Prefatory Note

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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.) **March 15, 2001**
Class II – FOMC

MONETARY POLICY ALTERNATIVES

Recent Developments

(1) The Committee's decision on January 31 to reduce the intended level of the federal funds rate by 50 basis points, to 5½ percent, and the announcement that it viewed risks as remaining weighted toward economic weakness were widely anticipated and had little impact on market yields.[1] Information becoming available over the intermeeting period–particularly widespread earnings disappointments, sharp declines in share prices, and a notable drop in consumer confidence–led market participants to mark down further their anticipated path of the federal funds rate. The market is now confident that the Committee will lower the funds rate by at least 50 basis points at the March meeting and has priced in high odds of a 75 basis point action. Looking further ahead, futures contracts point to expectations that the funds rate will move down to around 4¼ percent by the fall (chart 1).

(2) Against this backdrop, the Treasury yield curve has shifted lower over the intermeeting period, with short-term interest rates falling 50 basis points and longer-term yields dropping 30 to 50 basis points. Broad equity indexes have declined about 15 percent, in large part owing to declines in the prices of technology shares. Indeed, the technology-heavy Nasdaq has plunged 32 percent, but of late the weakness has spread to other sectors. Despite these substantial capital losses, markets have continued to function without significant signs of strain. However, the gloomier

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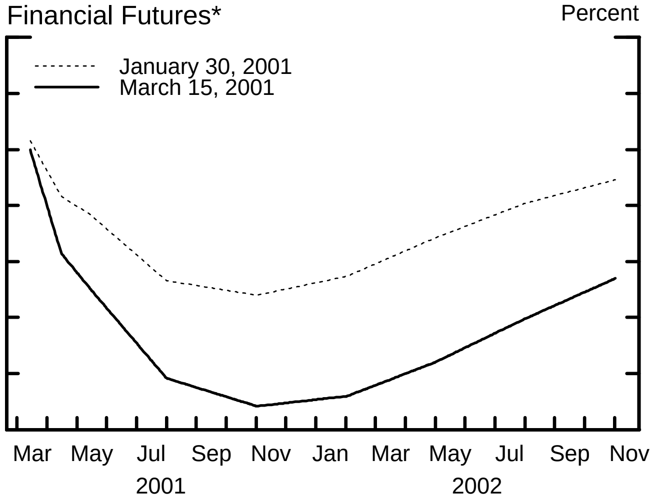
[1] Over the intermeeting period, federal funds have traded at rates near the target level. The Desk redeemed $3.2 billion of Treasury securities, mostly coupon issues, to continue bringing SOMA holdings into conformance with the per-issue limits. To offset the resulting reserve drain and meet longer-term reserve needs, the Desk purchased $9.4 billion of Treasury securities in the market and $790 million of Treasury bills from foreign customers. The volume of outstanding long-term RPs remained at $12 billion.

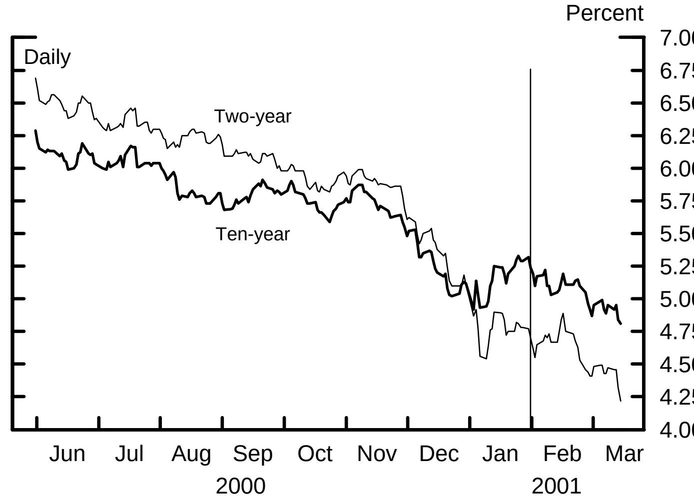
Chart 1
Financial Market Indicators

Expected Federal Funds Rates Estimated from Financial Futures*

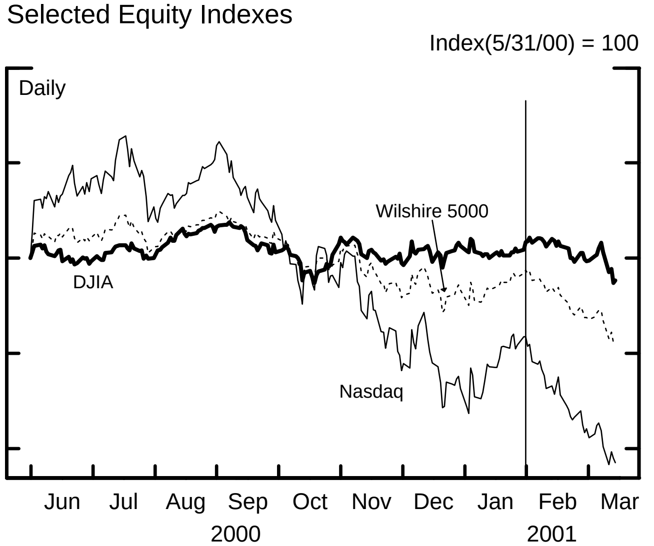


*Estimates from federal funds and eurodollar futures rates with an allowance for term premia and other adjustments.

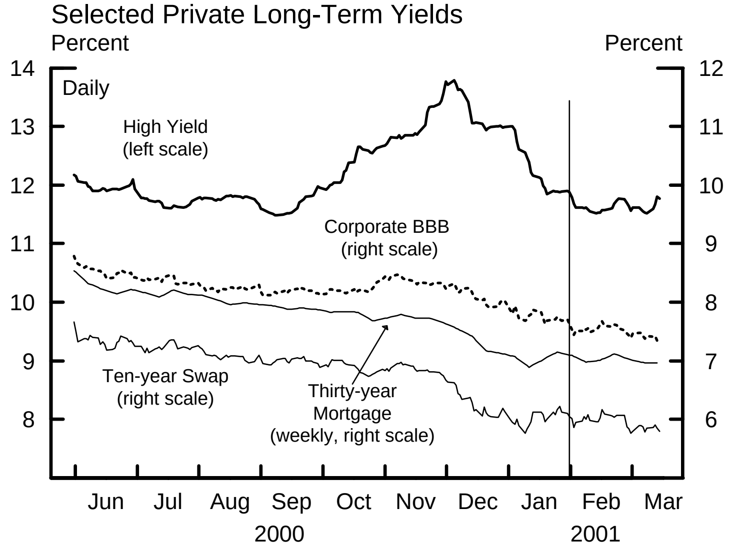
Selected Treasury Yields



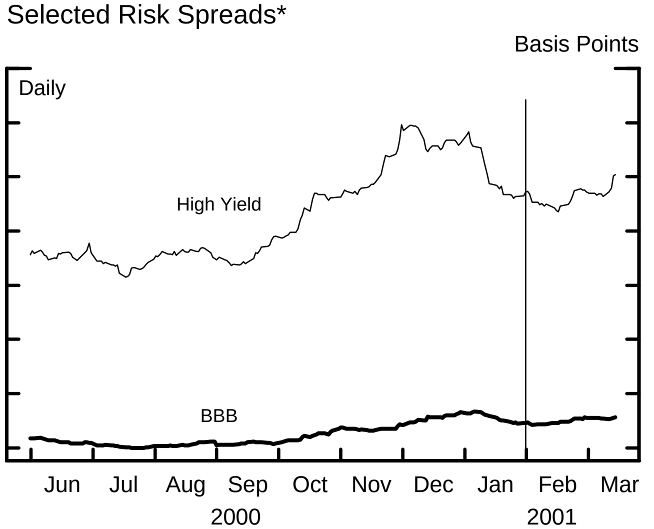
Selected Equity Indexes



Selected Private Long-Term Yields

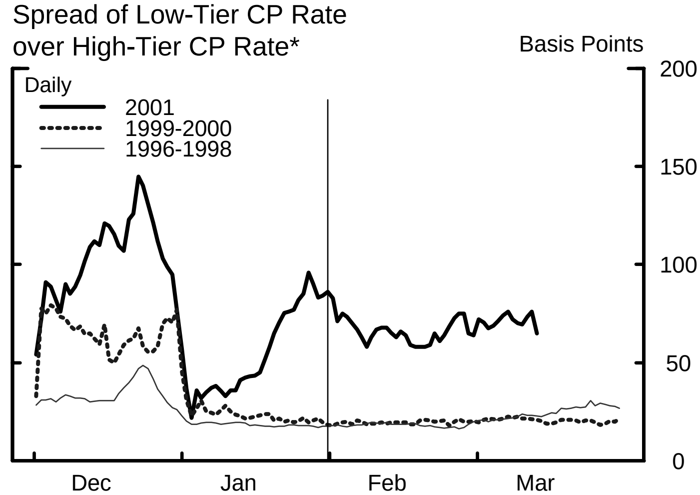


Selected Risk Spreads*



*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.

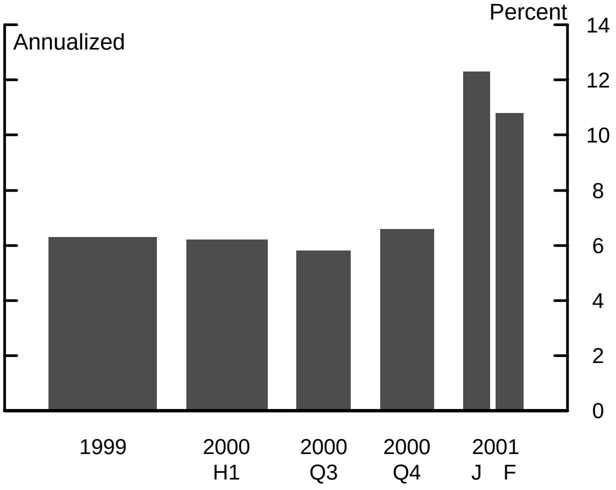
Note: Solid vertical line indicates last FOMC meeting.

profits outlook and unsettled prospects for corporate equities have put upward pressure on private debt spreads in recent days, especially for lower-rated corporations. As a consequence, rates on high-yield bonds have fallen only 10 basis points, while those on the bonds of better-rated corporations are off 35 to 45 basis points. At commercial banks, many lending officers report they have again tightened standards and terms on business loans since the beginning of the year, raising the cost and likely signaling the reduced availability of new loan commitments.

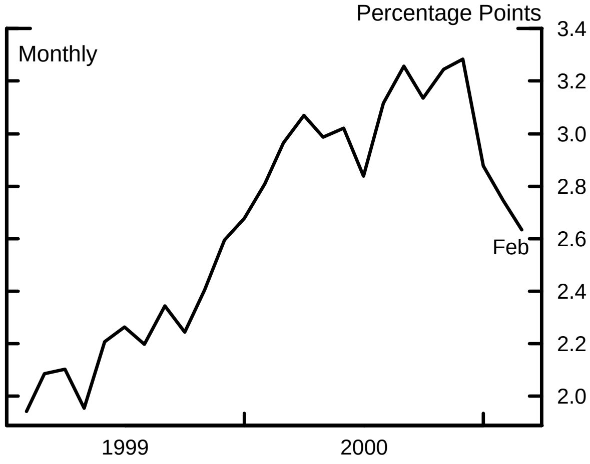
(3) Bond yields and stock prices fell in most other industrial countries over the intermeeting period, albeit generally by less than in the United States. Still, the dollar appreciated in value on foreign exchange markets, gaining 3¾ percent against a basket of major currencies (chart 2). The dollar strengthened most against the currencies of countries where the potential for economic weakening was seen to be greatest, increasing 3¾ percent vis-a-vis the Canadian dollar and 5½ percent relative to the Japanese yen. Over the intermeeting period, the Bank of Canada eased policy by 50 basis points, but market participants apparently harbored considerable concerns that this would be insufficient to absorb the impact on Canada of a slowing U.S. economy. The Bank of Japan trimmed 10 basis points from its call money rate, which now stands at 15 basis points, and some officials hinted that more easing might be in store. But with Japanese equity prices falling 13 percent over the last six weeks and raising doubts about the banking sector, the political coalition in power looking fragile, and forward-looking indicators pointing to very weak domestic spending, the prospects for economic activity in Japan seem poor. Market participants apparently viewed the economic expansion in Europe as more secure and seemed unfazed by the European Central Bank keeping its policy on hold. Nonetheless, the dollar gained 2¼ percent against the euro. Over the intermeeting period,

Chart 2
Financial Flows and Exchange Rates

M2 Growth



M2 Opportunity Cost*

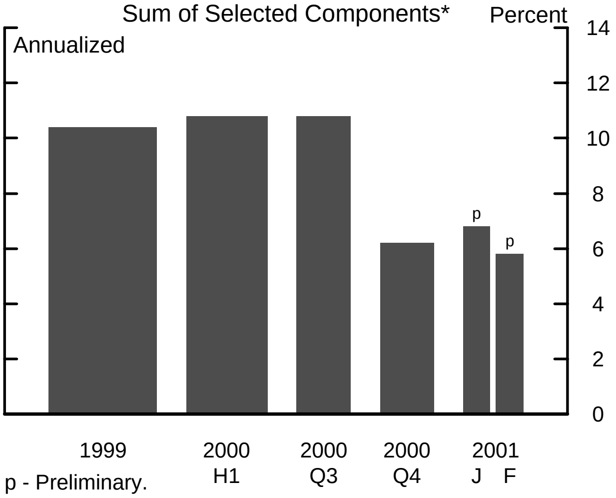


* Yield on three-month Treasury bill minus average return on M2 assets.

Growth of Debt of Domestic Nonfinancial Sectors

Business Debt

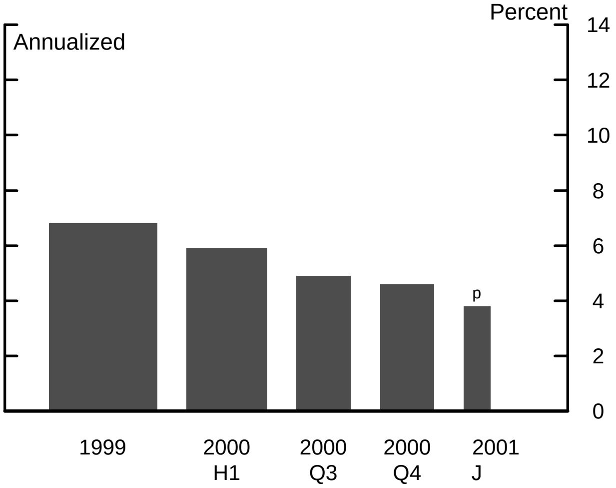
Sum of Selected Components*



p - Preliminary.

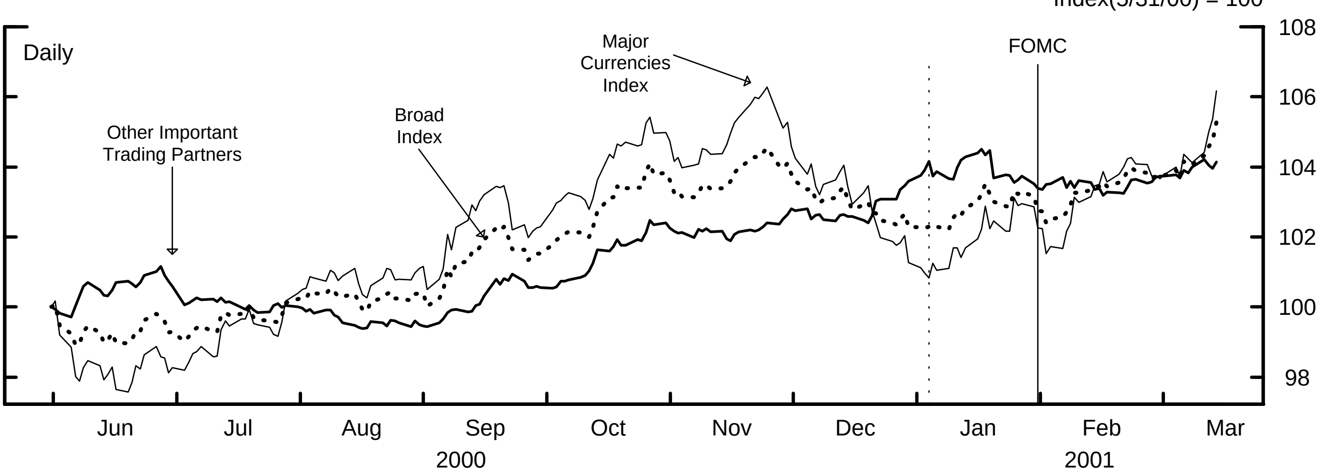
*Bonds, commercial paper, and C&I loans.

Total Debt



p - Preliminary.

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.

MARA:JW

U.S. authorities did not intervene.

(4) The dollar rose ¾ percent over the intermeeting period in terms of a basket of currencies of our other important trading partners. In Turkey, with a weak banking system adding to pressures on government finances and political tensions flaring, the central bank was forced to abandon its crawling peg in late February. The dollar initially appreciated over 50 percent against the Turkish lira but has subsequently fallen back some to end the period up about 30 percent. The spillover to other markets was contained, with investors withdrawing for a time from the debt of Argentina, which has similarly shaky finances and political troubles. On net, spreads on Argentinian debt edged lower over the period, reflecting confidence in the new finance minister. But with the outlook for the global economy looking poorer and investors somewhat more skittish, spreads on emerging market debt rose 65 basis points on net. Emerging market equity prices have followed U.S. markets down but have dropped somewhat less on balance.

(5) Falling interest rates have contributed to rapid growth in the monetary aggregates in recent months. M2 expanded at a 10¾ percent rate in February, down only a little from its January pace, with the strength in both months concentrated in its liquid components (see chart 2). In addition to declines in its opportunity cost, the robust growth of M2 this year may reflect the appeal of safe, short-term assets, given volatile equity markets and the yield advantage of money funds relative to longer-term investments. M2 also was lifted somewhat last month by a pickup in mortgage loan prepayments, the proceeds of which are temporarily held in bank deposits, and by larger than usual tax refunds. M3 growth, too, remained strong in February, at an 11½ percent rate, supported by a surge in institutional money market funds, whose yields lagged the declines in money market rates.

(6) Businesses have taken advantage of lower long-term interest rates and a receptive bond market since early in the year to issue a huge volume of bonds, a good chunk of which has been earmarked to pay down commercial paper. Many lower-rated commercial paper issuers, facing reluctant investors and elevated interest rates, also have turned to commercial banks. Bank lending to businesses has been robust since the turn of the year, despite the reported further tightening of standards and terms since then. On net, business borrowing appears to be growing about in line with the pace of late last year. Lower interest rates also have buoyed the mortgage market, supporting household borrowing, which was augmented by robust consumer debt growth early in the year. State and local governments, too, have moved to take advantage of favorable interest rates by stepping up issuance, only partly for refunding purposes. Overall, growth of debt of the nonfederal sectors early this year appears to have edged down from its pace of the last quarter of 2000, while growth of total domestic nonfinancial debt has been about maintained owing to some moderation in the contraction of federal debt.

MONEY AND CREDIT AGGREGATES

(Seasonally adjusted annual percentage rates of growth)

	Nov 2000	Dec 2000	Jan 2001	Feb 2001 (p)
Money and Credit Aggregates				
M2	4.2	9.6	12.3	10.8
M3	4.2	13.8	16.0	11.6
Domestic nonfinancial debt	5.4	5.8	3.8	n.a.
Federal	-9.2	-6.6	-7.1	n.a.
Nonfederal	8.8	8.6	6.3	n.a.
Bank credit	2.9	14.7	9.1	5.3
Adjusted[1]	4.1	11.4	6.6	5.2
Memo:				
Monetary base[2]	3.5	5.3	10.9	3.2
Adjusted for sweeps	3.8	5.5	10.7	3.4

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

Policy Alternatives

(7) In the staff forecast, an inventory correction intensifies further in the current quarter, holding output to a very small increase. With inventories better aligned with sales by the second half of the year and the effects of policy easings–including another 50 basis points assumed to occur at this meeting–working their way through to spending, output growth gradually picks up. Although consumption gets a lift from the expected decline of energy prices and the assumed retroactive tax cut, the deterioration in the net worth of households damps the rebound. Investment demand recovers gradually, supported by continued rapid growth in structural productivity. The staff assumption that policy will be on hold over the remainder of the forecast period implies a path for the funds rate that is higher than expected by the financial markets, contributing to some backup in nominal long-term interest rates, a decline in equity prices, and a more moderate depreciation in the dollar. Partly as a consequence, the growth of aggregate demand rises slowly over coming quarters and approaches that of aggregate supply only by the end of the forecast period. The extended period of subpar growth results in the unemployment rate rising to about 5½ percent, producing a small drop in core PCE inflation in 2002 from this year's projected 2 percent pace.

(8) The Committee could select a **50 basis point reduction** in the funds rate at this meeting if it thought an easing of at least this size would prove necessary to promote a return of economic growth to an acceptable pace over time. The resulting 5 percent federal funds rate would imply a real rate of around 3 percent–assuming that inflation expectations are in line with the staff forecast of core PCE prices. Even if this places the real rate below its long-run equilibrium value, an undershoot may well be needed for a time to counter the effects of the declines in equity wealth, the apparent downward revision to expected near-term returns on capital, a possible

overhang of productive capacity, and lower business and consumer confidence. Although the cumulative reduction in the funds rate of 1½ percentage points since the start of the year would represent a sharp and substantial change in the stance of policy, aggregate demand and attitudes have deteriorated quickly. The relatively rapid lessening of pressures in labor markets now likely in train should counter any tendency for inflation to move higher. If the Committee suspected that additional easing might be needed at some point, it might still prefer to move by no more than 50 basis points at this meeting so that it could better assess the initial response to its previous actions, the underlying strength of demand, and the extent of price pressures. In those circumstances, the Committee presumably would want to retain the current statement that the risks are weighted toward economic weakness. The Committee could also retain that statement if it believed that 50 basis points could well be sufficient to achieve its objectives, but saw the risks to that outlook as skewed to the downside.

(9) Market participants evidently expect at least a 50 basis point cut in the target funds rate at this meeting, with federal funds futures rates suggesting high odds that the reduction will be 75 basis points. Participants also reportedly expect the Committee to state that the balance of risks remains weighted toward economic weakness. Therefore, a 50 basis point move combined with such a statement likely would cause interest rates to back up. Price declines might be larger in equity markets, where investors seem to be hoping for especially aggressive Federal Reserve action. Further easings in the stance of monetary policy over time would continue to be anticipated, and current market expectations that the funds rate could be around 4¼ percent later this year might not be materially affected.

(10) The Committee could decide to reduce the target federal funds rate even more at this meeting–choosing a **75 basis point decrease**–if it saw the outcome in

the staff forecast as plausible and consistent with its objectives but subject to excessive downside risks. Sources of risk include the possibility of substantial further decreases in equity prices and tightening in credit conditions as profits continue to fall, and fragility in consumer and business confidence. In addition, recent profit and sales shortfalls in the technology sector could indicate a considerable overhang of high-tech capital throughout the economy or even a slower pace of structural productivity growth going forward. Either case would weaken investment spending for some time and probably necessitate significant monetary policy ease. Thus, a 75 basis point reduction in the funds rate at this time could be appropriate to provide some protection against the possibility of a prolonged period of economic weakness. Even if the Committee does not see inordinate downside risks to the staff forecast, it might view that forecast as involving unacceptably weak output and employment, justifying a greater easing than assumed by the staff. In the Greenbook, the unemployment rate rises noticeably above the level the staff judges to be consistent with stable inflation. Moreover, the Committee may see good odds that the economy can sustainably operate at a noticeably lower level of unemployment than is embedded in the staff forecast, and want to lean against appreciable increases in unemployment absent clearer evidence that such increases are necessary to contain inflation.

(11) A 75 basis point easing, if accompanied by a statement that the risks remain weighted toward economic weakness, would generate some price gains in both the fixed income and equity markets. But, given the skittishness in financial markets and the possibility that the stock adjustment process for capital and inventories may have a ways to run, the Committee might still see a preponderance of downside risks to the economy, even after the 75 basis point move and the likely reaction in asset markets.

(12) In developing its forecast, the staff has placed considerable weight on the recent deterioration in consumer confidence and equity wealth. If, instead, the Committee put more emphasis on the relatively firm indicators on spending and employment of late, it might view the forecast of output in the Greenbook as too pessimistic. In that case, it might think that less easing is called for than assumed in the staff forecast and much less than is anticipated by the market, inclining it to favor a smaller, **25 basis point reduction** in the target funds rate. Moreover, the disquieting readings on consumer prices for January might counsel caution in lowering the funds rate further. Given the sizable easing already undertaken this year, a more gradual approach to further reductions in the funds rate may now be appropriate, in part to allow time to gauge the effects of the policy actions in the pipeline.

(13) Market participants would be surprised by an easing of only 25 basis points, and debt and equity markets would sell off appreciably–and even more sharply if this action were combined with a shift to a statement of balanced risks. But if the Committee saw considerably more underlying strength in the real economy or greater inflation risks than did market participants, it might view as appropriate the resulting reassessment of the trajectory of expected policy and the consequent tightening of financial conditions.

(14) Under the staff forecast, including the assumed 50 basis point easing at this meeting, the debt of domestic nonfinancial sectors is projected to grow at a 5½ percent rate over the period from January to June. Sluggish economic growth and declining profits may make lenders somewhat more cautious, but a significant decrease in credit availability is not foreseen, and the debt of borrowers other than the federal government is projected to increase at an 8 percent annual rate over the same interval. This latter growth rate far exceeds the 3½ percent pace of nominal GDP growth foreseen for the first half of this year. For households, the expansion of

mortgage debt is expected to be well maintained, reflecting the influence of low mortgage interest rates on housing activity and mortgage refinancing. Consumer credit growth, by contrast, is seen as moderating significantly, as consumer outlays on durable goods are projected to be weak. Business debt growth should remain hefty as external financing needs continue to be substantial, owing in part to the weakness in profits.

(15) Under the Greenbook assessment of the likely evolution of nominal income and interest rates, the staff expects M2 growth to moderate to a 7½ percent pace over the February-to-June interval. Falling market interest rates, mortgage prepayment activity, and attractive returns on money funds relative to longer-term instruments are projected to lift M2 growth in the near-term. However, this boost, on balance, is smaller than in the first two months of the year, as the declines in short-term interest rates are assumed to slow from their pace around the turn of the year. M3 growth, projected at a 7 percent pace over the February-to-June interval, is supported by further strong expansion of institutional money funds following the assumed easing action at this meeting.

Alternative Growth Rates for Key Monetary and Credit Aggregates

	M2 Ease 75 bp	M2 Ease 50 bp	M2 Ease 25 bp	M3 Ease 75 bp	M3 Ease 50 bp	M3 Ease 25 bp	M2 Greenbook Forecast*	M3 Greenbook Forecast*	Debt Greenbook Forecast*
Monthly Growth Rates									
Dec-2000	9.6	9.6	9.6	13.8	13.8	13.8	9.6	13.8	5.8
Jan-2001	12.3	12.3	12.3	16.0	16.0	16.0	12.3	16.0	3.8
Feb-2001	10.8	10.8	10.8	11.6	11.6	11.6	10.8	11.6	5.4
Mar-2001	10.8	10.8	10.8	7.8	7.8	7.8	10.8	7.8	7.6
Apr-2001	9.9	9.5	9.1	9.2	9.0	8.8	9.5	9.0	5.2
May-2001	4.8	4.0	3.2	5.6	5.2	4.8	4.0	5.2	3.4
Jun-2001	5.8	5.0	4.2	6.4	6.0	5.6	5.0	6.0	5.7
Quarterly Growth Rates									
2000 Q2	6.4	6.4	6.4	9.0	9.0	9.0	6.4	9.0	6.1
2000 Q3	5.8	5.8	5.8	8.9	8.9	8.9	5.8	8.9	4.9
2000 Q4	6.6	6.6	6.6	7.0	7.0	7.0	6.6	7.0	4.6
2001 Q1	10.4	10.4	10.4	12.5	12.5	12.5	10.4	12.5	5.2
2001 Q2	8.7	8.2	7.8	8.1	7.9	7.7	8.2	7.9	5.4
2001 Q3	4.9	4.3	3.6	5.6	5.3	5.0	4.3	5.3	5.1
Growth Rates From To									
Jan-2001 Jun-2001	8.5	8.1	7.7	8.2	8.0	7.8	8.1	8.0	5.5
Feb-2001 Jun-2001	7.9	7.4	6.9	7.3	7.1	6.8	7.4	7.1	5.5
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	6.3	6.3	6.3	9.2	9.2	9.2	6.3	9.2	5.4
2000 Q4 Jun-2001	9.1	8.8	8.5	9.8	9.7	9.5	8.8	9.7	5.3

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

Directive and Balance-of-Risks Language

(16) 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.

(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 ___~~5-1/2~~ 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.