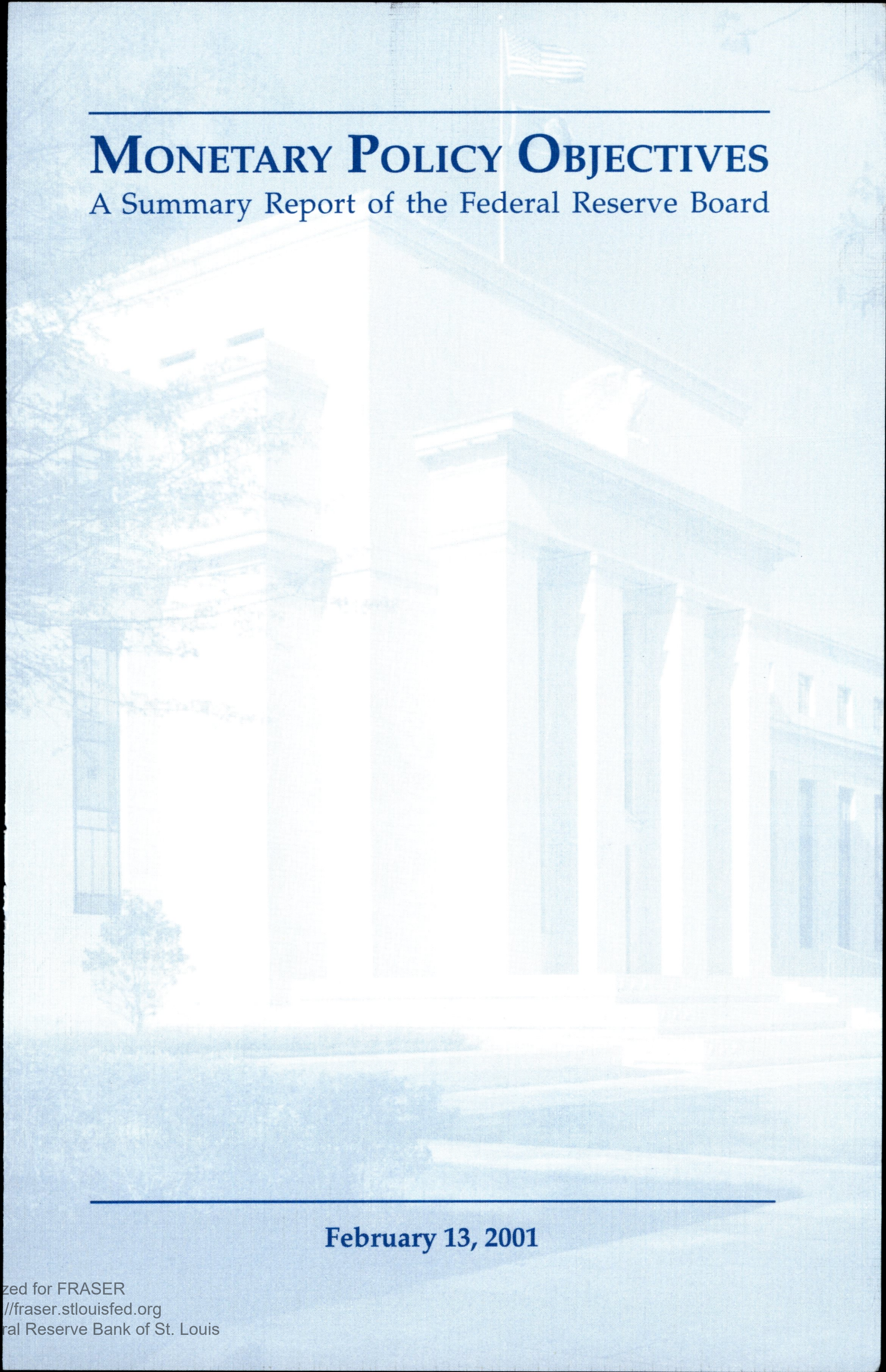

MONETARY POLICY OBJECTIVES

A Summary Report of the Federal Reserve Board

February 13, 2001

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This brochure provides the testimony by the Chairman of the Federal Reserve Board on the Board's semiannual Monetary Policy Report and excerpts from that report, as submitted to the Congress pursuant to section 2B of the Federal Reserve Act.

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Testimony of Alan Greenspan Chairman, Federal Reserve Board

I appreciate the opportunity this morning to present the Federal Reserve's semiannual report on monetary policy.

The past decade has been extraordinary for the American economy and monetary policy. The synergies of key technologies markedly elevated prospective rates of return on high-tech investments, led to a surge in business capital spending, and significantly increased the underlying growth rate of productivity. The capitalization of those higher expected returns boosted equity prices, contributing to a substantial pickup in household spending on new homes, durable goods, and other types of consumption generally, beyond even that implied by the enhanced rise in real incomes.

When I last reported to you in July, economic growth was just exhibiting initial signs of slowing from what had been an exceptionally rapid and unsustainable rate of increase that began a year earlier.

The surge in spending had lifted the growth of the stocks of many types of consumer durable goods and business capital equipment to rates that could not be continued. The elevated level of light vehicle sales, for example, implied a rate of increase in the number of vehicles on the road hardly sustainable for a mature industry. And even though demand for a number of high-tech products was doubling or tripling annually, in many cases new supply was coming on even faster. Overall, capacity in high-tech manufacturing industries rose nearly 50 percent last year, well in excess of its rapid rate of increase over the previous three years. Hence, a temporary glut in these industries and falling prospective rates of return were inevitable at some point. Clearly, some slowing in the pace of spending was necessary and expected if the economy was to progress along a balanced and sustainable growth path.

But the adjustment has occurred much faster than most businesses anticipated, with the process likely intensified by the rise in the cost of energy that has drained business and household purchasing power. Purchases of durable goods and investment in capital equipment declined in the fourth quarter. Because the extent of the slowdown was not anticipated by businesses, it induced some backup in inventories, despite the more advanced just-in-time technologies that have in recent years enabled firms to adjust production levels more rapidly to changes in demand. Inventory-sales ratios rose only moderately; but relative to the levels of these ratios implied by their downtrend over the past decade, the emerging imbalances appeared considerably larger. Reflecting these growing imbalances, manufacturing purchasing managers reported last month that inventories in the hands of their customers had risen to excessively high levels.

As a result, a round of inventory rebalancing appears to be in progress.

Accordingly, the slowdown in the economy that began in the middle of 2000 intensified, perhaps even to the point of growth stalling out around the turn of the year. As the economy slowed, equity prices fell, especially in the high-tech sector, where previous high valuations and optimistic forecasts were being reevaluated, resulting in significant losses for some investors. In addition, lenders turned more cautious. This tightening of financial conditions, itself, contributed to restraint on spending.

Against this background, the Federal Open Market Committee (FOMC) undertook a series of aggressive monetary policy steps. At its December meeting, the FOMC shifted its announced assessment of the balance of risks to express concern about economic weakness, which encouraged declines in market interest rates. Then on January 3, and again on January 31, the FOMC reduced its targeted federal funds rate ½ percentage point, to its current level of 5 ½ percent. An essential precondition for this type of response was that underlying cost and price pressures remained subdued, so that our front-loaded actions were unlikely to jeopardize the stable, low inflation environment necessary to foster investment and advances in productivity.

The exceptional weakness so evident in a number of economic indicators toward the end of last year (perhaps in part the consequence of adverse weather) apparently did not continue in January. But with signs of softness still patently in evidence at the time of its January meeting, the FOMC retained its sense that the risks are weighted toward conditions that may generate economic weakness in the foreseeable future.

Crucial to the assessment of the outlook and the understanding of recent policy actions is the role of technological change and productivity in shaping near-term cyclical forces as well as long-term sustainable growth.

The prospects for sustaining strong advances in productivity in the years ahead remain favorable. As one would expect, productivity growth has slowed along with the economy. But what is notable is that, during the second half of 2000, output per hour advanced at a pace sufficiently impressive to provide strong support for the view that the rate of growth of structural productivity remains well above its pace of a decade ago.

Moreover, although recent short-term business profits have softened considerably, most corporate managers appear not to have altered to any appreciable extent their long-standing optimism about the future returns from using new technology. A recent survey of purchasing managers suggests that the wave of new on-line business-to-business activities is far from cresting. Corporate managers more generally, rightly or wrongly, appear to remain remarkably sanguine about the potential for innovations to continue to enhance productivity and profits. At least this is what is gleaned from the projections of equity analysts, who, one must presume, obtain most of their insights from corporate managers. According to one prominent survey, the three- to five-year average earnings projections of more than a thousand analysts, though exhibiting some signs of diminishing in recent months, have generally held firm at a very high level. Such expectations, should they persist, bode well for continued strength in capital accumulation and sustained elevated growth of structural productivity over the longer term.

The same forces that have been boosting growth in structural productivity seem also to have accelerated the process of cyclical adjustment. Extraordinary improvements in business-to-business communication have held unit costs in check, in part by greatly speeding up the flow of information. New technologies for supply-chain management and flexible manufacturing imply that businesses can perceive imbalances in inventories at a very early stage—virtually in real time—and can cut production promptly in response to the developing signs of unintended inventory building.

Our most recent experience with some inventory backup, of course, suggests that surprises can still occur and that this process is still evolving. Nonetheless, compared with the past, much progress is evident. A couple of decades ago, inventory data would not have been available to most firms until weeks had elapsed, delaying a response and, hence, eventually requiring even deeper cuts in production. In addition, the foreshortening of lead times on delivery of capital equipment, a result of information and other newer technologies, has engendered a more rapid adjustment of capital goods production to shifts in demand that result from changes in firms' expectations of sales and profitability. A decade ago, extended backlogs on capital equipment meant a more stretched-out process of production adjustments.

Even consumer spending decisions have become increasingly responsive to changes in the perceived profitability of firms through their effects on the value of households' holdings of equities. Stock market wealth has risen substantially relative to income in recent years—itself a reflection of the extraordinary surge of innovation. As a consequence, changes in stock market wealth have become a more important determinant of shifts in consumer spending relative to changes in current household income than was the case just five to seven years ago.

The hastening of the adjustment to emerging imbalances is generally beneficial. It means that those imbalances are not allowed to build until they require very large corrections. But the faster adjustment process does raise some warning flags. Although the newer technologies have clearly allowed firms to make more informed decisions, business managers throughout the economy also are likely responding to much of the same enhanced body of information. As a consequence, firms appear to be acting in far closer alignment with one another than in decades past. The result is not only a faster adjustment, but one that is potentially more synchronized, compressing changes into an even shorter time frame.

This very rapidity with which the current adjustment is proceeding raises another concern, of a different nature. While technology has quickened production adjustments, human nature remains unaltered. We respond to a heightened pace of change and its associated uncertainty in the same way we always have. We withdraw from action, postpone decisions, and generally hunker down until a renewed, more comprehensible basis for acting emerges. In its extreme manifestation, many economic decisionmakers not only become risk averse but attempt to disengage from all risk. This precludes taking any initiative, because risk is inherent in every action. In the fall of 1998, for example, the desire for liquidity became so intense that financial markets seized up. Indeed, investors even tended to shun risk-free, previously issued Treasury securities in favor of highly liquid, recently issued Treasury securities.

But even when decisionmakers are only somewhat more risk averse, a process of retrenchment can occur. Thus, although prospective long-term returns on new high-tech investment may change little, increased uncertainty can induce a higher discount of those returns and, hence, a reduced willingness to commit liquid resources to illiquid fixed investments.

Such a process presumably is now under way and arguably may take some time to run its course. It is not that underlying demand for Internet, networking, and communications services has become less keen. Instead, as I noted earlier, some suppliers seem to have reacted late to accelerating demand, have overcompensated in response, and then have been forced to retrench—a not-unusual occurrence in business decisionmaking.

A pace of change outstripping the ability of people to adjust is just as evident among consumers as among business decisionmakers. When consumers become less secure in their jobs and finances, they retrench as well.

It is difficult for economic policy to deal with the abruptness of a break in confidence. There may not be a seamless transition from high to moderate to low confidence on the part of businesses, investors, and consumers. Looking back at recent cyclical episodes, we see that the change in attitudes has often been sudden. In earlier testimony, I likened this process to water backing up against a dam that is finally breached. The torrent carries with it most remnants of certainty and euphoria that built up in earlier periods.

This unpredictable rending of confidence is one reason that recessions are so difficult to forecast. They may not be just changes in degree from a period of economic expansion, but a different process engendered by fear. Our economic models have never been particularly successful in capturing a process driven in large part by nonrational behavior.

Although consumer confidence has fallen, at least for now it remains at a level that in the past was consistent with economic growth. And as I pointed out earlier, expected earnings growth over the longer-run continues to be elevated. If the forces contributing to long-term productivity growth remain intact, the degree of retrenchment will presumably be limited. Prospects for high productivity growth should, with time, bolster both consumption and investment demand. Before long in this scenario, excess inventories would be run off to desired levels.

Still, as the FOMC noted in its last announcement, for the period ahead, downside risks predominate. In addition to the possibility of a break in confidence, we don't know how far the adjustment of the stocks of consumer durables and business capital equipment has come. Also, foreign economies appear to be slowing, which could damp demands for exports; and, although some sectors of the financial markets have improved in recent weeks, continued lender nervousness still is in evidence in other sectors.

Because the advanced supply-chain management and flexible manufacturing technologies may have quickened the pace of adjustment in production and incomes and correspondingly increased the stress on confidence, the Federal Reserve has seen the need to respond more aggressively than had been our wont in earlier decades. Economic policymaking could not, and should not, remain unaltered in the face of major changes in the speed of economic processes. Fortunately, the very advances in technology that have quickened economic adjustments have also enhanced our capacity for real-time surveillance.

As I pointed out earlier, demand has been depressed by the rise in energy prices as well as by the needed slowing in the pace of accumulation of business capital and consumer durable assets. The sharp rise in energy costs pressed down on profit margins still further in the fourth quarter. About a quarter of the rise in total unit costs of nonfinancial, nonenergy corporations reflected a rise in energy costs. The 12 percent rise in natural gas prices last quarter contributed directly, and indirectly through its effects on the cost of electrical power generation, about one-fourth of the rise in overall energy costs for nonfinancial, non-energy corporations; increases in oil prices accounted for the remainder.

In addition, a significant part of the margin squeeze not directly attributable to higher energy costs probably has reflected the effects of the moderation in consumer outlays that, in turn, has been due in part to higher costs of energy, especially for natural gas. Hence, it is likely that energy cost increases contributed significantly more to the deteriorating profitability of nonfinancial, non-energy corporations in the fourth quarter than is suggested by the energy-related rise in total unit costs alone.

To be sure, the higher energy expenses of households and most businesses represent a transfer of income to producers of energy. But the capital investment of domestic energy producers, and, very likely, consumption by their owners, have provided only a small offset to the constraining effects of higher energy costs on spending by most Americans. Moreover, a significant part of the extra expense is sent overseas to foreign energy producers, whose demand for exports from the United States is unlikely to rise enough to compensate for the reduction in domestic spending, especially in the short-run. Thus, given the evident inability of energy users, constrained by intense competition for their own products, to pass on much of their cost increases, the effects of the rise in energy costs does not appear to have had broad inflationary effects, in contrast to some previous episodes when inflation expectations were not as well anchored. Rather, the most prominent effects have been to depress aggregate demand. The recent decline in energy prices and further declines anticipated by futures markets, should they occur, would tend to boost purchasing power and be an important factor supporting a recovery in demand growth over coming quarters.

Economic Projections

The members of the Board of Governors and the Reserve Bank presidents foresee an implicit strengthening of activity after the current rebalancing is over, although the central tendency of their individual forecasts for real GDP still shows a substantial slowdown, on balance, for the year as a whole. The central tendency for real GDP growth over the four quarters of this year is 2 to 2½ percent. Because this average pace is below the rise in the economy's potential, they see the unemployment rate increasing to about 4½ percent by the fourth quarter of this year. The central tendency of their forecasts for inflation, as measured by the prices for personal consumption expenditures, suggests an abatement to 1¾ to 2 ¼ percent over this year from 2½ percent over 2000.

Government Debt Repayment and the Implementation of Monetary Policy

Federal budget surpluses have bolstered national saving, providing additional resources for investment and, hence, contributing to the rise in the capital stock and our standards of living. However, the prospective decline in Treasury debt outstanding implied by projected federal budget surpluses does pose a challenge to the implementation of monetary policy. The Federal Reserve has relied almost exclusively on increments to its outright holdings of Treasury securities as the "permanent" asset counterpart to the uptrend in currency in circulation, our primary liability. Because the market for Treasury securities is going to become much less deep and liquid if outstanding supplies shrink as projected, we will have to turn to acceptable substitutes. Last year the Federal Reserve System initiated a study of alternative approaches to managing our portfolio.

At its late January meeting, the FOMC discussed this issue at length, and it is taking several steps to help better position the Federal Reserve to address the alternatives. First, as announced on January 31, the Committee extended the temporary authority, in effect since late August 1999, for the Trading Desk at the Federal Reserve Bank of New York to conduct repurchase agreements in mortgage-backed securities guaranteed by the agencies as well as in Treasuries and direct agency debt. Thus, for the time being, the Desk will continue to rely on the same types of temporary open market operations in use for the past year and a half to offset transitory factors affecting reserve availability.

Second, the FOMC is examining the possibility of beginning to acquire under repurchase agreements some additional assets that the Federal Reserve Act already authorizes the Federal Reserve to purchase. In particular, the FOMC asked the staff to explore the possible mechanisms for backing our usual repurchase operations with the collateral of certain debt obligations of U.S. states and foreign governments. We will also be consulting with the Congress on these possible steps before the FOMC further considers such transactions. Taking such assets in repurchase operations would significantly expand and diversify the assets our counterparties could post in temporary open market operations, reducing the potential for any impact on the pricing of private sector instruments.

Finally, the FOMC decided to study further the even longer-term issue of whether it will ultimately be necessary to expand the use of the discount window or to request the Congress for a broadening of its statutory authority for acquiring assets via open market operations. How quickly the FOMC will need to address these longer-run portfolio choices will depend on how quickly the supply of Treasury securities declines as well as the usefulness of the alternative assets already authorized by law.

In summary, although a reduced availability of Treasury securities will require adjustments in the particular form of our open market operations, there is no reason to believe that we will be unable to implement policy as required.

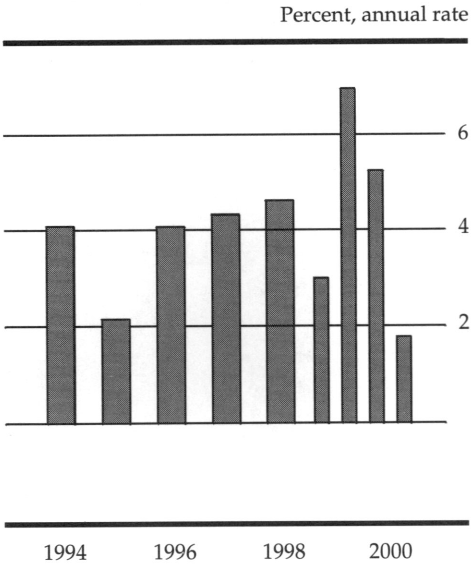
Monetary Policy and the Economic Outlook

When the Federal Reserve submitted its previous Monetary Policy Report to the Congress, in July of 2000, tentative signs of a moderation in the growth of economic activity were emerging following several quarters of extraordinarily rapid expansion. After having increased the interest rate on federal funds through the spring to bring the growth of aggregate demand and potential supply into better alignment and thus contain inflationary pressures, the Federal Reserve had stopped tightening as evidence of an easing of economic growth began to appear.

Indications that the expansion had moderated from its earlier rapid pace gradually accumulated during the summer and into the autumn. For a time, this downshifting of growth seemed likely to leave the economy expanding at a pace roughly in line with that of its potential. Over the last few months of the year, however, elements of economic restraint emerged from several directions to slow growth even more. Energy prices, rather than turning down as had been anticipated, kept climbing, raising costs throughout the economy, squeezing business profits, and eroding the income available for discretionary expenditures. Equity prices, after coming off their highs earlier in the year, slumped sharply starting in September, slicing away a portion of household net worth and discouraging the initial offering of new shares by firms. Many businesses encountered tightening credit conditions, including a widening of risk spreads on corporate debt issuance and bank loans. Foreign economic activity decelerated noticeably in the latter part of the year, contributing to a weakening of the demand for U.S. exports, which also was being restrained by an earlier appreciation in the exchange value of the U.S. dollar.

The dimensions of the economic slowdown were obscured for a time by the usual lags in the receipt of economic data, but the situation began to come into sharper focus late in the year as the deceleration steepened. Spending on business capital, which had been rising rapidly for several years, elevating stocks of these assets, flattened abruptly in the fourth quarter. Con-

Change in Real GDP



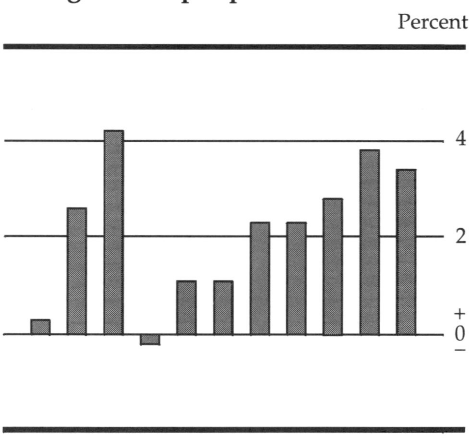
Note. Here and in subsequent charts, except as noted, annual changes are measured from Q4 to Q4, and change for a half-year is measured between its final quarter and the final quarter of the preceding period.

sumers clamped down on their outlays for motor vehicles and other durables, the stocks of which also had climbed to high levels. As the demand for goods softened, manufacturers adjusted production quickly to counter a buildup in inventories. Rising concern about slower growth and worker layoffs contributed to a sharp deterioration of consumer confidence. In response to the accumulating weakness, the Federal Open Market Committee (FOMC) lowered the intended interest rate on federal funds ½ percentage point on January 3 of this year. Another rate reduction of that same size was implemented at the close of the most recent meeting of the FOMC at the end of last month.

As weak economic data induced investors to revise down their expectations of future short-term interest rates in recent months and as the Federal Reserve eased policy, financial market conditions became more accommodative. Since the November FOMC meeting, yields on many long-term corporate bonds have dropped on the order of a full percentage point, with the largest declines taking place on riskier bonds as the yield spreads on those securities narrowed considerably from their elevated levels. In response, borrowing in long-term credit markets has strengthened appreciably so far in 2001. The less restrictive conditions in financial markets should help lay the groundwork for a rebound in economic growth.

That rebound should also be encouraged by underlying strengths of the economy that still appear to be present despite the sluggishness encountered of late. The most notable of these strengths is the remarkable step-up in structural productivity growth since the mid-1990s, which seems to be closely related to the spread of new technologies. Even as the economy slowed in 2000, evidence of ongoing efficiency gains were apparent in the form of another year of rapid advance in output per worker hour in the nonfarm business sector. With households and businesses still in the process of putting recent innovations in place and with technological breakthroughs still occurring, an end to profitable investment opportunities in the technology area does not yet seem to be in sight. Should investors continue to seek out emerging opportunities, the ongoing transformation and expansion of the capital stock will be maintained,

Change in Output per Hour



Note. Nonfarm business sector.

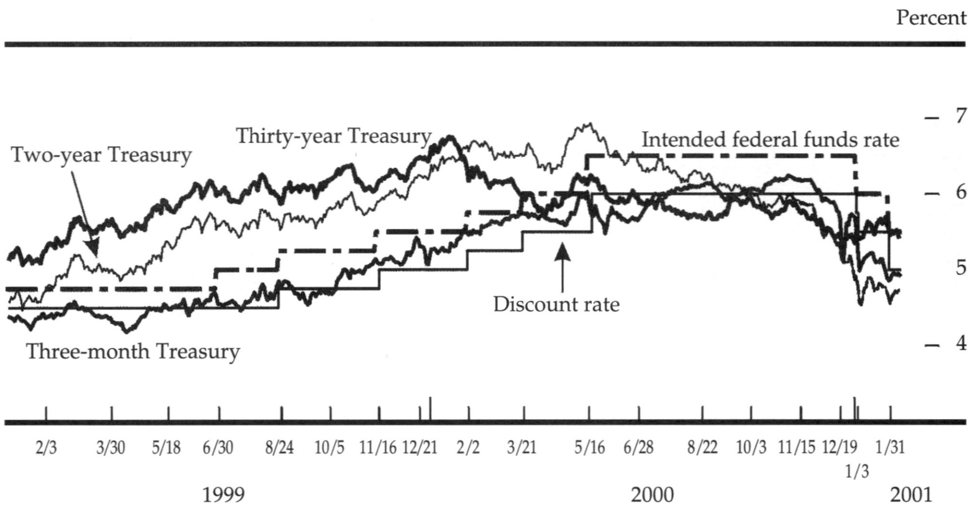
thereby laying the groundwork for further gains in productivity and ongoing advances in real income and spending. The impressive performance of productivity and the accompanying environment of low and stable underlying inflation suggest that the longer-run outlook for the economy is still quite favorable, even though downside risks may remain prominent in the period immediately ahead.

Monetary Policy, Financial Markets, and the Economy over the Second Half of 2000 and Early 2001

As described in the preceding Monetary Policy Report to the Congress, the very rapid pace of economic growth over the first half of 2000 was threatening to place additional strains on the economy's resources, which already appeared to be stretched thin. Private long-term interest rates had risen considerably in response to the strong economy, and, in an effort to slow the growth of aggregate demand and thereby prevent a buildup of inflationary pressures, the Federal Reserve had tightened its policy settings substantially through its meeting in May 2000. Over subsequent weeks, preliminary signs began to emerge suggesting that growth in aggregate demand might be slowing, and at its June meeting the FOMC left the federal funds rate unchanged.

Further evidence accumulated over the summer to indicate that demand growth was moderating. The rise in mortgage interest rates over the previ-

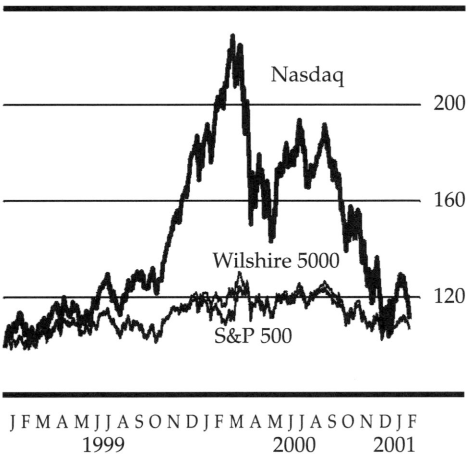
Selected Interest Rates



Note. The data are daily and extend through February 8, 2001. The dates on the horizontal axis are those of scheduled FOMC meetings and of any intermeeting policy actions.

Major Stock Price Indexes

January 4, 1999=100

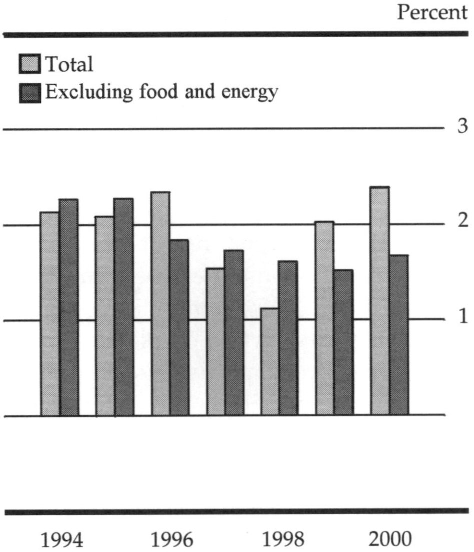


Note. The data are daily and extend though February 8, 2001.

ous year seemed to be damping activity in the housing sector. Moreover, the growth of consumer spending had slowed from the exceptional pace of earlier in the year; the impetus to spending from outsized equity price gains in 1999 and early 2000 appeared to be partly wearing off, and rising energy prices were continuing to erode the purchasing power of households. By contrast, business fixed investment still was increasing very rapidly, and strong growth of foreign economies was fostering greater demand for U.S. exports. Weighing this evidence and recognizing that the effects of previous tightenings had not yet been fully felt, the FOMC decided at its meeting in August to hold the federal funds rate unchanged. The Committee remained concerned that demand could continue to grow faster than potential supply at a time when the labor market was already taut, and it saw the balance of risks still tilted toward heightened inflation pressures.

The FOMC faced fairly similar circumstances at its October meeting. By then, it had become more apparent that the growth in demand had fallen to a pace around that of potential supply. Although consumer spending had picked up again for a time, it did not regain the vigor it had displayed earlier in the year, and capital spending, while still growing briskly, had decelerated from its first-half pace. With increases in demand moderating, private employment gains slowed from the rates seen earlier in the year. However, labor markets remained exceptionally tight, and the hourly compensation of workers had accelerated to a point at which unit labor costs were edging up despite strong gains in productivity. In addition, sizable increases in energy prices were pushing broad inflation measures above the levels of recent years. Although core inflation measures were at most only creeping up, the Committee felt that there was some risk that the increase in energy prices, which was lasting longer than had seemed likely earlier in the year, would start to leave an imprint on business costs and longer-run inflation expectations, posing the risk that core inflation rates could rise more substantially. Weighing these considerations, the FOMC decided to hold the federal funds rate unchanged at its October meeting. While recognizing that the

Change in PCE Chain-Type Price Index

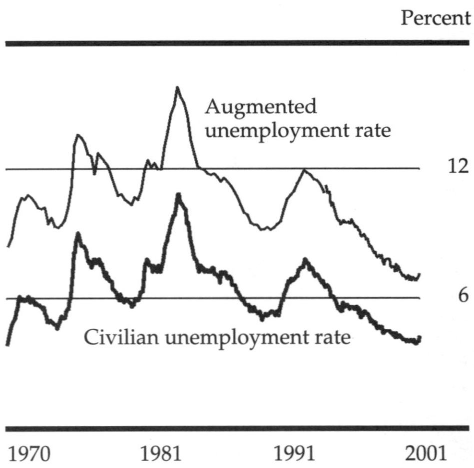


Note. Data are for personal consumption expenditures (PCE).

risks in the outlook were shifting, the FOMC believed that the tautness of labor markets and the rise in energy prices meant that the balance of those risks still was weighted towards heightened inflation pressures, and this assessment was noted in the balance-of-risks statement.

By the time of the November FOMC meeting, conditions in the financial markets were becoming less accommodative in some ways, even as the Federal Reserve held the federal funds rate steady. Equity prices had declined considerably over the previous several months, resulting in an erosion of household wealth that seemed likely to restrain consumer spending going forward. Those price declines, along with the elevated volatility of equity prices, also hampered the ability of firms to raise funds in equity markets and were likely discouraging business investment. Some firms faced more restrictive conditions in credit markets as well, as risk spreads in the corporate bond market widened significantly for firms with lower credit ratings and as banks tightened the standards and terms on their business loans. Meanwhile, incoming data indicated that the pace of economic activity had softened a bit further. Still, the growth of aggregate demand apparently had moved only modestly below that of potential sup-

Measures of Labor Utilization

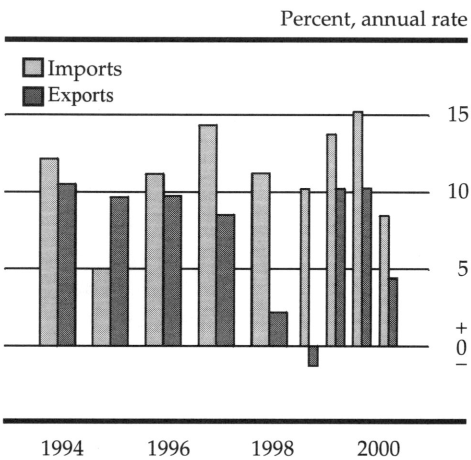


Note. The augmented unemployment rate is the number of unemployed plus those who are not in the labor force and want a job, divided by the civilian labor force plus those who are not in the labor force and want a job. The break in data at January 1994 marks the introduction of a redesigned survey; data after that point are not directly comparable with those of earlier periods. The data extend through January 2001.

ply. Moreover, while crude oil prices appeared to be topping out, additional inflationary pressures were arising in the energy sector in the form of surging prices for natural gas, and there had been no easing of the tightness in the labor market. In assessing the evidence, the members of the Committee felt that the risks to the outlook were coming into closer balance but had not yet shifted decisively. At the close of the meeting, the FOMC left the funds rate unchanged once again, and it stated that the balance of risks continued to point toward increased inflation. However, in the statement released after the meeting, the FOMC noted the possibility of subpar growth in the economy in the period ahead.

Toward the end of the year, the moderation of economic growth gave way, fairly abruptly, to more sluggish conditions. By the time of the December FOMC meeting, manufacturing activity had softened considerably, especially in motor vehicles and related industries, and a number of industries had accumulated excessive stocks of inventories. Across a broader set of firms, forecasts for corporate sales and profits in the fourth quarter and in 2001 were being slashed, contributing to a continued decline in equity prices and a further widening of risk spreads on lower-rated corporate bonds. In this environment, growth in business fixed investment appeared to be slowing appreciably. Consumer spending showed signs of decelerating further, as falling stock prices eroded household wealth and consumer confidence weakened. Moreover, growth in foreign economies seemed to be slowing, on balance, and U.S. export performance began to deteriorate. Market interest rates had declined sharply in response to these developments. Against this backdrop, the FOMC at its December meeting decided that the risks to the outlook had swung considerably and now were weighted toward economic weakness, although it decided to wait for additional evidence on the extent and persistence of the slowdown before moving to an easier policy stance. Recognizing that the current position of the economy was difficult to discern because of lags in the data and that prospects for the near term were particularly uncertain, the Committee agreed at the meeting that it would be especially attentive over coming weeks to signs that an intermeeting policy action was called for.

Change in Real Imports and Exports of Goods and Services



Additional evidence that economic activity was slowing significantly emerged not long after the December meeting. New data indicated a marked weakening in business investment, and retail sales over the holiday season were appreciably lower than businesses had expected. To contain the resulting buildup in inventories, activity in the manufacturing sector continued to drop. In addition, forecasts of near-term corporate profits were being marked down further, resulting in additional declines in equity prices and in business confidence. Market interest rates continued to fall, as investors became more pessimistic about the economic outlook. Based on these developments, the Committee held a telephone conference call on January 3, 2001, and decided to cut the intended federal funds rate ½ percentage point. Equity prices surged on the announcement, and the Treasury yield curve steepened considerably, apparently because market participants became more confident that a prolonged downturn in economic growth would likely be forestalled. Following the policy easing, the Board of Governors approved a decrease in the discount rate of a total of ½ percentage point.

The Committee's action improved financial conditions to a degree. Over the next few weeks, equity prices rose, on net. Investors seemed to become less wary of credit risk, and yield spreads narrowed across most corporate bonds even as the issuance of these securities picked up sharply. But in some other respects, investors remained cautious, as evidenced by widening spreads in commercial paper markets. Incoming data pointed to further weakness in the manufacturing sector and a sharp decline in consumer confidence. Moreover, slower U.S. growth appeared to be spilling over to several important trading partners. In late January, the FOMC cut the intended federal funds rate ½ percentage point while the Board of Governors approved a decrease in the discount rate of an equal amount. Because of the significant erosion of consumer and business confidence and the need for additional adjustments to production to work off elevated inventory levels, the FOMC indicated that the risks to the outlook continued to be weighted toward economic weakness.

Economic Projections for 2001

Although the economy appears likely to be sluggish over the near term, the members of the Board of Governors and the Reserve Bank presidents expect stronger conditions to emerge as the year progresses. For 2001 overall, the central tendency of their forecasts of real GDP growth is 2 percent to 2½ percent, measured as the change from the fourth quarter of 2000 to the fourth quarter of 2001. With growth falling short of its potential rate, especially in the first half of this year, unemployment is expected to move up a little further. Most of the governors and Reserve Bank presidents are forecasting that the average unemployment rate in the fourth quarter of this year

Economic Projections for 2001

Percent

	Indicator	Memo: 2000 actual	Federal Reserve governors and Reserve Bank presidents: Range	Central tendency
Change, fourth quarter to fourth quarter[1]	Nominal GDP	5.9	3¾–5¼	4–5
	Real GDP[2]	3.5	2–2¾	2–2½
	PCE chain-type price index	2.4	1¾–2½	1¾–2¼
Average level, fourth quarter	Civilian unemployment rate	4.0	4½–5	About 4½

1. Change from average for fourth quarter of 2000 to average for fourth quarter of 2001.

2. Chain-weighted.

will be about 4½ percent, still quite low by historical standards.

The rate of economic expansion over the near term will depend importantly on the speed at which inventory overhangs that developed over the latter part of 2000 are worked off. Gains in information technology have no doubt enabled businesses to respond more quickly to a softening of sales, which has steepened the recent production cuts but should also damp the buildup in inventories and facilitate a turnaround. The motor vehicle industry made some progress toward reducing excess stocks in January owing to a combination of stronger sales and a further sharp cutback in assemblies. In other parts of manufacturing, the sizable reductions in production late last year suggest that producers in general were moving quickly to get output into better alignment with sales. Nevertheless, stocks at year-end were above desired levels in a number of industries.

Once inventory imbalances are worked off, production should become more closely linked to the prospects for sales. Household and business expenditures have decelerated markedly in recent months, and uncertainties about how events might unfold are considerable. But, responding in part to the easing of monetary policy, financial markets are shifting away from restraint, and this shift should create a more favorable underpinning to the expected pickup in the economy as the year progresses. The sharp drop in mortgage interest rates since May of last year appears to have stemmed the decline in housing activity; it also has enabled many households to refinance existing mortgages at lower rates, an action that should free up cash for added spending. Conditions of business finance also have eased to some degree. Interest rates on investment-grade corporate bonds have recently fallen to their lowest levels in about 1½ years. Moreover, the premiums required of bond issuers that are perceived to be at greater risk have dropped back in recent weeks from the elevated levels of late 2000. As credit conditions have eased, firms have issued large amounts of corporate bonds so far in 2001. However, considerable caution is evident in the commercial paper market and among banks, whose loan officers have reported a further tightening of lending conditions since last fall. In equity markets, prices have recently dropped in response to negative reports on corporate earnings, reversing the gains that took place in January.

The restraint on domestic demand from high energy prices is expected to ease in coming quarters. Natural gas prices have dropped back somewhat in recent weeks as the weather has turned milder, and crude oil prices also are down from their peaks. Although these prices could run up again in conjunction with either a renewed surge in demand or disruptions in supply, participants in futures markets are anticipating that prices will be trending gradually lower over time. A fall in energy prices would relieve cost pressures on businesses to some degree and would leave more discretionary income in the hands of households.

How quickly investment spending starts to pick up again will depend not only on the cost of finance but also on the prospective rates of return to capital. This past year, expectations regarding the prospects of some high-tech companies clearly declined, and capital spending seems unlikely to soon regain the exceptional strength that was evident in the latter part of the 1990s and for a portion of last year. From all indications, however, technological advance still is going forward at a rapid pace, and investment will likely pick up again if, as expected, the expansion of the economy gets back on more solid footing. Private analysts are still anticipating high rates of growth in corporate earnings over the long-run, suggesting that the current sluggishness of the economy has not undermined perceptions of favorable long-run fundamentals.

The degree to which increases in exports might help to support the U.S. economy through a stretch of sluggishness has become subject to greater uncertainty recently because foreign economies also seem to have decelerated toward the end of last year. However, the expansion of imports has slowed sharply, responding in part to the softening of domestic demand growth. In effect, some of the slowdown in demand in this country is being shifted to foreign suppliers, implying that the adjustments required of domestic producers are not as great as they otherwise would have been.

In adjusting labor input to the slowing of the economy, businesses are facing conflicting pressures. Speedy adjustment of production and ongoing gains in efficiency argue for cutbacks in labor input, but companies are also reluctant to lay off workers that have been difficult to attract and retain in the tight labor market conditions of the past few years. In the aggregate, the balance that has been struck in recent months has led, on net, to slower growth of employment, cutbacks in the length of the average workweek, and, in January of this year, a small increase in the unemployment rate.

Inflation is not expected to be a pressing concern over the coming year. Most of the governors and Reserve Bank presidents are forecasting that the rise in the chain-type price index for personal consumption expenditures will be smaller than the price rise in 2000. The central tendency of the range of forecasts is $1\frac{3}{4}$ percent to $2\frac{1}{4}$ percent. Inflation should be restrained this coming year by an expected downturn in energy prices. In addition, the reduced pressure on resources that is associated with the slowing of the economy should help damp increases in labor costs and prices.

FRB1-18000-0201-C