**Minutes of the Federal Open Market Committee Meeting on August 12, 2003**

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, August 12, 2003, at 9:00 a.m. Those present were the following:

Mr. Greenspan, Chairman
Mr. Bernanke
Ms. Bies
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
Mr. Guynn
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Parry

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

Messrs. McTeer, Santomero, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Eisenbeis, Evans, Goodfriend, Howard, Judd, Madigan, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

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

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

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Mr. Moore, First Vice President, Federal Reserve Bank of Cleveland

Mr. Hakkio, Ms. Mester, Messrs. Rasche and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Kansas City, Philadelphia, St. Louis, and Cleveland respectively

Ms. Hargraves and Mr. Tootell, Vice Presidents, Federal Reserve Banks of New York and Boston respectively

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

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CHAIRMAN GREENSPAN. Good morning, everyone. Would somebody like to move approval of the minutes of the June 24-25 meeting?

MR. FERGUSON. I'll move approval of the minutes of the June meeting.

CHAIRMAN GREENSPAN. Without objection. The next item on the agenda is the proposed election of Brian Madigan and Charles Evans as Associate Economists to serve until the election of their successors at the first meeting of the Committee after December 31. Would somebody like to move the approval of both?

MR. FERGUSON. I'll move both of those.

CHAIRMAN GREENSPAN. Is there a second?

SPEAKERS(?). Second.

CHAIRMAN GREENSPAN. Without objection. Thank you very much. Dino Kos, you're on.

MR. KOS.[1] Thank you, Mr. Chairman. I'll be referring to the charts that were just circulated. Fixed-income markets in the intermeeting period were characterized by a high degree of volatility, as market participants readjusted their expectations for the future path of monetary policy in response to the Committee's June 25 statement, comments from various Committee members emphasizing near-term growth prospects, the generally positive economic data, and a relatively strong corporate earnings season.

The top panel on the first page graphs the U.S. three-month deposit rate in black and the three-month deposit rates three, six, and nine months forward in the dashed red lines. In the weeks before the June meeting, rates were trending down, as further easing by the Committee was anticipated in light of the various comments by Fed officials about the risk of deflation and the need to take aggressive measures to counteract it. The 25 basis point easing move at the June meeting—less than the 50 basis point cut many had expected—combined with language that suggested a better outlook for the economy, led markets to re-price short-term interest products. Many concluded that the easing cycle was perhaps finished and that there was only a small probability that the Fed would take so-called unconventional monetary policy

[1] The materials used by Mr. Kos are appended to this transcript (appendix 1).

actions. That move toward higher expected interest rates accelerated on July 31 with the release of the second-quarter GDP data, which came in higher than expected, and the continuing strength in some of the manufacturing and service sector surveys.

Treasury yields had declined sharply in May and into early June, based on the same set of expectations. Market participants expressed their views by putting on carry trades along the Treasury yield curve as well as in other sectors such as swaps, agencies, and mortgages. As these expectations were revised, the liquidation of positions—aided by some very strong technical factors that I'll get to in a second—accelerated, and yields rose along the curve. The two-year note traded to an intraday high of 1.93 percent on August 1, creating an unusually wide spread between its yield and the funds rate, especially taking into account the various statements by Committee members that the funds rate was likely to stay low for a long time. The two-year note yield subsequently eased back a little to 1¾ percent. Similarly, the yield on the ten-year note moved to an intraday high of more than 4½ percent from about 3.1 percent or so. The bottom chart graphs the "breakeven" rate on ten-year TIPS since January 2000, calculated by subtracting the TIPS yield from the nominal yield. The breakeven rate has traversed a well-worn range of between 125 and 225 basis points. I would make two points. First, despite the market's apparent fixation on deflation during the last few weeks and months, the breakeven rate drifted down only slightly and did not get far below 175 basis points before reversing recently. Second, the recent rise in nominal rates has been mostly an increase in real rates, which could be seen as consistent with expectations for an improved macroeconomic environment.

Still, the question remains: What were the factors that led to the sharp selloff in fixed-income markets? While incorrect expectations for policy played a role, at least as large a role was probably played by the dynamics of the mortgage-backed securities market. Unlike earlier cycles, the mortgage market is now larger than the Treasury market. Anecdotal reports indicate that a large percentage of MBS holdings are actively hedged by fund managers, all of whom are using fairly similar models.

The top left panel on page 2 graphs the distribution of MBS coupons as of December 31, 2002. The largest concentration of coupons was at 6½ percent. The shaded area to the right represents a very rough estimate of the portion of the distribution of mortgages that were candidates for refinancing based on December's average mortgage rate of 6.05 percent. In short, the shaded area represents the portion in which the homeowner's option to prepay is in the money. These estimates are crude and require the usual health warnings, but the trends are interesting and revealing nonetheless. The top right panel depicts the comparable distribution as of May 31, 2003. By then the thirty-year fixed-rate mortgage had come down to about 5½ percent and was still falling as we were heading into June. Nearly the entire distribution was in the money. However, with the backup in yields, mortgage rates rose even faster than other rates. By late July, the thirty-year fixed rate was reported by Freddie Mac in its survey to be at 6.14 percent. The most recent distribution of the coupons, which is as of June 30, gives a picture of the degree to which mortgages went from being in the money to being out of the money. Adding up the three bars in the unshaded area of the middle left panel indicates that a total of about $1 trillion of mortgages was suddenly out of the money.

Now, as rates were falling, fund managers were buying Treasuries as fast as possible to hedge against a shortening of duration caused by prepayments. Once rates began to back up, the risk was an extension of the portfolio. At that point the model suggested selling Treasuries to keep duration from increasing. Since the structural position of the mortgage market is well known, some speculators were no doubt front-running those flows and adding to the liquidity demands. The middle right panel graphs an estimate of the duration of the universe of fixed-rate mortgage-backed securities. In a span of about five weeks, that duration increased from about one-half year to more than three years. The increase was the largest ever seen over such a short period of time. The bottom panel on page 2 attempts to quantify the hedging needs generated by the backup in yields. Each bar represents the estimated purchase or sale of ten-year Treasury equivalents for each half-month period since the beginning of the year. The red line is the ten-year Treasury yield. As with most estimates, these figures are to be treated gingerly. The calculations assume that the entire MBS universe is actively hedged. That is not the case. But even if only half is managed in this way, the numbers are still very large. On the other hand, this graph does not include whole loans held by banks, thrifts, and the GSEs, some of which we know are managed actively. Nor does it include the activities of the mortgage servicers.

As the hedging in the mortgage-backed market reached something of a climax in late July, the activities of MBS investors increasingly pressured the swap market, which is the other major hedging vehicle for mortgage investors. The top panel of page 3 graphs the ten-year swap spread, which jumped more than 30 basis points in late July. Scattered reports of spotty liquidity circulated during this period. But for dealers and some investors the important point is not necessarily the level of the swap spread itself but the rate of change, since risk-management models make assumptions about the speed with which positions can be hedged.

The middle panel shows the standard deviation of the twenty-day change of the swap spread going back to 1993. Typically this measure of volatility was very small, less than 1 basis point, until 1998 when it suddenly spiked to about 4 basis points in the aftermath of the Russian default. In recent years, swap spreads have become somewhat less volatile as the spread narrowed. In July the volatility shot up again to a level comparable to or higher than that seen in 1998 and mid-2000. Occasional rumors circulated again about some bad positions and some losses in the dealer community, and liquidity was reported to have decreased as demand for fixed payer swaps rose. Nevertheless, the markets generally worked well. And as shown in the top panel, the spread itself has dropped more than 20 basis points from its peak. Mortgage and agency spreads also widened suddenly in late June and July. That is not surprising given the shifts in the mortgage market and, in the case of GSEs, the entity-specific news that buffeted them. On the other hand, the corporate market and, for that matter, the equity markets were not noticeably affected. The bottom panel graphs the investment-grade corporate spread year-to-date. Although it has ticked up in recent days, it moved slightly lower over the intermeeting period and is substantially down from January 1. The high-yield and EMBI spreads in the bottom right panel show broadly similar—and benign—patterns. U.S. equity markets on balance are slightly higher and traded in a narrow range over the period.

Turning to page 4, the reversal in our bond markets is not isolated. This page graphs the ten-year yield since April 15 for the United States, Germany, Canada, Sweden, Australia, Japan, and Mexico. All of these sovereign yields reached their lows in mid-June and then rose together. While part of the explanation may be that the economies are more interrelated, the more convincing explanation may be that bond markets are more interrelated and are especially sensitive to U.S. yields. I have just two minor points to add. First, the ten-year yield is now higher than that of the German Bund for the first time since May 2002. Second, the more than doubling of the ten-year JGB yield—from about 43 basis points to about 110 basis points at the peak—created much discussion about the losses on the books of Japanese banks. But it was little more than discussion, in part because the rally in the NIKKEI, it was argued, offset some or all of those losses. More recently, ten-year yields in Japan have retreated to about 89 basis points.

The top panel on the next page graphs the euro-denominated three-month cash deposit rate and the rate three, six, and nine months forward since mid-April. With weak sentiment and downbeat data, the market expected that the ECB would ease policy, which it did on June 6, cutting rates by 25 basis points. That is not marked on this graph, I should point out. The forward rates suggest that the market expected further easing, though less, through much of July. However, as the global bond market selloff accelerated, euro area forward rates trended higher and spiked on July 31 after the U.S. GDP report. The nine-month forward rate has eased off a bit since. The dollar has risen modestly against most currencies since June, consistent with the higher yields and the more upbeat view of the economic outlook. The dollar–yen exchange rate, shown in the middle right panel, continued to trade in the 117 to 120 range that it has been trapped in all year. The Ministry of Finance (MOF) continued to intervene, buying $19 billion in the period and raising its total intervention for the year to $75½ billion. In general, the yen has been depreciating or stable against most currencies. The bottom panel graphs the Australian dollar, the Canadian dollar, the euro, the pound sterling, and the U.S. dollar against the yen since January 1. The first three currencies have risen against the yen while sterling and the U.S. dollar have moved little. The U.S. dollar–yen relationship looks rather like a straight line since January 1 but perhaps mostly because of the frequent intervention by the MOF. The days Japan intervened in dollars are marked with small boxes on the red line.

Turning to page 6, let me say a word on reserves. The Desk has faced an unexpected decline in the growth of currency, as shown in the top panel on the page. That slowdown is due mostly to reflows from overseas for reasons that are not fully clear. Regardless of the reasons, the slowdown and the resulting overall pattern in autonomous factors have led us to shrink the System Open Market Account (SOMA) slightly by reducing our holdings of long-term RPs and essentially ceasing outright purchases for the time being. This is the second instance in the past year when we have had to contend with an unexpected need to temporarily contract SOMA. We have used the flexibility inherent in the long-term RP book to do that. But we have found that a book of RPs with a maturity of twenty-eight days at times does not give us enough flexibility to adjust the balance sheet on very short notice. So in order to give us more flexibility, I plan to shift the long-term RP book from a typical maturity of twenty-eight days to fourteen days at our regular Thursday operations. The change is purely a technical measure and does not require a change in the authorization, but I did want to advise the Committee before we implement the change. We plan to announce this modification to the primary dealers later this month and manage the shift in late September. Again, the main benefit of this change would be to provide the Desk with greater flexibility in addressing the demand for banking system reserves over the two-week length of the maintenance period. We will, however, continue to arrange operations with an original maturity of up to a maximum of sixty-five business days when reserve needs are expected to persist for relatively longer periods of time. That is often the case around the year-end, for example, when the total volume of temporary operations typically peaks in response to seasonal growth in currency.

Mr. Chairman, there were no foreign exchange operations. I will need approval of the domestic operations. If possible, after I take any questions on my regular report, I would like to make a few comments about Ginnie Maes.

CHAIRMAN GREENSPAN. On the contraction in currency growth, was that concentrated in particular countries?

MR. KOS. It’s basically everywhere. It occurred in all regions, I believe, except Africa—and Iraq, as President Parry reminds me. There are reflows of currency from Latin America, eastern Europe, and all of the other major regions.

CHAIRMAN GREENSPAN. Is it possibly a disinflation problem? The rate of inflation is falling everywhere. The decline in the growth of currency seems rather dramatic, and it calls out for an explanation. You’re not about to give it to me! [Laughter]

MR. KOS. I wish I could. I don’t know if Mr. Reinhart has any insight, but it’s a bit of a mystery.

MR. REINHART. I would point out, Mr. Chairman, that growth in currency held domestically also has been about flat, but that had been growing relatively slowly for the last four months. Where we get the slowdown is in our estimates of the currency held abroad. That's a fact, not an explanation.

MS. JOHNSON. Well, I'd say that the improvement that's apparent in Argentina—whether it will be long-lasting is a different question—no doubt has had an impact in getting people to use the domestic currency there.

CHAIRMAN GREENSPAN. That's the reason I asked if there were any regional or country concentrations, but Dino says no.

MR. KOS. It's everywhere.

MR. PARRY. Do we have any data on shipments of euros? Could there be a substitution process under way?

MR. KOS. I have not seen any data on that. I don't believe that the ECB makes those data available if they have them. Obviously, the euro is becoming used more actively. Some countries in eastern Europe have currency boards, but I don't know that that would explain the shift in the reflow of U.S. currency. I don't believe the size of those countries, which is fairly modest, would be large enough to explain what we've seen.

MR. STEWART. We do know that the European Central Bank has been studying our ECI (extended custodial inventory) system because they want to make the euro more available globally. So that's a strategy that they have announced, but we haven't seen the numbers yet, as Dino said.

MR. PARRY. One thing we could do is to check with the cash product office. They and New York work closely together on such issues.

CHAIRMAN GREENSPAN. It's very likely that this currency development is utterly benign and of no significance whatever. But then again, it may not be. The only reason I raise the issue is that the data may be trying to tell us something. My view is that, whenever we see a significant statistic that is at variance with our then-current model of the way the world works, we shouldn't readily dismiss it without some understanding of it.

MR. KOS. Well, in this case the first thing we need to do is to respond appropriately in terms of our balance sheet management. Then, I agree with you, the next order is that we need to understand it a little better.

CHAIRMAN GREENSPAN. On the MBS coupon distribution, the dates on your charts are not adjusted to the actual period when the refinancings or other mortgage loans occurred. In other words, there's a two- or three-month lag, so the current mortgage rate is really not the relevant one. Or more exactly, with these MBS coupon distributions, the relevant rate is the current rate but adjusted to the point of initiation, not the acquisition by the holders of the MBS securities.

MR. KOS. I agree. I presented the picture in this way for simplicity because of the difficulty of making that kind of calculation—locking in the closing date and the like—which is what one would really need to do to calculate this with precision. I was not trying to be absolutely precise but to give a sense of scale in terms of how these mortgages can move in very large sizes into and out of the pool of candidates for refinancing, if you will.

CHAIRMAN GREENSPAN. Further questions for Dino?

MS. BIES. Could you talk a little about the fails that have been happening? How have dealers been able to react when there has been a fail so that it hasn't disrupted the liquidity in the marketplace or added to the volatility?

MR. KOS. The volume of aggregate fails has been very large. It actually has been larger in the aggregate than what we saw in the aftermath of September 11. The biggest component of the fails has been in the current on-the-run ten-year note. The precise cause is difficult to pin down. Certainly there seems to be a large short base in that issue in particular—and in some others as well—which is creating a demand for that specific security, and the size of that issue is modest. That's one point I would make. The second thing I would say is that there are no concentrated positions, so we can't point to one or two dealers that seem to be boxing this. The third point is that the fails have not affected the cash market. That is, even though the back office hasn't been settling these trades the way they would be settled normally, that has not affected yields or how the traders are looking at the marketplace. What I'm trying to say is that so far it has been a back office event; it has not migrated from the back office to the front office.

Let me mention two other things. First, the FICC, the former GSCC, did attempt to do a netting among its members to try to clear this up. But because that group doesn't include nonmembers, the problem basically reappeared immediately. So that did not work. The hope is that with the new ten-year note that was auctioned last week, which also will be reopened in a month, there will be enough supply to clear this up. We'll see. That may be more information than you asked for! Sorry.

MS. BIES. No, fails always worry me when they reach that magnitude. I worry what that does to the day-to-day functioning of the dealers.

MR. KOS. They've been functioning fine. I think the situation has created concern among some of the dealers that as these fails age, higher capital requirements will kick in under the SEC's rules. So there's been an effort to get some regulatory relief, if you will, on that side.

CHAIRMAN GREENSPAN. Further questions?

MS. MINEHAN. This may be a question that's impossible to answer, but I'm going to ask it anyway. You mentioned that the downward trend in ten-year yields had a lot to do with our move of only 25 basis points and the discussion of deflation in our statement. But ten-year yields and mortgage rates had been coming down for some time. The big mortgage lenders had to have been wrong in their hedging activities. Does anybody have any sense, independent of our comments about deflation and so forth, what the bounceback in yields might have been solely as a result of the improvement in the economic data? I recognize that it's very hard to say.

MR. KOS. I would agree with your opening statement that it's impossible to answer that with any precision. It's very hard to assign percentages to the causes. In my own mind, the dynamics in the mortgage market clearly were a very important factor. Anecdotally, dealers do suggest that some of them in fact believed that so-called unconventional monetary policy actions might well be implemented around the middle of this year. Exactly who believed what and the responses that those beliefs triggered is hard—

MS. MINEHAN. That had to be the frosting on the cake or the fuel for the fire because I think there was something already there.

MR. KOS. Well, there was something already there. But it's interesting to look at the chart on the breakeven rate on page 1, which I like a lot, in part because it suggests that, at least in this segment of the market, people were not really buying the deflation story. So, yes, there were some disconnects here, and it's hard to put all the pieces together in a tidy story.

MR. BERNANKE. But that's the ten-year compensation noted on the first page.

MR. REINHART. I would point out, President Minehan, that there's some empirical work that suggests that hedging flows on the order that we saw over the intermeeting period would be associated with a 20 percent rise in implied volatilities on longer-term rates. So just to get a sense of perspective, hedging activity doesn't ultimately change the level of the ten-year rate, but it does increase the amplitude. In the magnitudes that Dino has been talking about, that's the rule of thumb we've been using.

CHAIRMAN GREENSPAN. Further questions? If not, would somebody like to move to ratify the transactions since the last meeting?

MR. FERGUSON. I'll move to ratify the transactions.

CHAIRMAN GREENSPAN. Without objection. Dino, you wanted to talk about Ginnie Maes.

MR. KOS. Yes, let me say a quick word on that. The Committee will remember that last November you directed the staff to come up with a proposal about how we might incorporate Ginnie Mae mortgage-backed securities into the System Open Market Account. This was part of the alternative assets work that we began some time ago. We've essentially completed that work, and we've learned a lot from the process. Initially I had intended to bring this issue to the Committee either at the June meeting or at this meeting, but other topics took precedence. Currently, with the market's rather intense focus on unconventional monetary policy measures and also the recent volatility in the MBS market, there is the strong possibility that any decisions the Committee might make in this area would be misinterpreted. In addition, given the fiscal situation and the slowdown in currency growth, there really is no immediate pressure to add to SOMA's list of available assets to purchase. So after some consultation with Vincent and in turn with the Chairman, the suggestion was made to defer consideration of this topic until early next year when the environment might be more conducive. So that's the suggestion that I come to you with today.

CHAIRMAN GREENSPAN. Any comments? That's fine. We now move to the economic situation, and I call on David Wilcox and Karen Johnson.

MR. WILCOX. Thank you, Mr. Chairman. As you know from the August Greenbook, we received quite a few encouraging indicators during the intermeeting period. Let me mention just a few. Sales of light vehicles in July ran at a 17.2 million unit annual clip, up 1 million units from the average selling pace in the second quarter. Chain store sales have been on a noticeable uptrend the last several weeks. The data on orders and shipments of capital goods improved in May and June. Moreover, the national ISM index as well as a number of the regional purchasing managers' reports either moved up in July or held steady at a high level. And earnings reports for the second quarter generally came in to the high side of analysts' expectations.

By comparison, the list on the other side of the ledger is short. The two employment reports we received during the intermeeting period both were disappointing. At the time of the June meeting, we had expected that the change in payroll employment would have been in positive territory in June and July; instead, it dropped 70,000 in June and another 30,000 in July. The decline in initial claims during the past several weeks has been reassuring but, for what it's worth, our preferred near-term filtering model sees the available recent labor market indicators, including claims, as pointing to only little change—up or down—in payroll employment over the next month or two. In line with this view, we assumed in the current Greenbook that labor demand will just stabilize in August and September before beginning to move up at a pretty hefty clip by the end of the year.

In economic forecasting, the majority doesn't necessarily rule, and in this case we saw the encouraging news on the spending side as fighting the discouraging news with respect to the labor market pretty much to a draw—leaving us still expecting a marked pickup in the growth of real GDP, from well below the growth of potential—3.1 percent—during the first half of the year to somewhat above potential in the second half. The list of factors supporting this acceleration is familiar from our repeated incantation of it. Fiscal policy still should add significantly to the growth of aggregate demand over the third and fourth quarters even as the severe distress at the state and local level offsets a part of the federal stimulus. Monetary policy remains supportive of a pickup in growth, and structural productivity appears to be on a relatively steep upward trajectory.

The key question we had to confront in adjusting the longer-term outlook was how to react to the run-up in interest rates that has taken place, as Dino discussed, since the last meeting. There were two dimensions to this question. First, for purposes of putting together the forecast, should we downweight some of the increase in rates as merely reflecting an increase in inflation expectations, and to that extent not an increase in real rates? If one were to judge from the relative behavior of nominal and indexed Treasury securities, a goodly portion of the run-up in nominal rates—maybe as much as half—could have reflected an increase in inflation expectations, at least in the eyes of bond investors. On the other hand, we had to wonder why, just as inflation compensation in the Treasury market seemed to be taking off, near-term inflation expectations as reported in the Michigan survey of consumers were dropping like a rock and longer-term expectations were holding steady. We certainly weren't hearing any stories from the business sector about the rebirth of pricing power. In the end, we treated the whole of the increase in nominal rates as reflecting an increase in real rates. While inflation expectations might have gone up on Wall Street, the same does not seem to have been true on Main Street, where the spending and investment decisions are made. Moreover, it is worth noting that at least in some precincts of Main Street, particularly those having to do with housing, even the purely inflation-related component of nominal interest rates seems to be relevant for the determination of demand.

A second important question related to the change in the interest rate environment was whether we should downweight the negative implications of the run-up in rates on a second theory—namely, that it might have reflected an improvement in business sentiment, and thus should be interpreted as a symptom of faster growth rather than a cause of slower growth. While business sentiment might well have improved, we nonetheless concluded that we needed to apply our standard multipliers to the whole of the increase in rates, for two main reasons. First, in a line of thought much like the one we applied to the issue of the real-versus-nominal split, while sentiment might have improved on Wall Street, it was less apparent that it had done so on Main Street. Hiring through early July seemed to be in the doldrums, and as I mentioned earlier, the subsequent drop in claims has encouraged us to think only that the decline in payrolls has come to a halt. While investment demand has been improving, we have no evidence of a dramatic breakout. Moreover, the indications available to us were that outside forecasters were not marking up their projections, and this impression was corroborated in yesterday's Blue Chip release, which reported essentially no change in the consensus growth projection for this year and next. Second, and perhaps more important, we felt that we had to maintain some fidelity to our previous forecasting methodology. For better or for worse, we had taken on board the full implications of rates as they stood at the time of the June Greenbook, not applying any discount for the possibility that bond investors might have been having their own bout of irrational exuberance. Given that earlier decision, it would have been logically inconsistent in the current forecast round for us only to have taken on board a portion of the rebound in rates. Altogether, the change in financial-market assumptions over the intermeeting period—the increase in interest rates, the stronger dollar, and the lower level of stock prices—were a small negative for our projection of GDP growth over the second half of this year and sliced a little more than ½ percentage point from our projection of growth next year. In this regard, two other quick points are worth noting. First, for all our angst in the current forecast round over the proper interpretation of the run-up in rates, our latest forecast of real GDP growth—both for the second half of this year and for next year—is virtually unchanged from our forecast two rounds ago, before the bond market dip and rebound had gotten under way. Second, I should caution that, from the perspective of our forecast, the bond market adjustment is not over. As you know, market participants currently seem to expect that the funds rate will be on a substantially steeper trajectory over the next few years than we have assumed in the Greenbook, and long rates have been set accordingly. If events unfold as we have projected, financial markets will have some learning to do. In particular, we have assumed that over the course of next year, as inflation continues to edge down even in the context of a vigorous economic expansion, the market's funds rate expectations will converge substantially toward ours. As a result, bond rates will tail off and finish next year about 60 basis points lower than would otherwise have been the case. I mention this not to claim any great clarity in our foresight but rather to underscore that bond market misperceptions continue to play a role even in the current projection.

Before leaving the real side of the projection, I should mention one piece of news that came in after the close of the Greenbook but would not have greatly affected our thinking had we known about it—namely the historical revision to the BLS data on productivity and costs. As you know from the Greenbook supplement, productivity growth over the last three years was marked up considerably, based on new data showing a sharper drop in hours worked than previously estimated. We are inclined to see those revised data for previous years as having little or no implication for a number of the variables of greatest concern to you. In particular, they have no implication for the growth of potential output because any adjustment we might make to the trend growth of output per hour would be offset by an equal-sized adjustment to the trend growth of hours. Second, they have no implication for inflationary pressures because any revision to the trend in output per hour would be offset by an equal-sized revision to the trend in compensation per hour, leaving unit labor costs unaffected. All that said, the growth of productivity in the second quarter was nothing short of stunning, and we certainly will have to contemplate once again whether our assumption for the growth of potential GDP—already apparently far above the market consensus—needs to be marked up further.

Inflation continues to look very subdued. We were a little surprised by the extent of the increase in core PCE prices in the second quarter, but this turned out to reflect an unexpected bulge in so-called non-market-based prices. This makes us a little uneasy because we believe that measurement issues in this component of the index are especially acute. The market-based component of the core PCE price index came in right on our projection as of the last Greenbook. In the second half of this year, we expect core PCE price inflation to run a little higher than in the first half, reflecting the removal of some factors that we think held inflation down temporarily earlier this year: Owners' equivalent rent was held down relative to tenants' rent by an adjustment for utilities costs, and we expect utilities costs to be a neutral factor during the second half of the year. Motor vehicle incentives rose sharply during the first half of the year, and we are assuming that they will taper off as we move to the new model year. States and localities are in the process of implementing some hefty increases in tuition, other fees, and excise taxes as part of their drive to restore their fiscal health, and we've factored these changes into our thinking for the second half as well. That said, we see the underlying trend in inflation as still pointing downward. With a noticeable margin of slack in resource utilization persisting through the whole of next year, we continue to project that core PCE price inflation will finish next year below 1 percent. Karen Johnson will continue our presentation.

MS. JOHNSON. The staff outlook for real GDP abroad in the current Greenbook is little changed from the one we presented last time. Again this round we are looking for real growth in the rest of the world to strengthen on average from less than 1 percent in the first half to about 2½ percent in the second half of this year and to nearly 3½ percent during next year. With the calendar now telling us that we are well into August and thus about halfway through the third quarter, you might reasonably expect that evidence of such an acceleration should be emerging in the data for real activity abroad.

For July, we are mostly limited to survey data for evidence on production and demand. But it is encouraging and consistent with our forecast that euro area and U.K. PMI reports and euro area consumer confidence figures for July show improvement as do readings on U.K. business confidence and Japanese business conditions for small and medium sized enterprises. We have a wider range of data on real economies abroad for the second quarter, and I scrutinized these data for developments during the quarter that supported our projection of accelerating economic activity. After showing weakness in May, German manufacturing orders moved up strongly in June. French industrial production fell significantly in April and May but then rebounded in June. U.K. industrial production also strengthened in June. At least in part, both of these indexes reflected a jump in energy generation that may have been tied to the very hot summer weather. The preliminary figure for U.K. second-quarter real GDP shows a rebound in growth from the flat first-quarter outcome. Canadian employment moved up strongly in June but slipped back a bit in July. In Japan, machinery orders rose in May and June, and housing starts ended the quarter with a sizable increase. Among the Asian emerging-market economies, export orders expanded in Singapore in July; and industrial production in June rebounded or strengthened further in several, including China, Taiwan, Korea, and Singapore. But to be honest, some indicators signaled deceleration over the quarter, with drops in June in industrial production in Germany, Italy, and Japan. Japanese GDP, released this morning, reportedly grew more than 2 percent at an annual rate in the second quarter, surprising us and most other forecasters, particularly with respect to exports. All in all, my list of confirming data seems far from conclusive, and indicators from Germany and Japan appear to be mixed. Nevertheless, although we detected no basis in these data for an upward revision to our forecast, we saw no need for a downward revision. So we have maintained the same positive trajectory for total foreign GDP that we had presented in the previous Greenbook.

Our reading of financial market developments over the intermeeting period is that, on balance, market participants have become somewhat more optimistic about near-term activity abroad, confirming our basic view and leaving financial conditions generally supportive of recovery. Since the June FOMC meeting, euro and sterling three-month eurocurrency futures rates have shifted up, removing from market rates expectations of further easing on the part of the ECB and Bank of England. We see positive market reaction to the most recent indicators, along with statements by Japanese officials and the ECB about more-favorable prospects in their respective economies, as consistent with our expectation that economic activity abroad is already recovering from the sluggish pace earlier this year.

Further gains in equity prices in the major foreign industrial countries over the intermeeting period reinforce the view that market participants see stronger activity and improved corporate earnings as likely in the near term. Moreover, greater total stock market wealth should have some positive effect on household spending and should provide some stimulus for business capital expenditure. The Japanese TOPIX index rose sharply in early July as foreign investors reportedly augmented their holdings of Japanese equity. Although some of those gains subsequently were retraced, the index is up about 5 percent since the June FOMC meeting. Stock indexes are also up on balance over the period in the euro area, Switzerland, the United Kingdom, and Canada. All of these indexes remain well above their recent lows in March.

Ten-year government interest rates have risen as well, with rates in the major foreign countries reaching a low in mid-June and climbing rapidly since then. Market commentary linked movements in foreign rates to those for dollar rates, as discussed by Dino and David, and most foreign rates displayed volatility similar to that for U.S. rates in recent weeks. This co-movement at least in part reflects shifts in demand by global investors as expectations for future monetary policy here and abroad evolved and as returns on dollar securities rose. However, long-term rates abroad, particularly those in Europe, moved up significantly less than did U.S. rates. With the exception of Japan, long-term rates are now back about to where they were in late April and early May. Japanese ten-year rates, after falling to less than 45 basis points, have jumped back to about 90 basis points—their level in late December. We see these higher rates as lessening a bit the favorable character of financial conditions abroad. But the magnitudes of the increases are not large, and the effects are widely seen, even in Japan, as more than offset for many in the private sector by the rise in stock prices.

For many of our foreign trading partners, the expected recovery in real output growth in the United States and the associated rebound in the global high-tech sector will be critical factors in any acceleration of output. Accordingly, we wrestled with the issue of whether the downward revision for next year in the staff's forecast for U.S. real GDP growth should be reflected in a similar revision for foreign growth. Although adjustments were made for some countries, on balance these were offsetting, leaving our figure for average growth during next year unchanged.

Two of the elements tending to bolster growth abroad are the intermeeting rise in the exchange value of the dollar and somewhat more expansionary fiscal policy now expected for Germany and France. We have raised the projected path for the dollar over the forecast period in response to its recent step-up. Although we still project a slight downward trend in real terms for the weighted-average dollar, the stronger value of the dollar—and thus weaker value for foreign currencies—now projected for each quarter relative to the June forecast implies some boost to activity abroad. In Germany, where real GDP growth was likely negative for a third consecutive quarter in Q2, the government has announced its intention to inject some fiscal stimulus, and we have revised up our forecast for 2004 as a result. France is expected to use the German stimulus as cover for its own somewhat smaller fiscal expansion.

All in all, the data that have become available since the June FOMC meeting, the financial market developments over that period, revisions to the U.S. forecast, and macroeconomic policy shifts, both actual and prospective, resulted in our making many marginal adjustments to our forecasts for individual foreign economies. However, those minor adjustments left the average for real output growth and inflation abroad very similar to that in the June forecast. Such an outcome, along with our slightly higher path for the dollar, yields an arithmetic contribution to U.S. real GDP growth from net exports of about zero for the second half of this year and about minus 2 percent for next year. For the remainder of this year, a rebound in exports to a moderately positive growth rate is crucial for the external sector to have a net neutral effect on U.S. expansion. For next year, we see imports responding strongly, as historical experience suggests, to the projected strengthening of U.S. economic activity. Thus, although we anticipate that export growth will remain solid, the external sector on net should again subtract slightly from U.S. real GDP growth. That concludes our remarks, and we'd be happy to take questions.

CHAIRMAN GREENSPAN. Questions for our colleagues? President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. I had a question for David on the ten-year rates looking ahead. The assumption you're making, which you explained very thoroughly, is that we will get a 60 basis point decline in ten-year rates next year. Well, suppose it is now next spring and we've seen real GDP growth of over 4 percent for several quarters in a row. Some people think that long-term rates actually will be turning in the other direction and going up at that point. I don't think that's a completely implausible scenario. So I was wondering how you would interpret such a development next year if it did occur. And what would the effect be on the forecast if ten-year rates did trend up and hit, say, 5 percent by the end of next year?

MR. WILCOX. We would interpret that as a further tightening of financial market conditions. It would certainly come as a surprise to us if that were to occur. Let me step back a bit and put as clearly as I can the contour of rates we see for next year. We have rates easing back, as you noted, despite the fact that ordinarily—absent any bond market level adjustment—we'd have a gradual trending up in the ten-year rate. The reason that would occur is that the ten-year rate is an average of expected future short rates and the bond market would be folding in higher rates at the end of the ten-year period. So, holding everything else constant, the ten-year rate would be trending up. Despite that, our projection is that, as financial market participants gradually adopt our view of the outlook for real activity and the inflation process, that rate will come down a little. If the bond market were to go in the other direction, as I said, that would constitute a tightening in financial market conditions. If the increase were on the order of magnitude that you suggested, with the ten-year rate moving up to 5 percent, I don't think that would in and of itself constitute a dramatic restraint on aggregate demand. It might mean a couple of tenths or something like that over the subsequent four quarters. But that would not be a helpful development in terms of producing our expected outcome for aggregate demand.

CHAIRMAN GREENSPAN. The accompanying productivity rate would have something to do with that particular scenario.

MR. WILCOX. Indeed. I was interpreting President Moskow's question as involving a sort of disembodied upward drift in interest rates. If it were to emanate from a different view about productivity growth, then the implications might be different. But even in that case, it might still signal a wider gap than we had been projecting between actual and potential GDP.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Yes, speaking of productivity, the numbers in the Greenbook forecast for next year that jumped out at me were the very large employment gains and the very slow productivity improvement. I'd like to know the intuition underpinning those projections because I'm not sure those are the numbers I'd write down if I were trying to forecast them.

MR. WILCOX. The intuition is that, as best as we can figure out, a large amount of restraint on the part of employers is an important factor at the moment. We think that shows up in the sluggish payroll employment gains of recent quarters; and it is mirrored by the fact that we have actual productivity now well above structural productivity. In our projection for next year, employers are gaining confidence in the durability of the expansion. Our view is that, as their confidence rises, they will bring their employment levels back into a more normal alignment with their output, which would generate the kinds of employment increases that you have noted. That, in turn, would bring productivity very gradually back toward trend, though we don't have the gap between actual and structural productivity closing completely; that gap persists throughout 2004 in our projection.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Dave, for some time now, market forecasts of inflation have been quite a bit higher than the forecast of the Board staff or for that matter of the Committee members. As an example, the inflation forecast for next year of the 10 lowest Blue Chip forecasts is about ½ percentage point higher than ours, and of course, the midpoint of the Blue Chip forecasts is even higher. Can you explain why that difference persists for so long? Second, are you at all concerned that, if other forecasts began to line up with ours, that development in itself could put some downward pressures on inflation? It would be an indication that the market's expectations for inflation were changing and we already have a very low inflation rate.

MR. WILCOX. As to why there's a gap between our projection and outside forecasts, I think part of the explanation is that we have a substantially more optimistic view about the rate of growth of the economy's productive capacity. If one compares our forecast with the Blue Chip forecasts, implicitly we have potential growing more rapidly than they do. But that's not the whole story. We have the unemployment rate coming down as well. We generate less inflation pressure out of that in part precisely because we are more optimistic about productivity growth. And that greater optimism about productivity growth helps alleviate any buildup of inflation pressures in our view. I would note, too, that the data over the last few months have come in to the low side of our projection.

MR. PARRY. I know.

MR. WILCOX. So we've seen nothing of late to cause us to call into question either our assumptions about the rate of growth of structural productivity or potential GDP or the inflation outlook. As I mentioned in my briefing, the only surprise we've had lately was in the somewhat irritating so-called non-market-based component of the core PCE price index. But the market-based component has been quite consistent with our expectations.

MR. PARRY. Well, what about the second point I made—that, if others were to change their forecasts and become more convinced about the possibility of inflation rates being lower, that could put some downward pressures on inflation rates as well going forward.

MR. WILCOX. That's not an element of our projection. It would be a factor putting downward pressure on nominal bond rates. That's in part the mechanism by which we see the market and the outside world learning about or coming into line with, if you will, our view of the world. On our forecast, they should see a combination of strong growth in aggregate demand coupled with much lower rates of inflation than they expected. As that happens, the market should bring interest rates down, as I was discussing with President Moskow.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. David, to what extent do you think that the recent and presumably prospective fuel price increases might offset the tax cut effect in the next six months or so?

MR. WILCOX. We certainly have assigned a big role to the very sizable increases in cash flow that are occurring. We have disposable income growing over the second half of this year at nearly a 5 percent rate of increase. Importantly, that reflects the $35 billion in additional cash flow—not at an annual rate—that's accruing to households in the third quarter from the combination of lower withholding, the advance refund of the child credit, and reduced estimated tax payments. So the fuel price increases are a restraint, but they are overwhelmed by the stimulus that we think the federal government is delivering.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. I have another question about the shape of your forecast versus the shape of others. The strength of producers' durable equipment spending in both halves of 2004, but particularly in the second half, and the overall Q4-over-Q4 increase is quite remarkable. Now, I grant you that the investment tax credit works its way into the calculations here. But most business people tell me that, regardless of the investment tax credit, they really want to spend money on equipment only when they actually need the equipment. During the 1990s there was a pretty sizable run-up in the level of spending on equipment and software as a share of overall spending. It blipped up in association with Y2K and came back down again. But it's at a fairly high level still. I wonder about the acceleration in E&S expenditures that's built into this forecast; a 19 percent increase in the second half of next year seems like a lot.

MR. WILCOX. It is an important driver of the contour of our forecast. But I'd come back exactly to your statement that firms will ramp up investment only when they feel they need it. It’s that kind of logic that has led us to be rather restrained in our assessment of the prospects for the second half of this year. A lot of the anecdotal information that we have suggests that firms at the moment are delivering those nice surprises to earnings importantly through cost-cutting measures and not through capacity expansion.

MS. MINEHAN. Right.

MR. WILCOX. By next year, with a very strong acceleration in business output, we think firms are going to be feeling the need to engage in a substantial expansion in their E&S spending. The importance of that factor is illustrated in one of the alternative simulations in the Greenbook. That simulation indicates that if a surge in investment does not come through—we did the experiment with respect not only to E&S spending but expenditures on structures and inventories as well—the pickup in overall activity next year will be substantially attenuated.

MS. MINEHAN. Yes, and then the numbers, at the top level anyway, would start to look more like the mainstream of the Blue Chip forecasts.

CHAIRMAN GREENSPAN. If there are no further questions, who would like to start the roundtable? President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. The Seventh District economy is still sluggish. Many of our contacts, as well as the available data, indicate that the Midwest has been underperforming the rest of the nation. Nevertheless, we are seeing a few signs of improvement. We’re hearing that more firms are releasing funds for capital expenditure, mainly for maintenance, repair, and replacement of existing equipment. Indeed, some producers of agricultural and construction equipment are now seeing orders picking up and prices firming. However, many businesses seem to be focused on meeting near-term goals. Their planning horizons are short, and their expansion plans remain cautious.

We surveyed some of our contacts regarding the impact of rising interest rates, and the results were mixed. Many homebuilders and realtors indicated that potential homebuyers moved quickly to close deals before rates went higher. In contrast, refinancing activity has plunged according to many of our bank contacts. Automakers have yet to see much effect from higher rates. As you know, light vehicle sales rose sharply in July, with a surge at the end of the month, when the incentives were increased. One manufacturer told us that the industry has now fallen into a pattern of incrementally boosting or layering incentives as the month progresses. While the automakers continue to lament their reliance on discounts, they are encouraged that consumers are once again responding to these incentives.

The automakers and other contacts remain concerned about the sustainability of consumer demand, given the stubbornly weak job growth. While labor markets in the Seventh District did not deteriorate, there are few if any signs that hiring is picking up. Both of the large temporary-help firms that we contact indicate that orders remained flat through July, and these firms continue to believe that the BLS data significantly overstate the gains in temporary-help jobs. The BLS has changed its sampling procedure in a way that gives less weight to the large temporary-help firms, and at least one of the companies headquartered in our region plans to meet with the bureau to discuss the discrepancies. We recently received the results from Manpower's fourth-quarter survey of hiring plans. The survey shows a modest improvement in hiring expectations from the third quarter but they are still below those of a year ago. These data are confidential and will not be released until September 16, which coincidentally is the day of our next FOMC meeting.

Turning to the national outlook, since our last meeting we've seen that household spending is holding up, capital expenditures are showing more life, and inventories are so low that we should soon get a boost to production as firms restock. Furthermore, tax cuts are showing up in people's pockets, and there is plenty of liquidity out there to support higher spending. To be sure, the July employment report was weak. However, the fall in initial claims over the past few weeks is somewhat encouraging. The increase in long-term rates is a concern, but our feeling is that the current level of interest rates will still support a pickup in real economic activity. So, while we've yet to see the strong growth needed to close resource gaps, recent developments on balance are broadly consistent with the solid second half that we forecast in June. Therefore, I view this as a time for us to wait and watch.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Thank you, Mr. Chairman. The Twelfth District economy appears to have gained some momentum coming into this quarter, although attitudes are still more cautious than optimistic. Consumer spending is holding up generally and is actually picking up for leisure-related businesses such as restaurants. The recent rise in mortgage rates appears to be accelerating home sales, as buyers on the fence look to lock in interest rates that are still below historical norms.

The IT sector is benefiting from the effects of a pickup in investment in equipment and software. Jobs are being shed at a slower pace in IT manufacturing. And Intel and Apple reported strong revenue growth in the second quarter, while Microsoft plans to increase R&D and also hiring. Nonetheless, firms remain focused on cutting costs and increasing efficiency. So although they will be adding jobs down the line, growth will be muted, and many of the jobs lost in the recent downturn are not expected to come back. Residents of tech-dependent areas such as San Francisco and the Silicon Valley seem to agree, as on balance people are moving out of these areas.

In the Northwest, sour conditions in Boeing's commercial side remain a drag on the economy. Boeing recently announced yet another series of job cuts, this time of between 4,000 and 5,000 workers. Boeing's commercial woes apparently are due to three trends: a decline in the overall demand for commercial jets, a loss of market share to AirBus, and a shift in airline demand toward smaller planes.

All District states except Oregon have signed budgets for this fiscal year. Despite widespread press reports of drastic cuts in spending, most states, including California, actually will show a small increase in nominal spending in fiscal year 2004 compared with 2003. California avoided a decline in expenditures without raising general taxes, mainly by putting off some hard choices for at least another year. The state's near-term fiscal problems were handled through a combination of spending deferrals, fee increases, use of one-time revenue sources, and just over $14 billion in debt financing. On the heels of the budget signing, Moody's downgraded the state's general obligation bonds, while Standard and Poor's reaffirmed its earlier downgrade. The rating agencies' concern is not the state's immediate debt burden but rather its inability to address the long-term imbalance between planned spending and expected revenues, which is somewhere on the order of $8 billion.

For the national economy, recent economic data generally were somewhat stronger than expected. It was encouraging that real final demand by domestic purchasers jumped sharply in the second quarter and that the increase was not only because of strong auto sales but was broad-based and included investment in equipment and software. The recent improvement in manufacturing output and the strengthening in corporate profits also raise the odds that the long-anticipated investment-led rebound in the economy may be under way. However, there still is plenty of room for uncertainty about the next few quarters. First, disappointing labor market developments may suggest that businesses aren't very comfortable about the future and also may undermine the confidence of households. Second, there is the issue of how to interpret the tightening of financial conditions since we met in June, especially the increases in interest rates. To some extent these increases suggest slower growth going forward, since they may represent the market view that policy will be tighter in the future because we are less concerned about deflation than we were in May and because the situation with respect to the federal deficit has deteriorated. But part of the increase in rates also probably indicates stronger growth prospects for the economy.

On balance, we have changed our forecast very little from last time, although our confidence that an acceleration in activity is under way has strengthened somewhat. Our forecast is a little weaker than the one in the current Greenbook. We expect real GDP growth of about 3½ percent in the latter half of this year and 4½ percent in 2004. As before, this performance doesn't appear strong enough to eliminate excess capacity in the economy by the end of next year. As a result, we expect core PCE inflation to average about 1 percent in 2004, which is about as low as I would like to see it go. Thank you.

CHAIRMAN GREENSPAN. First Vice President Stewart.

MR. STEWART. The economy in the Second District has shown increasing signs of strength in a variety of sectors. Employment has expanded in the past three months. Retailers have reported strong sales results, and one major firm suggested that the tax cut is showing up at retail cash registers. Reports indicate that the finances of the State of New York and of New York City have improved substantially recently, reflecting both tax increases and some surprising strength in revenue, probably from Wall Street.

In terms of jobs, the best improvement this year has been in New Jersey, but we see signs of a pickup in a number of areas of New York City's economy. In particular, Wall Street firms are reported to be enjoying strong growth in profits and revenues, and financial firms have done some scattered hiring, unfortunately including one of our senior bank supervision officers.

Tourism seems to be strong, with hotels reporting a noticeable pickup in occupancy in the late spring. Upstate New York has generally lagged—though in the Hudson Valley, employment is growing, and housing markets have been strong. Despite long-term problems in the upstate industrial areas, manufacturing seems to be strengthening in the District. Our August survey of New York manufacturers, to be released on Friday, will report improvement in general conditions for a third straight month, reflecting strength in new orders and shipments. There is also sustained high optimism about the future. For the first time in a while, respondents report plans to add to inventories over the next six months. In the near term though, inventory and employment plans remain rather subdued, and firms report that they are unable to boost prices.

Turning to the nation at large, I think of the forecast expansion in the economy as progressing in stages. The initial impetus has been provided by the expansionary fiscal and monetary policies. The first sectors to advance should be households and defense spending, and the indicators suggest that both are growing strongly. Growth should then be transmitted to inventories and then to capital spending. Will growth spread from consumer spending to inventories? We still see continued liquidation of inventories, and businesses remain quite leery about making any near-term plans to add to stocks, whether from domestic or foreign suppliers. Our New York survey suggests that plans to add to inventories apply to the longer term.

Capital spending does look better, with good growth in the second quarter and some strength in recent orders. But there isn't any widespread commitment in the business community for a full-bodied capital expansion. Despite improved business optimism, firms may be reluctant to increase hiring for quite some time or to add to inventories. Firms seem increasingly committed to a new business model in which improvements in sales and production will be met as far as possible through efficiencies gained from the existing workforce. Executives will be slow to accumulate inventories in anticipation of future sales because companies have developed new techniques to manage their stock of goods more efficiently, as shown by the long-term trend in inventories. As a result, we may continue to see strong growth in productivity and improved profitability with stagnant employment. Unlike traditional recoveries, business optimism about sales and profits will be very slow to show up in hiring and inventory accumulation.

Another sector that we expect to gain momentum over time is U.S. exports, which may be shaped by similar forces. I've been dismayed by the extent to which our counterparts overseas are counting on a U.S. recovery to jumpstart their own economies. Nonetheless, like the Greenbook, we see some early signs of a pickup in the major foreign economies, including improved business sentiment. However, my view is that underlying business caution about expanding employment and investment is even greater in Europe and Japan than it is in this country. Thus, we may see a less robust recovery overseas than in past cycles and consequently less push from U.S. export growth than we would normally expect. Clearly, the risk in this scenario is the need to finance a very large U.S. trade deficit.

In sum, we seem to be off to a decent start in a number of areas, but I am less certain that we will be seeing growth spread to all sectors as we have in past expansions. Moreover, even given the strong staff outlook, a substantial gap between actual and potential output will remain, raising the likelihood of further disinflation—perhaps more than is indicated in the Greenbook projection. Thank you.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. Readings on economic activity from our Southeast region were still somewhat mixed in June and early July, but there were encouraging signs. Anecdotal information suggests that retail sales in June and early July exceeded year-ago levels, and sales very recently were boosted by what has become an annual tax-free back-to-school shopping weekend in several of our states. Our important housing industry remains healthy. While commercial construction was down nationally, activity in that sector across our region seems to have bottomed out. Developers continue to tell me that there are now at least early discussions of future projects, despite continued high vacancy rates and a substantial amount of sublease space that is a drag on the market.

Manufacturing in our area is a mixed bag. While we still are seeing some declines in textiles and chemicals, we're getting nice boosts from our defense and auto-related segments. A contact in the packaging industry, which often leads an acceleration in activity, reports that there has been a recent pickup in one-time orders and that overall commercial orders remain steady. Tourism is also a mixed picture. Facing disappointing attendance, Walt Disney World laid off some of its craft and maintenance workers for the first time in nine years. On the brighter side, the top official of Atlanta's convention and tourism authority told me recently that the bookings for next year look measurably better than this year's, and he is encouraged that things are finally beginning to turn around.

We're still not picking up any signs of significant hiring plans in our region. The trend continues to be one of utilizing temporary staff until economic conditions have clearly stabilized. Our contact at one Atlanta temp service firm noted a major pickup in her business, which provides workers for the light industrial and warehouse segments of our regional economy.

Lastly, we’re now seeing some signs that venture capital activity is beginning to pick up in the technology sector of the economy that has become increasingly important in Atlanta and in other parts of our Southeast region.

On the national front, I interpret recent data as providing tangible evidence that the pickup in activity that we’ve been expecting is more and more likely to be realized. The second-quarter GDP data, the positive trend in spending on business equipment and software, the increase in nondefense capital shipments, the modest improvement in the ISM manufacturing index, the latest measures of productivity, and other data that David cited are all encouraging. It seems to me that the key question is what the trajectory of the expected pickup will be. Will it be the more optimistic path of the Greenbook and some private forecasts or the somewhat more modest trajectory reflected in the central tendency of the midyear forecasts submitted by Committee members? While one can see where greater upside momentum might come from, I think for now the evidence is more consistent with a more measured pickup.

While we may get the sharp turnaround in employment laid out in the Greenbook, it is my sense that many companies will continue to work mightily to hold on to the labor cost gains they have made. The rapidly rising health care and pension costs associated with each new hire will get even closer scrutiny, and with more gains available from expenditures on technology, many companies will be able to continue to substitute capital for labor.

If a rebound in job growth is delayed and stretched out, the increases in income and aggregate demand that would normally accompany employment gains will be pushed out some as well. The path for a rebound in investment spending is also not clear to me. We’re still not seeing in the numbers or picking up anecdotally clear evidence that investment spending is accelerating sharply. Indeed, the yet-to-be-released NFIB survey suggests that neither low interest rates nor the investment tax incentives in the President's program are yet adding to what have been modest investment plans.

Our Bank's GDP forecast remains on the low side of the range of Committee members' forecasts. We're also somewhat skeptical about the most optimistic views of potential. And we do not see the output gap as being large enough for long enough to make the pressure for future disinflation of the kind suggested in our statements compelling. While the recent backup in rates will have some effect at the margin, financial market conditions remain very favorable, and fiscal policy and monetary policy remain accommodative, as most of us have noted repeatedly in recent meetings. From a short-term perspective, our differences regarding the projected path of the economy over the next several quarters are not particularly important since I believe they imply similar near-term paths for the funds rate. Rather, differences in the assumed paths for output and inflation are more important in terms of what we communicate to the public and financial markets about our outlook and our likely policy concerns going forward. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. Economic conditions in the Third District have improved slightly since our last meeting, and our District appears to be faring somewhat better than the nation. Regional manufacturing has been firming. In July our Business Outlook Survey index of general activity advanced further into positive territory to 8.3 percent, up from 4 percent in June. The indices of new orders and shipments improved significantly in July, showing strong positives for the first time in several months. However, it's important to note that these increases were not widespread among the firms in the manufacturing sectors represented in the survey. Rather they were concentrated in firms that make products used in residential construction—not surprising, given the strength in the housing market.

In a special question, we asked our respondents to give us more-detailed information on when they think their sales will increase and by how much. The majority of our firms are expecting sales to rise over the next four quarters, with most predicting gains in the 1 percent to 4 percent range. Over half of our respondents expect sales to improve as soon as this quarter, and the percentage goes up over time. To accommodate the expected increase in sales, our firms report that they will need to start adding staff before they need to expand capacity. But many believe that they can wait a while before doing either. One-fourth of the firms expecting sales growth will begin hiring workers this quarter, but almost 30 percent will wait until sometime in the second half of next year. In addition, half of the firms say that they will not need to increase capacity until the second half of next year. These responses are consistent with forecasts that suggest the pickup in overall activity will be a gradual one.

Our labor markets continue to improve slowly and appear to be doing marginally better than those in the rest of the nation. Payroll employment in our three states increased in June for the fourth consecutive month. I don't want to overstate the strength; the increases have not been large, and employment levels are back only to where they were at the beginning of the recession. Still, the direction is positive. Although the three-state unemployment rate rose in June to 5.7 percent, it remains below its recession high set last winter, and it is below that of the nation.

There has been a modest increase in retail sales since our last meeting. Sales of general merchandise rose in July compared with June. Nevertheless, the cool weather through much of the spring has left stores with excess inventories of summer goods. Discounting has been fairly widespread as retailers attempt to clear the way for fall merchandise. Retailers continue to describe consumers as worried about job security and cautious in their spending. And retail firms do not expect the recently enacted tax cuts to provide much of a boost to sales. Auto sales remained steady in July, but cautious dealers have brought inventories more in line with desired levels than they have been in the last couple of months. The residential real estate sector is still strong but not as strong as a year ago. Some banks in our region have seen a slowdown in mortgage applications. Commercial real estate markets remain soft, with little change in recent months. In sum, I would characterize the tone as cautiously optimistic. The outlook of the region's business community remains positive, with most of our contacts expecting steady or slowly improving conditions.

Turning to the national economy, we have seen an improvement in economic conditions since our last meeting, but the second quarter's 2.4 percent increase in GDP overstates that improvement. The surge in defense purchases last quarter is unsustainable. Even with that, growth was still a percentage point lower than potential and not strong enough to generate job growth. Labor markets continue to disappoint. While initial claims have dipped below 400,000 per week, they remain high enough to suggest that net job destruction is continuing.

There are some positives, however. Business fixed investment rebounded in the second quarter, and the data on new orders for nondefense capital equipment suggest that business investment in equipment, particularly computers, is likely to continue to strengthen. Growth in consumer spending picked up in the second quarter, although much of that was driven by incentives on autos. Auto inventories are now sufficiently lean that manufacturers probably will increase production in the third quarter even if sales decline somewhat in August and September. Manufacturing is stable to up slightly, although the recent rise in oil prices, if sustained, may damp activity. The tax cut is now showing up as reduced withholding and higher take-home pay, which should help stimulate the economy. Monetary policy is very accommodative, and the real fed funds rate has fallen since our last meeting.

Although we're not there yet, the economy is poised for stronger growth in the second half of the year. Financial market indicators also point to such a resurgence. Indeed, bond market participants have built in a fairly sharp rebound in economic activity, as was pointed out this morning. I think they're overly optimistic. In fact, I have some concern that the recent rise in long rates will retard the incipient strengthening we are seeing. But I suspect that long bond yields will ease off a bit as traders begin to realize that we will need to maintain a low fed funds rate for longer than they now expect. We may want to emphasize our resolve in today's statement. Thus, I would want to see more signs of a rebound, particularly job growth instead of continued job declines. Given the positive signs we do see, today I think we are about where we need to be on monetary policy.

Before closing I will note that concerns about deflation and the risks of hitting the zero bound have diminished somewhat since our last meeting. However, I'm not sure that our public statements have helped illuminate the situation very much. We are trying to walk a very thin line here. On one hand, we want to convince markets that we are poised to do whatever it takes to keep the economy from slipping into deflation; on the other hand, we don't want to suggest that such a scenario is a probable one. I'm gratified that we will be discussing our communications strategy sooner rather than later, as I think it can only become more important as the recovery progresses. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Pianalto.

MS. PIANALTO. Thank you, Mr. Chairman. Reports from the Fourth District are consistent with the story of the U.S. economy: slow, steady growth and slowly improving conditions, coupled with mixed economic signals and still a great deal of lingering anxiety. The one bright spot in the Fourth District's economic scene is Lebron James. He's the high-school basketball phenomenon who was the number one draft pick in the NBA. The Cleveland Cavaliers drafted him and have sold a lot of season tickets as a result. And this young man hasn't played a game for them yet. The reason I'm bringing this up is that Lebron and I attended the same high school. [Laughter] Clearly, the more recent Akron St. Vincent graduate is having a greater impact on the Cleveland economy than the one who graduated many years ago!

The driving force behind the lingering anxiety in the Fourth District is China. I haven't been able to have a single conversation with a member of the business community recently without that conversation slipping into a discussion about China and its rapid growth as a U.S. trading partner. I have to say, though, that the business people I talk to don't speak about China as a business partner but rather as a source of intense competition. Last year the United States imported as much from China as from Japan, although we exported far less to China than to Japan. Many of the manufacturers are complaining that it is difficult to export to China because of trade impediments and because China unfairly pegs its currency to the U.S. dollar.

I interpret the preoccupation with China that I'm encountering in the business community as a proxy for the expansion of the global trading order, of which China is but a part. That expansion in global trade and the international linkages are clearly affecting the decisions that business people in our District are making. Some of them are reconfiguring their supply chains to source goods from companies abroad. Others are locating their production facilities in foreign countries. For many manufacturing companies in our area, all that's left in the District are assembly and testing. The prices of items produced in China and elsewhere are clearly affecting our firms' pricing strategies. The economic emergence of China and other developing countries appears to be forcing adjustments in the capital and labor markets in many nations, not just ours, and this process is going to take many, many years to play out.

I suspect that today U.S. capital spending, production, and employment are weaker than otherwise would be the case and that relative prices of manufactured goods are also lower as a result of this phenomenon. Business persons I speak to have indicated that making capital expenditure decisions in this environment has been very complex. For some manufacturing companies, the productive capacity located in the United States may no longer have the same economic value as it once did. And we're seeing an increase in corporate mergers, acquisitions, and restructuring that are all part of this process.

Intense foreign competition is probably also an element in understanding why the higher disposable incomes that we see and the monetary accommodation that exists have not yet totally been translated into greater domestic production and employment. My business contacts are telling me that there is business out there; they're just not getting it. These stories appear to have been confirmed, as was mentioned earlier, by the excess of final sales over gross domestic product now evident in the second-quarter numbers. If this anxiety that I'm hearing about from our District manufacturers is pervasive throughout the country, it may be that the pickup in business fixed investment will not materialize as quickly as forecast in the Greenbook. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you very much, Mr. Chairman. Not a lot has changed in the New England economy, but the tone of comments and attitudes, especially about prospects for the second half, has brightened a bit. To be sure, the labor market remains in the doldrums, with unemployment stable in June and employment levels still on the decline. Other measures of the labor market are weak as well, with initial claims rising and help wanted advertising suggesting that hiring activity is declining. Residential real estate markets remain strong even in the face of rising interest rates, likely because people are trying to get their mortgage loans before interest rates go up further. And commercial vacancy rates have stabilized, albeit at high levels.

State and local governments continue to deal with deficit problems by significant reductions in services and increases in revenue. There may be no new taxes, but as an example, about $0.5 billion in new fees and charges helped to narrow the deficit of something like $3 billion in Massachusetts for 2004. So a significant amount of funds are coming in the form of new sources of money from the state's populace.

As with the nation, gloom about current conditions appears to be offset somewhat by a modest optimism regarding the future. Consumer and business confidence suggest expectations of better conditions by year-end. In addition, the index of leading indicators for the Massachusetts economy has been in positive territory for four months, predicting growth in the economy over the second half. This pattern of less stellar current growth with some optimism about the future was particularly evident in conversations with regional manufacturers. For most of the more than one dozen companies contacted, current results were either flat or marginally lower in the first half of 2003, but losses were abating. Obviously, the results varied by industry, with pharmaceuticals and medical products experiencing solid rates of revenue growth, aerospace business mixed, and revenues at manufacturers of technology-related goods, chemicals, and business services products unchanged or lower.

Despite current conditions, optimism about growth in the next two quarters and beyond prevailed among these manufacturers. Competition remains keen, and companies believe that their cost-cutting and restructuring has been significant enough to enable better profit growth through the rest of this year and into 2004. In that regard, many believe that sales have reached a trough in their industries and that slow but steady growth could be on the horizon. Technology again is the exception. Many software and equipment manufacturers spoke about two issues that have been mentioned by others today. The first, as President Parry said about California, is that the high-tech jobs that are leaving the New England region are not likely to come back. The second, as mentioned by President Pianalto, is the concern in the technology industry about China and India. That's where the jobs are going, and most people don't expect those jobs to come back. So there are concerns about the long-term ability of the economy to expand in the technology area, in equipment and software in particular. Uncertainty is a factor for everyone, to be sure. As one contact put it, "Things aren't getting worse, and they may be getting marginally better, but it's too soon to tell."

There may also be tentative signs of a pickup in local economic activity that we see through the banking system. Large New England banks are beginning to see some increase in loan demand, and the shift of loans into problem status continues to decrease. This contrasts a bit with the discussion about bank credit in the Bluebook and other staff material. In part there may be some bifurcation between lenders to shared national credit borrowers and other C&I lending. For the shared national credit loans, there continues to be a greatly reduced willingness to lend, especially by foreign banks, which played a relatively larger role in these credits in the '90s and experienced a greater share of the losses as well. For smaller C&I loans, banks seem to be ready and willing to lend, as witnessed both by the anecdotes we hear and by comments from respondents to the Senior Loan Officer Opinion Survey. Whether this willingness to lend portends a much brighter picture going forward, however, remains unclear.

For the national economy there are uncertainties as well. Growth in the second quarter was surprisingly strong, but most of the surprise was in automobile purchases and government spending, though it is true that equipment and software purchases showed some signs of life as well. But we've seen growth surprises before in this bumpy recovery. One is reminded of the third quarter of last year, when GDP jumped to a 4 percent pace on the back of consumer spending on durables—again, autos—and then slid to a 1.4 percent pace in the fourth quarter. I don't think that's necessarily going to happen again, but it does bear keeping in mind.

Certainly, federal government spending has been strong, and fiscal policy remains in a highly stimulative position, though state and local spending cuts subtract from this. Monetary policy is stimulative as well, though market volatility and a steeper yield curve have subtracted from that as well. Combined with policy stimulus, consumer spending indicators, new orders data, improvements in some confidence measures, low inventory levels, rising profits, and productivity all suggest that increased strength in the second half of this year is all but baked in the cake. Labor markets remain weak, to be sure, and growth during the second half is not likely to eat much into excess capacity. Thus, the unemployment rate seems likely to stay at its relatively elevated state, and inflation could trend down.

The big question is, After a third-quarter and maybe fourth-quarter burst, where is this economy going? Will it proceed on the path described in the Greenbook, with a sharp acceleration in 2004, or on a path that settles down to about potential along the lines of most private forecasts and ours in Boston as well? I don't have a clear answer to this question, but I'm not sure one is necessary right now. For now, a policy-driven acceleration seems assured. It will not be sufficient to absorb much excess capacity or to reduce unemployment, but it could accelerate the process of easing the restraint and caution that is so palpable in corporate America.

Markets took a bit of a wild ride in May and June in part because they became convinced, for whatever reason, that yields would move only in one direction. But they appear to have stabilized a bit and the current level of rates does reflect, at least to some extent, a sense of market optimism about future growth. The best thing we could do right now, in my view, is to leave well enough alone.

That takes me to the issue of communication. Clearly, what we say has assumed an importance that is in many ways unfortunate. In part that's because the outlook has been so uncertain; an inflection point is near by most people's estimates, and the markets are looking for a sense of guidance about it. Thus the entire body of our communication—the post-meeting statements, speeches, testimony, and news articles—is being perused more closely than ever before, at least during my time on the Committee. We're going to have a chance to talk about this issue in September; and I, like a lot of you, am looking forward to it. However, whatever our decision today, this scrutiny of our communications places a higher premium than usual on what we say in our public statements. I would strongly suggest that we keep our statement as short, simple, and familiar as possible.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Thank you, Mr. Chairman. On balance, economic activity has picked up a little in our District over the past several weeks. Consumer spending appears to have accelerated at least a bit. Tourist-related activity, in particular, has shown some renewed strength in our region despite the wet weather—somewhat in contrast to what you said about the Southeast, Jack. Maybe all the tourists are visiting the Fifth District for some reason! Residential construction and sales are still strong, and there are at least a few signs of a pickup in business capital spending, although a lot of this involves replacement of computers and related high-tech equipment rather than something more fundamental.

Perhaps most significantly though, a development that is striking in our region is what I would call a fairly pronounced shift toward greater optimism about the near-term outlook among our business contacts despite the recent run-up in long-term interest rates. For example, one of our Baltimore directors, who regularly surveys 10 to 12 people in the heavy construction and industrial sectors of the economy, told us at the last Baltimore board meeting that his contacts were more optimistic than at any time in the three or four years he has been on the board. And the manager of a restaurant that my wife and I frequent made a point of coming over the other night to tell me how great business was. On several occasions recently, spontaneous comments like that have been made to me. I suppose that reflects at least to some extent the initial impact of the tax cut. It's a little eerie, though, because when people make those types of comments to me they seem to be looking for confirmation from me that happy times are either already here or just around the corner. I did buy a more expensive glass of wine that night, [laughter] but that's as far as I would go.

MS. MINEHAN. That's a leading indicator!

MR. BROADDUS. The one sector in my area where optimism is still scarce— actually nonexistent—is the old-line, traditional manufacturing industries such as textiles and furniture in the Carolinas. Most recently, the Pillowtex company based in North Carolina folded, wiping out about 5,000 jobs in that state alone, which I think was the largest job loss from a single event in the state's history. The total number of layoffs amounted to about 6,500. That company sold towels and a lot of other soft goods under the Cannon and Fieldcrest labels. I inadvertently referred to the company as "Pillow Talk" during a staff meeting the other day, which was an indication of both my age and my bad taste in movies. [Laughter] But it's no laughing matter in the communities where that company had plants—mostly in central North Carolina.

On the national economy, the Greenbook forecast is certainly plausible, including the considerable step-up in GDP growth going forward that the staff continues to project despite the downward revision in the projection. Like other people, I'm impressed by the more positive tone of some of the recent data and the anecdotal commentary that I just mentioned. My main concern, and others have expressed this concern as well, is that the additional 25 basis points of further disinflation projected for 2004 in the Greenbook could turn out to be too optimistic. I would cite three reasons to be concerned, and some of them have been mentioned already. First, the latest employment report does suggest that the output gap is still growing; that is in the nature of a baseline fact as I see it. Second, given the substantial total job loss in the economy since early 2001 relative to the trend growth in the labor force, I think the 6.2 percent unemployment rate may not be fully conveying the downside impulse that's coming from labor markets into the economy. Finally, the continuing surprising strength—almost amazing strength—in productivity growth suggests that trend productivity growth may well turn out to be higher than expected, along the lines of the first alternative scenario in the Greenbook, which I thought was especially interesting.

On that last point, in the late 1990s rising productivity growth had a powerful effect on demand because it was extrapolated—producing excessively optimistic expectations of future labor and capital income growth in that period that caused spending to grow even faster than potential output. It would be nice if we could get something like that now. But things could well turn out differently in today's environment, where the public's view of economic prospects is much more subdued, obviously, than it was in the late '90s, given the continuing job losses and excess capacity in a number of industries. Rising productivity growth today, in contrast to the late ’90s, could well cause the output gap to widen further if spending does not keep pace with potential output.

As the Greenbook alternative scenario indicates, that outcome would obviously put additional downward pressure on inflation. We would have to move the funds rate below 1 percent just to keep the real funds rate from rising. Indeed, in such a situation, we might well want to reduce the real funds rate below zero. In those circumstances, I think the zero bound would become a serious practical problem, not just a theoretical issue, because it could undermine the public’s confidence in our ability to provide the required stimulus with monetary policy. Obviously, if that kind of situation developed, it would involve a disinflation risk. We would have to make a convincing case that we could in fact provide the stimulus ultimately by expanding our balance sheet to whatever extent necessary in those circumstances, if they arise.

Let me say again that I, too, think economic prospects are looking at least a little better now. And in my view the probability of deflation and the risk of hitting the zero bound are still relatively low. But the high productivity growth scenario, which in some sense is the most favorable scenario from the standpoint of longer-term growth, does involve a significant disinflation risk in the near term. So I agree with what I’m hearing from several others around the table that it’s too soon to sound the “all clear” signal. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. As far as the Ninth District is concerned, overall economic activity is stable to improving. Let me just cite a few examples of that. On a year-over-year basis, employment is stable in virtually all District states, but I’d say that the undertone of the labor market has improved. There clearly are stirrings of net hiring, in particular for some higher skilled positions. I can probably make the same set of statements for manufacturing. Most measures indicate that activity in that sector has been stable in recent months. But again there seem to be some hints of a greater level of optimism among at least some producers. Residential construction, which of course has been a bright spot, is still up significantly on a year-over-year basis. The same is true for sales and prices of houses. So that sector continues to do well. Of course, that was the situation before the recent increase in mortgage rates, but I'll be surprised if that increase has a material effect on activity in the housing sector, in the short run at least.

Surprisingly, there are some new projects under way in nonresidential construction activity, mostly expansion of hospitals and other health care facilities and some office building construction in a few of the medium-sized cities in the District. Finally, after a slow start, tourism activity seems to have picked up in many parts of the District, and that apparently has brought with it some improvement in retail sales as well, mostly in the tourist centers. So overall I would say that the situation in the District is improving, although probably not at a rapid rate.

As far as the national economy is concerned, many people have observed already—and I agree—that the latest actual data are clearly on the more positive side. But I would sound a somewhat cautionary note here. We know that those data are unreliable; they can be subject to significant revisions; and one or two months don't make a trend. Nevertheless, given the improvement in the data and given that the stimulus we're all anticipating and have talked about is now upon us, I do think some acceleration—probably significant—in economic activity going forward is likely. That said, the precise timing remains open to question, at least in my mind.

Clearly there is no real inflation or inflationary pressure in front of us, as best I can judge, and that prospect could be reinforced if productivity is better than the Greenbook forecast suggests for next year. Part and parcel of that scenario is the likelihood that employment will be slower to pick up as we go forward or that employment gains will be more modest than is typically the case. But with real growth continuing, an acceleration in growth in prospect, and inflation low, it seems to me that overall the economy is in pretty good shape.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. We do have some recovery in the Eleventh District, but it is underwhelming. The high-tech, communications, and transportation sectors and the Mexican economy are all drags on the local District, while the defense and energy sectors provide a mild boost. There are some signs of growth in interest-sensitive sectors such as construction. Overall, the recovery remains slow and mostly jobless. Private employment is up just a 0.1 percent over the first half of the year. The sectors that helped remake the Texas economy from oil to high-tech in the 1990s—namely, semiconductors, telecom, computers and computer-related equipment—have turned on us, and now Texas has lost proportionately more of those jobs than have other parts of the nation. Since its peak, the semiconductor industry has shed 32 percent of its workforce in the Eleventh District. In the computer industry and the communications sector, job losses have been 34 percent and 43 percent, respectively.

Air transportation in the District has experienced a second sharp decline recently, with employment in that sector falling nearly as much last quarter as in the fourth quarter of 2001. Surprisingly, though, the air transportation sector in our region has not suffered as big a decline as in other parts of the nation. While American and Continental have made major staffing cuts, Southwest Airlines has not had to lay off any workers. The District isn't getting any help from exports either. Monthly Texas exports have been drifting down over the past year, dipping further recently. Export-related job losses are greatest in manufacturing, of course, which cut

6,000 jobs in June. To top it all off, the sugar industry has even moved out of Sugarland, Texas, where it has operated for decades.

There are some mildly positive signs, however. A few of our high-tech manufacturers such as Texas Instruments and defense manufacturers such as Lockheed Martin have announced expansion plans, sizable new contracts, or boosts in new orders. Job gains have picked up for the past several months in construction, health and education services, and even a bit in the hotel industry. The drilling part of the oil business is still fairly strong, and that's mainly for natural gas. The share of temporary workers has been increasing since early 2002 even though the demand for temporary workers from large companies remains slow, as many undergo restructuring and consolidation. The Texas unemployment rate dipped in June, and maquiladora employment is slowly coming back, though it faces an increasing challenge from China. The big concern just across the border is low wage competition from China. Overall, the Texas index of coincident economic indicators picked up in June, increasing at an annualized rate of 1.2 percent.

Turning to the nation, we're in the midst of the slowest expansion in post-World War II history, as measured by employment. In the previous nine expansions, it took an average of eleven months for employment to regain its pre-recession peak; the high was twenty-three months in the so-called jobless expansion that began in 1991. At twenty months into our current expansion, jobs are still down 2.6 million from the level in February 2001. So we're certain to set a new high for the number of months it takes to get all the jobs back.

If we look at the consumption and income data, it's hard to see that a recession and slow recovery ever took place. Another way of saying that is that, if we look at the behavior of productivity, we've had the second strongest recession–expansion phase in the post–World War II period. Average productivity growth in the twenty-eight months from peak to present has been stronger than in nine out of the ten business cycles in postwar history. The GDP growth process hinges on three factors: innovation, investment, and reorganization. Technological progress appears to be doing a very good job in the innovation part of this process, raising productivity enough to keep GDP growing despite the job cuts. The snafu seems to be in the economy's ability to muster up the investment funds and the confidence needed to invest and reorganize. On that score there are reasons for cautious optimism. The second-quarter GDP release shows that, for the first time in a long time, spending on nondefense capital goods is adding some lift to the economy. Overall, I believe the situation looks a little more positive nationally. Consumer spending has continued to hold up, tax cuts have come on line, and now investment spending appears to be showing some signs of a turnaround. It's getting easier to believe that a solid recovery is beginning to take hold.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Thank you, Mr. Chairman. From a wide variety of contacts in the Eighth District, including fairly large firms like the May Company and Enterprise Rent-A-Car as well as a lot of small companies, the overall assessment of the business situation is along the lines of "not yet." It's not that the economy is sinking but just that there's no real surge of activity as yet.

On a somewhat more hopeful basis, my contact at J.B. Hunt, which is one of the largest trucking companies in the nation, said that intermodal transport business—that's the piggyback business with trucks and trains—is up 15 percent this July over last July. The higher traffic is in the form of manufactured goods going westbound and imports from the West Coast coming back eastbound. On the regular trucking side, no dramatic change has occurred, but business is a bit better. The pickup started in the last third of June and seems to be continuing into the early days of August. Again, I would emphasize that he described it as an uptick, certainly not a surge.

My UPS contact said that he had just gotten back from Asia and that a noticeable pickup was taking place in Japan; that's how he led off our conversation. He characterized business in the United States as essentially unchanged. My FedEx contact started off by saying that there was no change in activity for them, no sign of inventory restocking. He does not expect to see any particular change before the fall or beyond. Again, the tone was more hopeful, but nothing really solid is in the works.

My contact at Wal-Mart said that to him the data do not look as good as everyone seems to think. Wal-Mart's sales in July got a fair amount of press, but he noted that it's relatively easy to see improvement based on comparisons from last year because of the weak numbers a year ago. He commented that Wal-Mart is not seeing very much from the childcare tax credit checks that have gone out. Wal-Mart will cash those checks for customers. For checks cashed at their stores, about 15 percent of the funds are being spent compared with about 25 percent of the rebate checks that went out two years ago. As for the paycheck cycle that I've talked about before, my contact reported that it was as pronounced in mid-July as in the one in May, which was as pronounced as any for five years. That is, people are coming in to shop when they get their paychecks, which suggests that spending is liquidity constrained. He also said that the company's growth in sales is about two-thirds from increased traffic and about one-third from increases in the amount being spent per each sales ticket. He prefers to see the proportions reversed because that would indicate stronger underlying demand rather than that customers are being taken from competitors. In my contact's view, Wal-Mart's inventories are in pretty good shape, at only about 1 percent above the desired level. He thinks that other retailers are probably somewhat more excessively overstocked than Wal-Mart and that inventories in the retail sector in general are probably a bit above desired levels. So he did not foresee any inventory surge in the near term.

On the national level, I believe the Greenbook forecast makes a lot of sense. I view that forecast as the median best guess, but I always like to think about the distribution around that forecast. For the first time in several years, my own sense of the distribution is that it's skewed more to the right of that median. I think there's more of a possibility of upside surprises. I'm not saying that's my best guess, but I think there's more room for upside surprises than I've felt for a couple of years. I'd point, for example, to the possibility of inventory accumulation, maybe not right away but as we move into next year.

I'd also like to emphasize the importance of corporate profits numbers going forward. If we see some good corporate profits, I think that's going to loosen the purse strings on capital expenditures, and it's going to make the stock market perform better. A virtuous cycle of all sorts of things could flow from an improved corporate profits picture. So I think we're on a good track. I believe the takeoff is going to be slow, but to me the prospects ahead of us seem much improved. Thank you.

CHAIRMAN GREENSPAN. Why don't we break for coffee and come back in ten or fifteen minutes.

[Coffee break]

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. The Tenth District economy has strengthened since the last meeting. Although economic growth is certainly not robust, it is at least showing some positive signs. The labor markets are still soft, but they do appear to be improving slightly. Employment has slowly edged up since the end of the Iraqi war, moving almost to year-ago levels. Layoff announcements did rise somewhat in July, but that was due mainly to some anticipated job cuts at certain military bases.

Manufacturing activity showed further signs of recovery in July. New orders were up. Our manufacturing index was 16 in July, up from 6 in June and minus 2 in May. That's consistent with other improvements, such as increases in capital spending and expectations of future production that remain generally favorable. The negatives were that current production did slip back to below year-ago levels and plans for future hiring and capital spending remained unclear. There's a certain sense of wanting to go forward but a hesitancy that still remains.

Consumer spending has continued to rebound from the dip during the war. Retailers contacted in mid-July said that their sales were up a little from previous months and at or above year-ago levels in most locations in our region. Commercial real estate, though still weak, has shown some signs of stabilizing. Office vacancy rates were unchanged in the second quarter, and construction activity leveled off after trending down for the last year and a half. Housing activity remained strong. The recent increase in mortgage rates has caused a fairly sharp reduction in refinancings, but so far we've not heard any reports that it is curbing housing demand itself. Energy activity remains an important source of strength. Drilling for natural gas continues to expand, supported by high prices and the lifting of some environmental restrictions recently in Wyoming.

State and local budgets remain a drag on the District economy. Colorado, Nebraska, and Oklahoma are planning to implement some further spending cuts. Also, legislators in Nebraska and Kansas are talking about—and in fact are very close to—enacting some tax increases. Pricing trends are little changed since the last meeting. Retail prices have been stable. In manufacturing, our contacts tell us that prices of materials have continued to rise while prices of finished goods have continued to encounter downward pressure. The farm economy is recovering. Those areas that have a crop have a very good crop. Some areas in western Kansas and Nebraska still are experiencing a drought, and farmers there are relying on government payments as they have in the past.

Let me turn to the national economy. It appears, as others have noted, that the economic forces are in place for sustainable recovery, making a rebound to trend growth this year possible and to above-trend growth next year most likely. We have accommodative monetary policy and fiscal policy, strong productivity, and a healthy financial system that can support the credit needs of businesses as those needs materialize. Of course, as we've talked about today, the significant increase in long-term interest rates is a topic receiving a lot of attention. While the rise in long-term rates can be a negative, obviously, part of the increase reflects simply a rebound from the dramatic declines in May and June. But I think those rates also have risen because investors are more confident about the strength of the recovery. In addition to anticipating the strong monetary and fiscal forces propelling the economy forward, we're now beginning to see the strength reflected in economic and financial data. Inflation-indexed Treasury yields suggest that real interest rates are higher. In addition, the inflation premium has in fact increased.

Putting this all together, my outlook for the economy continues to be for real GDP growth of about 3½ percent in the second half of this year, which is below the Greenbook's 4 percent. I think growth next year will be closer to 4 percent than the Greenbook forecast of 4.8 percent. Of course, if business becomes confident about the outlook and business fixed investment increases to the 13 percent suggested in the Greenbook, then we could see growth in the range of 4½ percent or better. So, while I see upside risk to growth, it is based on my forecast of growth most likely being near 4 percent, not the 4.8 percent projected by the staff. Relative to that 4.8 percent, I think there's probably some downside risk.

Let me turn briefly to the inflation outlook. I expect core inflation to remain relatively stable. While the output gap may put some downward pressure on inflation, I would be reluctant to place too much weight on the output gap as a predictor of inflation going forward. More significantly, financial markets and market economists seem to me to be expecting somewhat higher inflation. In my view, the inflation risk for 2004 is about balanced. More generally, given the outlook, I think the risk of unwelcome deflation or disinflation caused by a collapse in aggregate demand is negligible, although I do recognize that continued strong productivity, along with modest economic growth, could lead to some further disinflation. Thank you.

CHAIRMAN GREENSPAN. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. For quite a while we've been saying that a strengthening in the economy was coming but we didn't know its timing or extent. Like others, over the intermeeting period I saw a number of encouraging signs on the timing question that suggest growth in fact has already been strengthening. Data for the second quarter supported that judgment, showing a bit of a pickup under way. Notably, those data preceded the latest round of tax cuts and probably had little to do with the extra financial stimulus that we got in the second half of May and early June. It's especially encouraging that capital spending seemed to be on the upswing, including increases in shipments and orders of non-high-tech equipment in both May and June. Among other things, this trajectory in the second quarter implies that we don't need quite as abrupt a strengthening in demand and activity as we previously had imagined in order to get growth at or above the growth rate of potential toward the end of the year. Moreover, the fragmentary information for early in the third quarter that David Wilcox talked about—sales, initial claims, and purchasing managers' surveys—tends to support the hypothesis that growth is indeed in the process of breaking above the sluggish pace at which it has been running since last summer. The pickup in activity is not confined to the United States. There are indications of a turnaround overseas, supporting the staff forecast of much stronger growth in our trading partners. This is importantly a spillover from the United States, but it also reflects expectations of stronger domestic demand abroad.

While the timing of the pickup appears to be more settled, the extent of the acceleration continues to be in doubt. My best guess continues to be that macroeconomic policy stimulus, along with a number of other favorable developments we've talked about at recent meetings, will support growth that is sufficiently vigorous to begin to erode economic slack later this year. But we haven't seen such growth yet, and a couple of developments over the intermeeting period that others have mentioned argue in favor of a cautious assessment.

On the demand side, a key issue is whether, after the recent tightening, financial conditions remain supportive of a substantial narrowing of the output gap over the next six quarters and beyond. There are reasons for concern. One way of looking at this question is to judge whether the path of short-term rates implied by the term structure looks compatible with such an outcome. In that regard, the implied upturn in Eurodollar rates next spring is at odds with the flat path in the staff forecast and I suspect from the tenor our last meeting with many of our own forecasts as well. The market seems to be anticipating some combination of a more vigorous bounceback in demand and greater inflation pressure than is built into these forecasts. Presumably then, were higher rates to persist for long in the absence of positive surprises to demand, we'd have to mark our projections down—and perhaps considerably.

But there are some ameliorating factors that suggest that the risks from the higher rates may not be that large. For one, rates are still quite low. In nominal terms, most bond rates are only a bit above the levels of early May before the good news on growth and the passage of substantial fiscal stimulus. Moreover, I see a considerable part of the rise in rates as an endogenous response to ongoing positive developments. Some small part of the increase likely was an upward adjustment in inflation expectations or at least a reduction in fears of deflation—not such a bad thing under the circumstances. Resulting levels of real corporate bond rates are especially low, as risk spreads have come in so far this year. In my view, a portion of the pickup in rates results from greater confidence and optimism on the part of private investors responding to better data and to Federal Reserve statements. This is evidenced in the resilience of equity prices and the persistence of narrow corporate risk spreads despite huge increases in bond yields. I find it hard to believe that this isn't being echoed to some extent in the attitudes of businesses as they make spending decisions. Such a shift in psychology has been a necessary condition for stronger economic activity, and it reduces one downside risk to the forecast.

Finally, if markets are wrong, they will correct themselves, and rates will fall back. In the staff forecast, market participants come to the realization soon enough that inflation and short-term rates will remain damped longer than they anticipated so that the resulting decline in long-term interest rates happens in time to preserve above-trend growth for the forecast period.

An additional cautionary piece of information came on the supply side of the economy, where we had yet another reminder of the astounding pace of productivity growth. As many of you have remarked, not only does such growth raise the bar for required expansion of demand, this increase in productivity has been achieved with very little capital deepening. Businesses are able to enhance efficiency by rearranging production processes with about the current level of capital and only relatively gradual updating of the stock. That has damped the feedthrough of productivity growth to demand, in marked contrast to experience in the 1990s, and has made it harder to close the output gap. At the same time, rapid productivity growth has been holding down unit costs and contributing to continued disinflation.

On balance, I see incoming data as consistent with my view that growth is in the process of strengthening but also as not materially relieving my concerns about overall downside risks to our dual objectives. With inflation already low and slack considerable, it's important to have a prolonged period of growth above potential not only to minimize lost output and wealth but to limit the extent of disinflation. We don't want to end up with an inflation rate that may provide inadequate scope for monetary policy to meet unexpected downward shocks. This imperative has implications for maintaining a highly accommodative stance of policy for some time into the future and for the balance of risks that we will discuss in the second part of the meeting. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. I'll divide my review of the intermeeting period into two sections. One I would describe as what we know, which is to say what happened. The second is what we think, or how we interpret the data. First, what do we know? As others have said, the data on the real economy during the intermeeting period have been quite mixed. The labor market continues to disappoint, with a fall in the latest reading on private payroll employment and a shortening of the workweek. However, many other types of economic data admittedly have been more positive. On the output side, manufacturing activity seemed to climb a bit toward the end of the second quarter and is at least holding in the early part of this quarter. On the spending side, the limited information from July, namely for light vehicle sales and chain store sales, I think indicates that consumers are holding up their end in this nascent recovery. With regard to business fixed investment, anecdotal evidence from the surveys that we undertake here and from surveys of capital spending by others have been a bit more upbeat as well. So what we know about the real economy has been relatively positive but there are still some negatives as well.

What about the financial markets? I'd say that there's perhaps a bit of bifurcation there. Equities have turned in a very respectable performance since the last meeting. The S&P is basically unchanged, but the Nasdaq is up about 2 percent, and that may well reflect some positive earnings surprises and an improved outlook. As we've discussed, however, the fixed-income markets have had a much less even run since the last meeting, with intermeeting increases in two-year and ten-year yields that are quite dramatic by historical standards. Importantly, real yields as measured by TIPS rose significantly less than nominal yields on Treasury securities, which suggests some increase in anticipated compensation for inflation. Similarly, as Governor Kohn has already indicated, market expectations for monetary policy during the intermeeting period also showed a clear upward shift in the outlook for interest rates.

Now, outlining these facts is relatively easy. The hard part, obviously, is for us to try to interpret them. In that regard, I think there are three important questions. The first is, Are these facts consistent with the staff forecast and outside forecasts of gradually improving growth, particularly with growth starting now in the third quarter? My interpretation is that the facts do seem to be consistent with the judgment that the economy will experience the much-expected turnaround in the second half of this year. Admittedly, of course, that growth is still a forecast, but it seems to me that, since the last meeting, the odds of that growth occurring have certainly picked up substantially. Even the much-discussed run-up in fixed-income yields, put in a broader context going back to May 5, the day before our May FOMC meeting, does not seem so outsized.

The second question is, Are these data internally consistent? The answer, as is always the case, is “no, they are not.” Inconsistencies and questions I think still abound. First and foremost, why is job growth so sluggish? Is it a sign of uncertainty on the part of businesses? Or on the other hand is it just the negative side of a very good productivity story? That’s hard to answer; I think it’s probably a little of both. In my view, the productivity numbers should reign supreme here. Another question with respect to job growth, as it turns around very slowly, is whether it’s likely to slow down the spending behavior of consumers. My judgment is “no, it is not.” I believe that the stimulative monetary policy and fiscal policy plus a gradually improving labor picture are likely to be sufficient to support consumer behavior, which will be an important part of this turnaround.

Again in the category of whether these data are internally consistent, one struggles a bit with what the message is from the financial markets. Governor Kohn has already done, as one would imagine given his background, a superb analysis of the financial markets. So I will be modest and not attempt to replicate exactly what he has said. But I do find the communication challenge we face with respect to the markets quite difficult to understand. Nobody can understand fully why market expectations for monetary policy have shifted so dramatically toward a future tightening by the FOMC. It may be due to the more positive tone in the recent economic information, as Governor Kohn has suggested, but it may also be that communication challenges will create a bit of a problem for us going forward. So I’d say we still have to be on the lookout in that regard.

The final issue with respect to interpretation of these data is what they mean in terms of the various risks to our dual mandate. On that I'd have to say that I recognize, as President Poole suggested, that there might be some upside risks. A quick turnaround in inventory accumulation, for example, could hit us in the third or the fourth quarter, though that would not be a negative development. But by and large my concerns about the risks tend to be much more to the downside, particularly with respect to the price stability issues. If one looks at any of the forecasts—and certainly our staff forecast of economic growth is high among them—for the next six quarters they all imply a still large pool of underutilized resources at the end of the forecast period. In all of the alternative scenarios in the Greenbook, particularly the most optimistic ones with faster structural productivity growth or the lower NAIRU, we end up having far less of a cushion in terms of the inflation rate. In the two most optimistic scenarios, the core PCE inflation rate drops far below 1 percent, well outside the bounds of what I would think of as price stability. So I have some concerns about the risks going forward, which I see as being primarily on the downside. And I think this is really quite problematic.

If I go outside the context of the Greenbook and look at other forecasts, my concerns, if anything, are heightened. As a number of members already have pointed out, our staff is probably at the high end of the consensus outlook for GDP growth as compared with the Blue Chip forecasts. This suggests to me that there may be some risks to the downside with respect to the staff forecast. I think the risks are somewhat asymmetric, with the greater probability of an outcome that is perhaps somewhat weaker than the staff envisions. That weaker outcome may emerge from three different types of surprises that are possible, though not certain. The first is that the export picture may be a little weaker; other economies may not turn around as quickly as the staff forecast and Karen have suggested. The second—and one that certainly shows up in the more pessimistic outside forecasts—is that the recent change in financial conditions may have a stronger impact on refinancings than anticipated. Again, that's not a certainty, but it is a risk that is not picked up fully in the Greenbook. The third, as implied by President Pianalto's comments, is that the usual multiplier–accelerator effects may not work as envisioned; and as we get into 2004, there's a real risk that some of the strength we see in 2003 may not be translated into business decisions to invest.

So where does that leave us? Frankly, given the relatively positive tone of the incoming data and given market expectations, I think it's probably prudent today to sit tight with respect to monetary policy itself. On the other hand, the absence of a policy response today makes it even more important that we maintain a vigilant posture in our written statements, particularly with respect to the price stability part of our mandate. I will stop there and leave the rest of my comments until the second part of the meeting. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. I would also refer to a comment that Governor Kohn made regarding the need for the shift in psychology that apparently is beginning to occur. Last week I talked with four contacts at major banks—CEOs or others in senior leadership positions—and the most notable change in their description of recent developments at their banks is the across-the-board improvement in business psychology that they are observing. It has not yet been reflected in C&I loans in a broad way, though an exception is one of the major Midwest banks, which has seen more activity in C&I lending in the rural markets than they've observed for the past five years. However, in the major money markets, they do tend to see increased activity in some of the areas of capital lending activity. Venture capital activity has gone from awful to signs of improvement, I'm told. The corporate bond market is still strong, and the attractiveness of that market has helped diminish the growth in C&I lending. Markets are described as improved, particularly in the high risk area, and the leveraged transactions tend to be up. Another factor that's important is that loan quality is no longer mentioned as an issue of concern. We have seen continued improvement in asset quality in both the consumer and the business sectors for some time. So while there is optimism and a significant improvement in psychology, that has not yet translated into business activity, at least as represented by the business channel.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. The criticism of the Fed over the intermeeting period has been as intense as at any time since I've been here. Have we lost our touch, or are we dealing with a complicated set of new issues? While obviously I'm biased, my vote is for the complicated set of issues.

I see four major ones. Number 1: There has been a huge positive productivity shock. According to the NBER, the recent positive shock seems to be slightly greater than the one that occurred in the late 1940s. To find one as large one has to go all the way back to 1917. Number 2: There has been a jobless recovery. Note that final sales actually grew 3.4 percent in the second quarter, at a time when everybody was complaining about the soft economy and dropping employment. We did have another jobless recovery in the early '90s, but that jobless recovery was of a very different nature. Number 3: Inflation is threatening to go below our target range. Inflation did get as low as it is currently a few times in the '20s and '30s, but in the modern era that has happened only once for a brief period in 1955. Number 4: We are trying to explain everything to the public. As far as I can tell, this has never happened in such a complicated environment. So we have four quite rare events interacting with each other, and the combination makes for a tricky interplay of policy and communication. As an illustration of the confusion, I quote from one of the news clips that I received just yesterday: “Treasury notes fell on speculation that the Fed will say economic growth is accelerating, boosting expectations the Fed will raise interest rates in coming quarters.” Were there to be a jobless recovery in the presence of a positive productivity shock and declining inflation, it is quite possible that an optimizing central bank should respond by lowering interest rates, not raising them. Other such anomalies can be easily imagined.

Apart from lamenting our fate of having to explain all of this, what should we actually be doing about monetary policy? I think the matter boils down to three questions we must ask ourselves. My questions are a little different from Roger’s questions and are differently organized. The first question is sustainability. Does the fledgling recovery need more juice to sustain itself? The second question is vigor. Will the recovery need more juice to get aggregate demand all the way back to full employment reasonably soon? The third question is inflation. Will inflation fall below our target range in the meantime? Unlike a traditional situation in which the issue confronting a central bank might be that of determining when to raise rates as a recovery proceeds, in this case if the answer to any of these questions becomes “yes,” we ought to be lowering rates instead. That said, tentatively at this point I would not answer “yes” to any of the questions.

As for sustainability and vigor, consumption and housing have remained strong. Investment is beginning to pick up steam, and inventories are thin. Government spending will be high and rising for a while yet. At this point the recovery looks as if it should be sustainable and vigorous, even if it has been so long delayed. Whether more juice will be needed at some point is a question that we can’t really answer right now.

As for inflation, core PCE inflation is flirting dangerously with what I think most of us would consider the bottom of an acceptable range for inflation, about 1 percent a year. There would seem to be a clear risk that prolonged output gaps will lower inflation further. But that eventuality doesn't seem to be in anybody's forecast, either in the baseline Greenbook forecast or the other fifty-four Blue Chip forecasts, none of which has inflation falling below our presumed target range. I might note, though, that two of the alternative scenario Greenbook forecasts do have this result. According to the staff, at these levels inflation generally responds quite sluggishly to output gaps. And the standard forecast is that the expected narrowing of output gaps will ward off the proverbial unwelcome substantial drop in inflation.

The summary of all this is that, while the unusual combination of events makes it inappropriate in my view for us to behave like a central bank that would traditionally be raising rates in a recovery, there doesn't seem to be enough present evidence of the need to lower them either. I guess that means we should sit tight for now. Thank you.

CHAIRMAN GREENSPAN. Governor Bernanke.

MR. BERNANKE. Thank you, Mr. Chairman. Like most everybody else, I'm encouraged by the recent data. The surprisingly good second-quarter GDP number looks even better when one takes into account the big negative contributions of the foreign sector and inventory investment, both of which should tend to reverse at least partially over time. Particularly when the normal cyclical inventory rebuilding kicks in we should see a period of strong growth, and Secretary Snow's analogy of the economy as a coiled spring may finally seem apt. Despite the good news, I think it's premature to conclude that we should not consider further rate cuts, if not at this meeting then at some time in the near future depending on how the data play out. My concern is focused on the behavior of inflation both in the short term and in the long term.

Regarding the short term, though I can see that output gaps are extremely hard to measure, the most reasonable guess is that the current gap remains substantial. Moreover, because of rapid productivity growth, the gap may close very slowly in coming quarters even if output growth is quite strong. That’s bad news for workers, and it poses some risks to consumer spending. More to the point, a persistent output gap implies that additional disinflation over the next year remains a distinct possibility. Even if we consider actual deflation to be too remote to worry about, further disinflation poses important risks. Disinflation offsets monetary policy ease already in the system, and very low inflation may limit the ability of monetary policy to respond by conventional means to future adverse shocks. In short, we should continue to consider disinflation unwelcome and to be vigilant about its possibility.

The longer-term issue can be summarized by the following question: Where do we want the inflation rate to be when the economy returns to full employment and sustainable growth? A good bit of research at the Board and elsewhere has suggested that a positive steady-state inflation rate improves economic performance by reducing the frequency at which the zero bound is binding on the policy rate. I surveyed a number of the relevant papers in preparation for this meeting. Virtually all conclude that zero bound considerations should lead one to choose a steady-state inflation rate between 1 and 3 percent. Recently, several authors have become more daring and have given point estimates of the optimal inflation rate, with the choice almost always being 2 percent. The memo by Elmendorf, Reifschneider, and Wilcox entitled “Deflation and the Conduct of Monetary Policy,” circulated to this Committee before the June meeting, was explicit in putting the magic number as 2 percent PCE inflation. I don’t want to take a stand today on what the long-run inflation rate should be, and that's obviously something we should decide as a Committee. But I note that the FOMC central tendency forecast for PCE inflation for 2004 was 1.0 to 1.5 percent, somewhat more optimistic than the Greenbook forecast of under 1 percent. Is inflation of 1.0 to 1.5 percent what we want to be heading for in the long run? If so, fine. Otherwise it seems to me that our policy should reflect our long-term objectives.

Finally, I have some concerns about our communication. Government bond yields have risen a good bit lately; and while that rise is unlikely to derail the recovery, it does not help. Some would argue that an increase in bond yields at this stage of the recovery is normal. That may be historically accurate, but it misses the point. Historically, inflation has typically been higher than the Fed would like, so the FOMC has responded to strong growth by raising interest rates to forestall any inflationary impact. This time around is different, or should be. Inflation is not a threat. Therefore, the FOMC does not need to take away the punch bowl so early in the party, so by rights interest rates should remain subdued despite the pickup in growth. Judging by federal funds futures and other indicators, however, the markets have largely missed this point and have bid up interest rates well beyond where they ought to be in some sense, to the detriment of the recovery. To the extent that we can sharpen our message that economic growth no longer implies an immediate and automatic policy tightening, we should make every effort to do so. I understand, along the lines mentioned by Governor Gramlich, that communicating this subtle point is a difficult challenge. But the economy would benefit if we could meet that challenge. Thank you.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. Thank you, Mr. Chairman. I'm going to focus on a couple of issues that Governor Bernanke just discussed and that many of you have mentioned, too—namely, communicating our policy and our views about the issues facing us today. I want to talk about this from the point of view of the two dictates in our mission statement, potential growth in the economy and inflation. One of the things I find striking in my conversations with people who participate in the bond markets is the difference in our perceptions regarding where we are in this particular recovery. As several people mentioned earlier, the market tends to believe that, when the recovery begins, the Fed is going to take away the punch bowl and start tightening interest rates right away. Most of us have really been engaged in this profession—old as we are—only when the Federal Reserve has been trying to fight inflation. That has been the System's focus since the '70s. What is unusual here is that the economy has emerged from a long-term secular problem of exceedingly high inflation, and now the rate of inflation is within or near the range we might want to set for a long-term inflation target. As a result we're not trying to achieve a secular decline in inflation, we're focusing more on the cyclical aspects of it. I don't believe the Street is really differentiating these two issues.

A second issue—and one of the reasons that inflation is so low—is that productivity growth is significantly above what any of us has seen. In fact, the productivity numbers that just came out are high even for the early stages of a business recovery. If we believe that productivity will stay somewhere above its long-term trend, the pickup in inflation that we normally would see is not likely to occur. While we hope that inflation will go up from where it is currently, in the Greenbook forecast inflation remains significantly below what many of us find comfortable. I certainly am uncomfortable when I see inflation forecasts of less than 1 percent.

The other issue I see, as I look at the risks to the forecast, is addressed in the alternative scenario in the Greenbook that is called "prolonged subpar investment." That is the root cause of this recession to begin with. The slowdown in business fixed investment created the recession; it was not consumer-driven. If business investment doesn't pick up as we're expecting, the output gap will get wider, and inflation will continue to drift lower. While capital expenditures have increased at some companies, we're still not hearing very robust plans for capital expenditures as companies have released their earnings reports. I think most people around the table today have been hearing mixed reports about capital spending intentions.

So I share the doubts expressed about how businesses are going to survive in a world with continuing low inflation, which limits pricing power. I'm not sure how they can achieve the earnings growth for the next five years that we still see in the S&P numbers and other earnings forecasts. What's going to give? Well, they are going to have to resume capital expenditures in order to achieve that growth and continue to get an extraordinarily high pace of growth in productivity. Alternatively, without the capital deepening, we will continue to see what has been going on over the last couple of years—more reorganizations, the shutting down of plants, and the restructuring of product lines.

So in summary, I'm concerned about the strength of capital expenditures relative to the staff forecast, and I see that as one of the biggest risks going forward. In terms of our communications, I would love to find some way—maybe we can talk about this in September—to make people understand that we are now in a different mode for the long term with regard to both inflation and productivity. As a result, the output gap will be large for a while even if economic growth is high in the short run. Thank you.

CHAIRMAN GREENSPAN. Thank you very much. Let's turn now to Brian.

MR. MADIGAN.[2] Thank you, Mr. Chairman. I'll be referring to the material labeled "Briefing on Monetary Policy Alternatives," which was distributed during the break. The sharp rise in market interest rates was, without a doubt, the major

[2] The materials used by Mr. Madigan are appended to this transcript (appendix 2).

development in financial markets over the intermeeting period. As shown in the top left-hand panel of your first exhibit, yields on ten-year Treasuries and other high-grade bonds generally climbed about 110 basis points on balance. The increase took place amid considerable volatility, the right-hand panel. As Dino noted, the steep advance in yields triggered a cascade of portfolio adjustments, including in particular a large volume of hedging transactions by mortgage investors, and the volume of those transactions and the high degree of volatility briefly took a toll on liquidity in a number of fixed-income markets. The stresses were particularly visible in a spike in swap spreads, the middle left-hand panel, but market functioning has improved considerably in the past few days.

One potentially significant development is the substantial increase in compensation that bond investors require for inflation, the solid and dotted lines in the middle right-hand panel. However, the most recent results from the Michigan survey, shown in the inset, suggest no pickup in households' longer-term inflation expectations and, in fact, indicate some further decline in their anticipated short-term inflation rates. As shown in the bottom panel, the sharp increase in yields over the intermeeting period to an important degree represented a reversal of a considerable decline over the previous period, as a number of you mentioned earlier. The recent run-up in rates, while sparked by Federal Reserve words and actions, also reflected incoming corporate earnings reports that were better than anticipated, some of the economic data releases, and perhaps the news that the federal deficit was widening substantially. Thus rates are now higher than they were in early May.

The reversal in market sentiment showed through clearly in expectations for monetary policy. As indicated by the dotted line in the top left-hand panel in your next exhibit, just before your last meeting many investors apparently anticipated that the funds rate would be eased to 75 basis points before long and that the rate would remain low for an extended period of time. By contrast, the solid line suggests that markets now think you probably will begin to firm policy next spring. Although the direction of the revision is not surprising, its extent may be. And the fact that markets see tightening as commencing in less than a year apparently indicates that they see the expected rebound in growth as potentially leading directly to inflationary pressures without much of a role for a persistent output gap in determining price changes.

The top right-hand panel provides additional information about market participants' expectations for your policy stance in the near term. According to a survey conducted by the Desk, all twenty-two primary dealers anticipate that you will leave the target for the federal funds rate unchanged at today's meeting. Sixteen expect that the risk assessment will also be unchanged—that you will again see balanced risks to sustainable growth, downside risks to inflation, and downside risks overall. Four seem to think that you will shift your view of the risks to growth to the downside, while two believe that you will move to a judgment that the two components, as well as the overall assessment, are balanced.

The market's view of the likely course of monetary policy contrasts with the Greenbook assumption that you will keep the funds rate at 1 percent through 2004. As David Wilcox discussed earlier, the staff forecasts that such a policy stance, in combination with the monetary and fiscal stimulus that is either in place or coming on line, should result in a considerable acceleration of aggregate demand. However, because the staff also projects continued strong expansion of productivity and hence aggregate supply, an output gap lingers throughout the projection period. That leaves the civilian unemployment rate at 5.5 percent at the end of 2004—a touch higher than in the June projection—and brings core PCE inflation to a tad below 1 percent next year.

Some discomfort with that higher track of unemployed resources is the first of three basic arguments outlined in the middle left-hand panel that might support an inclination to ease policy at this meeting. Even if you find the Greenbook forecast to be credible, you might prefer to pursue more-rapid gains against economic slack—and, perhaps, to increase slightly the inflation buffer in view of concerns about the zero bound to nominal interest rates. A FRB/US simulation not reported in the Greenbook indicates that a 25 basis point lower path for the federal funds rate would boost GDP growth ¼ percentage point over 2004. Also, even if you view the Greenbook outcome as acceptable, you might want a little more insurance that it will eventuate. Second, you might be concerned that aggregate demand could turn out to be weaker than in the staff forecast, perhaps because of a larger impact of the recent advance in long rates than in the Greenbook, or because the expected, and seemingly emerging, brightening of business sentiment fails to materialize. Third, you might see a good chance that aggregate supply could be even stronger and inflation even lower than projected by the staff, reflecting robust productivity gains and, perhaps, declining inflation expectations on Main Street, if not on Wall Street, feeding through to wages and prices.

On the other hand, you might see the Greenbook projection of accelerating output and decreasing slack as supporting an unchanged stance of policy, as indicated in the first bullet in the right-hand panel. Some of the data that have become available since the last meeting may be early evidence that economic activity is now in the process of accelerating, as the staff has been projecting. Also, the additional fiscal impetus now being implemented should help sustain the projected improvement, and you might want to see some evidence of the effects of that stimulus before undertaking further action. Moreover, the recent increases in long rates could be seen as a possible signal of a pickup in business confidence and a strengthening of spending that may outrun those forecast by the staff. A calculation reported in the Bluebook suggests that if bond investors use something like a Taylor rule in forecasting future monetary policy, then the recent run-up in interest rates implies that their expected level of output a year and a half ahead has revised up as much as 1 percent. If the Committee places appreciable weight on this possible signal, it might be inclined to leave the stance of policy unchanged at this meeting. Finally, the recent increases in inflation compensation implied by indexed securities, while not confirmed by other gauges of inflation expectations, may incline the Committee toward moving gingerly in providing any further stimulus. In these circumstances, the Committee may wish to defer action at this meeting and assess the data over coming weeks to determine whether adjustments to the stance of policy are necessary.

As I mentioned, such a policy decision is uniformly anticipated in financial markets, and most investors expect that you will couple it with unchanged assessments of the risks to attainment of your objectives for growth and inflation. As noted in the bottom panel, such an evaluation of risks would seem consistent with developments over the intermeeting period. The encouraging incoming data on spending and the backup in market rates may be viewed as having roughly offsetting effects with respect to the risks to the attainment of sustainable growth, leaving them balanced. And the continued very low rates of inflation, accumulating evidence that productivity growth remains strong, persistently weak labor market performance, and a small downward revision to the staff economic forecast may be seen as arguing that the risks to inflation remain tilted to the downside.

While certain developments over the intermeeting period—particularly the sharp backup in interest rates and the rise in inflation compensation—could be taken instead to argue for adjustments to the risk assessment, in the current environment any change might well prompt a sizable market reaction and possibly reignite recent volatility. The prospect of a strong response presumably would not deter the Committee from revising its assessment if the case was clear. However, should the case for change be seen as marginal, the possibility of an outsized reaction—together with the Committee's intention to revisit its communication policy at its next meeting—might set a relatively high hurdle for the FOMC to reach a judgment at today's meeting that the risks had changed. Thank you, Mr. Chairman. That concludes my prepared remarks.

CHAIRMAN GREENSPAN. I vaguely recall seeing another survey of primary dealers, which showed 60 percent of them—or something like that—indicating that they thought we would move toward balanced risks. It was circulated today. I may have misread it.

MR. FERGUSON. It was the Stone McCarthy one.

CHAIRMAN GREENSPAN. That's the one. Did I misread it? How did that percentage get to be so significant?

MR. FERGUSON. It was the Stone McCarthy survey, but part of the challenge is interpreting the words that were used. It says no change in the balance of risks.

CHAIRMAN GREENSPAN. The previous one was a risk toward weakness.

MR. FERGUSON. Right.

CHAIRMAN GREENSPAN. They got this different result so I assume—

MR. KOS. If I could, I think one of the issues here was the wording of the question used to ask the dealers about their assessment of the likely balance of risks statement. We found that we had to go back to some of the dealers, in some cases more than once, to get clarity because they did not—

CHAIRMAN GREENSPAN. In other words, no change in the balance of risks means that they expect the same statement about the balance of risks that we made previously?

MR. KOS. That's the way that some dealers interpreted it, yes.

CHAIRMAN GREENSPAN. I see. So Stone McCarthy thinks it is—

MR. KOS. Again, the question may have been posed slightly differently, and there may have been different follow-ups.

CHAIRMAN GREENSPAN. I did find that survey result rather startling when I saw it this morning. Questions for Brian? If not, let me proceed. Perhaps the most interesting development we are observing, and a number of you have commented on it, relates to the emergence of a clear divergence between the views of this Committee and a significant portion of the investment and financial community with regard to the evolving economic situation. Indeed, as I read the views expressed by the members around this table, there also is a divergence between the central tendency of the members' outlook for economic activity and the staff forecast. In fact, there's probably a problem in the way the economy looks to most people. As best we can judge, GDP for the month of July is already more than 2½ percent above the second-quarter average at an annual rate. This means that GDP will be 2½ percent higher for the third quarter even if we have zero change for August and September. And from what we can already observe in the most recent data, zero change is very unlikely for the month of August. What we're seeing is an accelerating GDP, not as a forecast but as it has begun to be reflected in incoming indicators. One would scarcely infer that from the anecdotal comments around this table.

Part of the reason for the apparent difference between perceptions and the GDP data relates to the fact that GDP measures final sales and, as such, it consolidates out a significant amount of intermediate activity that is reflected in the comments of our contacts in the business community. Consumption expenditures are clearly at a very significant level. We know that recent motor vehicle sales are in fact higher because our data for such sales are based on full coverage. But we also know that motor vehicle firms are having very significant pricing problems and that domestic manufacturers currently tend to be unprofitable in many of their operations. I think this provides us with a clue as to where the general problem lies. As I see it, the fundamental problem for business firms really gets down to the issue that a few of us have commented on today, namely the lack of pricing power. There is no evidence of any improvement in business pricing power, and that fundamentally colors the way the business community sees its activities. Profits are rising, but business executives seem to be surprised by the improvement in their profits. To a substantial extent, those profits are coming out of cost-cutting activities, and that inevitably means, as I've said in the past, that business firms are still taking advantage of potential productivity gains that were not exploited during the boom period of 1995 to 2000. So, unless and until businesses see some prospect of passing through more of their costs to prices, it is my experience that the business community will have a very forlorn view of the outlook and some reluctance to move forward on capital investments except for those that are essential to maintain current operations.

As we look at this process, we tend to formalize it essentially in terms of a model structure in which the rate of inflation is related to the level of the gap in GDP. While the results of fitting the data to such a model are reasonably robust, there is evidently a considerable amount of noise in the data. As a consequence, it would be perfectly credible to get rising inflation with a constant output gap for several quarters and not violate the underlying robustness of the relationship.

In any event, we are looking at different views of the way in which the economy functions. In the past, as a number of you have mentioned, the tendency of the Federal Reserve has always been to tighten when the economy showed signs of a macro pickup. In this period we have a very obvious reluctance to move in that direction largely because we're looking at a world in which global competition is much greater than it was earlier. To use the example of natural gas, the real problem in natural gas distribution is the fact that there are a lot of remote deposits of natural gas that cannot readily be moved to where the demand for the gas is located. Similarly, in the past there were areas of capacity for various types of output that could not be moved to markets in part because some of them were behind the Iron Curtain but also because of the inability to move goods and services the way they can be moved now.

Clearly we are looking at a different economic world from the one we have experienced historically, and we are moving ahead of the markets in our assessment of that new world. But in doing so, we have to be very careful. I say that even though it may very well be—and indeed I think the evidence supports the probability—that in the end the Fed will turn out to be right and the markets wrong. Still, there is a fairly large minority probability that the outcome will be the other way around. The reason I say that stems from my observation over the years of economists who have constructed very convincing models of how the economy functions, only to see those models break down when applied to real world situations. The most famous example undoubtedly was the very clever Stock-Watson model developed a number of years ago on short-term forecasting. It had worked for every business cycle prior to its publication, and it failed the first time it was actually applied. That sort of experience leads me to suggest that a little humility probably is required here. We need to be wary of talking ourselves into viewing certain relationships as absolute and persuading ourselves that it cannot be otherwise.

This leads me to propose that we maintain the policy stance we adopted at our June meeting. That would coincide incidentally with what the primary dealers suggest we ought to be doing. I think we have to be aware, however, of a very significant upside risk to this economy. It relates largely to the fact that inventory changes can be very rapid. Business firms almost surely are still liquidating some inventories, at least insofar as the available July data seem to indicate. Indeed, C&I loans and commercial paper adjusted for mergers and acquisitions were declining into July and have only very recently stabilized. And I understand that staff in querying market contacts as to why commercial paper issuance has stabilized found no evidence of any inventory accumulation. To be sure, it's not accumulation per se that's critical. A slowing in the rate of reduction can move the economy. That effect would be amplified, of course, if the economy were to experience a normal swing in inventory investment. That would involve a swing from a $20 odd billion annual rate of liquidation, which I gather is roughly what we are experiencing in the current quarter, to accumulation at an annual rate of something on the order of $60 billion to $70 billion at an annual rate. In the context of the staff forecast for final sales, such a swing would occur if businesses returned to inventory accumulation at a pace that was in line with what have been normal inventory–,sales ratios. We do have what appears to be an ongoing downward trend in such ratios and the staff is not projecting any near-term impetus from inventory rebuilding, but an upturn in inventory accumulation does occur in 2004. There's no reason in my view why it can't occur in the fourth quarter of this year or even within the next several weeks.

When an inventory swing occurs, it is always a big surprise. What we find is that, even though surveys may show that business firms think their inventories are at normal levels, they may nonetheless in a very short period of time perceive them to be inadequate and initiate a pronounced turnaround in inventory investment. So that is a significant risk to the forecast, and it should temper the degree of assurance with which we comment publicly about the economic outlook, which I presume a number of us will be doing in the months ahead. It is very easy to become certain about economic behavior that may have been very consistent over a number of years, and yet history contains what can be very disturbing surprises in this regard. I merely suggest that one remember that history.

I can't add terribly much to the evidence that profits and cash flows are rising. Lead times are still very tight. We certainly would be better off with a resumption in the growth of employment, but I think we have to recognize that the aggregate amount of compensation is a function of the GDP and its distribution is a function of whether it's related to employment or productivity. Obviously, if at any given level of compensation and GDP we have an acceleration in productivity, the economy will end up with higher unemployment, and those who are employed will earn higher real wages. What invariably happens in that case is that the distribution of income becomes less equal but the level remains the same. Unless we can argue that the propensity to spend is significantly higher in the lower income groups than in the higher-income groups, which seems to be the conventional wisdom though it does not seem to be validated all that much by the data, then whether we are getting productivity gains or getting more employment only modestly affects the average propensity to consume. Even so, there's very little doubt in my judgment that rising employment does affect overall confidence and exerts an effect on consumption from that direction. So it is important that we get the rate of GDP growth up adequately above that of productivity to get an upturn in employment. I must admit that I'm a little skeptical about the size of the 2004 rise in employment projected in the Greenbook. That's basically because I find it hard to believe that productivity growth is going to fall as far as the staff has it declining. But that's a minor issue.

In any event, the critical policy issue today probably is reasonably clear for us. What is not clear is how we will proceed beyond today. I think the incoming data are going to matter to a very considerable extent in testing the differing hypotheses of whether in fact we are living in a world that differs substantially from the one we have experienced in the post–World War II period. That's because the model we're working with is not the model of the post–World War II American economy. My bottom line is that we should stay where we are with the funds rate at 1 percent and retain essentially the same risk evaluations that we adopted in June. Governor Ferguson.

MR. FERGUSON. Mr. Chairman, I support both parts of your recommendation. I will say to your broader philosophical question that I'm still struggling with whether or not being in a new world of greater uncertainty suggests more caution or more aggressive behavior, given where the price measures are and the outlook for inflation. But for today I think your recommendation seems to be the sounder one.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. I'm very comfortable with your recommendation on both counts, Mr. Chairman.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, recent data give me more confidence that an acceleration in economic activity has finally begun. At the same time, however, there is an uncomfortably high risk that inflation may move lower than would be desirable. On balance, I do favor leaving the funds rate unchanged at the present time and waiting awhile to see if the incipient rebound continues to develop. I favor retaining our current risk assessment, with the risks being balanced for growth and weighted toward the downside for inflation. In expressing our risk assessment, I would prefer to use the wording in the Bluebook that we actually vote on rather than an interpretation like the one in the last press statement. I'd feel more comfortable voting for a particular risk assessment if I knew in advance exactly how it would be expressed to the public. This is an issue that I hope will be on the agenda for our discussion of communications in September.

CHAIRMAN GREENSPAN. It will be. President Poole.

MR. POOLE. Mr. Chairman, I support the recommendation to keep the federal funds rate where it is. Let me talk briefly about the communication process. Ahead of communication strategy logically comes the policy substance. We have to know what it is that we really want to communicate, and I think sometimes that's part of our problem. First of all, it's easier to communicate a policy decision—what the federal funds rate is going to be—because we pick the number. And it's relatively easy to explain the reasons for that decision in terms of the background of the recent data. It is much more difficult to communicate conditions under which we might change the rate in the future—the response rule or the policy rule, if you will. It's the regularity or predictability of the response that the market really wants to know because to a great extent that determines what people will do and affects the decisions they make. I don't think we’re necessarily of one mind around the table about what our response rule will look like. I will tell you what my view of it is in a very general form in the current situation. I think we are likely to want to keep the funds rate at the current level unless we see a very good reason to change it. That is, I believe we would tend to hang back from changing the rate until there is some compelling reason to do so. If the economy is weaker than expected, there’s a lot of room for longer-term rates to fall, which would provide more monetary accommodation without our doing anything. I think we’re unlikely to want to raise rates quickly to fight inflationary pressures because we’re not likely to confront such pressures in the immediate future. But I feel quite strongly that we should not commit ourselves to any given length of time that the rate would remain where it is. In sum, I believe it is very difficult to explain the policy response function that we might follow looking ahead.

So my instinct on this is that we should minimize—absolutely minimize—the foreshadowing of likely future changes in policy and concentrate on what we are doing right now. Therefore, I would prefer to see the balance of risks statement provide no hint about future policy in terms of a final sentence about the two risks taken together. It seems to me that the market is going to read that as a forecast of the probable future direction to policy, whereas I personally think we ought to be telling the market that we’re going to be on hold at a 1 percent funds rate for the foreseeable future.

CHAIRMAN GREENSPAN. President Pianalto.

MS. PIANALTO. Mr. Chairman, I support your recommendation on the fed funds rate and on the balance of risks statement.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I, too, support your recommendation, Mr. Chairman. I had a reaction to your discussion about the potential for an inventory swing to be a source of upside risk. I've heard discussions in the technology arena about long supply lines, very low inventories, and the possibility that when demand begins to accelerate—people in the industry say "if"—there will be the potential for a strong reaction to that demand so that it can be supplied. An offset to that, and one that I worry about a little, is the increasing proportion of foreign goods that are used in our overall capital investment process. I'm not sure how much that would offset the pickup from an inventory swing. With regard to the communication process, I don't think we should change anything about the last statement as you have recommended. But I do agree with Bill Poole that developing a mechanism whereby we try to assure the market that we are going to do one thing or another for a long period of time is a recipe for the kind of market volatility we've had. And I think we ought to be very careful about that.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. I support your recommendations, Mr. Chairman. I must say I'm attracted to Bob Parry's suggestion. I'd like to think about it a little more, but on the face of it his suggestion makes a lot of sense to me, and I'm looking forward to our communications discussion next month.

CHAIRMAN GREENSPAN. First Vice President Stewart.

MR. STEWART. I support your recommendation, Mr. Chairman. I also promise not to get too pessimistic, but I feel that business decisionmaking is different than it used to be. I think that's partly because of the global competition that President Pianalto talked about but also because of pressure from investors for a low-risk, high-return strategy. This is something that's familiar in the market, as I know it.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. I support your recommendation for no change in the fed funds rate and no change in the three-part statement. I think it's the right thing to do and anything else could confuse the markets. I have some sympathy with the notion that we don't want to be too explicit about where we're going if we don't know exactly. So I agree that we ought to be cautious, along the lines of Bill Poole's argument about not promising too much, because we know we may not be able to deliver.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I support your recommendation. I'd like to associate myself closely with Bob Parry's suggestion that we think about the merits of having some discussion of how we are going to explain our action before we vote. I'd also associate myself with Bill Poole's comment about being extremely careful in terms of what we say about future policy actions. We may be as surprised on the other side in future months as we have been with the disinflation in recent months. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I, too, support your recommendation, Mr. Chairman. I would comment that what struck me about your remarks was the discussion about who has the right model—whether the Federal Reserve does or the market does. Of course, there are lots of other possibilities. In that regard I have to admit that I'm less concerned about further disinflation or even deflation than perhaps many others around the table. It's true that we've had a positive productivity shock in the United States, China, India, and probably parts of Central and Eastern Europe, and I'm no doubt leaving out some important places. But it's not clear to me that we ought to be as concerned as I think we are about further reductions in the rate of inflation.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I support both parts of your recommendation. In particular, I would not want to change the format of the statement that we've been using for the last two meetings; today would not be the appropriate time to do it. I look forward to the discussion at our next meeting of how we're going to communicate in the future.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. Mr. Chairman, I support your recommendation, and I, too, look forward to our September discussion on communications.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I support both parts of your recommendation.

CHAIRMAN GREENSPAN. Governor Bernanke.

MR. BERNANKE. I support both parts of your recommendation, Mr. Chairman. Let me just say a word on the communications issue because we do need to be very careful. We've seen in the last two meetings that our words have been far more powerful than our policy decision in terms of changing markets. So, indeed, our communications are a very, very powerful tool. Now, the reaction of the Committee has been that it's so powerful that perhaps we want to stay away from it completely. [Laughter] But if we give no information about our future intentions, then somehow or another the market has to make an assumption or come to some conclusion about what our policy is going to be. The presumption, therefore, is that we are so bad at giving information that we better leave it to the market to draw information from nothing. I don't want to be that pessimistic. I would hope that in the future we could think of ways that we could fine-tune our communication to use it productively. Particularly near the zero bound, it could become an important part of our tool kit. Obviously, bad communication is much worse than no communication, but I wouldn't want to rule out communication completely as a way of trying to enhance our arsenal. Thank you.

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. I support both parts of the recommendation, and I also look forward to our meeting in September regarding communications.

CHAIRMAN GREENSPAN. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. I also support both parts of your recommendation. I agree with those who've said that it's very difficult to talk about the future. And I play second fiddle to no one in my humility regarding my ability to forecast; as you can attest to over the years, that humility is well earned. I also agree with President Poole that it would be very risky and counterproductive to promise to keep rates at a particular level for a certain period of time. But like Governor Bernanke, I think we need to work on how we talk about our assessments and judgments regarding the economy and our objectives going forward, without perhaps being very specific. To the extent that the markets make their judgments about future rates with a more accurate estimate or knowledge of what we're thinking about, we're going to get better feedback from the markets. The markets are going to act in a more stabilizing way even when they don't agree with us, which is fine. But they need to know what we're thinking about in order to do a good job of assessing how the 800-pound gorilla in the money markets views the outlook. So, while I agree that we need to give more thought to it, I haven't given up entirely on trying to do something in terms of how we communicate about the future. Thank you.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. I support both parts of your recommendation. I think if we did anything other than keep the negative bias today, the funds market would go even crazier, and long rates would back up even more. I just don't see how we can do that.

I'm probably the only one here who is not particularly looking forward to the September discussion [laughter] because I'm not sure I see my way through it. I guess I should confess that it's partly because my wife has been telling me for forty years now that I don't communicate particularly well. [Laughter] So I have that adverse mental association with the whole concept.

I just find this a very hard issue to address. First, on the statement itself I have expressed my reservations before about adding up or balancing the output risk and the inflation risk. I've always had that problem. Second, I think the phrase "the probability, though minor, of an unwelcome substantial fall in inflation" may have served us well a couple of months ago, but as the probability of this substantial fall gets more and more minor, that sentence is going to have to be changed. And I'm not sure how to do that. The third problem is that any time we change anything in this paragraph, even a comma, there is a huge market reaction. The way the market reacts even to minor inflections of what we say scares me. So I think that's a real problem in trying to communicate and be honest about what we think.

Along with many of you, I share the reluctance to pre-commit to a future policy course. However, I'm on the side of Governors Bernanke and Kohn in feeling that we probably do have to get into this issue a little in terms of explaining our assessment of the outlook. At some point, the way we do it now is not going to work—and maybe that point has come already—but I just don't know how best to change our approach. This whole process takes place in a fishbowl. So I find the topic very difficult and depressing, and I don't look forward to discussing it. Sorry.

CHAIRMAN GREENSPAN. I just want to note that we have not been issuing a press release after the end of each meeting for very long. We can always return to our previous procedures, if that will make you sleep better.

MR. GRAMLICH. No, I think we have to do this, but I just don't see how to do it.

CHAIRMAN GREENSPAN. Well, we can leave it to Vincent to explain it and solve the problem. Would you read the appropriate directive language?

MR. BERNARD. The wording is on page 14 of the Bluebook. For the directive: "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 1 percent."

Then for the risk assessment sentences that are not part of the directive: "Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks to the Committee's outlook for sustainable economic growth over the next several quarters are balanced; the risks to its outlook for inflation over the next several quarters are weighted toward the downside; and, taken together, the balance of risks to its objectives are weighted toward the downside in the foreseeable future."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

| | |
|---|---|
| Chairman Greenspan | Yes. |
| Governor Bernanke | Yes |
| Governor Bies | Yes |
| President Broaddus | Yes |
| Governor Ferguson | Yes |
| Governor Gramlich | Yes |
| President Guynn | Yes |
| Governor Kohn | Yes |

| | |
|---|---|
| President Moskow | Yes |
| Governor Olson | Yes |
| President Parry | Yes |
| First Vice President Stewart | Yes |

CHAIRMAN GREENSPAN. Where is Michelle Smith? Will you distribute the proposed statement, Michelle? [Pause]

MR. FERGUSON. May I speak?

CHAIRMAN GREENSPAN. Yes.

MR. FERGUSON. I think the statement looks good. It's quite consistent with the last statement, which I gather from our survey is what the markets expect. So in that sense I think this is a good statement. I wouldn't change anything about it.

CHAIRMAN GREENSPAN. This, as you notice, is repeating words we've stated previously. I might say that a number of us have been struggling with this whole communication issue. Vincent, do you want to discuss what our plans are on this?

MR. REINHART. Well, like Governor Gramlich, I am not looking forward to the next meeting.

CHAIRMAN GREENSPAN. I'm sorry, I may have cut short the previous discussion. I was assuming because I heard no negative comments that the statement is okay with everyone. But I don't want to assume that. Are there any further comments? Yes, President Moscow.

MR. MOSKOW. I think the wording of the last paragraph is a real improvement. The only question I have is in the second paragraph where the term "mixed" is used to describe the labor market indicators. I tend to view them as less positive.

MR. PARRY. The "mixed" is because of the initial claims data.

MR. MOSKOW. But those involve seasonal issues and—

MR. PARRY. Yes.

CHAIRMAN GREENSPAN. Well, the initial claims are down. And the payroll employment statistics clearly had a bias in them; the seasonal that occurred in the payroll employment series because July 4 was on a Friday is potentially a problem. The unemployment rate came down. The numbers are truly mixed. To say more than that we'd have to add another sentence, and I'm not sure we should be doing that.

MR. MOSKOW. I just hope it doesn't give too optimistic a view of the labor market at this point, which I view as a real question.

CHAIRMAN GREENSPAN. Yes.

MR. GRAMLICH. I'd like to say that in my previous statement I attacked the summary paragraph, but I agree that it's much better this time. It elaborates our assessment of the situation in a more realistic way.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Could I reflect an opposite concern? Our statement the last time said something along the lines of this wording: The probability, though minor, of an unwelcome fall in inflation exceeds that of a rise in inflation. Therefore, we believe that, on balance, the risk of inflation becoming undesirably low is likely to be the predominant concern for the foreseeable future. Now we've added a third sentence that not only talks about disinflation again but also mentions warding off unwelcome disinflation for a considerable period. I'm just wondering whether that's veering a little too much toward the commitment side than we need to or ought to do at this point. I would be happy if we stayed more or less with the way we worded it the last time—that is, ending after the second sentence of the last paragraph. As the statement is drafted here, we now have three sentences emphasizing the disinflation concern, and I think that's hitting it too hard.

MR. BERNANKE. The sentence is very consistent with the Chairman's testimony.

MR. FERGUSON. That last sentence comes directly from the Chairman's testimony, I think.

CHAIRMAN GREENSPAN. Yes. May I suggest something? I have some sympathy for what you're saying. But this is not the meeting to make that change.

MS. MINEHAN. I thought we'd come up with a statement from the Committee for this meeting that was as identical to the last one as we could get. That's what I had in mind when I supported the recommendation.

CHAIRMAN GREENSPAN. But remember it's a combination of wording that's almost identical to the last statement plus wording from my testimony on monetary policy, which is essentially what we have been using.

MS. MINEHAN. Yes.

CHAIRMAN GREENSPAN. Also, the definition of what constitutes "a considerable period" is very flexible.

MS. MINEHAN. I realize that. But the big surprise of your recent testimony was not this statement about disinflation. It was the relative optimism about the prospects that the economy was going to get better. I thought it was a very balanced statement on your part. The optimism, combined with the ranges of our expectations for growth, which under most people's assessment of potential and so forth were surprisingly upbeat, was conveyed in the context of all the hand wringing we had been doing over several weeks about further disinflation or deflation. So to me that sense of optimism was the surprise in your testimony. Therefore, to go back in this statement to three sentences of emphasis on disinflation seems to me to be changing a bit the sense of our outlook in an environment in which I don't think we should change it.

MR. FERGUSON. Mr. Chairman, may I speak to this? I see others want to comment as well.

CHAIRMAN GREENSPAN. Go ahead.

MR. FERGUSON. My sense of the last sentence, Cathy, is that it's actually rather important, given what we've seen in terms of changes in fed funds futures. It's not that I think we ought to attempt to micromanage markets because I know we can't. But in terms of the communications challenge, I do believe that it's quite important for us to say as best we can that we expect to maintain an accommodative policy, whatever that might be, recognizing that growth will probably pick up and has to pick up eventually. I think it would have some very beneficial effects to say that we can remain accommodative for a period of time, though again I'm not sure what that period of time is. But my read of the last sentence in the last paragraph is that in some sense it is the key response to the very volatile and uncertain markets we've seen. I think it would be helpful after this meeting for us to be quite clear about it. It's not news in the sense that the Chairman has already said it once in his testimony on the semiannual report on monetary policy objectives. Moreover, I think it is consistent with what the markets are expecting and more helpful than not in terms of being far less likely to create uncertainty. On the other hand, I don't think it commits us to anything that we don't want to commit to because—by definition, if you will—if the data come in stronger, we'll respond to that.

MS. MINEHAN. I really worry about our trying to target anything in any market with this statement.

MR. FERGUSON. I'm not suggesting that we try to target anything. I just want to try to be clear about what we know and what we in this room are sensing. I think the outside world probably hasn't picked that up.

CHAIRMAN GREENSPAN. Yes. There is a critical addition to this statement, an issue that wasn't mentioned in the last statement, and that is business pricing power.

MS. MINEHAN. Yes.

CHAIRMAN GREENSPAN. We tend to talk about inflation in the context of the CPI or the PPI, the usual measures. But really what this whole deflation issue is about is pricing power. There is none out there of which I'm aware. My judgment would be that, as soon as I see the emergence of business pricing power, I would start to think about voting to remove the imbalance with regard to inflation. In other words, so long as pricing power is nonexistent, I would say that the risks of an emergence of inflation are minimal. It's little more than definition. So I do think we're in a period when we actually can make a statement that we can hold tight for—using a flexible term—"a considerable period" without too much risk. If pricing power starts to pick up and everyone notices that it's picking up, which means profits will be moving and the whole system will be changing, I think we could readily change our statement in such circumstances with no significant disruption.

MS. MINEHAN. I don't debate that at all. I think that's totally accurate. My concern is that this statement introduces yet another slight variance in a market environment that has already been volatile. So I think we'd be better off making the statement plain and simple and letting the market sort things out. Then we can figure out in a little more organized way in September how we want to communicate some of these points.

MR. GUYNN. Maybe all has been said that can be said, but I want to echo that last comment. I'm uncomfortable with the last sentence, and not because it's not helpful in the current circumstance; I think Ben and Don made the point very well that it is. My concern is that it will be the first time that, as part of the statement, we have made some very explicit comments about future policy, and I'm afraid it's going to set a precedent. I think we'll be expected in future statements after our meetings to make parallel kinds of comments at times when that would not be helpful. I'm trying to weigh the helpfulness in the current circumstances against moving ten feet more down the slippery slope of how much we say in these statements before we have a chance to talk about this next month. I just wonder if that's a good trade today.

CHAIRMAN GREENSPAN. I'd like to hear from the rest of you. I agree with Governor Ferguson that there are slight variations in the way to say this. We could say, for example, "in these circumstances the Committee believes" rather than "the Committee judges." That alternative is perhaps a bit softer; "judges" may be a stronger word. But this is an important issue, and I'd like to hear from those of you who have views one way or the other on this. Governor Gramlich.

MR. GRAMLICH. I'll suggest a compromise. A lot of people do word counts on these statements—count how often a particular word is used. I think we can convey Roger's sense of the message in that last sentence but cut down the use of the word "disinflation" by one, by dropping "aimed at raising" all the way through to "disinflation." In other words, Roger wants to convey that policy accommodation can be maintained for a considerable period, and we can do that without all these words and without raising the word count on disinflation. So my first point is to offer that as a compromise. Second, I actually like this sentence, but procedurally I would not be upset if we waited until next time, after we really think through all the implications, to include it. So my first preference would be just to drop the phrase I mentioned, and my second choice would be to hold it over until next time.

MR. HOENIG. On balance, I think it would be preferable to drop the last sentence because it does change the statement, which gets attention, and then expectations change. If we just repeat what we said before, we're signaling to everyone that policy is on hold. In terms of policy announcements or implications, I think that is the safer course, and we can have a full discussion of these communication issues at the September meeting. I recognize that this last sentence comes out of the semiannual monetary policy report, but if it becomes part of the Committee's statement, it will receive more emphasis.

CHAIRMAN GREENSPAN. I don't wish to imply that the monetary policy report and testimony have the same status as these statements.

MR. HOENIG. No, I'm not suggesting that you are. I'm just saying that having that wording here does tend to bring out the point more forcefully.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Cathy, if I understand what you're saying, you're recommending that we simply drop that last sentence?

MS. MINEHAN. That would go a long way.

MR. POOLE. I would associate myself with that position—whether or not it's yours.

MS. MINEHAN. It is.

MR. POOLE. Dropping the last sentence would be a good idea in my view. I read that next-to-the-last sentence as a pretty clear signal that we're going to be on hold for the foreseeable future because of the concern about a possible further decline in inflation. Making the statement very, very terse, which dropping that last sentence does, seems to me to send a signal that we're going to stand where we are—that we're satisfied with the current stance of policy and that's where we're going to be. I think making the statement very terse in and of itself sends that message.

MR. PARRY. That's what we did last time.

MS. MINEHAN. Yes.

MR. MCTEER. Look at where it got us!

CHAIRMAN GREENSPAN. Don.

MR. KOHN. Actually, I rather like this last sentence or some variation of it, though I recognize that it involves a bit of a risk. But I also recognize, as I think most people around the table would acknowledge, that what is built into the markets now is not what we think is going to happen. That's not to say that we can tell them exactly what's going to happen, but I'm a little concerned that there is a disconnect between what they think our reaction function is and what it actually is. There is a difference in the inflation pressures they see coming and the inflation pressures we see coming. So I think it's worth taking the risk to change the statement to make that point. I thought taking the sentence from the Chairman's testimony, though I agree it gets much more attention and emphasis in the statement here, was a good way to do that. To me having the same statement that was in the testimony and retaining the same balance of risks as last time—even after the better economic data we've had—emphasizes our judgment, which is a little different than the market judgment. If the market wants to stay where it is after seeing this statement from us, that's fine; but it's not clear to me that market participants understand what our thinking is, and I think this would help—

MS. MINEHAN. Why doesn't "foreseeable future" do that for you in the context of taking out the third sentence?

CHAIRMAN GREENSPAN. I've been listening to this conversation, and I will tell you that there is something to the point that the last sentence is essentially repeating the sentence immediately preceding it.

MS. MINEHAN. Right.

MR. KOHN. It emphasizes it, I think.

CHAIRMAN GREENSPAN. If there is any significant doubt among us, we should not decide this issue on a majority vote. If there is a substantial concern among even a large minority of this group, whether they're currently voting members or nonvoting, I think we'd probably be wise to leave it until we can discuss matters more fully in September. Governor Bernanke.

MR. BERNANKE. I would appeal to the Committee to retain the sentence because in my view it makes a very big difference. I think the addition of the sentence will go some way to bringing policy expectations in the market toward what I heard around the table during the entire meeting today. It will have a beneficial effect on the United States economy, which is the ultimate goal of this Committee. I understand that due process and fairness considerations would militate toward going the bureaucratic way and having this issue on the agenda for September. But given our ultimate objective of helping the economy, I think the right thing to do is to leave the suppressed, or shortened, version in this statement; and I would appeal to the Committee to leave it in.

MR. BROADDUS. Just to weigh in on this, I tend to have the opposite point of view from Governor Bernanke. I support Cathy's position for a lot of the reasons that have already been stated. I just don't think this is going to buy us that much. I don't think we need it, given the language in the preceding sentence. Also, I'm a little concerned that we have been criticized, maybe unfairly, for trying to manipulate markets, and I think putting this sentence in is going to revive some of that sentiment. We don't really need that. We are going to talk about this topic next time. So for me the tradeoffs are such that I favor pretty strongly not putting it in this time.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. Mr. Chairman, I'm sort of split on the last sentence. I think the final sentence in the second paragraph on pricing power is a really good addition, and I like that a lot. A part of the last sentence that troubles me is the phrase "without ultimately stoking inflationary pressures," which we haven't talked about. That phrase makes me uncomfortable. In light of your admonition to be humble, to say that we can maintain an accommodative stance "for a considerable period without ultimately . . ." sounds like an extreme position. I would suggest that we might want to end the sentence by putting the period after the word "period."

CHAIRMAN GREENSPAN. It used to be there. Let me tell you what the alternatives seem to be coming down to. I would say that we have two choices. Either drop the sentence completely, or just say, "In these circumstances, the Committee believes that policy accommodation can be maintained for a considerable period." I hate to ask for a vote, but it's the only way I'm going to get a real sense of this group. One alternative is to leave in the truncated version; the other is to drop it entirely. I will stipulate that, unless we get a significant vote in favor of putting it in, I would recommend that we drop it and bring it up for discussion—not this particular sentence but the basic process—next time. May I see a show of hands?

MR. PARRY. Could you read it again, please?

CHAIRMAN GREENSPAN. Yes. In fact, let me read the whole last paragraph. I think that's a better way of doing it. "The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. In contrast, the probability, though minor, of an unwelcome fall in inflation exceeds that of a rise in inflation from its already low level. The Committee believes that, on balance, the risk of inflation becoming undesirably low is likely to be the predominant concern for the foreseeable future. In these circumstances, the Committee judges that policy accommodation can be maintained for a considerable period."

MR. PARRY. "Judges" or "believes"? You said "believes" the first time.

CHAIRMAN GREENSPAN. I know, and the reason I changed it was because I had "The Committee believes" in the preceding sentence. I'll put it back to "believes" and use "judges" in the previous sentence. Can I see a show of hands on dropping that last sentence completely?

MR. GUYNN. Those who prefer to drop it?

CHAIRMAN GREENSPAN. Yes, to stop at the phrase "the risk of inflation becoming undesirably low is likely to be the predominant concern for the foreseeable future." That's the end of the statement, period. Let's get a count.

MR. REINHART. Everyone, both voting and nonvoting members of the group?

CHAIRMAN GREENSPAN. Yes, in this case it should be voting and nonvoting members on the grounds that this is a procedural question and I think everyone's voice should be heard. So, can I just see by a show of hands those who prefer to drop the sentence completely? One, two, three, four, five, six, seven. It's seven of nineteen?

MR. PARRY. Eighteen.

MR. POOLE. Bob McTeer had to depart to catch a plane.

CHAIRMAN GREENSPAN. Well, on the basis of that vote it's right on the margin. But I would say that we have to put in the truncated version of the final sentence.

MR. FERGUSON. I think that's right.

CHAIRMAN GREENSPAN. And we will revisit this issue because this whole question is going to be a very important one. Finally, Vincent you can get your few words in. Maybe there's nothing left to say!

MR. REINHART. Mainly, I should issue a warning that the next meeting will be a long day for you. We'll reconvene the meeting after lunch to talk about both the process and the content of the press statement. That will be the first item of discussion on communications. And then, depending on the outcome of that discussion, we'll ask what you'd like to talk about at the January meeting—whether you want to consider more aspects of communications in January.

MR. MOSKOW. So that means the discussion on communications next time would not affect our statement after the September meeting. Is that right?

MR. REINHART. I don't know practically how to do it any other way because—

MR. PARRY. The meeting could start at 5 o'clock in the morning.

MR. REINHART. We could start at 5:00 p.m. For someone from California that would be easier! [Laughter]

CHAIRMAN GREENSPAN. Well, we can start at 7:30 a.m. and serve breakfast.

MR. REINHART. If that's what you would like, we can do that.

MS. SMITH. I should just let you know that the media people know exactly when each FOMC meeting begins. We'd have to explain to them that the meeting started at 7:30 a.m. and give them some reason for that. Otherwise we could see some excitement out front.

CHAIRMAN GREENSPAN. I see. Do we have to announce that in advance?

MS. SMITH. We announce when the meeting begins. Typically the media people wait on the phone until 9:00 a.m., and someone from our office scurries back to the phone and says the meeting began at 9:00 a.m.

CHAIRMAN GREENSPAN. What happens if we're two minutes late?

MS. SMITH. We would tell them it started at 9:02 a.m.

MR. REINHART. It's also the case that they often—but not always—ask when the meeting ended. So we may very well have to explain why the meeting has been extended if we reconvene after lunch.

CHAIRMAN GREENSPAN. Can we have a dinner meeting the previous night without creating a big problem?

MS. SMITH. As sort of an intermeeting meeting?

CHAIRMAN GREENSPAN. Governor Gramlich has an insight.

MR. GRAMLICH. I don't have an insight. I have a question. I've been worried about this increasingly as our meetings have gotten longer. What happens if we're not done at 2:15 p.m., the time we usually release the press statement?

MS. SMITH. We haven't had to face that. [Laughter]

SPEAKER(?). Good answer.

MS. SMITH. We don't commit to having the statement out at 2:15 p.m. It has just been our practice to release it then.

MR. GRAMLICH. We don't commit to a time?

MS. SMITH. Right.

MR. GRAMLICH. So it's easier to go beyond the typical time period on that end than it is on the other?

MS. SMITH. I gave you a bit of a legalistic interpretation. These people will get a little crazy if they don't hear something from us around the usual time.

CHAIRMAN GREENSPAN. Governor Ferguson has an interesting recommendation.

MR. FERGUSON. Well, it's a procedural recommendation. I think we could easily have a dinner meeting the previous night, and we could treat it as we do any other intermeeting discussion.

MR. REINHART. If an intermeeting discussion is held, it wouldn't be announced until later.

MR. FERGUSON. Yes, we announce it the way we did it after—

CHAIRMAN GREENSPAN. Oh, I thought you were talking about having a conference call.

MR. FERGUSON. Well, we could have a conference call. Either we could have a conference call to discuss communications, or we could do it in person. But in either case, we'd announce the fact that we met for an intermeeting discussion in the same way that we announce conference calls.

CHAIRMAN GREENSPAN. A conference call for this type of discussion is very difficult to do.

MR. FERGUSON. Yes, I think we'd want to discuss this issue in person. But I would say—and frankly I don't know if you'd want to handle a breakfast meeting this way—that theoretically we could argue that we would treat a breakfast meeting as though it were any other intermeeting discussion. And we would announce that in the usual way, when we release the minutes of the previous meeting.

CHAIRMAN GREENSPAN. Have a breakfast from 7:30 to 9:00 a.m.

MR. FERGUSON. The breakfast would be from 7:30 to 9:00 a.m., and then the regular meeting would begin at 9:00 a.m.

CHAIRMAN GREENSPAN. Then the meeting begins. That's a little sneaky.

MR. FERGUSON. Well, it's legal in terms of our definition of a meeting, [laughter] but I think it's easier to handle the dinner meeting in that way.

MR. GRAMLICH. That's why we need lawyers.

MR. FERGUSON. No, that's why you don't need lawyers! [Laughter] I would suggest that we have the dinner meeting; it's easier to bifurcate that from the regular meeting and treat it the way we do any other intermeeting discussion.

MR. SANTOMERO. It also gives us more flexibility and time.

MR. FERGUSON. Yes, it also gives us more flexibility and time.

MR. REINHART. Okay. We will arrange a dinner on Monday before the next meeting to discuss communications.

CHAIRMAN GREENSPAN. Is it anybody's birthday, incidentally? [Laughter]

MR. FERGUSON. You need to announce the date of the next meeting before we close today.

CHAIRMAN GREENSPAN. The next meeting is September 16. We will get together on Monday night, September 15, for a dinner and discussion.

END OF MEETING