Prefatory Note

The attached document represents the most complete and accurate version available based on original copies culled from the files of the FOMC Secretariat at the Board of Governors of the Federal Reserve System. This electronic document was created through a comprehensive digitization process which included identifying the best-preserved paper copies, scanning those copies,[1] and then making the scanned versions text-searchable.[2] Though a stringent quality assurance process was employed, some imperfections may remain.

Please note that this document may contain occasional gaps in the text. These gaps are the result of a redaction process that removed information obtained on a confidential basis. All redacted passages are exempt from disclosure under applicable provisions of the Freedom of Information Act.

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

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

Strictly Confidential (F.R.) **January 26, 2001**
Class II – FOMC

MONETARY POLICY ALTERNATIVES

Recent Developments

(1) Interest rates backed up slightly and equity markets sold off following the announcement that the FOMC had left the stance of policy unchanged at its December meeting.[1] However, yields generally declined over subsequent days, as the wording of the Committee's announcement and weaker economic data apparently fostered a sense that an easing of monetary policy was imminent. Even so, the timing and size of the FOMC's 50 basis point cut in the target federal funds rate on January 3 surprised market participants, and many inferred that additional monetary easings would occur sooner than they had expected. Over the entire intermeeting period, interest rates on short-term Treasury securities and the highest-grade private debt fell substantially, in some cases by nearly a percentage point, with only a small portion of the declines on private debt reflecting an unwinding of year-end premiums. Current futures quotes indicate that investors place high odds on an additional 50 basis point easing at this meeting and anticipate that the federal funds rate will be about 125 basis points below its current level by year-end (chart 1). However, options quotes suggest a relatively high degree of uncertainty about this extended outlook.

(2) The Committee's action and the market's inference about the likelihood

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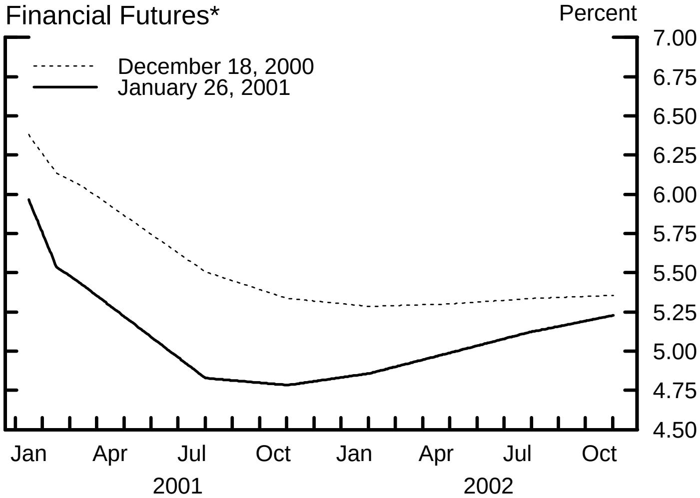
1. Federal funds traded at rates near the FOMC's targets over the intermeeting period, except on the last business day of the year. On that day, the Desk's generous reserve provision pushed the effective rate down to 5.41 percent, a fairly typical deviation from target for a year-end. Since the last FOMC meeting, the Desk has redeemed $1.8 billion of Treasury securities, mostly Treasury coupon issues, to continue bringing SOMA holdings into conformance with the per-issue limits. In part to offset the resulting reserve drain, the Desk purchased $3.5 billion of Treasury coupon securities in the market and $670 million of Treasury bills from foreign customers. To accommodate the seasonal runoff in currency, it trimmed the volume of outstanding long-term RPs by $9 billion, to $13 billion.

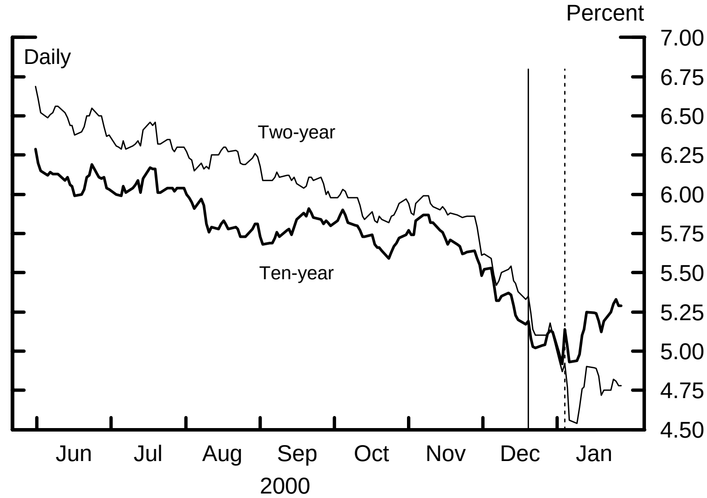
Chart 1
Financial Market Indicators

Expected Federal Funds Rates Estimated from Financial Futures*

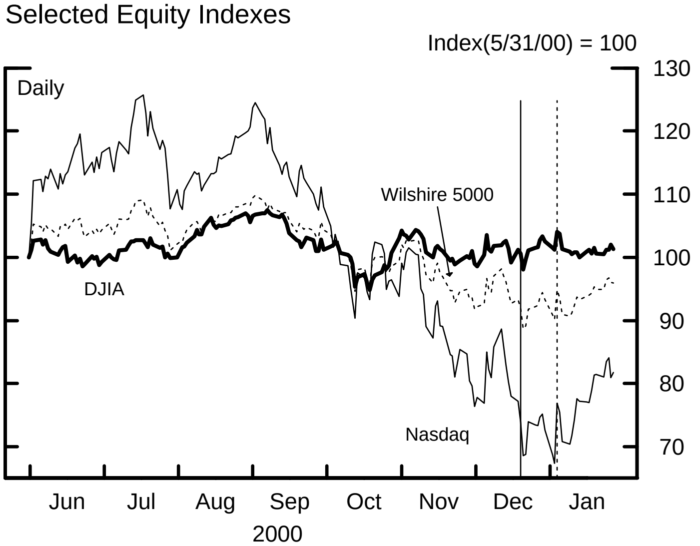


*Estimates from federal funds and eurodollar futures rates with an allowance for term premia and other adjustments.

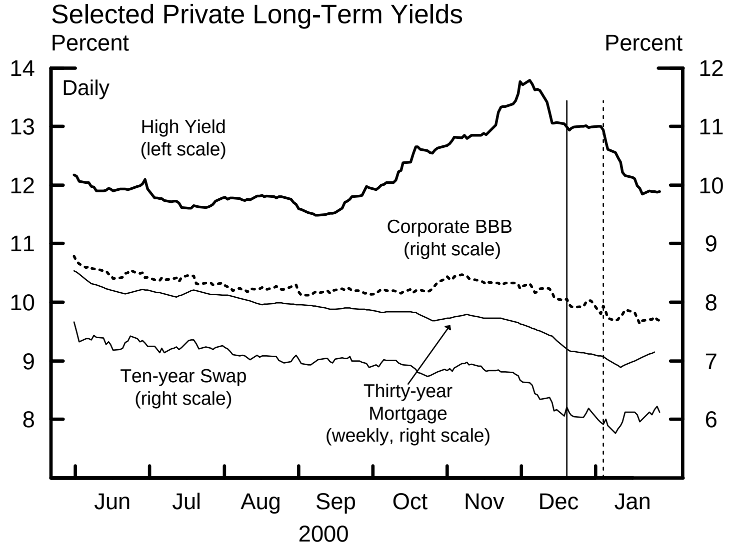
Selected Treasury Yields



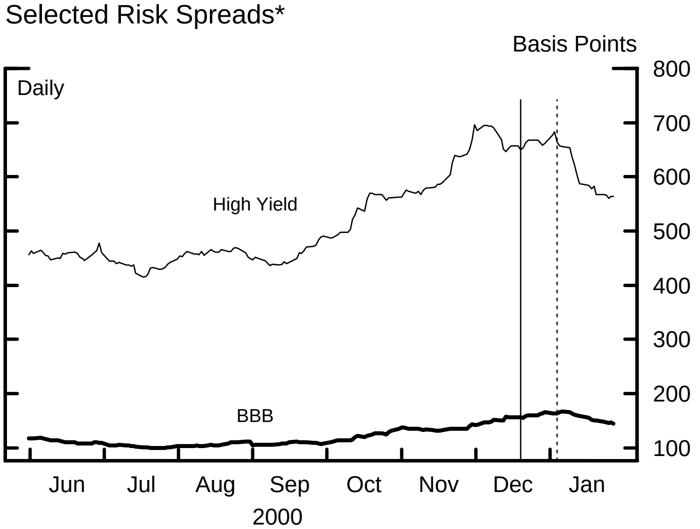
Selected Equity Indexes



Selected Private Long-Term Yields

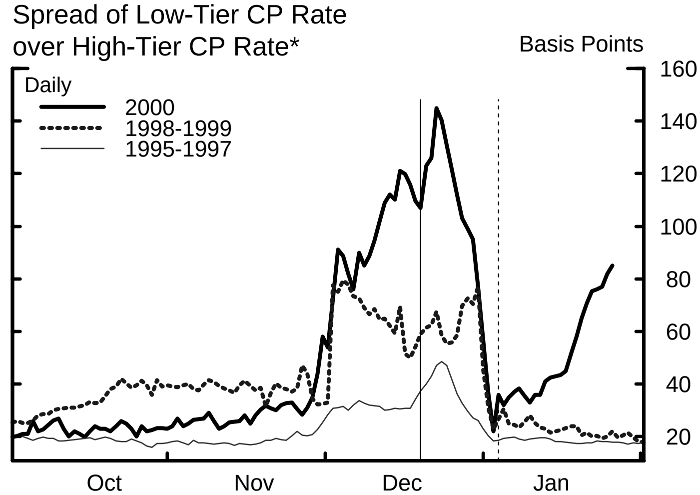


Selected Risk Spreads*



*These spreads are the difference between the yields on the Merrill Lynch 175 and BBB indexes and that on the Merrill Lynch AAA index.

Spread of Low-Tier CP Rate over High-Tier CP Rate*



*30-day nonfinancial, A2/P2 rate less AA rate.

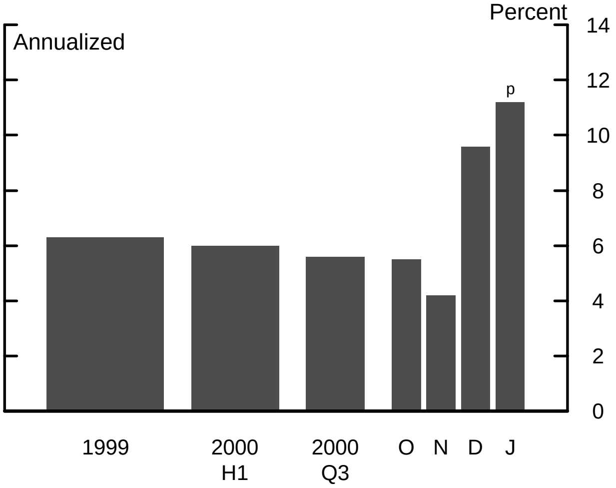
Note: Solid vertical line indicates last FOMC meeting. Dashed vertical line indicates January 3 cut in target federal funds rate.

of future easings apparently contributed to a sense that the odds of a prolonged period of economic weakness had diminished. This revision to sentiment bolstered equity markets, with broad equity price indexes increasing, on balance, over the intermeeting period despite further substantial downward revisions to analysts' near-term earnings expectations. Moreover, yields on lower-tier investment-grade bonds and junk bonds fell 35 and 116 basis points, respectively. The abatement of safe haven demands, along with heightened prospects for a large tax cut and perhaps some increase in inflation compensation, contributed to a small rise in longer-term Treasury yields. In some segments of financial markets, however, concerns about risk appeared to escalate. Results from the January Senior Loan Officer Opinion Survey indicate that a majority of banks have further tightened their standards and terms on business loans. Moreover, risk spreads on lower-rated commercial paper have widened significantly since early January, as the defaults of California utilities, along with the earlier downgrades of other prominent commercial paper issuers, seem to have increased investor wariness. To date, fallout from the difficulties of the California utilities has been limited, although rating agencies have announced that the debts of some corporations and municipalities affected by the West Coast electricity situation have been downgraded or are being monitored for possible downgrade.

(3) In December, overall business debt grew at a moderate pace, but the patterns of financing continued to reflect heightened investor concerns about risk (chart 2). Although issuance of investment-grade bonds was brisk, virtually no equities or junk bonds were brought to market. Bank business loans grew rapidly, with the advance owing partly to lower-rated commercial paper issuers temporarily drawing down lines of credit at banks to avoid paying high year-end premiums, and commercial paper outstanding declined. Since the intermeeting policy move in early January, a substantial volume of corporate bonds, including a number of junk bonds,

Chart 2
Financial Flows and Exchange Rates

M2 Growth



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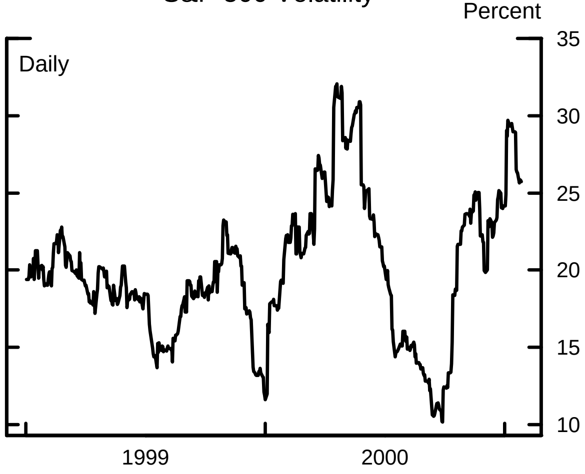
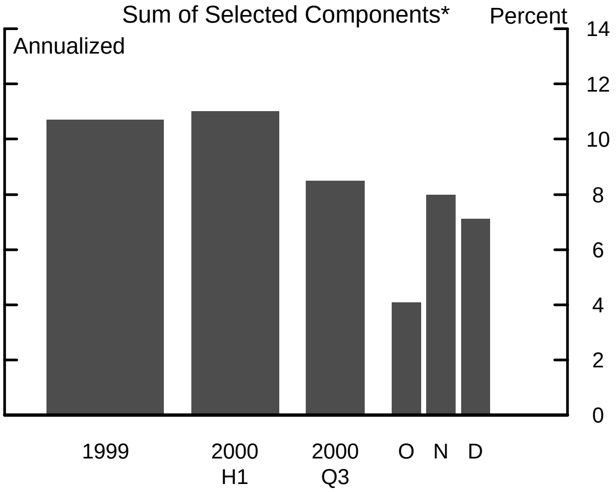
S&P 500 Volatility*



*30-day rolling standard deviation of the daily percentage change.

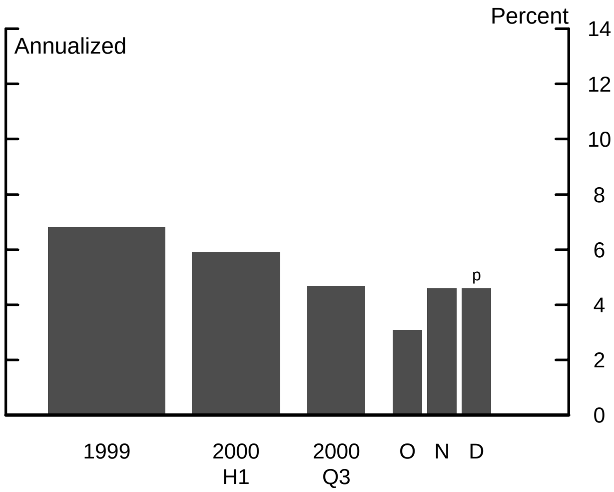
Growth of Debt of Domestic Nonfinancial Sectors

Business Debt
Sum of Selected Components*



*Bonds, commercial paper, and C&I loans.

Total Debt



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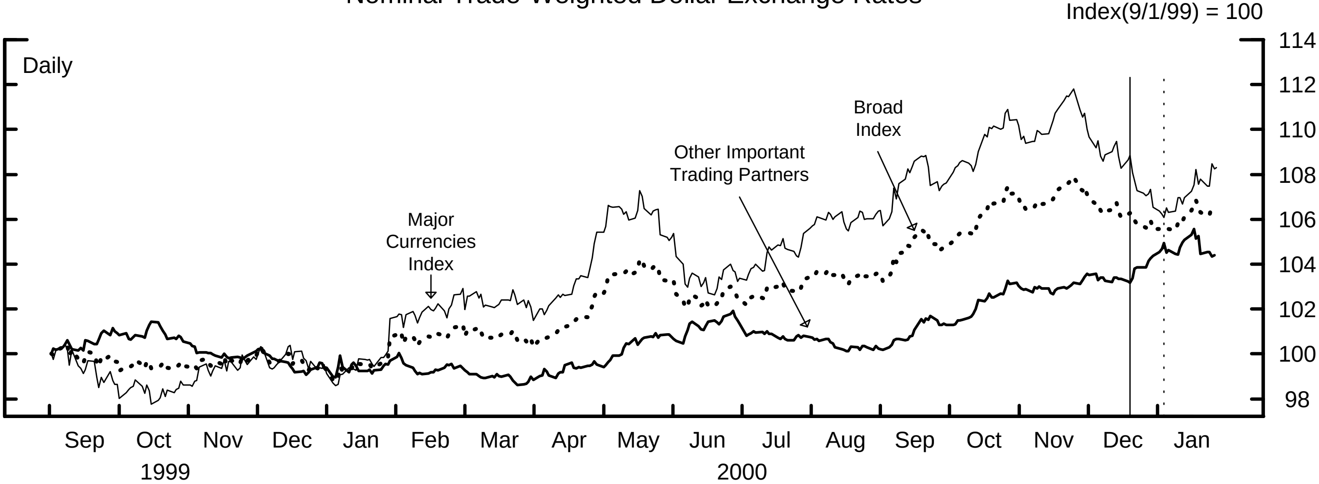
Nominal Trade-Weighted Dollar Exchange Rates



Solid vertical line indicates last FOMC meeting.
Dashed vertical line indicates January 3 cut in target federal funds rate.

has been issued in response to lower yields in more receptive markets. Business loans have continued to advance briskly in January, likely boosted by further substitution out of the commercial paper market. With lower-rated borrowers dissuaded by elevated interest rates and unable to issue at maturities beyond a few days, the outstanding amount of commercial paper has continued to run off in January. In the household sector, consumer credit is estimated to have decelerated sharply in December, and bank loan data suggest continued moderation early this year. Mortgage growth is estimated to have remained relatively strong, however, supported by declines in mortgage rates. Federal debt continued to contract late last year and in January. Data for debt growth in recent months are partial and preliminary, but on balance it appears that nonfederal and total debt expanded at a moderate pace, similar to that recorded in the third quarter of last year.

(4) M2 growth picked up sharply in December and appears to have risen further in January.[2] The strength likely reflects in part investors' decisions to seek the safety and liquidity of M2 assets, such as retail money funds and liquid deposits, in response to the rise in equity market volatility in November and December. Also, the recent declines in short- and intermediate-term rates have narrowed the opportunity cost of holding M2. M3 has grown even more rapidly than M2, boosted in part by faster issuance of large time deposits to fund a pickup in bank credit, which accelerated to an 11 percent annual growth rate in December. In addition, institutional money funds have ballooned as their yields, which adjust to changes in market rates with a lag, have become more attractive with the fall in short-term market interest rates.

(5) While the weaker economic outlook in the United States, along with

2. Money stock data incorporate revisions from the annual benchmark and seasonal review and are confidential until their release on February 1.

lower interest rates, tended to put downward pressure on the foreign exchange value of the dollar, economic stagnation in Japan exerted a countervailing influence. Since the December FOMC meeting, the dollar was about unchanged, on net, against the currencies of the major industrialized countries. The dollar lost 3 percent of its value relative to the euro, on net, as economic growth in Europe came to be seen as likely to outpace that in the United States. The dollar also depreciated vis-à-vis the Canadian dollar as the momentum in domestic spending and the prospect of considerable fiscal stimulus in Canada were thought likely to cushion the impact on Canadian exports of softening U.S. aggregate demand. By contrast, incoming economic data for Japan proved disappointing to hopes that economic recovery had gained a foothold, and the dollar appreciated 4½ percent against the yen over the intermeeting period. The bleak Japanese economic picture revived talk that the Bank of Japan may return its official interest rate, now at ¼ percent, to zero, and money market futures rates, as well as longer-term yields, shifted down a touch. The exchange value of the dollar rose about 1 percent against a basket of currencies of our other important trading partners. General concerns about the effects on Latin America of a slowing in U.S. growth supported the dollar relative to the Mexican peso and the Brazilian *real*. The currencies of many Asian emerging market economies that are viewed as especially vulnerable to a slowing in global demand for electronic goods also slipped against the dollar. Still, in most emerging markets, bond spreads narrowed somewhat, and prices rose in equity markets. U.S. authorities did not intervene in foreign exchange markets over the intermeeting period;

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MONEY AND CREDIT AGGREGATES

(Seasonally adjusted annual percentage rates of growth)

	Oct. 2000	Nov. 2000	Dec. 2000	Jan. 2001 (p)
Money and Credit Aggregates				
M2	5.5	4.2	9.6	11.2
M3	4.4	4.2	12.5	15.7
Domestic nonfinancial debt	3.1	4.7	4.6	n.a.
Federal	-10.0	-9.2	-6.7	n.a.
Nonfederal	6.2	7.9	7.2	n.a.
Bank credit	-6.0	2.7	14.4	7.3
Adjusted[1]	-5.1	4.0	11.0	4.0
Memo:				
Monetary base[2]	4.2	0.4	5.0	19.8
Adjusted for sweeps	4.6	0.9	5.2	18.9

1. Adjusted to remove the effects of mark-to-market accounting rules (FIN 39 and FASB 115).
2. Adjusted for discontinuities associated with changes in reserve requirements.
p -- preliminary

Longer-Term Strategies

(6) This section considers longer-term strategies for monetary policy as well as the policy implications of several of the alternative scenarios presented in the Greenbook.[3] All of the charts include a baseline scenario in which the Greenbook forecast is extended through 2005 using the FRB/US model, adjusted to preserve the key characteristics of the economy embodied in the judgmental forecast. In this extension, potential supply is assumed to expand at the same rate as in 2002, with structural labor productivity growth continuing at 3 percent per year. The earlier acceleration of structural productivity had helped to hold down price increases because efficiency gains outpaced the lagging pickup in real wages. But with the leveling out of structural productivity growth, this disinflationary effect wanes, and the degree of labor market slack consistent with steady inflation (the effective NAIRU) edges up from about 4¾ percent currently to about 5¼ percent by 2005.[4] Also after 2002, the federal surplus on a NIPA basis remains roughly stable at its current value of about 2 percent of GDP. The dollar is predicted to depreciate at a 5 percent rate per year in real terms, and foreign economic growth picks up somewhat. Together, these last two factors roughly stabilize the ratio of the current account deficit to GDP.

(7) In the **alternative strategies for monetary policy** shown in chart 3, the baseline policy keeps the federal funds rate unchanged at 5¾ percent beyond 2002. In contrast to the conditions underlying the long-run scenario section of a number of bluebooks in recent years, potential supply and aggregate demand are approximately in balance at the end of the Greenbook forecast in 2002, and little impetus to raise or lower inflation rates is in the pipeline. Moreover, the real federal funds rate at that

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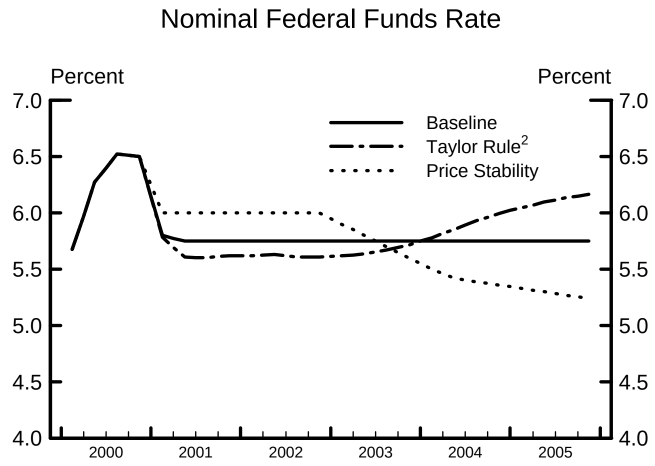
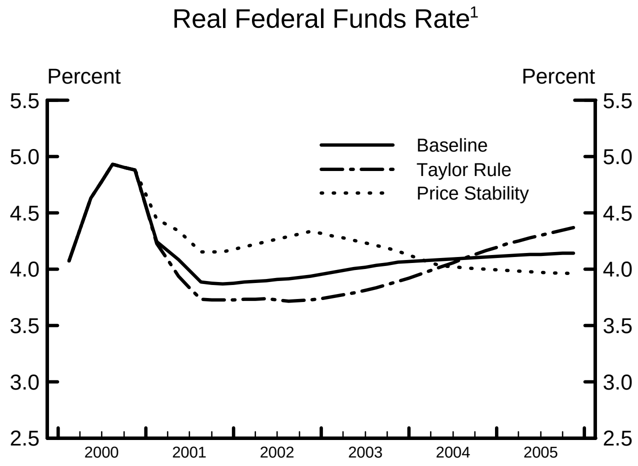
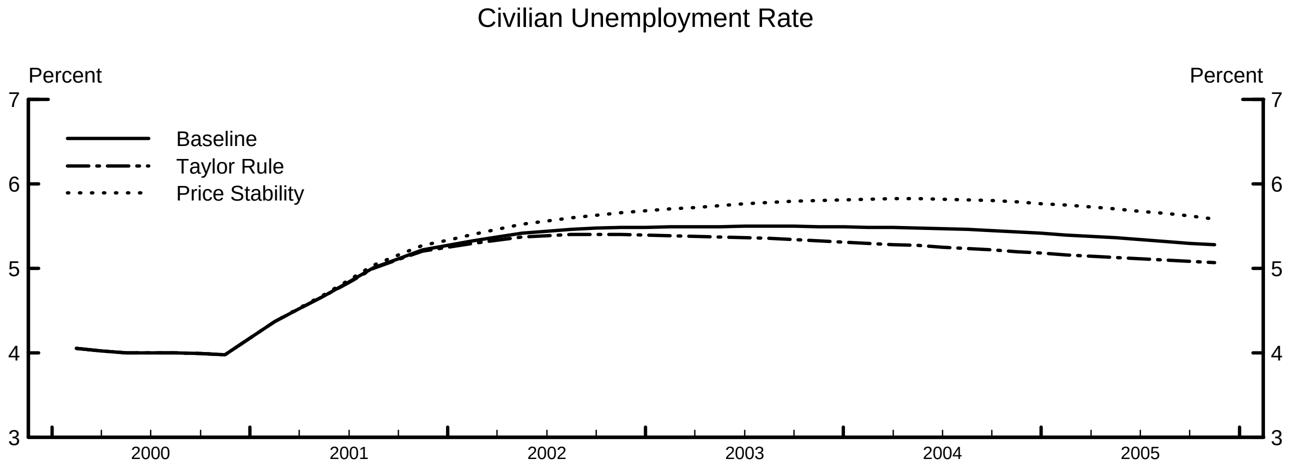
3. See pages I-13 to I-15 of the January 2001 Greenbook.

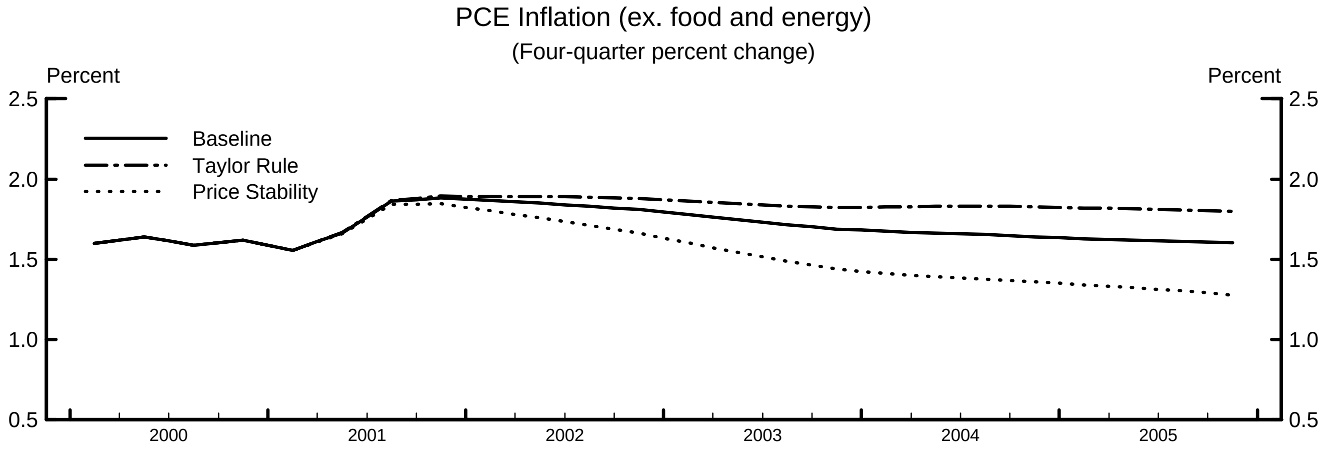
4. Past 2005, the effective NAIRU would be expected to rise somewhat further and settle in at its long-run value of 5½ percent.

Chart 3
Alternative Strategies for Monetary Policy









1. The real federal funds rate is calculated as the quarterly nominal funds rate minus the four-quarter percent change in the PCE chain-weight price index excluding food and energy.

2. The Taylor rule uses a concept of potential output corresponding to the effective NAIRU, rather than corresponding to the long-run NAIRU as in the original specification of the Taylor rule.

time is close to its equilibrium level (recognizing, of course, the considerable uncertainty that surrounds this and all other aspects of our projections). Consequently, under this policy, the unemployment rate remains in the vicinity of the effective NAIRU from 2002 to 2005, and core PCE inflation is little changed. The Taylor rule policy sets the federal funds rate in response to core PCE inflation and the gap between actual output and the level of output consistent with the effective NAIRU.[5] The equilibrium real interest rate used in the rule is that implicit in the extended Greenbook baseline (slightly above 4 percent), while targeted inflation is set at 1½ percent. As shown by the dot-dash lines, the path for the federal funds rate given by the Taylor rule follows the baseline assumption reasonably closely, although the nominal and real federal funds rates are a bit lower in the near term and a bit higher later.[6] With the price stability policy, the Committee places inflation on a path to virtual price stability–as measured by core PCE inflation at a 1 percent rate. In order to accomplish this objective, policy has to be tighter than the baseline at some point. In the alternative shown, the funds rate is kept at its current 6 percent level for a time so that the required tightness occurs early in the simulation period, and thus inflation is on a perceptible downward track beginning in 2002.

(8) Chart 4 presents **alternative supply-side scenarios**. The 4 percent NAIRU scenario has been designed to explain the good performance of inflation in recent years in terms of a permanently lower long-run NAIRU, rather than on the basis of transitory effects of accelerating productivity. Again, monetary policy is assumed to follow a Taylor rule, but one that incorporates a lower inflation target

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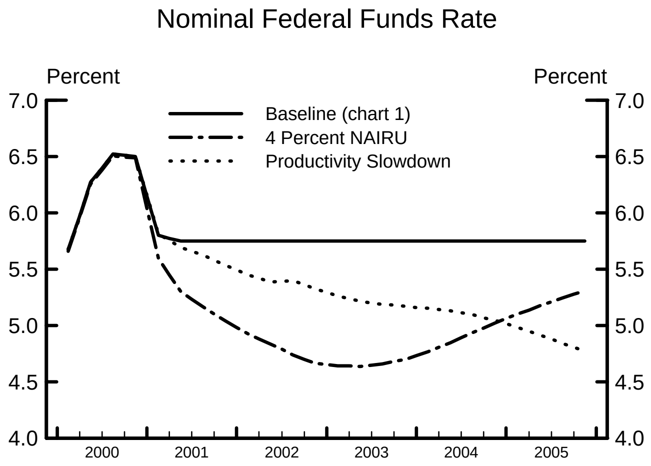
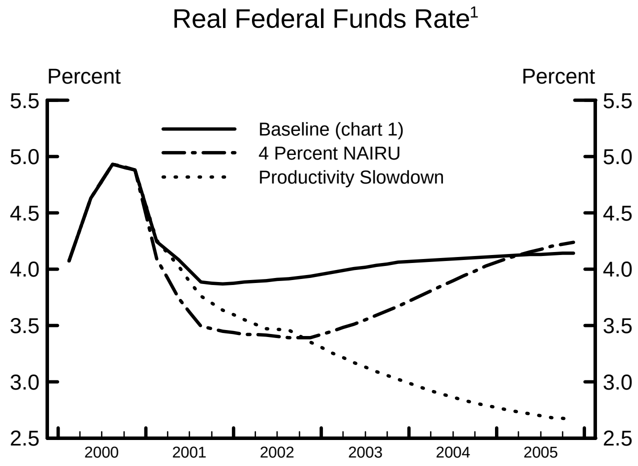
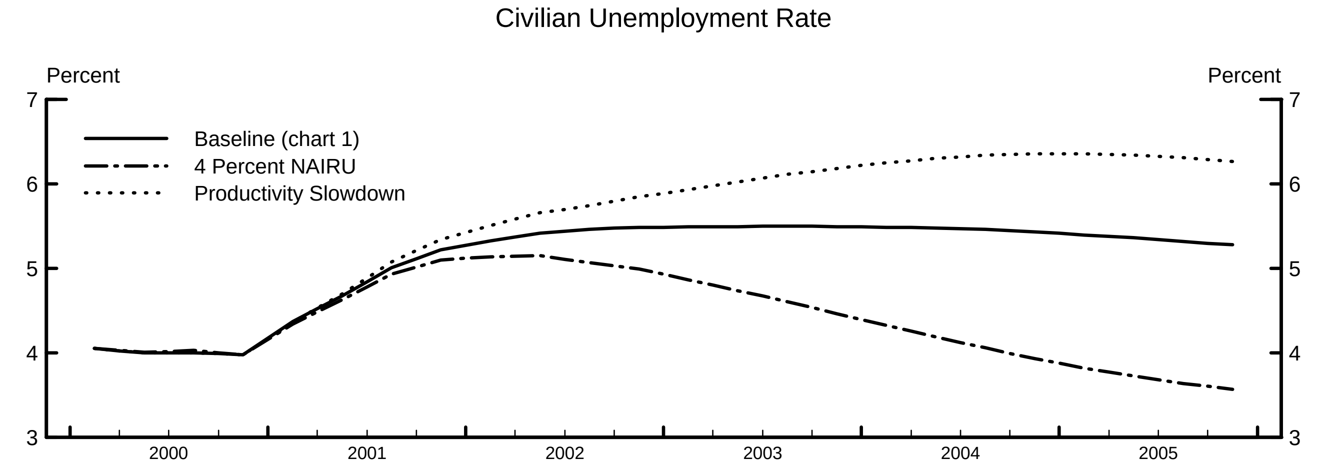
5. In the policy rule, coefficients on the contemporaneous output and inflation gaps are equal to ½.

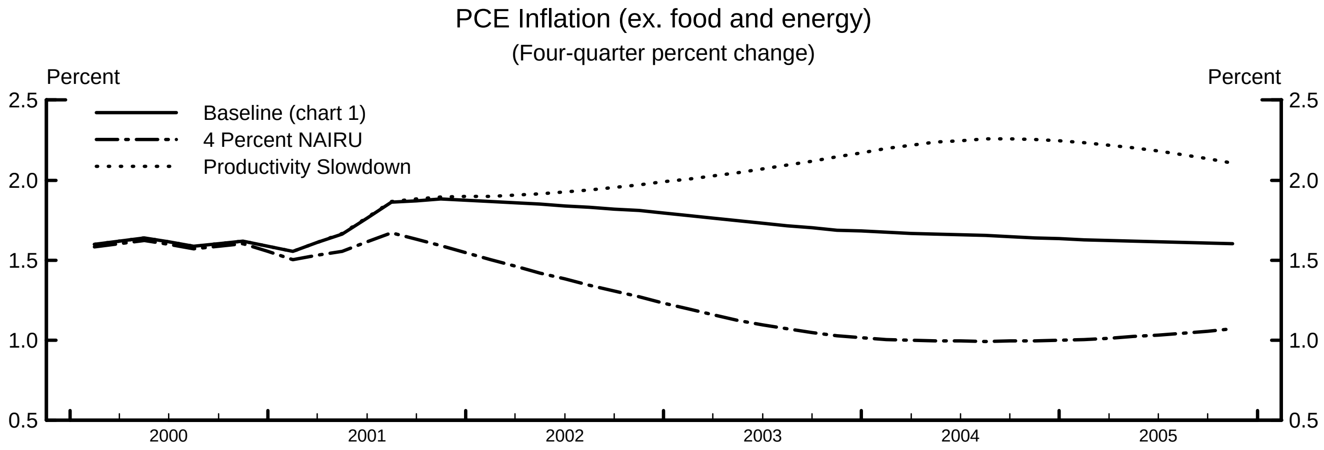
6. In 2005, the Taylor rule has not yet stabilized the economy at targeted inflation and an output gap of zero, but would do so in the longer run.

Chart 4
Alternative Supply-Side Scenarios









1. The real federal funds rate is calculated as the quarterly nominal funds rate minus the four-quarter percent change in the PCE chain-weight price index excluding food and energy.

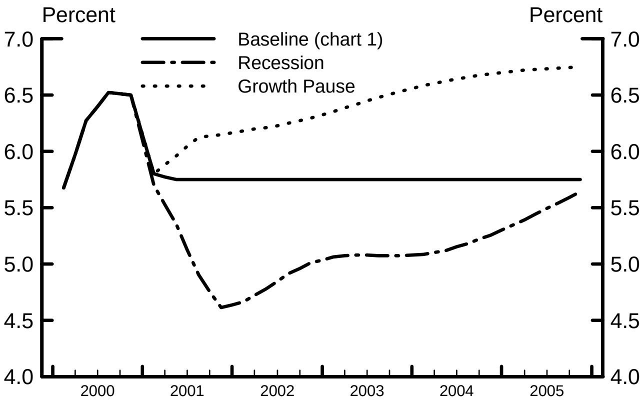
(1 percent) than was used in the baseline's Taylor rule, as the Committee takes advantage of the "opportunity" of emerging slack to make further progress toward price stability.[7] As shown by the dot-dash line, the federal funds rate is eased aggressively over the next two years to limit the rise in the unemployment rate, but the lower NAIRU means that a decline in inflation to 1 percent still can be achieved. The productivity slowdown scenario retains the staff view of the NAIRU and the role of changes in structural productivity growth in the inflation process, but assumes that the rate of structural productivity growth going forward falls permanently to 1½ percent (its 1973-94 average) rather than continuing to run at 3 percent as in the baseline. Slower trend growth raises the effective NAIRU sharply, which puts upward pressure on inflation, but it also weakens demand; on balance, demand is restrained more than potential supply relative to the baseline, lowering the equilibrium real interest rate. If policy follows the Taylor rule, as assumed in this scenario, the federal funds rate drifts down, but by less than the decline in the equilibrium real funds rate in order to check the rise in inflation.

(9) Chart 5 considers the implications of **alternative demand-side scenarios** presented in the Greenbook, but under the assumption that monetary policy follows the Taylor rule. In the recession scenario (dot-dash lines), weakness in aggregate demand is more pronounced than in the baseline by enough to push the economy into an outright recession. The downward impetus to demand reverses fully during 2002. As shown, the unemployment rate rises to 6 percent in 2002 even though the federal funds rate is reduced to about 4½ percent by the end of 2001. Even with the unemployment rate rising well above the effective NAIRU, inflation

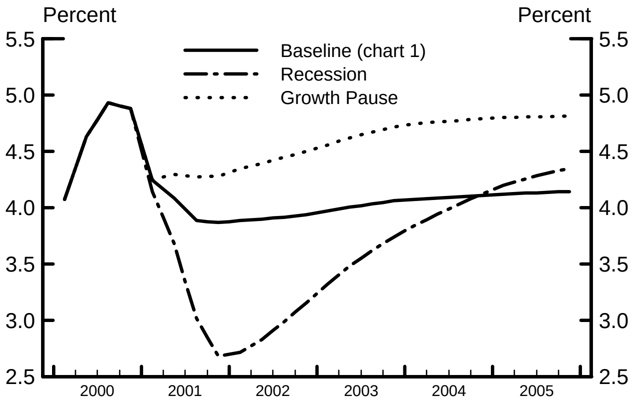
7. The rule also incorporates a slightly lower equilibrium real interest rate that arises on account of an increase in potential output that is not accompanied by a corresponding increase in government spending or foreign GDP.

Chart 5
Alternative Demand-Side Scenarios

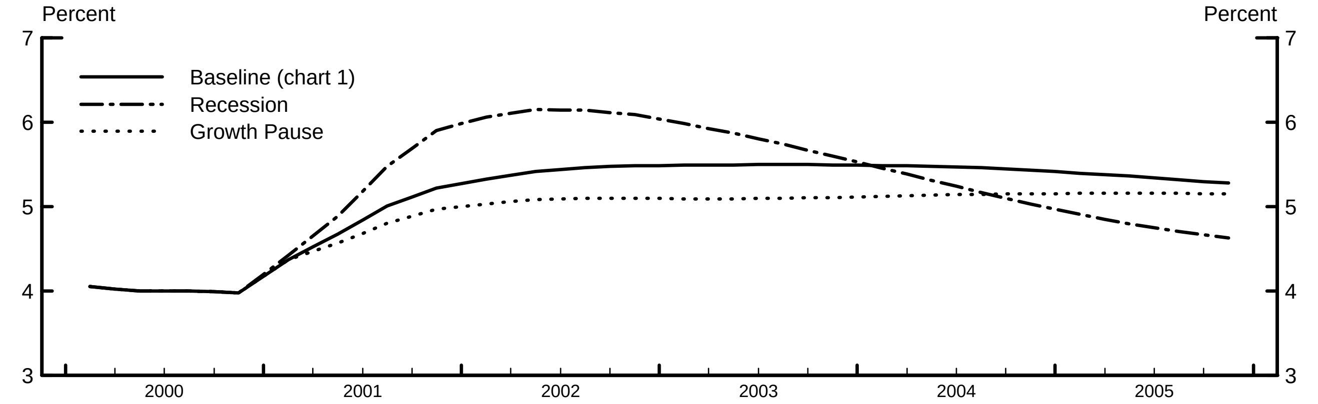
Nominal Federal Funds Rate



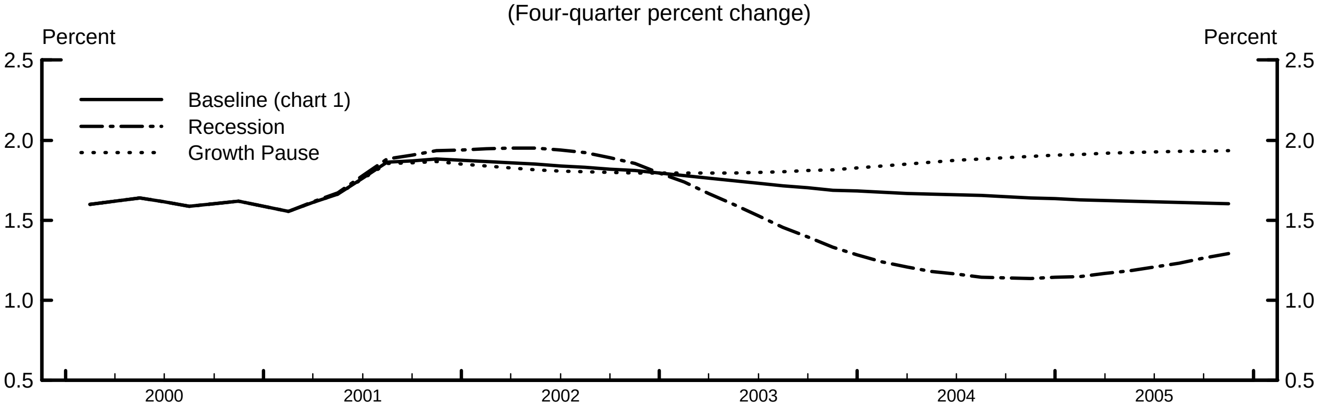
Real Federal Funds Rate[1]



Civilian Unemployment Rate



PCE Inflation (ex. food and energy)
(Four-quarter percent change)



1. The real federal funds rate is calculated as the quarterly nominal funds rate minus
the four-quarter percent change in the PCE chain-weight price index excluding food and energy.

increases slightly in 2002 as lower interest rates induce a steeper drop in the exchange value of the dollar than in the baseline, raising import prices. In the growth pause scenario, the near-term weakness in aggregate demand stems solely from excess business inventories and not also from a slowing in final demand, as in the baseline. After excess inventories are worked off, the greater underlying strength in final demand shows through to aggregate output growth. As shown by the dotted line, the Committee lowers the federal funds rate to 5¾ percent in the current quarter but promptly reverses this action. With final demand persistently stronger than in the baseline scenario, after 2001 both nominal and real interest rates need to rise further.

Medium-term Projections of M2 Growth

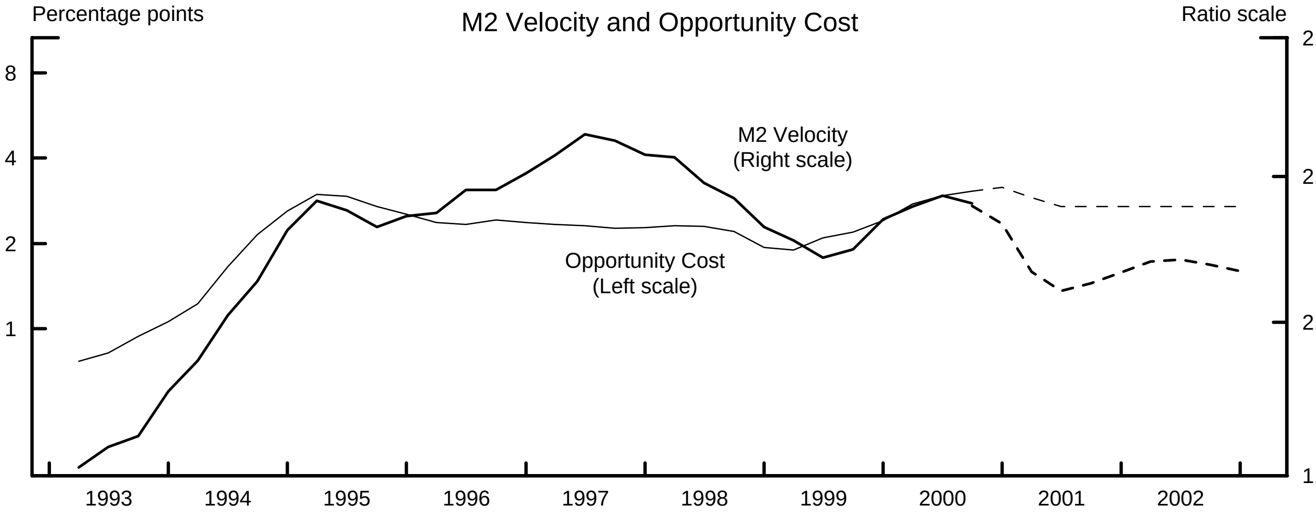
(10) This section briefly reviews the growth of M2 last year and presents staff projections for the next two years that are consistent with the Greenbook forecast. (See table below.) Since the mid-1990s, in contrast to earlier in that decade, the demand for this aggregate has conformed fairly well on average with historical relationships to opportunity cost and spending (chart 6). In that context, analysis of the deviations of M2 growth from projections, against the backdrop of other developments in financial markets, could be helpful in understanding the evolution of financial conditions and their implications for the economic outlook. Moreover, in the very long run, trends in M2 and prices should be related.

Growth Rates of M2 and M2 Velocity
(in percent)

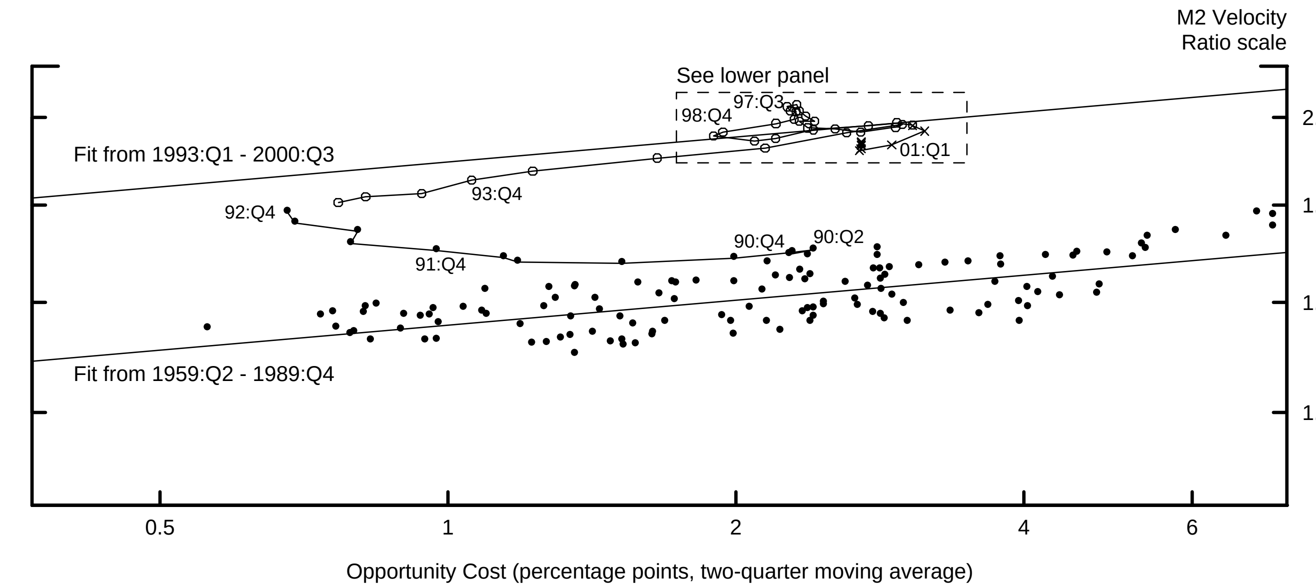
	Actual	Projected	
	2000	2001	2002
M2	6.1	5½	5½
V2	0.0	-1½	0
Memo: Nominal GDP	6.1	3¾	5½

(11) Even though velocity and opportunity cost have moved together on average over recent years, significant divergences also are apparent that may be related in part to the unusual behavior of the equity market. Beginning in 1996, investors apparently began to view equity returns as quite attractive, and flows into equity mutual funds surged at the expense of M2, with the result that velocity trended higher through mid-1997. However, velocity subsequently moved back down as the further runup of equity prices boosted stock market wealth appreciably relative to income,

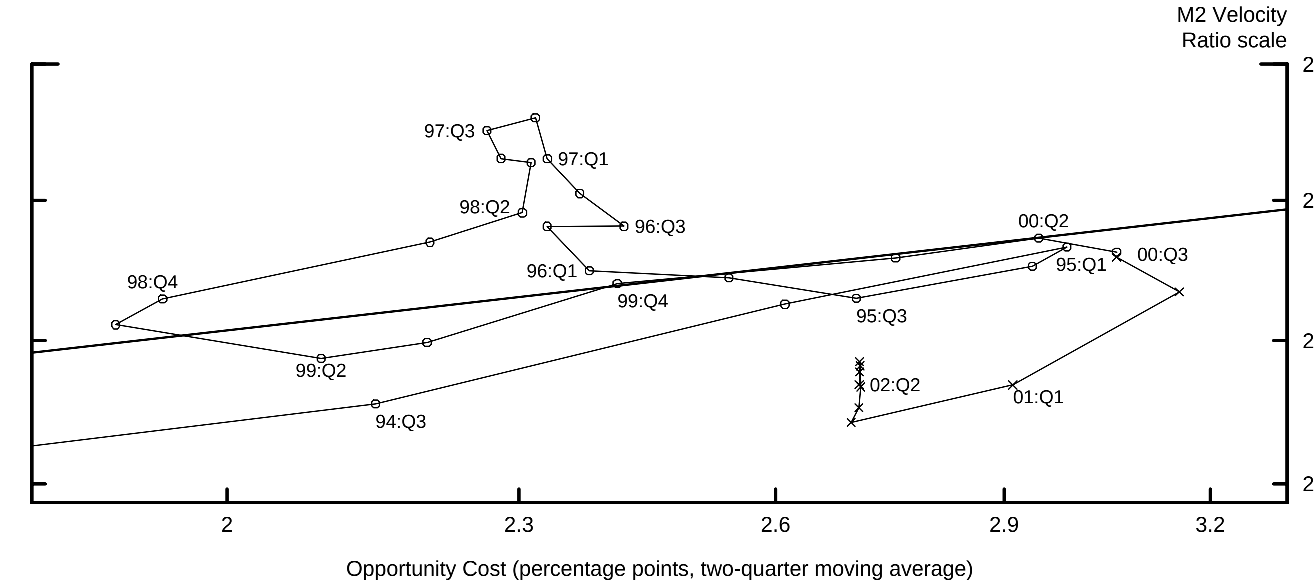
Chart 6



Note: The scales are set to match the estimation results shown below. Opportunity cost is a two-quarter moving average of the three-month Treasury bill rate less a weighted average of the interest rates on M2 components.



* The two regressions were constrained to have the same slope.



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and households seemed to take steps to rebalance portfolios by reallocating funds to assets in M2. M2 velocity has been flat over the past two years. In 2000, the damping effect on money demand of the rise in opportunity cost appeared to be offset by the response of households to equity market volatility and to a flat, and at times inverted, yield curve, which gave investors little incentive to shift funds out of M2 assets and into longer-maturity capital market instruments.

(12) M2 growth is expected to moderate somewhat in 2001 as the expansion of nominal income slows. The downshift in M2 growth is tempered, however, by the reduction in short-term interest rates stemming from the assumed 75 basis points of policy easing in the first quarter and by the anticipated flatness of the yield curve. In addition, lower mortgage rates in the forecast spur a wave of mortgage refinancing activity that pushes up M2 growth as mortgage servicing agents temporarily place the prepayments in transaction accounts before remitting them to holders of mortgage-backed securities. Moreover, households are expected to favor M2 assets in view of the disappointing returns in the equity market anticipated in the staff forecast. With M2 growth slowing considerably less than nominal income, M2 velocity is projected to fall notably this year. In 2002, the staff assumes that short-term rates hold steady and that savers will have largely completed their adjustments to the flat yield curve and lower expected returns on holding equities. In this environment, M2 growth is expected to level out, running at about the same pace as nominal income. Even though inflation persists over the next two years in the staff forecast, M2 growth on average in 2001 and 2002 is only modestly above the 4½ percent average pace that would be associated with price stability because of shortfalls in the growth of real output relative to that of potential.[8]

8. The rate of growth of M2 at price stability is derived under the assumption of stable velocity by summing the staff's estimate of potential real GDP for the next two years (about 4 percent) and the residual bias in the GDP deflator (½ percent).

Short-run policy alternatives

(13) The staff has again revised down its outlook for economic growth in the near term, reflecting weaker expansion in aggregate demand than previously projected and more aggressive production cutbacks to align inventories better with sales. However, final demands over the forecast horizon are supported by the effects on consumption and investment of continuing elevated structural productivity gains and are augmented by the substantial declines in most interest rates over recent months as well as by projected decreases in energy prices and the foreign exchange value of the dollar. As a result, the inventory correction is completed fairly promptly, and projected economic growth resumes in the spring and picks up thereafter. Despite the economic rebound, the sizable shortfall from potential output growth in the next few quarters quickly pushes up the unemployment rate to around 5¼ percent by year-end. By then, though, aggregate demand is expanding at a pace just short of potential and the unemployment rate edges only a bit higher over the remainder of the forecast period. With structural productivity growth leveling out, the rise in the unemployment rate is seen as necessary to keep core consumer inflation rates near current levels. Against this backdrop, the staff forecast assumes only a small additional cut in the federal funds rate in the near term.

(14) If the Committee found the staff assessment of the outlook to be both reasonable and acceptable, it might opt for **alternative A**, which would lower the federal funds rate 25 basis points to 5¾ percent. In the context of this forecast, such an easing leans against softness in aggregate demand while resisting an eventual pickup of inflation in circumstances of continued pressures on labor resources. In light of the considerable uncertainty about the prospects for spending, such a measured step could be seen as striking a balance between two possible scenarios for aggregate demand discussed earlier–a recession and a growth pause. To be sure, the market has

a more substantial easing at this meeting built into interest rates, but this expectation was shaped in part by the Committee's unexpectedly aggressive action earlier this month. Over a somewhat longer horizon, the structure of interest rates incorporates a drop in the funds rate to 4¾ percent by year-end–more than the Committee may see as likely to be necessary to restore acceptable growth. If so, it may view disappointing markets a little as possibly fostering more sustainable and stabilizing financial conditions. Indeed, the Committee may be concerned that another 50 basis point action hard on the heels of the January 3 move risks leading investors to expect even more ease at future meetings than currently. Such a reaction would heighten the possibility that the stimulus emanating from financial markets would give additional impetus to a rebound in spending that might soon be underway in any event. Given the lags in the effects of monetary policy, any resulting price pressures could be difficult to contain even with a relatively quick turnaround in policy.

(15) If the Committee were to choose this alternative, it might want to retain the current statement that the risks are weighted toward economic weakness, unless it were confident that the economy had stabilized and moderate growth was in prospect. With only a 25 basis point easing, market interest rates probably would back up, credit spreads would widen some, and stock prices would decline as the policy move fell short of market expectations and concerns about a prolonged period of economic weakness re-intensified.

(16) If the Committee thought the economy might well be weaker than in the staff forecast, it may wish to take another substantial easing action by cutting the federal funds rate 50 basis points at this meeting, as in **alternative A′**. As the recession simulation illustrated, a substantial shortfall in demand would require prompt and forceful policy action. Even if the Committee thought the staff forecast was the most reasonable point estimate, it might still favor a 50 basis point easing if it

perceived that the probabilities around that outcome were skewed toward considerably softer demand than in that forecast. With inflation and inflation expectations likely to remain quiescent for a while, a substantial easing to cushion downside risks to economic activity is unlikely to boost materially the risk of greater inflation pressures. Indeed, a substantial easing might also be viewed as appropriate if the Committee did not see outsized downside risks to demand but thought price pressures were unlikely to intensify at an unemployment rate near its current level, as in the 4 percent NAIRU simulation earlier in this bluebook. Financial market participants currently have built in high odds of a ½ percentage point cut in the funds rate at this meeting. Although conditions in some segments of financial markets have improved in recent weeks, developments in the commercial paper and bank loan markets indicate that suppliers of funds remain quite wary. Under these circumstances, the effects of surprising the markets with a smaller easing could be especially adverse.

(17) The market response to a 50 basis point reduction in the federal funds rate would depend importantly on the wording of the announcement and balance of risks statement that accompanied the action. Retaining a statement of risks weighted toward economic weakness would seem appropriate if, in light of the evident softening in demand and subdued readings on price and wage inflation, the Committee saw the possibility of below-trend growth as a more serious problem in the foreseeable future than the chance of a rise in inflation. Market participants expect the Committee to announce continued unbalanced risks toward economic weakness as well as to ease policy by 50 basis points. Still, markets might rally some if participants see this combination as confirming that the Federal Reserve intended to continue to counter economic weakness relatively aggressively. The dollar could weaken on foreign exchange markets as major foreign central banks are unlikely to

match the System easing at this time. A statement that risks were balanced would be justified if the Committee thought the 100 basis points of easing over the last month were likely to be sufficient to promote a rapid return to sustainable growth, which would keep labor markets relatively tight. Such a statement would cause market participants to reassess the prospects for future policy actions and roll back much of the expected easing going forward. In consequence, asset prices could give back some of their recent gains while the dollar could even strengthen a bit on foreign exchange markets.

(18) The Committee may choose the unchanged federal funds rate of **alternative B** if it is dissatisfied with recent rates of core inflation and wants to establish a downward trajectory for inflation, as in the price stability scenario in the second section of this bluebook. The rationale for this policy choice would be strengthened if the Committee saw the recent slowdown in the growth of aggregate demand as likely to be more temporary than does the staff and thus the recent policy easing as probably sufficient to counter the sluggishness in the economy that emerged recently. Regardless of the balance of risks statement, leaving the funds rate unchanged would come as a considerable surprise to market participants and would spark a sell-off in asset markets as participants reassessed the economic outlook and the Committee's posture. The backup in interest rates and drop in equity prices would prompt still more caution on the part of loan officers and investors.

(19) Under the Greenbook forecast, borrowing by the business and household sectors combined over the first half of 2001 is expected to stay around the reduced pace of the second half of last year. Consumer credit is projected to decelerate further over the first half, largely reflecting weaker outlays on consumer durables and some rising caution by households experiencing uncomfortable debt-servicing burdens. Recent declines in mortgage rates are expected to spur continued

heavy mortgage refinancing activity, mostly to reduce debt-servicing costs on existing debt but in a number of cases also to extract some equity. Lower bond rates and an improved tone to the corporate bond market already have begun to boost issuance; going forward, overall business borrowing should run somewhat above the subdued pace of the latter part of last year, when firms seemed inclined to hold off on their borrowing plans. Business borrowing from banks is expected to moderate, in part reflecting the increased reliance on bond offerings but also the more restrictive posture of loan officers. Debt of nonfederal sectors is projected to grow at about a 6½ percent rate from December to June and total debt to grow at a 4¼ percent rate, held down by paydowns of federal debt.

(20) M2 is projected to grow at a 5½ percent annual rate over the January-to-June period under the Greenbook forecast, well above the projected 2¾ percent growth of nominal GDP over the first half of this year. M2 growth should be boosted relative to that of nominal income by the decline in short-term market rates following the January policy easings and by a continuation of the heightened preferences of households for the more stable assets that comprise M2. Mortgage refinancing activity also is likely to lift M2 notably over this period. M3 is expected to grow at a 7 percent annual rate over the January-to-June period. Growth of institutional money funds is projected to be quite brisk as the yields on these funds lag the downward move in short-term market interest rates.

Alternative Growth Rates for Key Monetary and Credit Aggregates

	M2			M3			M2	M3	Debt
	Alt. A'	Alt. A	Alt. B	Alt. A'	Alt. A	Alt. B	Greenbook Forecast*		
Monthly Growth Rates									
Nov-2000	4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.6
Dec-2000	9.6	9.6	9.6	12.5	12.5	12.5	9.6	12.5	4.6
Jan-2001	11.2	11.2	11.2	15.7	15.7	15.7	11.2	15.7	2.9
Feb-2001	8.4	8.0	7.6	11.6	11.4	11.2	8.0	11.4	5.4
Mar-2001	7.3	6.5	5.7	8.4	8.0	7.6	6.5	8.0	6.2
Apr-2001	8.1	7.3	6.5	8.0	7.6	7.2	7.3	7.6	3.3
May-2001	2.7	2.0	1.3	3.8	3.5	3.2	2.0	3.5	3.4
Jun-2001	3.8	3.3	2.8	4.6	4.4	4.2	3.3	4.4	4.3
Quarterly Growth Rates									
2000 Q1	5.8	5.8	5.8	10.5	10.5	10.5	5.8	10.5	5.6
2000 Q2	6.2	6.2	6.2	8.8	8.8	8.8	6.2	8.8	6.2
2000 Q3	5.6	5.6	5.6	8.8	8.8	8.8	5.6	8.8	4.7
2000 Q4	6.5	6.5	6.5	7.0	7.0	7.0	6.5	7.0	4.1
2001 Q1	9.1	8.9	8.7	12.1	12.0	11.9	8.9	12.0	4.4
2001 Q2	6.3	5.6	4.9	7.2	6.9	6.5	5.6	6.9	4.3
Growth Rate Ranges									
From To									
Dec-1999 Dec-2000	6.2	6.2	6.2	8.6	8.6	8.6	6.2	8.6	5.2
Dec-2000 Jun-2001	7.0	6.5	5.9	8.8	8.6	8.3	6.5	8.6	4.3
Jan-2001 Jun-2001	6.1	5.5	4.8	7.4	7.1	6.8	5.5	7.1	4.6
1998-Q4 1999-Q4	6.3	6.3	6.3	7.7	7.7	7.7	6.3	7.7	6.8
1999-Q4 2000-Q4	6.1	6.1	6.1	9.1	9.1	9.1	6.1	9.1	5.3
2000-Q4 Jun-2001	7.2	6.7	6.2	9.0	8.8	8.6	6.7	8.8	4.4

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

Directive and Balance-of-Risks Language

(21) Presented below for the members' consideration is draft wording for (1) the directive and (2) the "balance of risks" sentence to be included in the press release issued after the meeting (not part of the directive).

(1) Directive Wording

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with MAINTAINING/ INCREASING/reducing the federal funds rate AT/to an average of around ___~~6~~ percent.

(2) "Balance-of-Risks" Sentence

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks [ARE BALANCED WITH RESPECT TO PROSPECTS FOR BOTH GOALS] [CONTINUE TO BE WEIGHTED MAINLY TOWARD CONDITIONS THAT MAY GENERATE HEIGHTENED INFLATION PRESSURES] [are weighted mainly toward conditions that may generate economic weakness] in the foreseeable future.