remain concerned about the inflation outlook going forward. In part, my concern stems from the fact that I do not see that the ongoing expected slowdown in economic activity is entirely demand driven. As I noted before, the impact of financial shocks and high commodity prices can plausibly lead to a decline in the growth rate of potential output. If so, there will be less offset to inflation going forward than incorporated in the baseline Greenbook forecast, which relies heavily on slack variables to control inflation. The Greenbook simulation entitled “costly reallocation” provides some welcome effort from the staff in this regard, and I appreciate that. Yet the details of that experiment were a bit sketchy for me, and at some point I would be interested in a little more detail as to how that actually plays out.

In my view, the main driver for the outlook of future inflation over the next two years is not, nor has it been, oil prices per se, but the path of monetary policy that the Committee will adopt over the next several months and quarters. I appreciate the memo that the staff produced regarding the stance of monetary policy. According to the memo, the current stance of policy is not unusually accommodative. However, I would like to note that that conclusion depends critically on the specific forecast and the nature of the FRB/US model. A different model, one that says that inflation expectations are more forward looking, may well lead to a very different conclusion. But I take the message of the memo to be that the assessment of the stance of monetary policy is dependent, at a point in time, on a model, and I very much agree with that assessment. Given that my model is somewhat different from the staff’s model, I continue to believe that monetary policy at its current level is accommodative and that, if this current stance is sustained, the economy will experience faster inflation in the medium term. Clearly, we must pay attention to the adverse effects of the financial disruptions. But we also must recognize that our policy actions today and over the next several months will affect the outcomes of inflation

over the medium term. As I said, it is my view that the current stance of policy is inconsistent with price stability in the intermediate term and so rates ultimately will have to rise.

Now, I acknowledge that there are risks to economic growth going forward. The slowdown and the financial market turmoil could turn out to be worse than I expect. I also recognize that, given the events over the weekend, now is probably not the time to shock markets by raising rates. But neither is it a time to panic and lower rates. A cut today may be reassuring to some in the financial markets, but it also may serve to scare markets by sending a signal that we are much more worried than perhaps they are. There is just way too much volatility and dust blowing around to make such snap judgments on monetary policy. We have been aggressive with our liquidity provisions, and we will continue to be so, and I support that. Stability coming from monetary policy is an important attribute, and I think we have an opportunity to provide some stability here. However, I am uncomfortable with the current Greenbook baseline path that has the funds rate remaining unchanged well into the second half of next year. In my view, that will not deliver an acceptable path of inflation outcome over the medium term. At the same time, I do not perceive an immediate threat to the unanchoring of expectations, so I can accept keeping the funds rate at an unchanged level at this meeting. But at some point, before the unemployment rate begins to improve substantially, I believe this Committee will need to raise rates in order to deliver on our inflation objectives.

Regarding language, I can live with the language in alternative B. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. President Stern.

MR. STERN. Thank you, Mr. Chairman. Well, even before the events of the last several days, I thought that this was the most severe financial crisis, certainly, that I have seen in my



career. And the last several days—as well as some of Bill’s comments about possible contagion spreading from breaking the buck and so on and so forth—have only heightened that conviction and my concern about where we are. So I think it is fair to say that the headwinds confronting the economy have intensified even further. It is difficult to comment on the degree or the duration, but I think we know the direction. As far as the near-term economic outlook is concerned, I wasn’t terribly optimistic about the next two or three quarters to begin with. If I were going to prepare a new forecast at this point—or even had I prepared one last week—I probably would mark it down a bit. But, of course, there is not much we can do about that at this stage.

As far as the inflation outlook is concerned, I have thought that, late in this year and into next year, inflation would start to abate, and recent developments perhaps heighten my conviction about that. But I will agree that it is still an open issue. So it seems to me that all of this suggests that the outlook, at least in terms of financial conditions and the economy in the near term, has clearly deteriorated. The inflation outlook, if anything, has perhaps improved a notch, or at least the outlook that I had earlier is a little more solid.

Given the lags in policy, it doesn’t seem that there is a heck of a lot we can do about current circumstances, and we have already tried to address the financial turmoil. So I would favor alternative B as a policy matter. As far as language is concerned with regard to B, I would be inclined to give more prominence to financial issues. I think you could do that maybe by reversing the first two sentences in paragraph 2. You would have to change the transitions, of course.

I would say that if we wanted to change policy at this meeting—and that is not my preference—I would do it by ½ percentage point, and I would think that the rationale would be

psychological reasons. Again, I don't think we are going to have a big effect on the near-term performance of the economy. But if we think psychology in the marketplace is sufficiently bad or that there is sufficient concern that the Federal Reserve somehow doesn't quite get it—I would think that all our actions cumulatively, including the actions over the weekend, should not make that a grave concern—then I think we would want to do more than ¼ percentage point. Thank you.

CHAIRMAN BERNANKE. President Evans.

MR. EVANS. Thank you, Mr. Chairman. The unfolding financial situation is injecting enormous uncertainty into the economic outlook and policy picture. Although this analogy is imperfect, today's uncertainty reminds me of March 2003. Then, on the eve of the invasion of Iraq, the FOMC decided that geopolitical uncertainty was so great that the Committee could not characterize the balance of risks at all in the policy statement. Today, the downside risks to output are almost too dispersed to characterize. In one or two weeks, we may know better that either the economy will somehow muddle through or we're likely to be facing the mother of all credit crunches. I think that the first outcome would be quite an accomplishment under the circumstances, but at the moment it's very hard to say how this will turn out.

Nevertheless, we have to offer an opinion. With respect to the economic landscape before the developments of last weekend, one thing that I kept hearing was that uncertainty and caution in the business community had increased in recent weeks and that they were causing many firms to hold back on spending and committing to financial investments. But a number of my contacts indicated that the weakness was not out of line with their earlier expectations. On the plus side, I got the impression that, with the exception of housing, there are not many excesses on the real side of the economy that needed to be worked off. Notably, I did not hear of inventory overhangs or

unused capacity, and Manpower even indicated that their clients had been careful not to go overboard earlier in the hiring cycle, and so we're not left with bloated workforces. Still, this sentiment and the incoming data did not paint a pleasant picture with regard to the national outlook. As one of my directors said, turning the common phrase against me, the economic problems that we are facing appear to be remarkably resilient. Even before last weekend's events, the economic risks had increased somewhat. We had the large rise in the unemployment rate, the recent weak consumption data, and heightened caution by firms. Now, of course, the financial risks have increased substantially and further threaten the growth outlook. At a minimum, credit standards are likely to tighten further and crimp spending.

I'm not looking forward to putting a forecast together in October. Dave and the Board staff have my sympathy and respect for doing this each meeting. It's unfortunate, Dave, that we haven't had the time to spend talking about the excellent special memo that you and your staff put together on gauging the effective stance of policy. I thought that was very helpful. I had on previous occasions mentioned that it would be nice to have some markers that we could look at, and at least for me, that was quite helpful. Now, it's not a large stretch to expect that inflationary pressures will recede, given what we're facing. We could see enough weakening in the economic outlook that the projected slack in the economy will point inflation more clearly down and below 2 percent over the medium term. Just last week I was still a bit skeptical that these forces would be large enough to achieve this disinflation. But we need to be forward looking, and that would be how I would mark my inflation forecast down today.

So what does this mean for policy today? I favor alternative B. In my view, we've kept the policy rate low so that we would not be far from appropriate policies if and when the risks to growth intensified enough relative to the risks to inflation. So we are well positioned to act if we need to. I

agree with President Stern that, if we were to act, we should do something significant on the order of 50 basis points. But I think we should be seen as making well-calculated moves with the funds rate, and the current uncertainty is so large that I don't feel as though we have enough information to make such calculations today. We will know much more in a couple of weeks, I hope at least about the changes in underlying financial conditions, and will thus have a better sense of the risks to both elements of the dual mandate and the associated policy actions. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. President Pianalto.

MS. PIANALTO. Thank you, Mr. Chairman. The recent financial market news is shaking people's confidence dramatically. But even before recent events, the evidence was already pointing to more effects of the financial crisis on the real economy than I had built into my projection at our last meeting. The reports from my District contacts and the incoming data caused me to revise down my near-term output projection even before the latest round of financial market troubles. The improvement in net exports that was reflected in the second-quarter GDP growth has not encouraged manufacturers in my District to revise up their export projections. They are still holding firmly to the opinion that the global economy is slowing and that export growth will slow with it for several quarters. Of course, manufacturers are concerned about weakness spreading further within their domestic customer base.

The ongoing turmoil in financial markets continues to affect businesses in my District. Some of the banks in my District are finding it very, very difficult to attract new capital and to manage their way out of trouble. I am hearing that credit is harder to come by for many borrowers who in the recent past would not have thought twice about their creditworthiness. Last week I met with a business contact with a very long and successful track record of buying and operating private companies. He reported that he had reached a deal with a bank to finance a project at a 7 percent

interest rate with the loan amortized over a fifteen-year term. On the morning of the close just three days later, the bank faxed him the paperwork, which reflected a 12 percent interest rate on a non-amortizing loan with a 10-year term. So the deal obviously is not going forward. One of my directors, who heads a very large regional banking organization, reported at our board meeting last week that many banks are shedding assets and that in some cases they are walking away from longstanding customer relationships in order to do so. He said that investors are very skeptical about putting new equity into banking deals and that those who have done so in the past vow not to be burned twice, let alone a third time.

Of course, inflation remains an important issue as well. My contacts, as Dave mentioned in his report, are not so confident that a broad array of intermediate and retail prices are actually going to move back down as a result of the recent decline in energy and other commodity prices. Several of my contacts report that major suppliers are trying to maintain their prices despite the decline in raw material costs just to make up for a long period of absorbing price increases. Nevertheless, most of my contacts agree that the commodity price environment has stabilized considerably, making me more confident that core inflation will gradually slow over the next couple of years.

At our last meeting, my forecast was broadly consistent with the Greenbook baseline. Today my forecasts for output and prices are broadly similar to the Greenbook's for 2009 and 2010, although I am expecting more weakness in economic activity in the second half of this year than the Greenbook is forecasting. My contacts in the manufacturing sector have persuaded me that exports are going to be weaker in the short term than I had previously thought, and I have also revised down my consumption path on the basis of the credit constraints on households. Although I am more encouraged about the recent decline in energy and commodity prices, I would like to see further evidence of price stability in these markets and also continued stability in inflation expectations for

a while longer before I reduce the upside risk that I place on my inflation outlook. However, a growing risk to my outlook is that the short-term weakness that I have now built into my outlook extends further out into the forecast period. I worry that my outlook doesn't fully capture all of the many ways in which financial forces at work in the economy are actually going to restrain spending.

On Friday, I was convinced that the best course of action was to keep an even keel in these rough seas—to be flexible, of course, but to look beyond the latest wave crashing over the bow. Only six weeks ago, inflation risks were on the verge of being unacceptable, and today the troubles of Wall Street are the focus. I was sure that we were going to be in for many more surprises; I just didn't know when and from where they would be coming. So I supported not only keeping our policy unchanged but also keeping our language changes to a minimum even if that language missed some nuances of the outlook. Given the events of the weekend, I still think it is appropriate for us to keep our policy rate unchanged. I would like more time to assess how the recent events are going to affect the real economy. I have a small preference for the assessment-of-risk language under alternative A. I think it captures my concern that the downside risks have intensified. However, I can support some of the comments and changes to highlight the financial market strains that were made by President Lockhart and President Stern. So I can support the language under alternative B with some additional comments about the financial strains that we are facing. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. President Lacker.

MR. LACKER. Thank you, Mr. Chairman. I'll be brief. The Fifth District hasn't changed much; it pretty well aligns with the national outlook. On the national outlook, I find myself, all except for the policy path, aligned well with the staff. There have been a lot of economic reports since the last meeting about particular categories of spending or particular sectors of the economy,

but they net out to only a small change, if any, in the broad contour of the outlook for me for overall growth. I expect it to be sluggish for the remainder of the year with recovery beginning at some point in the first half of next year. I'll commit the sin of saying that uncertainty is especially high now. There seem to be reasonably plausible risks in the outlook in virtually every spending category and, in many cases, on both sides of the outlook.

About inflation, so far our credibility has helped to prevent a pickup in compensation growth. In fact, it's heartening that compensation growth is coming in a little below expected in response to the energy price shock this year. This has allowed us to accomplish the inevitable decline in real wages without setting off an inflationary acceleration in wage rates. But we're still in the midst of an upsurge in core inflation, which the Greenbook expects is going to tick up near 3 percent this quarter. As I said before, I think it's critically important for us to emerge from this episode without trend inflation ratcheting upward, and I'm not sure we can take the forecasted moderation for granted. Inflation compensation has been well contained, and that has been heartening. But I have also said this before—I think the current level of five-year, five-year-forward inflation compensation seems more consistent with a trend above 2½ percent than it does with a 2 percent trend. So I'm not convinced that there's going to be much gravitational pull down from an elevated rate once core rises. At the very least, I think there's some uncertainty about that.

For financial markets, this is yet another historic week, as President Rosengren remarked. I think the questions facing financial market participants, the uncertainty they face, can be usefully partitioned into three broad categories. One is the aggregate magnitude of fundamental losses that the financial sector faces. Another is the location of those losses—where they are going to pop up within financial intermediary sectors. The third is the likelihood and the magnitude of fiscal transfers in the form of governmental support for particular firms. I think the weekend's events

have caused financial market participants to revise their assessments of the future. It seems to me at this early date in the process that the revision in the outlook has had more to do with the latter two categories than with the aggregate size of fundamental losses we have coming down the pipeline. That is to say, it's about where they're popping up, which firms are affected and are going to be hit, and about the likelihood of government support.

What we did with Lehman I obviously think is good. It has had an effect on market participants' assessment of the likelihood of other firms getting support, and I think you would have to attribute at least some of changes in equity prices to that. We're likely to see a lot more disruption this week and in the days going forward than we've seen so far. I don't want to be sanguine about it, but the silver lining to all the disruption that's ahead of us is that it will enhance the credibility of any commitment that we make in the future to be willing to let an institution fail and to risk such disruption again. On the other hand, if the disruption proves less severe than we expect, the silver lining is that that will strengthen our hand in the future as well. However, I would note that I don't think that what we did with Lehman has set a clear and firm boundary on the circumstances under which government support is likely to be forthcoming. All the language around not supporting Lehman was of a one-off nature. So I'm not sure about the extent to which we've diminished uncertainty about the likelihood of support going forward, and I think that such uncertainty is likely to exacerbate financial volatility in the months ahead until we can make more progress on articulating a reasonably principled policy on when we're going to intervene and when we're not, or at least enhancing clarity about that.

Overall, I don't take what's happened in the last few days as changing much. It's not obvious to me what the implications are for the outlook for inflation and growth, at least at this point. So I don't see a reason to deflect from our policy path at this point. I can support standing



pat with the funds rate today. I think that's a good idea. I think, looking forward, that we will want to raise rates sooner rather than later if core inflation doesn't moderate. I think we're more likely to require a path more like the August Greenbook than the current one. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. President Lacker, I have a question. I really would like your advice on this. Historically, if we look at situations like Japan and Scandinavia, ultimately there comes a point at which the banking system is decapitalized and dysfunctional and the government intervenes on a large scale. Those interventions have been very expensive, but in those cases I mentioned, they have generally restored the banking system to health and have helped the economy recover. What's your view on the right sequencing? Do you think that we should remain very tough until such time as it becomes inevitable that fiscal intervention is needed? Do you think that we should avoid fiscal intervention at all stages? I'm seriously interested in knowing what you, or anyone else who would like to comment, think is the appropriate stage, if any, at which fiscal intervention becomes necessary.

MR. LACKER. We have a legislated program of fiscal intervention—deposit insurance—and the boundaries around that are very clear. Which liabilities are insured and which ones are not are very clear. Around the edges there's some lack of clarity about what least-cost resolution means and the extent to which deviations from that can be verified, and that provides some room for the Federal Deposit Insurance Corporation to deviate from that and implicitly to forbear to some extent. But even that is sort of a well-contained and well-defined government support. That's what the Congress has enacted, and it's not clear to me whether we should go beyond that. Japan got down to deposit insurance. Scandinavia did, too. That seems like a natural benchmark.

CHAIRMAN BERNANKE. But I think this is a historical fact—that, once the banks became decapitalized, there were also capital injections into the banks in both of those cases.

MR. LACKER. Sure. Those were fiscal actions.

CHAIRMAN BERNANKE. Right.

MR. LACKER. And the FDIC does exactly that when it resolves a failed institution.

CHAIRMAN BERNANKE. President Hoenig.

MR. HOENIG. Mr. Chairman, I have thought about this considerably because I think we have come to a time in our history when we have institutions that clearly ought to be and may in fact be too big to fail. I think we tend to react ad hoc during the crisis, and we have no choice at this point. But as you look at the situation, we ought, instead of having a decade of denying too big to fail, to acknowledge it and have a receivership and intervention program that extends some of the concepts of the FDIC but goes beyond that. That is, if you are insolvent, it is not a central bank issue—we are a liquidity provider—and therefore the government comes in. But unlike the GSEs, everyone has to take some hit—the equity holders, certainly the preferred stockholders, also the subordinated-debt holders, and perhaps the senior ones—by assuming a certain amount of loss. They would have immediate access to—pick a number—80 percent. The research would help us pick that number, and they can have access, but the rest becomes a subordinate-subordinate position after the liquidation so that you have still a sense of market discipline in play and you don't get the system gaming it in that, if you know there's a bailout coming, you buy the debt and sell the equity short to make a bundle. I think therein lie the distortions that are absolutely detrimental to the long-run health of the economy.

Regarding how we go forward, I think we are going to have many lessons from this. Part of the problem has been very lax lending and, obviously now, weaknesses in some of the oversight. Also a history of our reacting from a monetary policy point of view to ease quickly to try to take care of the problem and, therefore, to create a sense in the market of our support has raised some

real moral hazard issues that we now need to begin to remedy as we look forward in dealing with future receiverships. We are in a world of too big to fail, and as things have become more concentrated in this episode, it will become even more so.

CHAIRMAN BERNANKE. I certainly agree—and the Treasury Secretary and I have said publicly—that we need a strong, well-defined, ex ante, clear regime. But we have the problem now that we don't have such a regime, and we're dealing on a daily basis with these very severe consequences. So it is a difficult problem.

MR. HOENIG. I think what we did with Lehman was the right thing because we did have a market beginning to play the Treasury and us, and that has some pretty negative consequences as well, which we are now coming to grips with.

CHAIRMAN BERNANKE. President Rosengren.

MR. ROSENGREN. I think it's too soon to know whether what we did with Lehman is right. Given that the Treasury didn't want to put money in, what happened was that we had no choice. But we took a calculated bet. If we have a run on the money market funds or if the nongovernment tri-party repo market shuts down, that bet may not look nearly so good. I think we did the right thing given the constraints that we had. I hope we get through this week. But I think it's far from clear, and we were taking a bet, and I hope in the future we don't have to be in situations where we're taking bets. It does highlight the need to look at the tri-party repo market, look at the money market fund industry, and look at how they're financing. There are a lot of lessons learned, but we shouldn't be in a position where we're betting the economy on one or two institutions. That is the situation we were in last weekend. We had no choice. We did what we had to do, but I hope we will find a way to not get into this position again.

CHAIRMAN BERNANKE. Okay. President Fisher.

MR. FISHER. Mr. Chairman, it may surprise you that President Yellen and I agree, [laughter] at least with the recommendation, as I do with the majority. I also agree firmly with President Hoenig. David wanted to know a little more about Houston, so I will start out with that, and then I'll quickly go to the policy matter.

The storm devastated Galveston and Beaumont. Their combined population is 650,000. The population of the greater Houston area is 6.5 million. The damage to Houston was moderate. The overall effect on the Texas economy should be relatively mild. We still expect employment growth this year of 1½ percent or so, plus or minus, even though the storm really hit hard an area that accounts for 26 percent of our employment and 30 percent of our output. In terms of the national impact, I think it's important to understand that the energy infrastructure took minor losses. The short-term functioning of that infrastructure is hampered by power losses and water problems. Gasoline prices have gone up because 3.9 million barrels a day, or roughly 22 percent of the U.S. refining capacity, has been shut down. By the way, that affects the spot market—I think that's some of the reason you've seen this weakness recently—and maybe the near-term futures market. If you look at the gasoline price market, the gasoline price went up another 13 cents yesterday, but the near futures market is down 19 cents. I think it reflects expectations that, once power is restored, the refineries will come back on line about a week later. So we will likely have a temporary bump-up in inflation due to the gas prices. But I think it is important to realize that this, unlike Katrina, didn't shut down the Mississippi, and the effect on other commodity prices is likely not to be significant, with one exception. If you look, you'll see that prices of soybeans and soybean oil have spiked recently. Clearly, the weather has an impact, but I think that's more supply–demand imbalance—something that I'm watching carefully.

The silver lining, if there is a silver lining to human tragedy, is probably twofold. One is, if you notice, that lumber prices are actually up this year, which is kind of odd in terms of lumber trading. Of course, lumber producers are probably pretty happy with the devastation in our state. Second, Mexican laborers will be very happy if we let them into the country because the Hispanics build most of our buildings in the United States. But I would say that the storm should not have any effect on nor should it alter our preferred policy direction, and I would like to talk about that very quickly.

I have been affected in my thinking about economic growth and inflation by what I'm seeing overseas. I'm globally oriented. I do expect that we're going to have less impetus from exports, which were significant in carrying our growth. Our numbers show that, and your numbers, David, show that, and all of our conversations have revolved around that. We were surprised on the upside by it. Now I think weakening economic growth elsewhere is likely to subdue that effect. We have also had an appreciation of the dollar. Oil prices have declined. I dove deep in my anecdotal explorations with the majors and also with all supply companies. For whatever it's worth, they are convinced that OPEC now has \$100 rather than \$70 as their benchmark. Most of them expect prices to slide down to somewhere in the \$80 range. But over the longer term, whatever that term may be, we're going to talk about \$100-plus oil. Then, of course, many commodity prices are off their peaks. They have retraced significantly—some entirely.

That said, in my anecdotal interchanges, I am still hearing about the likelihood, as I think President Pianalto mentioned, that people are seeking to preserve their margins. They've been stung for many years, and I'll just give you one case because I think it tells us something. If you talk to the CEO of Wal-Mart USA, what they are pricing to be on their shelf six to eight months from now has an average price increase of 10 percent. Now, of course, you might have this

reversed as we go through time. My biggest disappointment, incidentally, was that the one bakery that I've gone to for thirty years, Stein's Bakery in Dallas, Texas, the best maker of not only bagels but also anything that has Crisco in it, [laughter] has just announced a price increase due to cost pressures. But I do think we have a mitigation of inflation, and we also have a mitigation of the impetus to economic growth.

As to the current financial predicament, I want to go back to a comment I made a long time ago. This is not the first for me. I like to tease President Stern about his maturity—I don't go back to the Panic of 1890, but to Herstatt, 1974; New York City's failure, 1975; 1987; and what happened in Japan. Incidentally, you see the same pictures repeated in every newspaper. It's always the trader holding his head or looking up at the board. Now it's in color; it used to be black and white. I think it comes from the same archive, and it is repeated throughout time. [Laughter]

All of that reminds me—forgive me for quoting Bob Dylan—but money doesn't talk; it swears. When you swear, you get emotional. If you blaspheme, you lose control. I think the main thing we must do in this policy decision today is not to lose control, to show a steady hand. I would recommend, Mr. Chairman, that we embrace unanimously—and I think it's important for us to be unanimous at this moment—alternative B. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you very much. Coffee is ready. Why don't we take about thirty minutes? I have a couple of calls to make. See you at about 11:20.

[Coffee break]

CHAIRMAN BERNANKE. Okay. If we're ready, we can reconvene. First Vice President Cumming.

MS. CUMMING. Thank you, Mr. Chairman. In our forecast, we do show a downgrade in real activity in the near term since the August meeting. Downside risks to the economy we see as

still very considerable, and I would probably say that they really have increased quite a bit. I'll say a few more words about that. I'll also talk about the inflation front. We have long thought that inflation in the medium term will moderate, and we've been taking some comfort from recent developments that have been cited already.

On the weaker economic outlook, we see the intensification of adverse growth coming from many things mentioned already: the unemployment rate increase and the likelihood that consumer spending is going to be negative. I would put great stress also on indications that world demand is slowing abruptly, as Nathan mentioned. I think that all three of these things are occurring in an environment in which we have massive correction, adjustment, structural change in autos, housing, and financial intermediation. That adjustment is really interconnected—one has effects on the others. As part of this—particularly in the financial sector, I would say—in our senior loan officer survey we've seen indications that, even as rates in, say, the mortgage markets start to ease a bit, nonprice terms may still be tightening. President Pianalto talked about other areas in which borrowers are facing much tougher terms. As financial institutions feel their capital is constrained—and there's plenty of evidence that balance sheets are constrained across much of the financial sector—those kinds of nonprice rationing measures probably will become more evident. Second, as we discussed earlier, we've seen that credit losses, which thus far have been largely confined to the financial sector and increasingly their shareholders, run some risk of spilling over to other kinds of investors, who to date really have not felt that impact, such as money market fund investors, as mentioned earlier. In addition, the three big corrections that we have seen in autos, housing, and financial intermediation are not limited to the United States. In particular, as you know, several G-10 countries are facing very difficult situations in their housing markets, not much different from us; and the financial intermediation adjustment is truly a global correction.

On the inflation side, as I mentioned, we have acknowledged that we've seen elevated rates of inflation. But the recent developments—as we've seen in inflation expectations discussed earlier, in energy and other commodity prices, the unit labor cost developments that President Yellen discussed, and the year-over-year changes in import prices—are all pointing in the direction of some moderation of inflation and moderation of inflation expectations. In particular, we have looked at inflation expectations as measured by financial markets and feel that the decline that we see in those expectations cannot be explained simply by the drop in energy prices and technical factors but look larger than that. We would attribute that to indications, again, that global demand is slowing.

Coming into this meeting today, we favor alternative B. I would associate myself with the comments of President Stern and President Evans, that if we were, in fact, going to make a move today, it would be better to make a large move of 50 basis points. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. I think that, even before the recent intensification of financial market turmoil, there were trends becoming increasingly evident over the summer, since late June, that suggested that the economy was on a substantially slower path than it had been before. Resource utilization was falling appreciably, and the expected downward path of inflation in the future had much better odds of occurring. Indeed, I think that the expected weakness in the economy and the financial markets are interacting. We have one of these feedback loops in play. There has been a lot of concern not only in the United States but in other countries as well, as I heard in Basel last weekend, about a spillover—that the problems were not confined to the mortgage markets but were spilling into the loan books of the banks. That was related to the weakening in economic activity and was tightening up credit conditions, which would, in turn,



further weaken economic activity. So this feedback loop was at work certainly in the United States and was beginning to be felt a little more in other countries as well.

Since late June we have come to know a couple of things a little better. One is that consumption is not immune to soft labor markets, increases in energy prices, declining housing wealth, and tighter borrowing conditions. Even if we can't parse out the effects of each of these factors, consumption has weakened substantially. We have had three months in a row of declines in the retail control component and very weak auto sales. Although recent declines in oil prices will support disposable incomes and consumption, I think the other sources of restraint on households—declining house prices and tighter credit conditions—are more likely to intensify than to abate in coming quarters.

Another thing we know is that businesses have not gotten ahead of their need to shed labor, and they continue to trim staff in response to actual and expected weakness in demand. The decline in employment shows no signs of abating. Initial claims are running more than 50,000 higher than they were at the end of June, and they have remained elevated past the time that the introduction of the temporary extended benefits should have been felt. The unemployment rate is already  $\frac{1}{4}$  percentage point higher than anyone around this table predicted for the end of the year. The household survey, along with national income statistics, could be signaling greater softness in activity and higher output gaps than is evident in the GDP and spending data.

Another thing we have learned, as Nathan emphasized, is that foreign economies have not decoupled from the United States, and their prospects have been revised down substantially. They're absorbing the effects of weaker U.S. domestic demand on their exports, and growing risk aversion in financial markets is spreading abroad. The latter, the growing risk aversion, is beginning to have, as Chris Cumming was noting, effects on a number of emerging-market

economies, where capital inflows show signs of abating or even reversing; and indicators of financial stress have risen as a consequence of all this. Because of the stronger dollar, we will be able to rely less on exports going forward than we did before.

We never expected a rapid return to more normal financial market functioning, but the adjustment in the financial sector now looks to be more severe and to take longer than we thought before. Financial firms need to bolster profits to offset losses and track capital. They need to de-lever by reducing debt relative to equity. They need to consolidate, and above all, they need to protect themselves against the possibility of a run. All of this implies a prolonged period of very cautious lending and a high cost of capital for borrowers relative to benchmark interest rates. If the current severe financial situation persists, I think the flight to safety and liquidity could dry up credit to a broad array of all but the very safest borrowers and reduce asset prices with feedbacks on spending, and that feedback loop could intensify if these market conditions pertain. I think that's a substantial downside risk to the growth outlook.

Not all news affecting spending has been negative. Capital goods orders have held up. The decline in interest rates and commodity prices that respond to the markdown in global growth will help support domestic demand, and actions to stabilize the GSEs are helping the mortgage market. Activity is more likely to stagnate than to decline. But I think that we can be more certain than we were, say, at the end of June that the economy will move substantially away from our high employment objective over the next several quarters and that the downside risks to that are larger.

On the inflation side, incoming data have been disappointing, a little worse than anticipated, perhaps suggesting greater pass-through. The rise in import prices at the beginning of the third quarter was higher than anticipated. But we've also learned over the last couple of months that oil and other commodity prices can go down as well as up. The drop in retail energy prices helped to

reverse much of the run-up in inflation expectations at the household level and reduced inflation compensation in financial markets at least over the next five years. Weaker economies, along with lower commodity prices, are expected to reduce inflation in our trading partners, and that along with the dollar should lower import price inflation. The broadest measures of labor compensation available through the second quarter continue to suggest no upward pressure on the pace of increases in nominal labor costs. Despite elevated headline inflation, surprisingly good growth of productivity is holding down unit labor costs. Taking all of this together, I think that, despite the incoming inflation data, we can have greater confidence in our forecast that inflation will decline late this year and run much lower in the next few years than in the past year or so, though the risks to that still lie on the upside until we actually see the decline in headline inflation persist.

On policy, Mr. Chairman, I support alternative B, keeping the funds rate at 2 percent. I think that, at least for now, is consistent with lower inflation and a slow return to full employment in the future over time. We need to assess the effects of the financial turmoil. If asset price declines accelerate and the tightening of financial conditions is large and likely to be sustained, I would be open at some point in the future to a lowering of interest rates. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. Governor Warsh.

MR. WARSH. Thank you, Mr. Chairman. Let me do three things. I'll talk first about a modal forecast but probably give it short shrift; second, about financial market conditions; and third, about policy. Working under the assumption that our modal forecast doesn't look quaint a week from now, if the world were somehow to hew to a reasonably moderate view of how financial market conditions work going forward, personally I'd be a bit more optimistic than the Greenbook for the second half of '08. I think that the net export growth is likely to prove stickier than embedded in that forecast in spite of a stronger dollar and weaker global demand. But as we get to

2009 and 2010, I would actually be less rosy than the Greenbook. I don't see real catalysts for the economy to normalize and to approach trendlike growth. Key uncertainties around financial markets, labor markets, and housing and, I think, broader macroeconomic uncertainties that I've discussed before in terms of trade policy, tax policy, and regulatory policy, would make the creep-back to potential slower than embedded in those forecasts.

On the inflation front, I continue to be encouraged by the strength in the exchange value of the dollar and the work that is doing for us on import price inflation. I'm encouraged by the move down across a breadth of commodities—not just energy, metals, and food but really across the entire basket—but I'm still not ready to relinquish my concerns on the inflation front.

Let me turn now to financial market conditions. I have talked before about the financial architecture. I guess what we can say today with more confidence than I've been able to say before is that the dismemberment of the existing financial architecture has accelerated in the last few days and weeks, and we will very quickly look at business models, and industry will find new business models, we hope, to provide credit to the real economy. Financial markets have been testing financial institutions with weaker capital structures, uncertain management teams, and unsustainable business models. I think the question before us today that's hard to judge is whether financial markets are now to the point at which they are acting indiscriminately, testing all financial institutions regardless of capital structure or business model. I'd say that the evidence of the past twenty-four or forty-eight hours is still unclear. I think we'll have a greater clarity several days from now about whether markets are able to make the distinguishing judgments that we would count on.

Look at the CDS spreads for the two remaining independent broker-dealers, Goldman Sachs and Morgan Stanley, which Bill referenced. Goldman Sachs's CDS moved up another 190 or so

this morning. They are up 340 in the last two days. Morgan Stanley's are up 690. I wouldn't want to say whether those numbers are right or wrong. It may be that the business model is a failing one—that is, wholesale funding is no longer practicable in the world that we're now in. If the problems were confined to that part of the financial services industry, it would be tough and it would be ugly and, if you were a resident of New York, particularly painful. But I don't think it would rise to the level that would force us to recalibrate monetary policy. But if, in fact, those losses end up being endemic to all financial institutions, even those with strong deposit bases and higher capital ratios, then we certainly would have to take that into consideration. The few that are trying to swim against this tide are flailing; and without extraordinary actions either by a consortium of their competitors or by the official sector, they're likely to continue to fail. I think our efforts to date to protect the broader financial markets and the economy from knock-on effects in particular financial services sectors do seem to be helping to cushion the blow. But the prospect of some meaningful discontinuity and of some systemic risk remains real, and it's hard for me to judge today whether that prospect is as low as we might have thought even some weeks ago.

Ultimately, the question for the real economy is whether the emergence of this new financial architecture can come quickly enough to get credit markets to normalize. Is the suddenness of events in the last week going to accelerate the move toward a new financial architecture? Will the forces of creative destruction make that faster but ultimately bring credit back to these markets sooner? Are these forces so strong and overwhelming that all financial institutions will be hunkering down, clinging to an architecture that no longer works? That's a question to which I don't know the answer.

A couple of more points on markets. I think the work that was done over the past few days on Lehman Brothers should make us feel good in one respect. Market functioning seems to be

working okay—by which I mean that the plumbing around their role in the tri-party repo business, due in part to the Fed's actions, seems to be working. It's ugly. The backroom offices of these places are going crazy. There's a lot of manual work being done. So they wouldn't give it high marks. But it looks as though positions are being sorted out in a tough workmanlike way, and so that's encouraging.

Other than the CDS moves and the equity moves on the other broker-dealers, Goldman Sachs and Morgan Stanley, I don't think that that is the real specter that's casting some question over broader financial institutions. I think the Lehman situation, no matter what judgment we made this past weekend about whether or not to provide official-sector money, is not what is driving markets broadly outside of the investment banks. What's driving the broader uncertainty are questions about institutions like AIG that were rated AAA, that were so strong that counterparties didn't need collateral, and that were a certain bet to be a guarantor around stable value funds and all sorts of other products. If in a matter of weeks that AAA rating and that security could turn out to be worthless, then that would force institutions to evaluate two things. First, narrowly, how much AIG exposure do I have? Second, more broadly, if that's AIG, what about the rest of the insurance companies? What about the rest of the financial institutions, which aren't investment banks but are really representing the foundations of the U.S. financial system? So it is both those direct and indirect aspects that we have to try to understand as best we can. My own view is that the AIG question would be more financial devastation if these institutions turn out to be meaningfully insolvent but actually, in some ways, less market dislocation among intermediaries. That is, Lehman Brothers, Merrill Lynch, and Bear Stearns are touching and are in the middle of many more flows of data, and there are real losses being felt. But if an AAA company like AIG were really fundamentally insolvent, the direct losses to a range of institutions, particularly those that are not

just wholesale institutions but are retail institutions, could be very significant. I don't think we know the answer yet to the question of whether AIG speaks to a broader loss of confidence that could affect the foundations of the U.S. financial system.

Let me turn finally to policy, Mr. Chairman. I support alternative B and, based on some of the discussion from Presidents Lockhart and Stern, I'd make some simple suggestions that may strike a balance that acknowledges the concerns we have about financial markets but doesn't put us in the position where we are inclined to lurch in one direction, which as some people suggested could create more uncertainty than we intend. My suggestion, Mr. Chairman, would be to take the first sentence from alternative A, paragraph 2—"strains in financial markets have increased significantly and labor markets have weakened further"—and make that the first sentence of alternative B. Then strike the second sentence of alternative B, because I think we've largely covered that. That order gives proper attention, it strikes me, to the financial market developments. Finally, in the assessment of risk, Mr. Chairman, if you look at the last sentence, I would suggest modifying that ever so slightly by inserting the word "closely" and making one other modification. So that last sentence would read, "The Committee will continue to monitor economic and financial developments closely and will act as needed to promote sustainable economic growth and price stability." Also, if you think it's acceptable, rather than saying "financial developments" maybe there we would say, "The Committee will continue to monitor economic and financial market developments closely." Those would be my suggestions to try to strike that balance—that we are keenly focused on what's going on, but until we have a better view of its implications, we are not going to act. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. Governor Kroszner.

MR. KROSZNER. Thank you very much. Since the last meeting, there have obviously been a number of flare-ups in the fires that have been burning in the financial markets—the GSEs and then certainly what's come this past weekend and what's likely to come over this week and into the future. A number of people have mentioned things ranging from AIG to pressures on money market funds to some large financial institutions. There are some very large regional banks and a very large thrift that will be facing a lot of challenges as the uncertainties in the markets continue. I won't repeat what Governor Kohn said about the continuing pressures on the bank balance sheets. I think it is important to take into account that those pressures will be there going forward not only on U.S. institutions but also increasingly on international institutions. No one has mentioned UBS yet, but that's another institution about which there's a lot of concern, and if you look at CDS quotes there, they are skyrocketing also. Much as Governor Warsh said, I think that people are worried about what the next shoe to drop will be and whom we have to challenge. Whom do we have to get more information about to make us feel comfortable? If that suddenly becomes everyone, then of course the markets don't function.

I just want to focus quickly on consumption and consumer credit markets and then on inflation, and then I'll conclude. We have made some references to how consumers have acted in the past and whether they will continue to act this way. In some sense the consumer has been on a marathon since the early 2000s, facing an incredible amount of shocks—a lot of contraction in 2001, significant declines in stock market wealth, September 11, corporate governance scandals, sustained job losses, and low real income growth. Nonetheless, the consumer continued to consume. But now the consumer seems to be flagging. We have perhaps a very modest effect of the stimulus, which obviously can lead to negative payback for the rest of the year—so a drag going forward as well as drags from housing and stock market wealth, continuing job losses, rising



unemployment, and pressures on income. Although many of these shocks were similar to ones that happened earlier in the decade, it seems that consumers do not have the same resilience now that they did at one point. It's not surprising that, after having run this marathon, they're going to be a bit tired.

Part of it could also be the credit conditions that are putting much more pressure on them. Just to give you an anecdotal report, but it's from one of the largest providers of consumer credit in the economy. After stabilization basically through our FOMC meeting in August, we've seen some significant deterioration in delinquencies and in the performance of those who get into delinquencies—they roll right to full chargeoff much more rapidly. So we have seen not exactly a qualitative change but a significant deterioration. Also, the ability to securitize credit cards has changed dramatically. After our having opened the window and the markets having opened up in the second quarter, they basically haven't been able to do anything in the third quarter, and that's before this weekend. Obviously that's not going to be helping them.

Of course, there are some offsetting factors that can help the consumer. The very significant decline in mortgage rates has led to quite a response, according to this very large provider of consumer credit in the United States. The number of applications for mortgages, particularly for refis, has doubled over the last couple of weeks. So people do respond to prices, and that can help to ease some of their income burdens. Obviously, the reduction in energy prices and many food prices is helpful on that.

But of course, what has been good news for U.S. consumers may not be good news for international consumers. As a lot of people have mentioned, the rest of the world is seeing a very significant slowdown. I think the elevated commodity prices had helped to mask a lot of the underlying fiscal and structural problems in these economies, actually much like rising housing

prices in the United States had masked the problems in underwriting standards and what was going on in the mortgage market. So I think there are going to be significant challenges in a lot of countries around the world. The boost that we had earlier this year from the international sector is something we can't rely on.

On inflation, we're heartened by some of the lower energy prices. But I want to relate one anecdote. In a meeting at the OECD, the CEO of one of the largest private oil producers in the world was asked what reference price he used because obviously he has to make tens of billions of dollars of decisions on investment and so they thought here's someone who would really have a good notion of what the price of oil would be going forward. Without hesitation the person responded, "\$100, plus or minus \$50." [Laughter] That kind of uncertainty from someone who is really in the markets and making those kinds of decisions shows us that we have a reasonable degree of uncertainty in inflation pressures going forward. That said, I think the Greenbook forecast is where I would be also, although we're at uncomfortably elevated levels now. There are a lot of reasons to believe that, although they may be even a bit more elevated in the coming quarter, there are likely forces to bring things back down. This is particularly credible in the context of both survey-based and market-based expectations being quite contained, the market-based expectations being at the low of the year or even over the last couple of years.

So this brings me to support alternative B for no change today. On the statement, I do believe that some greater recognition of the stress would be valuable. I think it would be valuable to have something in the first sentence of paragraph 2 that focuses on the strains—perhaps just a single sentence about the strains—and then we can put the other pieces on consumption and housing into the next sentence. It is important in the final paragraph to leave our options open if we do see significant negative feedback effects so that we can make a move that wouldn't be a shock to the

markets but it also wouldn't be something that the markets could bank on. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. Governor Duke.

MS. DUKE. Thank you, Mr. Chairman. I continue to focus on the traditional commercial bank structure. I looked at two large retail banks, three regional banks, and three community banks, and two things came out of this. First, capital is driving everything, and the amount of capital that the banks need is now being driven more by the analysts and the rating agencies than it is anything that the regulators are doing. The banks feel as though they have done everything they can do in terms of capital management. They've quit buying back stock. They've cut their dividends. They've reduced expenses. There is no more capital available in external markets—not common stock, not preferred, not anything. One bank did issue some preferred stock through its own networks and a common stock issue—interestingly sort of snuck it into the market. They dribbled it out in small amounts because they found that, as soon as the markets determined that they were going to need to issue capital, they started to short the stock, figuring they could buy it back. So they did almost a reverse stock buyback.

The markets are fragile to dead. So what are they going to do? The only thing they can do is contract the balance sheet and not lend. Before I get to that, there was again discussion in several of the conversations about naked short selling. One bank reportedly had 103 percent of total outstandings in short interest, and that seemed odd to me. So I went and checked it this morning, and it turns out that it was not 103 percent. It was only 93 percent. But if you subtract out the stock that was owned by the officers and the directors, then it was over 100 percent. Another bank said that the rules in the disclosure that surround long positions have to be replicated somehow in short

positions because they're having just as much control over what happens in the fate and the management of the firm.

So what are they doing in terms of credit? Any heavy uses of credit or predominant uses of credit are just not being done. This eliminates all commercial real estate. They're actively trying to move that off their books. Participation loans, in which the participants get only the credit piece, are drying up. Those aren't available. No bank has any interest in going back into residential construction lending. One large bank said they were approving only one-third of the consumer credit that they would have approved a year ago. The secondary market for jumbos for takeouts on commercial are nonexistent, and one bank told me that, with the current cost of capital and cost of funding, the breakeven spread for a loan was 400 basis points over LIBOR. That's the new lending market, and I don't see it getting any better until some capital is available.

The credit quality side is actually a better story. First, except for residential real estate, it's really still pretty good. C&I lending is holding up extremely well. In commercial real estate, again, outside of residential development, things are really looking pretty good. Some small retail centers are showing softness with the small storefronts; and in areas like Michigan, they're worried about losing the anchor tenants. Other than that, everything is okay. The other consumer credit feels like a mild recession but, again, is normally cyclical. Home equity is awful. The bank-originated loans range from good—one institution had 39,000 loans with 44 past due—to performing similar to unsecured credit. The broker-originated loans, especially the later vintages, are 100 percent loss. Within the mortgages, the rate of acceleration in new past-dues has slowed down. About rejections, I asked them to project when the new delinquencies would be offset by the resolution of existing delinquencies, and they said somewhere between year-end 2008 and mid-2009. So we are moving through that process. The severity, however, continues to grow as housing prices decline. It does

appear that the portfolio lenders are getting their arms around the collection and the loss-mitigation effort. They're assigning resources, accountability, and priority. It looks as though they are finally set up to do a pretty good job on that, managing it on several fronts—the analysis of the issue, the early stage collection, contact, and loss mitigation—and actually assigning a permitted spend, if you will, to resolve the loan. Foreclosures are going to take a lot longer and are particularly affected by state law. Apparently in Florida it takes a year to get a property in foreclosure. So those foreclosures are going to happen over a fairly long period of time.

I asked about a bottom, and they said they do feel as though they're seeing bottoms in some markets—Ohio and coastal areas in California, although not inland. Las Vegas and Atlanta are overbuilding, but the in-migration will absorb it. Florida is a bottomless hole—speculation combined with insurance problems. In Arizona so much land was available that they can't find a bottom there. Regarding lot inventory, a community banker in Omaha said they had seven years of inventory in terms of lots, which I thought was pretty startling until I read in the *American Banker* the same story in Atlanta and the same story in Orlando. So I think when residential development does resume, it will be to work out the lot inventory. Also, the phantom inventory is at least as large as the current inventory—phantom inventory being defined as people who want to sell but don't want to sell in the current market. Asked to compare current credit metrics with those in the 1980s and 1990s, one contact said they peaked in 1988 at 5.8 percent nonperforming. Now they are at 1.66. I found a chart, and for the entire industry, nonperformers were 4 percent in 1991. They're 1.2 percent right now. So the credit metrics are just nowhere near what they were in the S&L crisis for the industry.

I came out of that really believing that, if we are going to do something, we need to address the availability of capital to commercial banks but we should leave the bad loans in the banks

because they're getting to the point where the portfolio lenders are doing a good job of working through these loans. To try to take them out and put them into another structure, we would just have to replicate that whole gearing-up process. I don't necessarily think that's the case with the servicers, particularly the servicers of private-label mortgages. That's something on which I know we've done some research here, and I want to investigate that a bit more to see if there's something to be known there.

In terms of the policy, I, too, would favor alternative B with some change in the language to paragraph 2. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you very much, and thanks, everyone, for very helpful comments. Let me try to summarize, and I will just make some comments, and then we can turn to the statement and policy.

The group indicated, of course, that economic growth has slowed and looks to be quite sluggish in the second half. I didn't hear a great deal of change in the general profile, with most people still viewing growth as being slow in the near term but perhaps recovering somewhat in 2009. But obviously there is a lot of uncertainty surrounding that judgment. The ongoing problems in housing and the financial system are, of course, the downside risks to growth. Another factor, which is becoming more relevant, is the slowing global economy, which together with the stronger dollar may mean that U.S. export growth will be somewhat less. Despite the tax rebate, consumer spending seems likely to be weak in the near term, reflecting a variety of factors that we noted before, including housing and equity wealth, credit conditions, and particularly perhaps the ongoing weakness in the labor market. The labor market is deteriorating, with unemployment up, although UI programs may play some role in the unemployment rate. It is somewhat difficult to predict the peak of the unemployment rate, given

the upward momentum we are seeing. Declines in energy prices, however, will improve real incomes and help consumer sentiment—so that is a potentially positive factor.

The housing sector continues to be the central concern in the economy, in both the real and the financial sides. There are no clear signs of stabilization, although obviously regional conditions vary considerably. The government action regarding the GSEs has lowered mortgage rates and may be of some assistance. Credit conditions have tightened, though, in other areas as well, including nonresidential construction.

Firms are continuing to struggle with weaker demand, higher uncertainty, and high costs. Manufacturing has been relatively stable to weaker, but we had at least one report of a survey that in the medium term the outlook is looking a little better. Inventories appear to be relatively well managed. Credit conditions for business vary, but there are indications that some firms are finding it very difficult to attract capital.

Financial markets received a lot of attention around the table. Conditions clearly have worsened recently, despite the rescue of the GSEs, the latest stressor being the bankruptcy of Lehman Brothers and other factors such as AIG. Almost all major financial institutions are facing significant stress, particularly difficulties in raising capital, and credit quality is problematic, particularly in residential-related areas. One member noted that it is not evident that markets are clearly differentiating between weaker and stronger firms at this point. Deleveraging is continuing, and securitization markets are moribund. Credit terms and conditions are quite tight and may be a significant drag on the economy. However, the medium-term implications of the recent increases in financial stress for the economy are difficult to assess. We may have to wait for some time to get greater clarity on the implications of the last week or so.

On the inflation front, recent core and headline numbers have been high, reflecting earlier increases in the prices of energy and raw materials. There are positive factors, including the significant intermeeting declines in the prices of oil and other commodities, which, if maintained, would bring headline inflation down rather notably by the end of the year or next year. The dollar has also strengthened. Generally speaking, inflation expectations, though noisy, have improved. We have seen a decline in TIPS breakevens and some decline in survey expectations as well. But it was noted that the five-by-five TIPS breakeven remains above a level consistent with long-term price stability. Nominal wage growth has remained subdued so far, slack is increasing, productivity has been strong, and therefore, unit labor costs are well controlled. Again, all of these factors are positive in terms of a better inflation picture going forward. On the other hand, recent declines notwithstanding, the cumulative increases in commodity prices over the past year or so do remain large, and there is some evidence that these cost increases are being passed through into core prices. Commodity prices are extremely volatile, which makes inflation very difficult to forecast and makes the inflation outlook, therefore, quite uncertain. Wages could also begin to rise more quickly as the economy strengthens. For all these reasons, inflation risks are still in play and remain a concern for the Committee. Some participants reiterated their concern that maintaining rates too low for too long risks compromising our credibility and stimulating inflation over the medium run. That is a very quick survey of the comments. Are there any comments or questions?

If not, let me just make a few comments. Personally, I see the prospects for economic growth in the foreseeable future as quite weak, notwithstanding the second quarter's strength. I think what we saw in the recent labor reports removes any real doubt that we are in a period that will be designated as an official NBER recession. Unemployment rose 1.1 percentage points in



four months, which is a relatively rapid rate of increase. The significance of that for our deliberations is, again, that there does seem to be some evidence that, in recession regimes, the dynamics are somewhat more powerful and we tend to see more negative and correlated innovations in spending equations. So I think that we are in for a period of quite slow growth. That is confirmed by what we are seeing in consumption, which probably would be quite negative if it weren't for the remainder of the fiscal stimulus package. Other components of demand are, likewise, quite weak. We are all familiar with the housing situation. Some other factors that were supportive in Q2 are weakening—a number of people have noted the export growth. Actually, it is net exports—which is important—not just exports, and we are seeing both slowing growth in exports and some forecast of increased growth in imports.

A factor that we haven't talked about much is the fiscal side. That has been supportive and may be less supportive going forward. Generally speaking, though, I do think—and I have said this for a long time—that the credit effects will be important. They operate with a lag. It is very difficult to judge the lag. But my strong sense is that they are still some distance from their peak; that they will begin to be felt outside of housing, in nonresidential construction, for example, in consumer spending, and in investment; and that this is going to be independent of last week's financial developments. I think that is going to be a major drag, probably well into next year.

There are a few positives, which give some hope of some improvement next year. We have talked about energy and commodity prices as they relate to inflation, but of course, the decline in energy and commodity prices is also a plus for consumers and raises real incomes and would be supportive of sentiment, as we have already seen. There are a few positive indications here and there on the housing market, a few glimmers of stability, particularly in some regions. I

think that the GSE stabilization is going to be very important. It has already lowered mortgage rates. It suggests that there will be a market for securitized mortgages, and I think that is positive. So if I wanted to outline an optimistic scenario, it would involve stronger indications of stabilization in housing, which in turn would feed into more confidence in the financial sector and would lead over time to improvement in the broader economy.

I do think that financial conditions are a major concern. The situation right now is very uncertain, and we are not by any means away from significant systemic risk. Even if we avoid a major systemic event, the increase in risk aversion, the pullback from all counterparties, the deleveraging, the sale of assets—all of these things are going to continue for some time and are going to make the financial sector very stressed, which obviously will have effects on the economy.

I have been grappling with the question I raised for President Lacker, and I would be very interested in hearing other views either now or some other time. The ideal way to deal with moral hazard is to have in place before the crisis begins a well-developed structure that gives clear indications in what circumstances and on what terms the government will intervene with respect to a systemically important institution. We have found ourselves, though, in this episode in a situation in which events are happening quickly, and we don't have those things in place. We don't have a set of criteria, we don't have fiscal backstops, and we don't have clear congressional intent. So in each event, in each instance, even though there is this sort of unavoidable ad hoc character to it, we are trying to make a judgment about the costs—from a fiscal perspective, from a moral hazard perspective, and so on—of taking action versus the real possibility in some cases that you might have very severe consequences for the financial system and, therefore, for the economy of not taking action. Frankly, I am decidedly confused and very

muddled about this. I think it is very difficult to make strong, bright lines given that we don't have a structure that has been well communicated and well established for how to deal with these conditions. I do think there is some chance—it is not yet large, but still some chance—that we will in fact see a much bigger intervention at the fiscal level. One is tempted to argue that by doing more earlier you can avoid even more later, but of course that is all contingent and uncertain. So we will collectively do our best to deal with these very stressful financial conditions, which I don't think will be calm for some time.

With respect to inflation, I accept the many caveats around the table. I have to say that I think, on net, inflation pressures are less worrisome now. The last two meetings have been very positive in that respect. The declines in energy and commodity prices are quite substantial. Natural gas, for example, has reversed all of its gains of the year. Steel scrap is down 40 percent in two months. We are seeing many other indications that commodity prices really have come down quite a bit. The dollar's increase is also quite striking, and we have talked about wages, TIPS, and other factors. So I think overall I see at least the near-term inflation risk as considerably reduced. I do agree, though, with the points that were made that we may well see pressure on core inflation for a while longer, despite this morning's reasonably benign number. The increases in commodity costs, although they have been partially reversed, have not been entirely reversed. Certainly over the last year to year and a half there is still a net substantial increase, which will show up as firms begin to pass through those costs.

It is also the case, of course, that we have seen a very, very sharp movement in commodity prices and the dollar. Therefore, there is no logical reason why that couldn't be reversed. Clearly, one problem we face is that the uncertainty about forecasting commodity prices is so large that it makes our forecasting exercises extraordinarily uncertain and means that

we need to be somewhat more careful than we otherwise would be if we were back in the days of the Texas Railroad Commission, when we knew the price of oil six months in advance. We don't have that privilege anymore. So I think core inflation may be elevated for a while. It may take a while for inflation to moderate. Everything I say is contingent on the dollar and commodity trends not being strongly reversed. But if those things are not reversed, I think we will see some improvement in inflation in the near term.

I also agree with those who say that, when the time comes, we do need to be prompt at removing accommodation. It is just as much a mistake to move too late and allow inflation, and perhaps even financial imbalances, to grow as it is to move too early and be premature in terms of assuming a recovery. I think that is a very difficult challenge for us going forward, and I acknowledge the importance of that, which a number of people have noted.

So that is a quick summary of my views. Let me just turn briefly, then, to policy. Do we have the statement? Let me just preview. I talked with Governor Warsh, and he gave me now during the break some of those suggestions he made. As they fit closely with other things that people said around the table, we have made a version here that incorporates them. I'll discuss that in just a minute.<sup>3</sup>

First, as a number of people have said, let me just say that I thought the memo that the staff prepared over the intermeeting period was extraordinarily helpful. We have been debating around the table for quite a while what the right indicator of monetary policy is. Is it the federal funds rate? Is it some measure of financial stress? Or what is it? I think the only answer is that the right measure is contingent on a model. As President Lacker and President Plosser pointed out, you have to have a model and a forecasting mechanism to think about where the interest rate is that best achieves your objectives. It was a very useful exercise to find out, at least to some

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<sup>3</sup> The statement referred to here is appended to this transcript (appendix 3).

extent, how the decline in the funds rate that we have put into place is motivated. In particular, the financial conditions do appear to be important both directly and indirectly—directly via the spreads and other observables that were put into the model and indirectly in terms of negative residuals in spending equations and the like. The recession dynamics were also a big part of the story. I hope that what this memo does for us—again, I think it’s extraordinarily helpful—is to focus our debate better. As President Plosser pointed out, we really shouldn’t argue about the level of the funds rate or the level of the spreads. We should think about the forecast and whether our policy path is consistent with achieving our objectives over the forecast period. I am sympathetic to the general view taken by the staff, which argues that those recession dynamics and financial restraints are important, that we are looking at slow growth going forward, and that inflation is likely to moderate. Based on those assumptions, I think that our policy is looking actually pretty good. To my mind, our quick move early this year, which was obviously very controversial and uncertain, was appropriate. Their analysis also suggests that the amount of insurance that we have is perhaps limited, given that they take a risk-neutral kind of modeling approach. Having said that, I think they have also clearly set out the conditions and the framework in which we can debate going forward exactly where we should be going. To the extent that those around the table disagree with the model or with the projection, then that is the appropriate way, it seems to me, to address our policy situation. So, again, I do very much appreciate that. It helped me think about the policy situation. As I said, I think our aggressive approach earlier in the year is looking pretty good, particularly as inflation pressures have seemed to moderate.

Overall I believe that our current funds rate setting is appropriate, and I don’t really see any reason to change. On the one hand, I think it would be inappropriate to increase rates at this

point. It is simply premature. We don't have enough information. There is not enough pressure on inflation at this juncture to do that. On the other hand, cutting rates would be a very big step that would send a very strong signal about our views on the economy and about our intentions going forward, and I think we should view that step as a very discrete thing rather than as a 25 basis point kind of thing. We should be very certain about that change before we undertake it because I would be concerned, for example, about the implications for the dollar, commodity prices, and the like. So it is a step we should take only if we are very confident that that is the direction in which we want to go.

Therefore my recommendation to the Committee—and I will open it up for comment in a moment—is to keep the funds rate at its current level. I listened very carefully to the conversation around the table in terms of the statement. I think it was President Lockhart, President Stern, and Governor Warsh, among others, who talked about strengthening the language on financial markets. So the draft statement that you have in front of you is an attempt to make that change. It has two changes relative to existing alternative B. First, as Governor Warsh suggested, it reverses the first two sentences and so focuses in the first sentence on “Strains in financial markets have increased significantly and labor markets have weakened further,” and then the rest of it is basically the same as it was. The other change, which is in the last paragraph in the risk assessment, is pretty small, but it is probably worth considering. The word “closely” has been added to suggest, obviously, that we understand that the situation is changing rapidly and that we are carefully following conditions as they evolve. Kevin, we took your word “market” there—what was the rationale for it?

MR. WARSH. My sense is—and this is certainly open for discussion—that we want the focus to be that we are really watching market developments closely. We are not trying to

monitor the broader economy, which we might not be able to measure too much. I will admit that we have “economic and financial markets,” with “closely” modifying both of them, but the idea was to put the focus on the market side to a slightly greater extent than we normally do.

CHAIRMAN BERNANKE. Okay. So I think that’s useful, although I do note that, all else being equal, there’s a slight barrier for making any change, and that one word is a change. President Fisher.

MR. FISHER. I am sort of indifferent about this, but I don’t want to forget what Governor Duke was talking about. It’s not just financial markets; it’s financial developments. We are also talking about the internal dynamics of what is happening in the banking system and the credit contraction you spoke of. So we lead off with financial markets. I don’t want people to think we are focusing only on markets—Governor Warsh, I would disagree on that point. It’s a minor disagreement, but I think it is overkill.

CHAIRMAN BERNANKE. All right. Let me open it up for any other comments on the statement or the policy action. President Evans.

MR. EVANS. Thank you, Mr. Chairman. It is really just a question. What type of reaction do we think will be engendered by inserting “closely”? Everybody understands that we monitor financial developments very carefully. So we are bringing attention to this. Will there be a presumption that we are likely to do something intermeeting or something like that? I am not saying that is wrong, but it is a question.

MR. DUDLEY. I would say that the markets will take it as a statement that is conditional on what happens in markets. If markets get sufficiently bad, if there is some threshold of deterioration, that can potentially provoke an intermeeting move is the way I think they would take it. Brian, would you agree with that?

MR. MADIGAN. I agree. The fact that the first sentence of the risk assessment has a parallel treatment of the upside and downside risks may communicate a bit the sense that you are not ready to ease immediately.

CHAIRMAN BERNANKE. Okay. We will decide. We will take a vote on it, if necessary. President Lacker.

MR. LACKER. Yes. I echo President Evans's concern. My recollection is—and I haven't consulted the record recently—under your predecessor there was some phrasing like “watch market developments closely” that came to be widely understood as a signal of an intermeeting move.

CHAIRMAN BERNANKE. I think it was “monitor closely.” Is that what it was?

MR. LACKER. “Monitor closely” or some language like that.

CHAIRMAN BERNANKE. Yes, “monitor closely.” Maybe you're right.

MR. LACKER. Yes, and that gives me pause. Then, about “market”—like a lot of economists, I am willing to construe the word “market” very broadly to include intermediation mechanisms of all types and the market for commercial credit in, you know, Dillon, South Carolina. [Laughter] But I am not sure that market participants are going to take it that broadly. They are going to take it in the sense of markets in traded financial instruments and organized exchanges and such. I just wonder if they are going to interpret it too closely as Wall Street.

CHAIRMAN BERNANKE. Okay. So the sentiment over here on this side is that nobody thinks “market” is important. Let's get rid of “market.” We'll discuss “closely.” President Plosser.

MR. PLOSSER. I think “market” may be construed too narrowly. We don't really mean it that way, I don't think.



CHAIRMAN BERNANKE. “Market” is already gone. All right. Other comments, suggestions, or thoughts? Governor Kroszner.

MR. KROSZNER. But I do think it is the delta, so it is the change. By including “closely,” I think the markets are going to look very closely at that change, and they are going to think that we are clearly trying to convey something with that. I just think we have to make sure that we feel comfortable in doing so. Certainly some people have suggested that they would be happy to move 50 basis points if they saw the markets moving, but I do think that that one particular word will get a lot of attention. Not that it should, but I think it is going to be focused on. Just as at one point we used the word “yet,” and that got an enormous amount of attention. And this has two syllables. [Laughter]

MR. FISHER. Unless you are from the south. [Laughter]

CHAIRMAN BERNANKE. The sad thing is that Governor Kroszner is right. We have seventeen people debating over this word, and it actually does matter. Does anyone else want to weigh in? Okay. I think my sense is that there should be a barrier, a bit of a hurdle, to changing; so I am leaning toward sticking with what we have. Would that be okay, Governor Warsh, do you think?

MR. WARSH. On “closely”?

CHAIRMAN BERNANKE. Getting rid of “closely.”

MR. WARSH. Let me ask Brian and Bill. Brian, without “closely,” how do you think the markets will react to that?

MR. MADIGAN. That you are not particularly ready to change your stance of policy.

MR. DUDLEY. I think the expectation going in is, for most people, that you are not prepared to ease today, but if things got really dark from here you would. So the question is, How do you convey that with the right word? You need something in between “closely” and—

MR. WARSH. I think the sentiment we are trying to suggest is watchful waiting. We are not indifferent, we are not clueless, we are paying attention, but we are not predisposed. Hence, Governor Kohn’s suggestion.

MR. KOHN. My suggestion was to substitute “carefully” for “closely.” I agree that “monitor closely” had this other connotation, but I think we should be seen as paying more attention than usual. There might be another alternative.

MR. DUDLEY. “The Committee will carefully evaluate economic and financial market developments.” That means you are on the case.

CHAIRMAN BERNANKE. Well, it is not an analytical thing we are doing. We are just watching closely.

MR. WARSH. Keenly? Carefully?

MR. LACKER. Mr. Chairman?

CHAIRMAN BERNANKE. Yes. President Lacker.

MR. LACKER. Including “closely,” what does that imply about the opposite? I mean, are we going to be able to take that out?

MR. WARSH. Well, we have done things like “in a timely manner” and other kinds of phraseology.

MR. LACKER. Yes, but this is an adjective.

CHAIRMAN BERNANKE. No, it’s an adverb.

MR. LACKER. There goes my credibility. [Laughter] If we take it out, can we use the phrase without it?

CHAIRMAN BERNANKE. What we have done in the past is basically just use a new phrase.

MR. LACKER. So that means we have to throw this phrase out.

MR. WARSH. Mr. Chairman, I would support “carefully.”

CHAIRMAN BERNANKE. Is that better? President Evans.

MR. EVANS. Just to be clear, we have gone a long way just now from its being a semantic discussion to whether or not the Committee wants to hint at the possibility of a near-term action. I do not have a problem with that. In fact, in my comments I suggested that the resolution of uncertainty might improve in the next couple of weeks, but that seems to be the principal issue here, which I don’t really recall us discussing in as much detail as we just have.

CHAIRMAN BERNANKE. No, you’re right. But there is another issue, which I think is the thing we’re concerned about and which motivates the change in alternative B, paragraph 2. We don’t want the world to feel that we are not awake, that we are not paying attention. We know that very unusual things are going on in the financial markets; and we are prepared, maybe not through monetary policy but through whatever mechanism is necessary, to address that.

MR. EVANS. Right. So I fully support that sentiment, and if you find the right wording that captures it, that’s fine with me.

CHAIRMAN BERNANKE. Other comments? President Plosser.

MR. PLOSSER. As long as we are throwing monkey wrenches into the language, I think we do signal our concern. In paragraph 2, we put the very first sentence, which says, “Strains in financial markets have increased significantly.” So we have acknowledged that at the very top of

this statement. So there is no going back on that. I am a little concerned about what moving back “closely” means. Another alternative that I’ll throw out would be, rather than use “closely,” to say that “the Committee will continue to monitor economic and financial developments.”

SEVERAL. That’s what it said last time.

MR. PLOSSER. Well, that seems fine. We are monitoring these things. Is this the FOMC statement dictionary we are going to? Is this the code book? [Laughter]

CHAIRMAN BERNANKE. Any other comments? All right. Let me just ask for a straw vote: “closely,” no “closely,” or “carefully.” Do we want “carefully”? All right. Is “carefully” more acceptable to those who are concerned?

MR. KOHN. It’s less of a code word. The intention was to loosen it up a bit but not revert to those code words that nearly promise intermeeting action.

MR. PLOSSER. We make note of this in the lexicon of FOMC terminology.

CHAIRMAN BERNANKE. The semiotics class will begin as soon as the—[Laughter]  
All right. “Carefully”—is that okay? I’m seeing nodding. All right? Governor Warsh?

MR. WARSH. Yes, sir.

MR. KOHN. I’m closing the dictionary.

CHAIRMAN BERNANKE. All right. So we are changing the last part of that sentence. We are striking the word “market” and changing “closely” to “carefully.” Any other comments or thoughts on the substance, sizzle, or marketing? Or as Rick would say, “moychandising”—but he’s not here. [Laughter] All right. If not, Ms. Danker.

MS. DANKER. I will be reading the directive from the Bluebook and the statement that was just circulated. “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 the federal funds rate at an average of around 2 percent.”

Then the statement is as it was handed out, except the last sentence reads, “The Committee will monitor economic and financial developments carefully and will act as needed to promote sustainable economic growth and price stability.”

Chairman Bernanke	Yes
First Vice President Cumming	Yes
Governor Duke	Yes
President Fisher	Yes
Governor Kohn	Yes
Governor Kroszner	Yes
President Pianalto	Yes
President Plosser	Yes
President Stern	Yes
Governor Warsh	Yes

CHAIRMAN BERNANKE. Thank you. The next meeting is October 28 and 29. Lunch will be available in the anteroom. While we have lunch, Laricke Blanchard will provide us with an update on congressional developments. Thank you all very much. The meeting is adjourned.

END OF MEETING