

**Meeting of the Federal Open Market Committee
March 20, 2001**

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., beginning at 9:00 a.m. on Tuesday, March 20, 2001.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Moskow
Mr. Poole

Messrs. Jordan, McTeer, Santomero, Stern, and Stewart, Alternate Members of
the Federal Open Market Committee

Messrs. Broadus, Guynn, and Parry, Presidents of the Federal Reserve Banks
of Richmond, Atlanta, and San Francisco respectively

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

Ms. Cumming, Messrs. Fuhrer, Hakkio, Howard, Hunter, Lindsey, Rasche,
Reinhart, Slifman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Ms. Smith and Mr. Winn, Assistants to the Board, Office of Board Members,
Board of Governors

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

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

Messrs. Madigan, Oliner, and Struckmeyer, Associate Directors, Divisions of
Monetary Affairs, Research and Statistics, and Research and Statistics
respectively, Board of Governors

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

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

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Eisenbeis and Goodfriend, Mses. Krieger and Mester, and Mr. Rolnick,
Senior Vice Presidents, Federal Reserve Banks of Atlanta, Richmond,
New York, Philadelphia, and Minneapolis respectively

Ms. Orrenius, Economist, Federal Reserve Bank of Dallas

Mr. Trehan, Research Adviser, Federal Reserve Bank of San Francisco

Mr. Haubrich, Consultant, Federal Reserve Bank of Cleveland

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CHAIRMAN GREENSPAN. I'd like to welcome Dino Kos to his first meeting as an officer of the FOMC. I tentatively welcome Dave Wilcox, but since he's not legally on board as an officer his welcome goes in escrow! We'll clear that up very quickly though, because our first agenda item is the election of Dave Wilcox as Associate Economist of the FOMC to serve until the first regularly scheduled meeting after December 31, 2001. Would somebody like to move that?

MS. MINEHAN. So move.

VICE CHAIRMAN MCDONOUGH. So move.

MR. FERGUSON. I'll also move that nomination.

CHAIRMAN GREENSPAN. Approved without exception. Welcome.
Would somebody like to move approval of the minutes for the January 31st meeting?

VICE CHAIRMAN MCDONOUGH. Move approval, Mr. Chairman.

CHAIRMAN GREENSPAN. Approved without objection. And now we turn to Dino Kos.

MR. KOS. Thank you, Mr. Chairman. I'm going to continue the tradition of another tall, wavy-haired guy with glasses and refer to the charts that were distributed this morning.¹

CHAIRMAN GREENSPAN. I always thought that you prepared them for him! [Laughter]

¹ Copies of the charts are appended to this transcript. (Appendix 1)

MR. KOS. On the first page the familiar forward rate agreements depict in red the decline of U.S. interest rates over the last few months. After the Committee's January meeting, both cash and forward rates were stable at first but began to decrease as the equity market fell under pressure, with announcements of earnings shortfalls in the corporate sector, and as speculation regarding an intermeeting move increased. That speculation was fueled by the comments of a former Fed official, who in fact started giving precise probabilities of an intermeeting ease. Currently, with the three-month cash rate--the solid red line--already below 5 percent, the market is anticipating further easing beyond any actions that may or may not come from this meeting. And the chatter about a 75 basis point cut at this meeting has coincided with the spillover of weakness from the NASDAQ to the broader stock indices. As of early this week, most of the primary dealers were expecting a 50 basis point easing move at this meeting, though a minority, 10 out of the 25, were forecasting 75. Another measure of expectations, the April fed funds futures, is at about 4.84 right now, though it's difficult to disentangle the degree to which that reflects expectations of a 75 basis point ease at this meeting or a 50 basis point move today followed by an intermeeting move.

Moving to the euro area--the blue lines--both cash and forward rates have been largely stable since the beginning of the year. The European Central Bank (ECB) has been symmetric in its rhetoric, trying to prevent the market from anticipating an early ease and taking what it is calling a wait-and-see approach. But I would note that forward rates began to trade below cash rates around early November, or roughly two months after the same dynamic was observed in the United States. European officials have dismissed suggestions that the market is sniffing out a euro-area slowdown and have explained their forward market as being pulled by movements in the U.S. market. Maybe yes, maybe no. But both forward rates and anecdotal surveys suggest that the market is anticipating 25 basis points of ease from the ECB this spring and a total of 50 basis points by the fall.

In Japan--the set of green lines--we can see that rates basically have made a round trip since last June. The Bank of Japan (BOJ) initially raised rates in August and then pulled back in the last few weeks with two cuts in the discount rate and a cut in the overnight call rate. Then yesterday the BOJ announced a change in its operating procedures; it indicated that it will target current account balances on its balance sheet, possibly increasing its acquisitions of Japanese government bonds (JGBs) rather than targeting the call rate per se. Japanese markets were closed today, so we'll have to

wait for reactions tomorrow in their markets. The call rate is expected to trade near zero.

Turning to page two, this set of charts is an updated version of ones introduced last time as a measure of financial conditions, taking the difference between two-year rates and the policy rates of some of the major central banks. The policy rates of the various central banks involve slightly different maturities; some use an overnight target and some use a target of as much as two weeks. The top panel is the two-year government yield less the central bank's short-term policy rate and the bottom panel is the two-year swap rate less the policy rate. In the top panel we show the German two-year note versus the ECB's refinancing rate. In the bottom panel we used the euro swap rate versus that same ECB rate.

Whether measured against the two-year note where the inversions occurred first or against the swap rate where the inversions followed a few months later, it seems that financial conditions, if one accepts this as a good measure of them, were rather tight by early this year. Now, since the January FOMC meeting, the central banks of Canada, the United Kingdom, and Japan also have eased policy. Only the ECB did not move. But the degree of inversion was broadly similar, as was observed at the time of the last Committee meeting.

Turning to page three, I have shown some of the developments in Japanese financial markets over the last few months. The top panel has dollar/yen graphed on an inverted scale, and you can see that the yen has been depreciating since December and is now in the 122 to 122-1/2 region. The market generally views the policy in Tokyo as desiring a weaker yen, but Japanese officials have been trying not to appear to be encouraging that weakening. But with the Ministry of Finance (MOF) having taken a laissez faire approach, the market is convinced that it is in accordance with their wishes. Nevertheless, the MOF is trying to walk that fine line, not wanting to antagonize interests on this side of the Pacific.

The middle panel shows the decline of JGB yields. That has involved an interesting move from above 1.60 to about 1.15 percent, especially since the finance minister was quoted as saying that the fiscal situation in Japan was on the verge of being "catastrophic." We have seen downgrades of Japanese banks, but at least in the bond market that seems to have been outweighed by expectations that interest rates would fall. Perhaps the market was anticipating yesterday's announcement by the BOJ. And regardless of what we may think of it, the JGB market has been the asset of

choice during periods of stress in Japan. Even at yields of near 1 percent, the carry, with a near zero financing cost, is still fairly profitable. But there's a sizable risk for the banks and the insurers that have loaded up on these bonds, if confidence in this market should falter.

The bottom panel shows the Topix and the Nikkei indices. They are both down between 15 and 20 percent, perhaps not surprising given what has happened in the economy, which I'm sure Karen will discuss later. And with a decline of that magnitude, the topic of bank capital adequacy has come back to the fore, especially with mark-to-market accounting soon to be introduced. But interestingly, the bank sub-index actually has performed in line with the broader average. A widely held presumption is that the government will pump more money into the banks as needed to help with bad debt cleanup.

On page four, the top panel has the euro-dollar exchange rate since the beginning of the year, from the time when this Committee first decreased rates in early January. The interesting point here is the weakness of the euro, which has surprised traders and analysts, given the reduced GDP forecasts for this country, the equity price pressures we've seen, and the reductions in U.S. interest rates versus steady rates in Europe.

The middle panel shows the degree of interest rate convergence over the period since January 1, which is especially notable at the short end. The green line shows the three-month spread in LIBOR between dollar and euro time deposits, which has moved from about 150 basis points to near 20 basis points. The blue line is the two-year swap differential, and that has come down from around 100 basis points to about 40 basis points. The red line, the 10-year swap spread, has been more stable. The less pronounced shift in that measure may suggest that the market perceives the reduced return on dollar assets to be a short-run phenomenon.

The bottom panel charts the value of the U.S. dollar on a year-to-date basis against a range of currencies. As you can see, the dollar has appreciated roughly 5 percent, give or take, against most currencies. That appreciation has occurred despite some of the negatives that I mentioned before. And market participants are puzzled about what might explain it. Among the explanations is that the market may just be getting it wrong, that a mis-pricing is going on. Another is that a V-shaped recovery is being factored in and that the market is looking beyond the valley. A less benign interpretation is that the market is pricing in slowdowns in other

countries that are not yet embedded in economic forecasts. And perhaps, though I'm not persuaded, there's a safe-haven effect going on. The reason I question that is because we have not seen other indicia of a true safe-haven situation, such as a widening of bid-ask spreads or other signs of stress in the market. Whatever the cause, surveys suggest that portfolio managers may be overweighted in euros relative to their benchmarks. So, from a purely technical perspective, the risk for the euro in the near term is that if portfolio managers move toward neutrality, the euro might be in for a rough time at least on a short-term basis.

Turning to the next page, the top panel reflects the lower yields that we have seen in the coupon portion of our fixed income market. The recent steepening of the yield curve is evident; the curve is now the steepest it has been since late 1998. Part of the reason for the short end outperforming the long end is the expectation that policy will continue to ease, to some extent because of a reallocation of funds from equities to bonds, though that's a hard point to get a handle on. But the underperformance at the long end might also be at least in part a reflection of comments made by the Secretary of the Treasury. Those comments raised questions in the minds of some people about the Administration's commitment to the buy-back program, which would affect the long end primarily, since that's where most of the purchases have been focused.

I mentioned the safe-haven or flight-to-quality factor. Again, there doesn't seem to be much evidence yet of a true safe-haven effect, although one area to keep an eye on is the emerging markets. The spread in the emerging market bond index (EMBI) has increased by about 100 basis points in the last month and a half. And as you can see from the red line for Turkey and the green line for Argentina--those are sub-components of J.P. Morgan's EMBI--the spreads have widened as the political situation in those countries has deteriorated. The news overnight that the Argentine finance minister has resigned may or may not help; we'll see. The market reaction so far, at least in early trading, has involved little change in that spread, but I think the message is "stay tuned."

Page six provides an update on the commercial paper market in a chart format you've seen before. The top two panels compare the year-end 2000 spread--in red--versus the spreads in the previous five years for 30- and 90-day commercial paper. The bottom panel depicts the yields so far this year. The California power situation and some downgrades of prominent companies like Daimler and Lucent raised anxiety early in the year, but the amount of outstanding commercial paper has actually declined in the last four

months. The reduction in A2/P2 paper outstanding was sizable, about one-quarter of the total. The good news is that this short-term debt has been refinanced with longer-term maturities and, in fact, issuance of both investment grade and high-yield paper has been running at a fairly strong pace year to date. But it's noteworthy that the A2/P2 spread has remained at a very high level relative to A1/P1, even as interest rates have fallen. So it does create a bit of a conundrum in that the market is willing to lend to some of these lower quality rated companies on a long-term basis but is unwilling to do so on a short-term basis.

Finally, on page seven, a point or two on reserves as we head into tax season. In the top panel the blue bars indicate the actual levels of major tax receipts during the March-to-May period in 1998, 1999, and 2000. The red, green, and orange bars indicate the projections of the New York, Treasury, and Board staffs for those same months in 2001.

In the bottom panel the blue line represents the New York staff's projected level of the Treasury's general balance for the period from March 15th to May 31st. We are forecasting elevated levels of the Treasury's balance at the Fed in late April-early May, to between \$15 billion and \$20 billion. For perspective, this compares to a peak of about \$30 billion last year and an historical peak of \$52 billion during the 1997 tax season. The underlying reserves over the period, assuming that \$12 billion of long-term RPs is rolled over and making a zero assumption for SOMA purposes, are roughly \$16 billion on average. We expect at the Desk to use a mix of term RPs to deal with reserve needs in this period.

Mr. Chairman, there were no foreign operations during the intermeeting interval; we will need a vote for the domestic operations. And I'd be happy to answer any questions.

CHAIRMAN GREENSPAN. The difference in the March, April, and May projections of the New York Bank and the Board staff is really quite substantial. There's a lot of money in that 2 percentage point difference. Have you endeavored to find out which guess is more likely to be the appropriate one?

VICE CHAIRMAN MCDONOUGH. You better say New York! [Laughter]

MR. KOS. I'm sure New York has the right answer! I have not endeavored to find out what the difference is in the models. I can only guess that there might be differences in capital gains projections. Is that the case, Don?

MR. KOHN. I don't know.

MR. KOS. That might account for some of the difference.

CHAIRMAN GREENSPAN. It doesn't matter. It's just that New York is right and we're wrong! [Laughter] I got the message!

In Argentina, Mr. Cavallo is replacing Mr. Murphy, as I hear. I also gather that they've abandoned their austerity program as a consequence.

MS. JOHNSON. I'm going to cover some of these developments in my briefing, so we might want to wait to discuss that. Actually though, I think there is some uncertainty about both of those reports.

VICE CHAIRMAN MCDONOUGH. They're negotiating.

MS. JOHNSON. Oh, Mr. Murphy is definitely out and Mr. Cavallo is in. Originally, Mr. Cavallo had been named cabinet secretary or chief. Now it appears that the current cabinet secretary might stay and that Mr. Cavallo will take the economy ministry post. But my guess is, whatever way it ends up, that he will have broad powers indeed.

CHAIRMAN GREENSPAN. Questions for Dino? If not--

VICE CHAIRMAN MCDONOUGH. I move approval of the domestic operations, Mr. Chairman.

CHAIRMAN GREENSPAN. Without objection. All right, let's go to our chart show, so to speak. It used to be called that.

MR. STOCKTON. Thank you, Mr. Chairman. If you simply picked up the March Greenbook and perused the forecast sheets, I could understand how you might conclude that the staff must have been on an extended vacation--either literally or figuratively--over the past two months. How could all of the events and turmoil of recent weeks have left so few marks on the economic projection? The forecast may leave the impression that we've done nothing during the intermeeting period. Well, let me assure you that it took endless meetings, hours of debate, and reams of computer output to do nothing--an outcome that might support the views of some about productivity in the government sector! But in fact, I would like to make the case this morning that, despite many surprises in the economic and financial data, there were some good reasons for ending up fairly close to where we started out.

Let me begin with the near-term developments, where we have had a considerable quantity of data to digest. On net, those data have painted a stronger picture of the economy in early 2001 than we had anticipated at the time of the January meeting, and we have revised up our forecast of first-quarter real GDP growth from a small negative to a small positive. Among the surprises, hiring averaged nearly 130,000 in January and February, in contrast to our expectation that private payrolls would be about flat over the first two months of the year. Sales of new cars and trucks were running at an annual rate of about 17 million units over that same period, and reports from the automakers suggest that the pace slackened only a bit this month. As a result, light motor vehicle sales for the quarter are likely to exceed our earlier forecast by about one million units. Likewise, starts and sales of single-family homes have been running at higher levels than we expected. And, outside of the residential sector, construction activity is estimated to have soared in January. Even new orders for capital goods, where the anecdotal news has been so bad, rose sharply in January to a level well above what we had been looking for. Finally, the level of inventory investment in the fourth quarter of last year came in about \$20 billion below our earlier forecast, resulting in a downward revision to our estimate of GDP growth that quarter, but also pointing to less of a drag from inventory investment in the current quarter.

On the basis of the reasonably upbeat readings from the labor market and the firmness of some of the spending indicators, a case could be made that we are continuing to underestimate the current strength of the economy. We included such a scenario in the Greenbook, not for purposes of aesthetic symmetry, but because we see some credible upside risks to our forecast.

In the end, however, we were not persuaded that the incoming information has painted a fundamentally stronger picture of the underlying economy. We still view the data, taken together, as suggesting that we are experiencing a sharp slowing in final demands and that the implications of that slowing for production are being amplified by efforts to correct inventory overhangs. As a consequence, we anticipate that manufacturing output outside of motor vehicles will fall nearly 3-1/2 percent at an annual rate this quarter and fall at a 1 percent pace in the second quarter. The size of these declines in factory output point to an offsetting downside risk to our near-term outlook.

Inventory dynamics are likely to play a significant role in shaping the contours of activity in coming months. In the motor vehicle sector, which has figured so prominently to date in the weakness we have seen in manufacturing, some real headway has been made. Through a combination of production cuts, sweetened incentives, and fleet sales, stocks of light motor vehicles have been worked down over the past few months. Of course, fleet sales and, to a lesser extent, the use of increased incentives may just be delaying the full extent of the necessary adjustments. In that regard, we continue to view the automakers' production schedules as too optimistic, and we expect some shortfalls from current plans. But, there is no doubt that the inventory situation in this industry is in better shape than a couple of months ago.

Elsewhere, inventory-sales ratios remain high in a number of industries--most notably machinery, semiconductors, lumber, metals, chemicals, and textiles. As in our last projection, we see the ongoing efforts to achieve a better alignment of stocks to sales as weighing heavily on activity through the middle of this year, knocking 3/4 percentage point off of GDP growth this quarter and 1/2 percentage point off the second quarter.

If the recent spending indicators are indeed signaling greater strength in final demands, that adjustment could proceed more quickly than we are currently forecasting. But I'd have to say that we are not optimistic on that score. As I noted earlier, there are reasons for thinking that some part of the recent strength in motor vehicle sales is transitory, and with consumer confidence and household balance sheets having deteriorated so markedly in recent months, we think consumer spending is likely to be very sluggish in the period ahead. And while new bookings for capital equipment jumped in January, those data are noisy, subject to substantial revision, and appear to contradict widespread reports of weak equipment demand. Moreover, the near-term weakness in the

economy is likely having effects on current incomes, earnings, and sales that should feed back into slower growth of household and business spending into the second half of the year.

All told, we are projecting the economy to limp along at a 1 percent annual rate through the second quarter--a pace that by the summer will have prevailed for three-quarters of a year and will likely have been accompanied by a noticeable rise in the unemployment rate.

We then project a gradual reacceleration of activity that is very similar to that traced out in the January Greenbook. As in our last forecast, the cessation of the inventory correction results in somewhat stronger growth of production. Moreover, we continue to expect fiscal policy to provide a modest boost to demand, and on our assumption that a small portion of the projected tax cut will be made retroactive this year, that boost comes a bit earlier than we had previously assumed. As before, declining energy prices also are expected to help bolster real income growth and corporate balance sheets.

As you know, we have made considerably larger adjustments to our assumed path for the federal funds rate. The baseline path in the March forecast is 75 basis points below that in our previous projection. Despite this substantial change, the growth of real GDP, the unemployment rate, and inflation are not much different than in the January forecast. In our view, a number of powerful forces have been working to offset the stimulative effects of lower short-term interest rates and, in essence, to lower the equilibrium real federal funds rate. To be sure, long rates have come down considerably, and we have seen some of the effects of those lower rates on spending, especially in the construction sector. But other aspects of the financial environment have turned more restrictive.

The largest single factor has been the stock market, which has fallen to nearly 10 percent below our previous projection. I won't pretend to know where the stock market is headed but, taking our forecast for structural productivity growth as a given, the implicit equity premium in this forecast moves up into the vicinity of historical norms. On currency markets, the dollar has moved up even as the funds rate has fallen, and its trajectory is projected to be higher than in our previous forecast. Combined with our downward revision to foreign activity, these changes in our external outlook also have acted to attenuate the effect of policy actions. Factoring in all of these developments, the projected level of real GDP in 2002 is just a touch below our January forecast.

We also saw little reason to change our inflation forecast. The incoming data have generally been on the high side of our expectations, especially for core CPI and PCE. Both of these measures are now showing about 1/2 percentage point acceleration from the same period a year ago. We gave only a small weight to the recent upside surprise in consumer prices, basically leaving our 2001 price forecast unchanged at this early point in the year. With noticeable slack developing in labor and product markets, pressures on wages and prices should begin to diminish later this year. And, with the indirect effects of declining energy prices also relieving inflation pressures, we are expecting core inflation to tail off in 2002.

It is obviously a significant understatement to say that the economy faces some very large risks in the period ahead, some of which are highlighted by the strong crosscurrents in the data. The declines in consumer confidence, for example, appear at odds with the still strong levels of auto and home sales. In our forecast, we have taken the middle ground between these indicators. But we highlighted in the Greenbook the consequences for the economy of a sharp rise in the personal saving rate, such as might result from an increase in precautionary saving accompanying a drop in confidence. All else equal, a 1 percentage point rise in the saving rate could add about 1 percentage point to the unemployment rate by the end of 2002.

We also are uncertain about the extent of any capital stock overhang that may have developed in the business sector. Different models and different periods of comparison tell quite different stories. Our forecast is consistent with some overhang having developed that will depress equipment investment, especially high-tech investment, below the levels suggested by the fundamentals as summarized by our models. But our forecast does not assume that the overhang is large, and growth of investment spending gets back on track by early next year. Again, we tried to give a sense of the magnitude of these risks with a couple of alternative simulations in which high-tech investment weakens to an extent only seen during recessions. Of course, tech investment could weaken even more than this--sometimes the unprecedented does happen--but this seemed like a reasonable starting point. Taken by itself, a high-tech recession causes the economy to grow more slowly than in the already weak baseline. But if that high-tech retrenchment were to be combined with a widely recognized slowing in the pace of technical progress, the accompanying drop in the stock market and

slump in investment spending would be sufficient to create an outright recession.

I think these simulations are useful in gauging the dimensions of the economic consequences of various shocks. But I will readily admit that they also have some serious shortcomings. As I reviewed this set of simulations again over the weekend, I had a nagging feeling that this analysis fails to capture the full range of the risks that confront you. Borrowing a lesson from the risk management literature, I would note that in considering the uncertainties in the economic outlook, it's likely that the unforeseen covariances will create the problems. The interplay between confidence, the stock market, investment, and policy could well be more powerful than the sum of any of these influences taken in isolation.

In the past couple of weeks, we have seen the interrelationship of risks begin to extend beyond the domestic economy and encompass more noticeably economic and financial developments abroad. On that observation, I'll turn the floor over to Karen who, by virtue of her responsibilities for following the rest of the world's economies, probably knows a thing or two about the complications of covariances.

MS. JOHNSON. Developments in the global economy are moving quickly and not always in a welcome direction. This morning I will comment briefly on developments that have emerged since we prepared the Greenbook. They include the latest news from the Bank of Japan, the further upward drift in the exchange value of the dollar, the January trade data that were released this morning, and developments in potential crisis countries.

On Monday, the Bank of Japan announced a set of measures that effectively reinstates the zero interest rate policy and that changes its operating procedures. This move is in response to a growing perception that the Japanese economy is in danger of sliding into recession and that the problems within the Japanese financial sector have become critical. Markets were expecting the return to zero interest rates, but were surprised by the scope of the changes announced by the Bank. The Bank will now implement policy by targeting the outstanding balances that private financial institutions hold with it rather than aiming for a particular overnight interest rate. The proposed increase in those balances from the current 4 trillion yen level to 5 trillion yen should lower the overnight interest rate to zero. In an effort to convince markets that short rates will remain there, and thus to induce lower rates farther

out the maturity spectrum as well, the Bank pledged to keep these balances elevated until year-on-year CPI inflation stabilizes at zero or above. Moreover, the Bank also announced its willingness to purchase additional JGBs, if necessary. With Japanese markets closed today for a holiday, we have few direct readings on market reaction to the announcement. Long-term interest rates, which had moved down to 1.16 percent through Friday, have edged down further in London trading since the announcement.

The move toward additional monetary ease is part of a broad set of initiatives announced by various Japanese officials in recent weeks. These announcements have included plans to achieve a more complete resolution of non-performing loans in the banking system, to put in place mechanisms to provide support for equity prices, and to change taxes and regulatory provisions so as to increase liquidity and trading in the real estate markets.

In the Greenbook forecast, we had anticipated that the return by the Bank of Japan to zero overnight interest rates would come soon. However, we remain somewhat skeptical about the commitment to effective reform by the Japanese government, given contradictory statements by various officials and the lack of strong political leadership, with Prime Minister Mori apparently on the verge of stepping down and no other politician coming forward to lead the reform effort. As a consequence, we revised down our Greenbook forecast for real output growth in Japan this year to minus 1/2 percent. The Bank of Japan's announcement makes us slightly more optimistic. But much depends on how market expectations change and whether other elements of the needed reforms proceed, especially those for the financial sector. Overall, we now see the situation as better balanced, with some upside risk as well as substantial downside risk to our baseline forecast.

The series of disappointing data releases and yet more policy announcements were accompanied by further depreciation of the yen; over the intermeeting period, the yen moved down more than 6 percent in terms of the dollar, with much of that occurring last week and early this week. The dollar gained as well against the Canadian dollar and the euro. On balance, the staff's index of the dollar in terms of the currencies of other major countries has risen more than 4 percent over the intermeeting period. This greater strength of the dollar at a time of significant slowing in the rate of growth of U.S. output and further downward adjustment in U.S. equity prices is somewhat puzzling. One possible explanation is that market participants share our view that the slowing in the U.S. economy will prove to be short lived and that the perceived rate of return on

U.S. assets over the longer run remains relatively attractive. Indeed, the market may be reflecting expectations that ECB officials will be reluctant to ease as their economies slow, further impairing the attractiveness of European assets. There may also be, as Dino mentioned, some safe-haven incentives contributing to flows into dollar assets, as asset markets globally have become more volatile.

January trade data were released this morning. The nominal deficit on goods and services was \$33.3 billion, little different from our Greenbook projection and about in line with market expectations. In January, both exports and imports moved up slightly from December but remained below their fourth-quarter averages. On balance, these data for trade, in conjunction with the balance of payments data for the fourth quarter that we received late last week, would not change our forecast significantly from that in the Greenbook.

Finally, some emerging market countries continue to attract our attention and the attention of markets as well. On Monday, Turkey and the IMF announced the framework of a new IMF program of financial support, following floating of the lira on February 22. The Fund signaled that it has no immediate plans to offer new money. For this program to succeed, difficult policy measures will be required of the Turkish authorities. Without serious effort by them and the maintenance of confidence on the part of private creditors, there is a risk of failure. Currently, markets seem to be awaiting more information about the specifics of the program.

In addition, Argentina is again experiencing political stress related to its economic policy agenda. Last Friday, Economy Minister Lopez Murphy announced a set of fiscal measures that implied serious fiscal restraint in order to come close to the performance criteria established in Argentina's IMF program. This announcement triggered the resignation of several members of the cabinet who represent the left wing of the coalition. Since then, former Economy Minister Domingo Cavallo has agreed to join the government, while last night Lopez Murphy resigned after only two weeks in office. The implications of these moves for the course of policy remain uncertain, although it may be that the fiscal restraint will be lessened. On Monday, S&P put the ratings of Argentine borrowers on credit watch with negative outlook, and asset markets reacted adversely. Both the political risks and the economic risks in Argentina remain high.

We'd be happy to answer any questions.

CHAIRMAN GREENSPAN. Questions for our colleagues? President Parry.

MR. PARRY. Karen, I'd like to ask two questions about Japan. The first is, does the change announced by Japan indicate that in terms of policy they're embracing some form of inflation targeting? Secondly, about a month ago there was some discussion, in the press at least, indicating that if Japan reverted to its previous policy of zero interest rates, Hayami would be forced to resign. I haven't heard anything about that in the last few days. I wondered if you could comment on both of those elements.

MS. JOHNSON. I think they came as close to inflation targeting as they could comfortably, given what they had said publicly not too long ago about it being inappropriate at this time. I see the announcement in some sense as a grand compromise, an attempt to be a little something for everybody. The people who have been advocating inflation targeting or other kinds of expectations adjustment steps got a statement that reserves will remain at this elevated level until deflation had ceased, until it is at zero or slightly positive. So that is implicitly, I think, an inflation target of zero or a small positive number.

MR. PARRY. Right.

MS. JOHNSON. Had they announced a higher number, I think it would not have been credible. So in my view they made a reasonable compromise on that score. Those people who have been arguing for some kind of liquidity-based, unconventional steps got a switch to reserve targeting instead of the current policy of interest rate targeting. They got promises that the government might indeed buy more JGBs--not a commitment, but at least an open door to that idea. So the people who have been pushing

in that direction got a signal that the government is prepared to do that and will in fact be doing that to some extent.

So the answer to your question is yes, but not exclusively. They have shown flexibility to all of these options that have been in the air now for so long. But as they pointed out themselves, and as I think is understood by most of the people in Japan, these steps are not in and of themselves going to move the Japanese economy into recovery. They will facilitate the success of other measures, but they are not sufficient by themselves to bring about a real turnaround.

In that vein, the talk of Hayami having to resign if Japan moved back to a policy of zero interest rates seemed to have evaporated about a month ago. I have not heard any suggestion that his resignation is imminent. In fact, the talk that they were reluctant to make that move because it would lead to his resignation is now all in the background. That may be because of the increased urgency we've seen in these various announcements in the past month or so and the heightened perception of the trouble they're in.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I have a couple of questions, Karen. One is a follow-up on President Parry's. I've wondered for some time in the case of both Argentina and Japan how one can know when, from the perception of the best policymakers in those countries, the situation has gotten bad enough to trigger action. In looking at this, my thought was that it's not bad enough yet because they think they have a lot of options available to

them. I heard you as still expressing skepticism that in their eyes it is bad enough yet to fix.

MS. JOHNSON. It's a skepticism about their ability to accomplish it, not about their perception that it's necessary. I think the biggest problem facing Japan right now is political. They are simply politically very weak. The LDP doesn't seem to know what to do. There are a few persons in the past six months or so who have articulated some strong views but they do not seem to have been able to build a sufficient political base to carry the day. The fact is that Prime Minister Mori is still in office. There is talk about moving up the day on which somebody else will take over the LDP but then denying that that's a resignation. The issue of the upper house election in July is a kind of hurdle for the party. If they had a strong person, they would have dumped Mori and put that person in. There's a vacuum of political leadership, not a lack of awareness of what the problems are. The LDP is not in a good position in the sense that the problems that need fixing are basically in the areas of the private sector where they have gotten their greatest support over the years. Let me add a footnote to what I just said. I think the leaders of Japan understand. I don't think they believe the people they rely on--the businessmen and the local officials--understand. The leaders believe that if they take the steps necessary, those people will not support them, maybe out of pure self-interest or maybe from a lack of awareness. So they are caught because they can't turn on their own supporters until everybody understands that that is the only alternative, and they aren't quite there yet. At the level of public officials, the problem is more a lack of political will than anything else. Our giving them a carefully reasoned argument isn't going to change anything. That is not the problem.

MR. JORDAN. Well, that's what I mean by "Is it bad enough to fix yet?" I think somebody once said that if you have no options you have no problem. They apparently still think they have a lot of options, as far as dealing with their people and getting the people to buy into a solution.

MS. JOHNSON. I have been in Tokyo very seldom and I don't pretend to have close contacts, but it's certainly my impression that the population in Japan does not act as if the country is in crisis. They do not act, after 10 years in which these problems have plagued the economy, as if they are prepared to do anything in an effort to solve them. They get up and go to work. They seem resigned to the present situation and not terribly unhappy with it. So in that sense I think your point is valid. But I read into the events of the past two months a heightened awareness of the bigger picture on the part of the people who are in a position to do something. They understand that the financial sector was put at such huge risk by the declines in the stock market. They understand that there is a serious probability that the economy will slip into an outright recession again, which would put further pressure on asset prices and could cause a real financial crisis. I think that awareness is not generally appreciated. Both the insurance companies and the financial intermediaries have very serious problems. A further downward movement in stock prices is only going to aggravate those problems. There is an urgency here. But you are quite right that the man in the street does not seem to feel that sense of urgency.

MR. JORDAN. Okay, that's helpful. The other question has to do with exchange rates because you suggested a hypothesis to me that I thought was very interesting. What I heard you saying is that expectations that the Federal Reserve either

has or will ease enough to stimulate a stronger recovery, combined with expectations that the ECB has not and will not ease sufficiently, cause the dollar to be stronger and the euro to be weaker.

MS. JOHNSON. But only maybe!

MR. JORDAN. Okay, but I know that doesn't show up in any textbook.

MS. JOHNSON. There is no interest rate arbitrage condition that is going to give you that one!

MR. JORDAN. So I'm wondering whether that reflects some serious rethinking about the factors that determine exchange rates over time.

MS. JOHNSON. Yes, I suppose. We've actually done some research on that. We've taken a sort of kitchen sink approach and put everything we can think of on the right hand side of the equation and sorted through the most recent data. It did not yield any real breakthrough. It didn't give relative growth rates quite as much of a major role as one might have thought, although the usual things appear in that equation. Our research did not suggest that we have to throw out all we think we know, but the data didn't fit very well either, frankly.

CHAIRMAN GREENSPAN. Have you tried a coin? [Laughter]

MS. JOHNSON. I'm a bit reluctant to get entirely on this relative growth bandwagon, even though I think market participants see the ECB's constant statements that they are somehow not very vulnerable to the rest of the global economy--that they're going to do just fine and therefore don't need to ease--as worrisome. I believe that's weighing on the euro, and that's why I put that sentence in my remarks. But you know, up until a year ago we all thought a primary factor was relative stock markets. The talk

was that somehow once the U.S. stock market began to go down, that was going to be a major event for the dollar and, in fact, that was perhaps the biggest reason to worry about the stock market. Never mind the economy, never mind the wealth effect, a decline in our stock market was going to cause this enormous disruption in exchange markets. We all believed that until it didn't happen. So it makes me a little leery of getting too enthusiastic about this notion that relative growth is really the story. There is a kind of market confidence, in a long-term perspective, with respect to investing in the United States as a business opportunity that dominates other business opportunities. Japan certainly doesn't offer that opportunity and apparently Europe doesn't offer it. And in this game of there being only three major currencies, that notion seems to prevail despite cyclical events.

CHAIRMAN GREENSPAN. Karen, is it possible that the change toward the United States and the dollar occurred much more slowly than the underlying productivity acceleration implied? Could there just be a lag effect here in the sense that a lot of the capital investment coming into the United States, specifically direct investment, is really a stock adjustment catch-up? It may reflect where the rest of the world, specifically Europe, would like to have been relative to the United States. Since there is somewhat of a physical limit on how much money one can move at any particular point in time, is it at all credible that what we're looking at here is what we would find in a stock adjustment model? Perhaps that capital inflow is reflecting the fact that the desired level of investment is still above the actual level. In other words, even though the desired level is now falling, it may still be above the actual level.

MS. JOHNSON. That certainly could be. The fact is, even though the volume is reduced, that we still have a plateful of merger and acquisition announcements and so forth on the table. In that vein, we received one unexpected bit of information from the fourth-quarter balance-of-payments data. Many of the elements of the data are already known before the actual tables are produced, but we don't know anything related to direct investment. And one surprise out of the fourth-quarter data was a big reduction in the flow of direct investment payments abroad. That is, people holding direct investments in the United States took a real beating in the fourth quarter and got much less income than they might have expected from their investments. That's no doubt reflective of where the U.S. economy was in the fourth quarter and, hopefully, it will bounce back. But if that's a big part of the picture and earnings that people make on their foreign direct investments in the United States disappoint again, that could produce some changes.

CHAIRMAN GREENSPAN. You mean if the earnings fall, the capability to repatriate into another currency goes down and the dollar is therefore under less upward pressure?

MS. JOHNSON. Well, I'm just thinking that in retrospect some people--the Japanese no doubt--didn't really think some of the investments they made in this country in the 1980s were such a good idea. And it's possible some of the Europeans will come to that view about the 1990s.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. I have a couple of questions for you, David, and I'd like you to look out a little beyond the forecast horizon. You commented on the alternative

scenario with a more aggressive reduction of the funds rate. I know you have projected the inflation rate out to 2002 under that scenario and I'd just like to get your impressions of what it might imply for 2003.

My second question has to do with the effects of such a policy on construction activity, given the comments in the Greenbook and in your statement about that sector. Banks in our region are beginning to lend more aggressively on real estate. If we were to pursue that more aggressive policy easing, would that perhaps have the effect of pushing the yield curve down? If that lowered the capitalization rates on real estate, we could see a fairly dramatic shift of funds into that sector as people look to deploy their assets, which might cause some--for lack of a better word--overbuilding in the real estate area. If construction takes off as implied or real capitalization rates fall, what effects do you think that might have down the road?

MR. STOCKTON. On your first question about the easier monetary policy scenario in the Greenbook, as you know, even in that scenario the unemployment rate still rises to nearly 5-1/4 percent by year-end and to just a little below 5-1/2 percent by the end of 2002. We don't see much disinflation benefit from that rise in the unemployment rate because according to the model--which as we've already discussed is a little weak in this particular area--the depreciation of the exchange rate that accompanies the more aggressive easing of monetary policy offsets the disinflation benefit somewhat. But beyond the 2002 period, unemployment would still be a bit above our estimate of the sustainable rate, and we'd probably see some very mild downward pressures on inflation in 2003. In our forecast, we have a slight upward tilt to our natural rate assumption because without any further acceleration of productivity there's a

tendency for the natural rate to rise. So we wouldn't get a lot of disinflation beyond that projected but we wouldn't see inflation pressures either.

Now, in terms of the more aggressive easing scenario and its potential to create some overbuilding in the real estate sector, that certainly is a possibility. It's very difficult for me to forecast the errors that banks might make, but they certainly have traditionally made those kinds of errors in previous long periods of economic strength. Moreover, real estate prices have been quite firm and construction activity has remained very strong despite the weakening we've seen in the stock market and the slowing we've had in output growth. So, with further easing, I think there would certainly be risks on the real estate side.

MR. HOENIG. Thank you.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I'd just like to make a comment on some work we've been doing in New York on the mysteries of the exchange rate. Rather than go to the textbooks to try to figure out why the exchange rates were behaving as they have been, we attempted to look at what had actually happened for an explanation. If we go back to 1970, say, and look at the fundamentals, the purchasing power parity tends to lumber along on its predictable path. But there are two periods of multi-year trends that don't seem to have an immediate explanation--the weakness of the dollar in the 1970s and the strength of the dollar in the latter part of the 1990s. And what seems to fit very well for those periods are the differentials in productivity. Forgetting the yen for a moment and just looking at the synthetic euro in the '70s and the real euro in recent years, the differential was very much in favor of Europe, as productivity in our

country began to collapse in '73 to a 1-1/2 percent annual rate. In the latter part of the 1990s the differential in productivity, as we well know, has been very much in our favor. That factor seems to provide a very good explanation of why the trend line in the dollar was down, especially in the mid- to late 1970s, and up since 1995. I think the market came to realize the importance of productivity rather late. In 1996-97 we were thinking that something different was happening and it looked as if it was productivity, but we weren't out making speeches saying that there's a productivity revolution going on in the United States. It has been only since that time that the market at least has become comfortable with the notion that the productivity change is very important. We, the Federal Reserve, are deemed to be quite expert in this area and because a number of us--including you, Mr. Chairman--have been saying that we believe the higher productivity trend is still in place, I think that gives some underlying strength to the dollar.

The other factor that seems to fit reasonably well in explaining shorter trends in currencies seems to be market expectations of growth rate differentials in the next six months. I don't mean what actually happens, but what people say they expect will happen over the next six months. That seems to give us a fairly good fit for shorter-term moves in the exchange value of a currency. So, we believe the productivity differential has given the dollar a very strong lift against the euro since 1996-97, and the expectations of stronger growth in this country have helped until recently. Now the question is, why do people currently think that the growth rate in the United States is likely to be firmer fairly soon and sooner than in Europe? I think there are a couple of reasons. Even though financial market participants are expressing much gloom, as Dino pointed out, they are behaving as if a V-shaped recovery or a U-shaped recovery with a very short

bottom is what they are anticipating. In Europe, people seem to feel more and more that the leaders of the ECB are living in a bit of a dream world. People see the economy weakening but, with ECB officials making statements that everything is all right, the perception is that the ECB is not in touch with reality. That may or may not be true, but I think that's a growing market perception.

Another relevant factor in the fairly recent past is the importance of the agricultural sector in those European countries. As a share of GDP, agriculture really isn't very important, but in the psyche of the society it's immensely important. If you had lived in Paris as I once did or in London as I once did, you would have thought you were in the middle of a farm economy. Agriculture's effect on the way people think, and on their confidence and sense of well being, is extraordinarily large--much larger than seems warranted by its share of GDP. And I think the malaise about the foot and mouth disease, spreading as rapidly as it is, has pulled down business and consumer confidence to a remarkable degree and that, too, is being reflected in the exchange rate differentials.

CHAIRMAN GREENSPAN. How does that explanation square with, let's say, the peak in the value of the dollar in February 1985, after a big run up, and the subsequent big run down?

VICE CHAIRMAN MCDONOUGH. It doesn't. That looks like an aberration that doesn't have an explanation on the basis either of the fundamentals or of either of the two factors I've cited. We can't find anything to explain that except an enormous market overshoot.

CHAIRMAN GREENSPAN. And the productivity differential, of course, is actually a real rate of return differential.

VICE CHAIRMAN MCDONOUGH. Exactly.

CHAIRMAN GREENSPAN. Which is sort of a standard. Indeed, that's essentially what Karen was arguing is going on at this particular stage.

VICE CHAIRMAN MCDONOUGH. Yes.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I wanted to follow up briefly on David Stockton's response to Tom Hoenig's question. One of the alternative simulations you typically included in the Greenbook last year was a lower NAIRU. I'm not a big fan of the NAIRU as a way of finding out what the inflation rate is going to be, but if you continued to provide that alternative simulation with easier monetary policy, what would that say about inflation?

MR. STOCKTON. There would be a significant disinflation built into the system. Even with that easier monetary policy, you would have to ease even more aggressively. We took that simulation out this time, not because we thought it was any less important than it has been in the past but because we were concerned about presenting too many simulations here. But that scenario basically suggested that at least another 100 basis points of ease would be necessary just to get the economy on the right track. That simulation would still show inflation running a little above 1 percent on our baseline funds rate assumption by the end of 2002.

CHAIRMAN GREENSPAN. Any further questions for our colleagues? Yes, President Poole.

MR. POOLE. David, I have a question about the saving rate. I'm sure that some of this internal debate you spoke of had to do with the saving rate. Perhaps it's a little below zero, but let's just assume it is zero for the moment. It's a lot easier to

imagine it going to plus 4 than to minus 4; there's a sort of asymmetry built into that situation. If the stock market returns to more historical norms of behavior, why shouldn't we expect the personal saving rate to go back toward historical norms?

MR. STOCKTON. Well, it depends on what you mean by historical norms. If productivity growth were to return, let's say, to the 1 to 1-1/2 percent rate that we experienced for a significant period of time, that would be associated with a very substantial decline in the stock market and a more substantial rise in the saving rate. The saving rate could perhaps move closer to historical norms than we're assuming in our forecast. When I said in my briefing that we had the equity premium in this forecast moving back toward historical norms, I said "given our assumption for structural productivity growth"--or words to that effect--which is significantly above the norm of the last 20 years.

MR. POOLE. But productivity growth from, say, 1948 to 1968 or 1973 was not all that different from what we're looking at today, yet the saving rate back in that era was much, much higher.

MR. STOCKTON. Yes, but we've seen changes in the longer-term trends in some components of income. For example, transfer income, which involves a much higher propensity to consume, is a larger share of income now than it was in the 1960s. It can explain some of that longer-term decline in the saving rate. It's clear that the saving rate could still have a fair ways to go on the up side. One other point I would make is to caution you not necessarily to take seriously the current published level of the saving rate. That often is revised by a significant amount at times of annual revisions. We revised down the level of the saving rate in this forecast in large measure because we

think BEA is using numbers for taxes this year that ultimately are likely to be revised down. They're more optimistic about--

CHAIRMAN GREENSPAN. It's reconciled to the flow-of-funds numbers, which obviously are not fully independent but still show pretty much the same trend.

MR. STOCKTON. Yes, indeed. We're talking about \$15 billion or so here.

CHAIRMAN GREENSPAN. Well, there's another possible explanation of this problem, which we're in the process of trying to evaluate at this point. If we look at the significant decline in the saving rate on the national income and product account definition by using flow-of-funds data--remember this excludes capital gains--what we find is not that net assets go down. In fact, they're pretty much stable. What's causing the saving rate to go down in an accounting sense is the very dramatic rise in debt, and that's virtually all mortgage debt. What is different about the earlier period versus the current period is the number of financial vehicles that enable the extraction of equity out of homes, such as home equity loans and cash-out refinancings. And by far not the least source of equity extraction is funds that become available as a consequence of the turnover of existing homes. The use of all of those vehicles is significantly higher in this recent period, enabling the normally unrealized capital gains to be either realized or converted to cash through the mortgage market. The problem with this explanation--and it could explain the whole issue--is that it is not necessarily consistent with a decline in the saving rate based on equity wealth. But it is consistent if one argues, which we can, that the extraction of equity from homes is a function of the unrealized capital gains in the stock market. Now, that's a credible sort of portfolio balancing argument, but it's a bit of a stretch, if I may put it that way. So, until we can understand the actual

relationship between the equity extraction out of the mortgage market and its effect on the saving rate and reconcile that to the capital gains in the equity market, we're not going to be able to answer the question you raise. And I think it is a really important question.

MR. POOLE. That might be the mechanism, but that doesn't tell us whether it's really sustainable in the long run to have such a very low saving rate.

CHAIRMAN GREENSPAN. Indeed.

MR. GRAMLICH. I've been worried about the saving rate, too. Dave, you said something that at a minimum may cause me to revise a comment I was about to make in the go-around. The personal saving rate is now negative .8, and by the end of the simulation period it goes up to plus 1.6--a 2.4 percentage point turnaround. Is any of that a change in the data or is that all behavioral?

MR. STOCKTON. The change is behavioral.

MR. GRAMLICH. The change is all behavioral?

MR. STOCKTON. Yes, it's behavioral. Also, we don't have the wealth-income ratio going back to the levels where it had been earlier. So, even within the simple framework that we used, there would be reason for the saving rate to remain below its historical norms. That is just another factor. The saving rate has fallen more in recent years than can be explained by the factors that we think drive it. So there is still a potential--which I assume is your point--for some upside risk associated with the saving rate and the levels that we're projecting if whatever caused that saving rate to decline reverses itself going forward.

CHAIRMAN GREENSPAN. Further questions? If not, who would like to start the roundtable? President Parry.

MR. PARRY. Mr. Chairman, economic growth in the West has undergone a notable retrenchment this year from what had been a very rapid expansion. However, revised data now put Twelfth District job growth for last year at 3-1/2 percent, making it the fifth consecutive year of growth at 3-plus percent. But this year, tangible signs of slowing are evident on a number of fronts. In high-tech--beyond the direct effects of the return to reality in the dot.com sector, which are modest--softening is apparent in manufacturing. Across product lines we see producers cutting investment plans and reducing jobs as they transition from their considerable optimism in the year 2000 to weaker demand this year. The shakeout among Internet firms continues to have some impact on commercial real estate in tech centers, though office markets are basically sound. Residential markets are mixed, with some pickup in permits. However, price performance outside of California and Hawaii is somewhat weaker. In coming months, home prices likely will be affected further by the decline in stock prices and withering options values, especially in California where exercised options accounted for about 13 percent of wage and salary income in 2000.

The energy situation remains a distinct negative. For natural gas the most extreme example of price hikes is the 150 percent increase over the past year for customers of PG&E in northern California, more than twice the national average. Regarding electricity, milder weather has brought down wholesale electricity prices in the West, though on-peak spot prices still are more than five times higher than on the East Coast. In California, power outages this summer seem inevitable unless we see at least a

10 percent reduction in usage. This inevitability was dramatically illustrated by the rolling blackouts experienced yesterday. Also, average wholesale costs in the West will be high again this summer since a good deal of the states' power will be bought on the spot market to cover peak usage. However, rate payers in California continue to be shielded from the high wholesale prices, with the State buying most of the power and accumulating the undercharges. We estimate that a full pass-through of wholesale electricity costs would mean another 70 percent rate hike.

CHAIRMAN GREENSPAN. That's seven zero?

MR. PARRY. Yes, 70. Data on the recent performance of the national economy have been mixed. Job growth, for instance, has held up better than we had expected. On the other hand, the industrial sector is contracting sharply. Overall, the recent data have been roughly offsetting, resulting in no change in our forecast that the economy will grow at a rate of 1 to 1-1/2 percent over the first half of this year.

By contrast, recent developments in the financial markets are more negative for the longer-term outlook. The lower stock market likely signals slower growth in spending. And the stronger dollar, which is probably a reflection of worsening conditions in some key foreign economies, could slow our output growth. In response, we have lowered the assumed funds rate path by 50 basis points. As a consequence, our forecast of output growth beyond the first half of the year is just marginally lower than it was last time. We now expect the real GDP growth rate to come in at 2-1/2 percent in the second half of the year and almost 3-1/2 percent in 2002, as the positive effects of the recent technology shock gradually reassert themselves.

Since output growth in our forecast remains below potential throughout the forecast horizon, labor market tightness is eliminated by late next year. That helps to contain inflation. Core PCE inflation is projected to come in at 2 percent this year and just a bit lower next year. Despite the assumed reduction in the funds rate, I must admit that we still see downside risks to the economy. My concern is based in part on the recent declines in consumer confidence surveys. Some recent work by our staff shows that these surveys may provide useful information about contemporaneous conditions before other data on the economy become available. This concern is reinforced by the recent behavior of the stock market. Taken together these expectations-based indicators suggest that many households and businesses expect to see an economy that is weaker than in our forecast. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. The pace of economic activity in New England is slowing, but by a number of measures it continues to grow and to grow at a faster rate than in the rest of the nation. Nonetheless, most contacts indicate a sense of concern about the future. Consumer and business confidence is off, and many contacts note that credit market tightness is affecting spending plans. They report a new emphasis on contingency planning and a concerted focus on increasing productivity and reducing costs.

Benchmark revisions to state employment data this January indicate that the region's job base grew faster than previously estimated and faster than U.S. employment over the same period. While these benchmark revisions are based on complete data only through mid-2000 and thus do not incorporate data for the last two quarters of the year,

they are consistent with other indicators. In particular, regional unemployment rates continue at a series low, with Connecticut experiencing the lowest state jobless rate in the nation. Initial unemployment claims have moved sideways rather than upward, and help wanted advertising, while volatile, remains at a level that suggests reasonably strong labor demand. In addition, the manufacturing workweek in January was an hour longer in New England than in the rest of the country and the growth rate of manufacturing wages has increased as well. Anecdotally, contacts continue to note tight labor markets as a particular concern, though high-tech employees may now be easier to find.

One reason why New England may not be experiencing the job woes of other parts of the country may be that the region's manufacturing industry mix is less concentrated in the auto and steel business and more oriented toward electrical equipment and industrial machinery--industries that are both adding jobs. Indeed, a majority of the Bank's Beige Book manufacturing contacts reported growth in sales and orders, though many noted some areas of weakness or were making contingency plans in case business softens.

Finally, fourth-quarter merchandise export data reinforce the pattern shown more broadly in employment. The dollar value of exports has risen more in New England than nationally, and individual manufacturing industries--electrical equipment for one--are holding up particularly well.

Beyond the job picture, other aspects of the region's economy retain vibrancy. In particular, real estate markets remain tight, especially in the Boston metropolitan area. Some foresee a softening in commercial real estate as failing dot.coms seek to sublet space no longer needed. But the forecast of commercial real estate conditions suggests

that space will be filled rapidly by firms that have been space constrained in the last several years. Indeed, rents have not softened and while a good deal of commercial building is under way, nearly all of it is fully committed.

So, the recent pattern of economic growth continues in Boston particularly and in New England more generally. But there are warning signs. Business confidence slumped in February after having fallen sharply in December, though the index still remains above 50. Consumer confidence also fell. In line with national trends, the drop is largely related to expectations about the future.

The recent sharp corrections in technology stocks and warnings about earnings do not bode well for growing regional technology employers like Cisco, Intel, and EMC. And Massachusetts state withholding taxes and sales tax revenues have been relatively weak. Thus, contacts repeatedly stress a sense of caution about economic conditions.

The Bank's Small Business Advisory Council met last week and I was again struck by the cautionary approach being taken even by firms that believe themselves relatively recession proof, like Most have had spending plans curtailed by tight credit markets and face the increasing pressure of major customers like Wal-Mart reducing inventory levels and demanding price cuts. Of particular note in the discussion was the focus on efforts to increase productivity and reduce costs. Sometimes that involves the use of new technology. But in the context of tighter credit markets and slowing cash flows, the focus mostly was on using existing technology better and working "harder and smarter" in many ways, big and small.

Turning to the nation, I am sure I'm not alone in being surprised by the degree to which current consumer spending on big ticket items such as cars and houses is at odds

with measures of confidence about the future and with the wealth effect of the declining stock market. Certainly, given the gloom and doom atmosphere on Wall Street and the media hype about--as well as the reality of--major layoffs, one would expect consumers to be increasing their savings, paying down debt, and reducing big purchases more than seems to be the case right now. Perhaps a larger retrenchment will occur, but the continuing strong picture for employment and income growth suggests that it might happen later rather than sooner.

In that regard, I recently attended a meeting of the policy board of the Kennedy School, Harvard University Joint Center on Housing Studies. The group includes prominent national residential builders and major suppliers of building materials. In the go-around, the large national builders noted some regional weakness, but for the most part indicated that they expected 2001 to continue along the lines of 2000, which had been one of their best years ever. These builders had a sufficient backlog of orders to be relatively confident about 2001, though 2002, of course, remains a question. Building materials suppliers, in contrast, faced excess supply conditions, consolidation within their industries, and falling prices.

Reflecting stronger current consumption data we, like the Greenbook, have revised our GDP forecast upward slightly for Q1, but our projection for 2001 remains about the same as earlier and quite close to that of the Greenbook. This similarity in outcome hides a number of differences in the numbers underlying the forecasts, but only one is significant. We remain less persuaded than the Board's staff that 4 percent is a good estimate for long-term potential growth. Thus, our estimate of the rise in the unemployment rate over the year 2001 is about half the 100-plus basis points projected in

the Greenbook and we see measures of inflation flattening out in 2002, not declining. Indeed, some on my staff find it hard to believe that unemployment could rise as much as in the Greenbook forecast--140 basis points or so from its current level over a couple of years--without a much bigger impact on demand, confidence, and a host of other things. And those developments, in turn, would necessitate much more policy ease.

Clearly, there are reasons to believe that the risks either to the Greenbook forecast or our own slightly different projections remain on the down side. The stock market deterioration, the foreign outlook, low readings on business and consumer confidence, high levels of consumer debt, the slowdown in manufacturing, and the seemingly endless supply of bad news in the high-tech world all feed into these risks. But I think it's also important to remember that we are experiencing a very rapid slowdown from an extended period of extremely rapid economic growth. In part the gloom and doom--earnings warnings, layoff announcements, and delayed new plant investments--reflect an adjustment from that period of robust growth. That could get out of hand, it's true. But for now, labor market and spending indicators suggest that gloom and doom should not completely rule the day.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. Sometimes it's hard to know whether an anecdotal report was intended to be good news or bad news. One of our directors recently reported that he had gone to a boat show and was told that they had sold only nine personal watercraft or jet skis this year compared to over a hundred last year. I said "That's great." Then he told me that he had bought one of the nine! [Laughter] But that report, together with a Wall Street Journal story about how well the

travel and boat show in Columbus had gone, prompted us to call around the country to find out how strong sales had been at travel and boat shows in January and February. And they were surprisingly strong. In Cleveland the attendance was higher than last year and better than they had expected. Large boat sales were about the same as last year and small boat sales were stronger, which surprised the dealers. In Chicago, Detroit, and St. Louis, the attendance also was better than last year. Only the New York show experienced a small decline in attendance, and our contact said it was because of adverse weather conditions during the week of the show.

We also saw some stories on corrugated paperboard producers, first in the Wall Street Journal in February, and subsequently in Cincinnati and Cleveland newspapers. So we did something the journalists probably would consider a dirty trick: We called the same companies, often reaching the same individuals quoted in those stories, to inquire about conditions in that industry. And most of them disavowed the way their stories had been portrayed in the articles. They said the situation wasn't nearly as bad as had been reported, though perceptions about how fast conditions were improving appeared to differ somewhat. Most noted a marked increase in sales in March relative to the first two months of the year, and none of the manufacturers we contacted expected a decline in sales for the year.

More generally, the reports of directors and advisory council members are as mixed as the data we have been observing. There are pockets of strength and pockets of weakness. In the case of large truck and steel manufacturers, there is severe weakness that is expected to last for a couple of years. But interestingly, LTV, which is in bankruptcy and starting last November had laid off 600 people, already had recalled 400

of those workers by early February. They now have 200 former workers who have not yet been recalled or are reapplying for lower-paying jobs.

While the general picture in manufacturing is one of weakness, exceptions include such firms as air curtain manufacturers, which reported a record backlog of orders--and interestingly, I thought--a manufacturer of hot tubs and patio furniture. The latter reported a strong rebound in sales recently. Specifically, our contact at that firm said that in late September-early October orders hit a wall and simply stopped. He described the autumn months of 2000 as the worst period he had experienced in the business. Those horrible months were followed by a flat December and then in January and February the company had a huge increase--40 percent year over year--in orders for hot tubs and patio furniture. And this is a firm that has been growing 20 to 30 percent a year for the last five years.

Another company that is headquartered in the District but manufactures and sells nationwide reported that while orders for construction materials generally had been down in recent months, orders for decking and siding materials were at record levels in December and January. They complained about energy costs, of course, but they said demand was out there. But even the energy sector is mixed. A director reported that a traveler in eastern and central Kentucky, where they produce coal and gas, will see a lot of celebratory high fives.

Construction in the region also is mixed. Public sector infrastructure spending is still very strong; another record year for orange barrels is expected. The residential construction sector is described as good, but the commercial sector is mixed. There is strong demand for warehouse space, which is in short supply, but industrial construction

spending is off significantly and is expected to stay depressed. People in the health-care industry report that it's still difficult to hire workers. They are still using recruitment bonuses and retention bonuses and they say that cost pressures are going to be passed through to health-care premiums in the period ahead.

We looked at all the leisure sectors--the recreation, travel, tourism, and entertainment businesses--and again found a mixed picture. There were reports, however, of significant overbuilding of restaurants, very low occupancy rates in hotels and motels, and some movie theater chains that have overbuilt and will have to retrench.

As for the national economy, it now seems reasonably certain to me that the economy did not continue to slow in the first quarter as it did over the fourth quarter. And I think the Greenbook generally has the direction right in its forecast of real output growth, though I won't go along with the staff on the unemployment numbers. I have to figure out why I don't go along with that projection; it just doesn't look right to me. Maybe it's the sort of thing that Cathy suggested--that some other developments would occur if that employment pattern begins to materialize.

Some of you may have seen the February survey of the National Federation of Industry and Businesses that was released last week; their index of small business optimism rose in February. I was especially interested in noting that capital spending plans had rebounded strongly and also that there was a decline in the percentage of firms reporting that they had raised or planned to raise prices. The survey also indicated that credit availability was not a problem. Of all the things we look at, it appears that access to credit is not a problem confronting this economy.

If the pace of economic activity of the last quarter and this quarter were likely to persist, then the current funds rate probably would be too high. But it's not at all clear that the current funds rate would be inconsistent with the pace of economic activity that the Greenbook projects for the second half of this year and 2002. The steep inversion of the yield curve, especially for maturities under one year--with the one-year bill rate now even lower than the two-year rate--on the surface does suggest some restraint. But the explosive growth of the various measures of money and credit does not.

On balance, I think our national network of directors and advisory council members have served us very well during this whole episode. They assured that our recognition lag was very short in the fourth quarter. We did act promptly, I believe, and we acted substantially. And now I think our attention is going to have to turn to the question of when it will be time to pause and let the effects of our actions and the inherent resiliency of this economy start to work through. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. Incoming data suggest that the slowdown in economic growth is continuing in our region and in the nation. Neither the District nor the nation appears to be slipping into recession, however, and there are signs that conditions have improved since the turn of the year. Still, in my opinion the risks remain squarely on the down side.

Conditions in the Third District are similar to those reported at the time of our last meeting. Manufacturing is the key source of weakness in our District as well as in other regions. Our Business Outlook Survey for March shows that manufacturing activity is still declining, albeit at a slower pace than earlier in the year. The indexes of

general activity, new orders, shipments, employment, and the average workweek were all negative. Still, manufacturers were not entirely discouraged, as suggested by survey indicators of future activity that were mostly positive. Respondents expected general activity and shipments to pick up over the next six months; moreover, their outlook has improved somewhat since earlier in the year. Capital expenditure plans are relatively weak, however, suggesting that respondents do not expect the improvement in manufacturing to be strong enough to spur general increases in capacity.

We have seen a modest improvement in retail sales in our District. January sales tax collections in Pennsylvania indicated that a slowing around the holiday season at the end of last year has been reversed in the beginning of this year. Some retailers have expressed concern that increased consumer expenditures on gasoline, electricity, and natural gas will continue to limit sales growth. The increase in energy prices added nearly a percentage point to Philadelphia's CPI between January of last year and January of this year. And PECO, the local utility, introduced another 25 percent increase in natural gas prices effective March 1st. Other retailers appear to be quite optimistic as they begin placing orders for summer items.

Data on the value of construction contracts suggest that work on nonresidential building and non-building projects will sustain our region at least through the first half of the year. Housing permits, however, are expected to decline slightly this year.

Labor markets in our District are still characterized as tight. The unemployment rate in Pennsylvania, New Jersey, and Delaware stood at 4 percent in January, less than that of the nation. Our directors tell us that it continues to be difficult to hire skilled labor in such fields as legal, financial services, and health care. But one of

our board members reports that cutbacks in manufacturing are increasing the pool of both skilled and unskilled workers available in the Philadelphia area temporary employment agency market. In fact, many people who are currently employed are coming in to fill out applications at temp firms in anticipation of losing their current jobs.

To summarize our regional outlook, we still expect economic growth to pick up to a moderate pace in the second half of the year, but the upturn may well occur a bit later than we previously had expected.

Turning to the nation, incoming real sector data suggest that the U.S. economy is in somewhat better condition than it was at the turn of the year, but again I would characterize the risks as clearly on the down side. Growth in aggregate demand for goods and services appears to have stopped decelerating. The retail sales figures suggest that consumer spending is growing at a moderate pace, but I would acknowledge that some of the strength, especially in autos, could be reflecting temporary incentives and discounts. The employment data show that payrolls are increasing at a pace well above that of the fourth quarter of last year, and the unemployment rate remains low. Manufacturing remains in decline but the rate of decline seems to have abated somewhat from earlier in the year. The recent increases in inventories and the cutbacks in production and sales suggest that inventories remain higher than desired and that the inventory correction will not be over as soon as originally thought or as I might have hoped.

The recent drop in equity prices is worrisome. Developments in the stock market could have important consequences for real demand and, therefore, economic growth. The rise in the market over the past few years bolstered consumer confidence and spending through the wealth effect. Now, with the fall in stock prices, a reverse

wealth effect is likely, as are more significant declines in consumer confidence and a retrenchment in consumer spending. Another risk comes from abroad. The world economy seems to be slowing, as we heard this morning. That would have a negative implication for U.S. exports and possibly for the U.S. financial market.

The one upside factor I see is the final tax cut passed by Congress, which might have an extraordinary effect in terms of increased consumer spending. I don't believe that is a significant risk, however, given the uncertainty about the effects of recent stock price declines, which seem likely to overwhelm any concerns about the tax reduction. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. Over the past few weeks I've had more unsolicited calls from concerned business leaders than ever before in my six-and-one-half years in this job. That's probably because the Seventh District economy is undergoing a somewhat more noticeable slowdown than the national economy, in large part due to our relatively greater concentration of manufacturing industries. Reports from our manufacturing sector contacts have indicated weakness for some time now, and we're starting to hear of some spillover effects in other sectors of the economy as well.

Nevertheless, a few anecdotes suggest that we may be near the bottom in manufacturing, although that assessment is still quite tentative. For example, much of our District's slowdown reflects the automobile industry's efforts to bring inventories into better alignment with expected sales. As David Stockton mentioned, light vehicle production was cut sharply over the past few months, and significantly increased incentives coupled with a large volume of fleet sales boosted light vehicles sales in

January and February to levels that were higher than many expected but were clearly not sustainable. Our Big Three contacts indicate that sales so far in March have been quite strong, but below the elevated January-February pace. As a result, the industry supply of light vehicles was brought back down to the usually desired 60 days by the end of February. Thus, significant progress has been made and the auto industry is probably close to bottoming out, although there are some important reasons why additional adjustments may well be needed.

First, the 60-day supply figure for February is based on sales of 17.4 million units, and the industry is not expecting sales to be maintained at that lofty level. Second, one of the Big Three recently scaled back its financial support to dealers in a number of areas, including a significant reduction in inventory financing assistance. And third, contacts continue to say that they want to cut back on the expensive incentive programs being offered to consumers. As a result, second-quarter production may not be as high as published assembly schedules suggest. Still, I think it's fair to say that most of the inventory correction is behind us.

Reports from contacts in the paper and steel industries also tentatively point to a bottom in the downturn. I, like Jerry Jordan, had some conversations with a few people in the paper business. One CEO with 40 years of experience in the industry said he had never seen a decline like this one, which has persisted for such an extended period of time. But he did indicate that declines in shipments of corrugated containers seemed to be leveling off in March. Also, capacity utilization in the steel industry has increased over the past few weeks, which may suggest some stabilization. On the other hand,

reports from industries such as heavy trucks, construction and agricultural equipment, printing, and high-tech continue to be very negative.

In large part reflecting weakness in manufacturing, our labor markets eased considerably early this year. The unemployment rate for our five states moved above 4 percent for the first time since mid-1997 and we're expecting that soon it will be above the national rate for the first time in 7-1/2 years.

Manufacturing weakness and job layoffs appear to be having some impact on demand. Several contacts reported that capital spending plans were being delayed or postponed. Some also noted that the manufacturing slowdown had affected other industries such as software services, travel--particularly business air travel--hotels, and tourism. Retail sales in the Midwest recently have been somewhat softer than in the nation and the housing sector indicators for the Midwest show less of an uptrend in recent months than the national figures.

Many business people I've spoken with recently noted that it has become more difficult to obtain credit. That's consistent with the responses from banks in our District to the special senior loan officer survey, which indicated a further tightening of credit standards and a widening of spreads in the Midwest.

Turning to the national outlook, the downside risks clearly dominate. Wealth effects are now substantially negative and measures of consumer confidence have fallen rapidly. Prospects for growth abroad have deteriorated somewhat, as we've discussed, and firms appear to be scaling back plans for capital spending. These current and prospective cutbacks by households and firms are having effects in sectors of the economy beyond manufacturing where weakness has been concentrated so far. While

this is normal in a period of slower growth, we should keep in mind the risk of further spillovers. On balance, however, the data released since our last meeting have been consistent with what still seems the most likely scenario, namely weak growth in the first half of the year followed by a rebound in the second half. Indeed, data on employment, retail sales, and especially homebuilding have been stronger than one might have expected and unlike the behavior of an economy in the early stages of a recession. And while not yet a major concern, it's important for us to keep in mind that inflation measures also have come in on the high side of expectations. Nevertheless, I think a continuation of our strategy of measured policy easing seems appropriate for today.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. At our last meeting I said that the Beige Book was the most negative I had seen--most negative in the sense of the most rapid deterioration of conditions--in both the summary of national developments and the report on the Eleventh District. I understand that it reflected conditions in early January. The current Beige Book, reflecting late February, depicted a somewhat better picture. The Eleventh District economy is softening but labor markets remain fairly tight despite high profile layoff announcements. Since the start of the year, Dell, Motorola, Nokia, and Texas Instruments have all announced major layoffs or early retirement programs in Texas. Overall our job growth has slowed to about half of the long-run average but has remained positive so far despite the spreading of contractions in manufacturing to service sectors such as transportation and retail trade. Not long ago the Texas economy had three positives going for it: higher energy prices, strong high-tech manufacturing, and a strong Mexican economy supporting Texas exports. High-tech manufacturing is now hurting

and the Mexican economy has slowed significantly. Of the three, only high energy prices remain, which is unfortunate for the country at large and for most of Texas as well.

Mexican real GDP, industrial production, and hours worked in manufacturing declined in the fourth quarter of 2000. Our leading economic index for Mexico has declined since September and is signaling sluggish growth this year. Texas exports, which are predominantly to Mexico, declined in the fourth quarter. The maquiladoras along the border are concentrated in industries like autos and high-tech that are experiencing sharply lower U.S. demand. Press reports forecast maquila layoffs of 1 to 2 percent. That has negative implications for U.S. border towns whose unemployment rates had finally fallen below 10 percent over the past couple of years. On the positive side, lower mortgage rates have helped to support our housing sector, and Beige Book contacts report a modest improvement in construction-related manufacturing.

Turning to the national economy, the dramatic decline in stock prices, even since our last meeting and including Dow Blue Chip stocks as well as NASDAQ tech stocks, is dominating discussion and making recession seem inevitable to most of the people with whom I talk. Opinion is about evenly divided between those who think we are about to be in a recession and those who think we already are. It seems as if January 31st was a long time ago and talk of the Fed's aggressive action in January has turned to talk of the Fed being behind the curve. Fifty basis points, which seemed hefty in January, is now regarded by many commentators as inadequate today and likely to disappoint financial markets. Frankly, I don't see an easy way out of the box we seem to be in. I agree that we don't want to appear to be easing policy to support the stock market--but I do believe the stock market is leading the economy down--nor do I want to be in a

position of having policy dictated by talking heads on Wall Street and in the press. The problem is that I think they're probably right. Not taking a particular action because they seem to be dictating it is reacting to them just as much as taking an action because of them. I believe the arguments for front-loading policy easing are just as valid today as they were at the last meeting. A 1/2 point cut today has been expected and priced into the markets for quite a while now, and even so equity markets have tanked and longer-term rates have fallen relative to short rates. It will take a bolder move to reverse the negative psychology, including the widespread feeling that we're behind the curve. We need to do more rather than less, sooner rather than later.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. Sifting through the variety of anecdotal reports we've been hearing on the region, it appears that our District economy has performed about in line with what the national statistics have indicated for the country, namely that growth has stabilized at a low rate. If we look at the District by region, conditions are very mixed. The parts of the District that are doing well are generally the metropolitan areas; the more rural areas that are dependent on natural resources and manufacturing are struggling. If we look at the District by various sectors of the economy, we see a similarly mixed picture, with some sectors doing quite nicely and some having a difficult time. In general, one bright spot clearly is construction activity, which remains healthy pretty much throughout the District. Another bright spot is employment, with the continuation of tight labor markets. But those taut labor markets are accompanied in some locations by reports of accelerated upward pressures on compensation.

At the national level, as I've already indicated, I have no disagreement with the Greenbook's estimate for growth in the current quarter. It appears likely to me that growth will turn out to be around 1 percent plus or minus, very similar to rate in the fourth quarter. That is, economic growth has stabilized at a low rate. Our model has the economy gradually improving from here, quite similar to the general pattern in the Greenbook forecast. I am concerned about the inventory correction process still ahead of us, but presumably that is reflected in the Greenbook numbers. In addition, it seems to me that significant risks stem from potential developments abroad. The list of foreign economies that are facing difficulties of some kind seems disconcertingly long, and it doesn't seem likely to me that we will skate through all of those potential difficulties without some reverberations.

On the other hand, the U.S. economy has proven quite resilient in the last 10 to 20 years. I think that is an important and fundamental characteristic, especially when monetary policy has been providing support, which it seems likely to continue to do.

CHAIRMAN GREENSPAN. President Gynn.

MR. GYNN. Thank you, Mr. Chairman. The slower pace of economic growth in the Southeast persists, but one gets the sense that things may be bottoming out. This overall perspective masks some very different stories by sector as well as substantial differences in the economies of our largest and strongest states, Florida and Georgia, and the smaller and less vibrant economies of Alabama, Mississippi, and Tennessee. Manufacturing in our region has continued to slide, with cutbacks and layoffs at high-tech, chemical, steel, and pulp and paper companies. Aerospace is also slowing and may slow more since the big rocket program at Lockheed Martin apparently has suffered a

cutback. Our auto industry, which is now substantial, has not completely escaped the industry adjustments but, with a large proportion of our auto production represented by foreign manufacturers with relatively newer and more efficient plants, the adjustments have been less severe. In fact, our director from Nissan reported that his company and others are continuing to make very large investments in new plant and equipment in the South. Energy and shipbuilding continue to be bright spots as well.

A big change has been the situation in the public sector. Significant revenue problems now exist in Alabama, Mississippi, and Tennessee, reflecting the divergent growth paths I mentioned earlier. Large cutbacks in education spending are being imposed and Tennessee is imposing an across-the-board reduction. Tourism remains about the strongest sector in our District, with almost no reports of slowing. The snowbirds have been flocking to Florida in record numbers and expectations are for a strong spring break as well. Perhaps most importantly, future bookings still look quite favorable.

Residential construction in January and February was at about the same respectable level of a year ago. Inventories of unsold homes appear relatively balanced, although some of our contacts in Atlanta, and in Tampa and Bradenton, Florida indicate some overbuilding in the high end of the market. Commercial construction has slowed but remains relatively healthy. A major architect told me last week that there was noticeably less new work in the pipeline, especially in high-end hotels, as lenders are demanding more and more equity in such projects. I was also told yesterday morning that three major tenants in the Atlanta market who had been shopping actively for large

blocks of new space have put those plans on hold as the chief financial officers of their companies have taken the upper hand and are working to restore margins.

Labor markets have loosened somewhat in certain markets and skill areas. Unskilled workers have become more available in recent weeks, but critical shortages remain for health care workers and information technology specialists. Finally, at the regional level I would note that a combination of weaker demand and competition continues to hold down prices except for the now familiar pressure points of health care and energy costs.

On the national front, the slowdown in the real economy--as opposed to that in the equity markets--appears to be stabilizing at a low but probably still positive rate of growth. I continue to find it difficult to judge exactly where we are in the inventory adjustment process; the breadth and depth of the high-tech adjustment, with all its tentacles seems problematic and likely to be more drawn out. And clearly, our somewhat weaker economy is more vulnerable to shocks of one kind or another. My own sense is that the rebound I still expect later this year is now less likely to be the sharp V-shape some people are talking about and more likely to be at least somewhat more protracted and a bit more moderate. My thinking is colored by my expectations for consumer spending and investment spending.

While consumer spending seems to have been somewhat resistant to the sharp deterioration in consumer confidence, I would cite several arguments for why we should see considerable moderation in consumer spending in the period ahead. After the spending binge of recent years, debt levels have risen measurably, as highlighted in the Greenbook.

runs a very large consumer credit

counseling service that sees 35,000 to 40,000 debt-saddled individuals across a wide range of incomes each year, that it seemed as if the consumer hit the wall late last year. Her organization was bombarded very suddenly and very unexpectedly with a 23 percent year-over-year increase in calls for counseling sessions in December. she reported that the increased pace of calls had continued in January and that her colleagues in similar businesses elsewhere in the country had had a comparable experience. When I asked her to follow up with her counselors regarding what was driving people to seek help, she reported back that it had been the combination of higher winter heating bills, higher gasoline costs, reductions in overtime pay, and the fear of job losses.

underscored how quickly and how completely the overtime pay had been eliminated in that industry. He also noted that the autoworkers are very explicit in saying that it was the overtime income that had fueled their aggressive discretionary spending. And, however one might view the wealth effect and its downside impact now, one has to assume that the erosion of net worth will surely interrupt the consumer's recent practice of spending all--and in some cases more than all--of his or her current income. So, consumer spending seems likely to grow only moderately.

Likewise, I now think investment spending on equipment will rebound more moderately and less quickly than I had thought earlier. Buyers can and likely will put off their next round of expenditures on new technology until they repair their margins and need more capacity. I'm hearing that whatever spending does go toward new technology will be directed even more at cost control and cost reduction. Suppliers of technology had their own excesses to work off, with a ripple effect down the supply chain. I still

believe very strongly in the promise of technology and the positive things that will come with it. But I think it will take a while before we again see the type of investment binge that helped the economy achieve the high rates of growth we had in the recent past.

So, I would urge some caution regarding the outlook for both consumer and investment spending. And I would note that the Greenbook as well as other forecast simulations suggest that reasonable assumptions about the impact of aggregate demand shocks--such as further cutbacks in consumer or investment spending--principally will affect the output path over the first half of 2001. More importantly, these adverse shocks only moderately affect the forecast for the second half of 2001 and into 2002. To me the inference one can draw from this simulation is that a substantially easier monetary policy--or maybe even outsized easing moves--would have a minimal impact on real output over the near term. This means that our policy focus should be on the last half of 2001 and into 2002 rather than on the early quarters of this year, which we have little ability to affect. I'm bothered by the growing perception that monetary policy can and should cure all the economy's aches and pains and do it almost overnight. Jerry, perhaps the story behind the demand for hot tubs is that they cure pains! [Laughter]

Our recent experience serves as a reminder to us that even a new economy can and will develop excesses and imbalances that have to be worked through. And we need to resist the thinking that we should try to fix the problems that invariably come from unrealistic investments. Although monetary policy can provide a cushion during such periods, it cannot and should not prevent necessary adjustments from taking place. Using outsized policy easing to attempt to prevent those adjustments would only take our sights

off the longer-run consequences for inflation and for future growth that might stem from a too accommodative monetary policy. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Broadus.

MR. BROADDUS. Mr. Chairman, our District economy would have to be described as soft overall but conditions are still mixed, as I have been reporting for the last several meetings. Manufacturing activity in our traditional old-economy industries like textiles and furniture and paper continues to weaken. We hear many reports of layoffs, reduced hours, and decreased output in an effort to adjust inventories. Like Michael Moskow, I'm getting a lot of letters and unsolicited advice, especially from my contacts in the manufacturing sector. Much of that advice, incidentally, is not very gentle. It seems fairly clear that most of these industries are a lot weaker now than they were recently or weaker even than they have been since the last recession.

Conditions are more disparate across the high-tech manufacturing industries we have in northern Virginia and in the research triangle area of North Carolina, but overall they're still notably softer than they were a year ago. Factory shipments and orders were up a little in February according to our latest monthly survey of District manufacturing activity, and similar to Cathy Minehan's comments about New England manufacturers, the tone seemed a bit stronger too. I should point out, however, that this information was gathered several weeks ago before the big drop in equity markets, and these firms might not be quite as optimistic now. So, the manufacturing sector doesn't look good, but elsewhere conditions seem a little brighter, as many other people around the table also have pointed out.

Retail sales and employment in our region were down in both January and February but, as in other parts of the country, car sales have picked up recently and store sales across the District have improved. Residential construction is still very strong, with a lot of homebuilding here in the Washington area, though strength in that sector is apparent uniformly across the District. Nonresidential construction also continues to be reasonably healthy. We're not hearing quite as many anecdotal comments as we were earlier about extremely tight labor markets but they are still reasonably firm.

Unemployment rates have not moved much; they remain at quite low levels in all our District states. North Carolina is a bit of an exception. While the unemployment rate is still at a low level in that state, it has moved up a little because of the heavy concentration of manufacturing there. In sum, we have a very weak picture in the factory sector but modestly encouraging developments elsewhere in our regional economy.

Turning to the national economy, I believe the situation we face today is particularly difficult. Clearly, the equity markets have just finished one of the worst weeks in recent memory. Earnings forecasts continue to be written down. Also, large layoffs, especially in the high-tech sector, have added to the sense of unease that has been moving across the country and in my view accelerating of late. I think one would have to say that, at best, economic conditions in the country are fragile. Still, if we compare this Greenbook to the last one, David, I would say that there are grounds for optimism.

Most importantly, the projected growth in private domestic final purchases for the first quarter has been revised up significantly from 1-1/2 percent to a little over 3 percent, largely on the basis of actual data. You have a lot of information to back up that forecast. All the major components of private demand--including PCE, business fixed

investment, and residential investment look better now than they did in January. In my judgment that is probably due, at least in part, to the stimulative impact of the fairly significant drop in long-term rates that we've had, and I think we need to keep that in mind. The 10-year Treasury rate is now all the way down to 4-3/4 percent. I think the more favorable outlook also reflects some underlying confidence in the longer-run prospects for the U.S. economy, a point that Karen Johnson made very well in a different context. The sense I get from most of my contacts is that we're likely to have a rough period in the near term but in the longer run the situation may not be so bad.

The Greenbook does, of course, expect near-term weakness. The projection is that growth in real GDP will be held to below 1 percent by the continuing drag from inventory adjustments and by the drag from the foreign sector. But the inventory adjustment is projected to be completed by the third quarter of the year, and real GDP growth is forecast to be over 3 percent again by the fourth quarter. If we can get that result, I'd consider it a quite favorable outcome, given the situation we're facing and some of the commentary we're hearing. And I think there's a reasonably good chance that we can.

Of course, as everybody knows, the main risk in the outlook is that rising unemployment and falling stock prices may cause business and consumer confidence to fall significantly further before the inventory adjustment is completed. In that regard the fact that the University of Michigan's preliminary report did not show a further decline in its index of consumer confidence was encouraging. I know the index has come down quite a lot from its peak but the pause reported in the most recent figure was promising, given that a drop had been widely anticipated. That may have been due in part to the fact

that the unemployment rate has not risen much to this point. Also, the stock market decline, while dramatic, in my view can still be called orderly to date. And while credit market conditions are tighter, I don't hear people telling me that credit is not available. In that regard, we don't have the kind of credit situation we've had in past slowdowns.

On balance, given what we know now, I see no compelling reason to believe that the reductions in the funds rate that were priced into the term structure prior to last week's stock market decline will be insufficient to carry the economy through the current inventory correction. Thank you.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. The Tenth District economy remains sluggish but some signs of stability are beginning to appear. Manufacturing activity continues to decline and auto sales in most of our areas remain relatively weak, although some recent pickup has been noted. Incoming data on other sectors have had a more positive tone. Interestingly, like David Stockton, we really did expect to find a lot of gloom and doom with respect to the real economy and we didn't. We found some positive elements in the situation.

Let me turn to specifics. I'll start with the slower industries first, which include, of course, manufacturing. Our Bank's most recent manufacturing survey showed a decline in January. Activity was below year-ago levels, for the first time in the six years we've conducted this survey. Capital spending was also down from a year ago. And purchasing managers were not nearly as optimistic about future activity as they were earlier. One of our directors, _____ indicated that his firm's business was down about 5 percent from a year ago due to lower export demand and also the effects in

rural areas of the decline in wealth among hobby farmers. He has had to lay off about one-third of his workforce, a noticeable reduction in that particular market.

Consumer spending remains soft but also has shown some signs of a firming. Auto sales were down sharply in January but subsequently recovered somewhat. And most of the retailers we contacted in February said that their sales were about level and that they were seeing some increase in traffic. For example, one of our contacts, a furniture manufacturer who sells in Denver, reported a significant increase in traffic and greater interest in some of their big ticket items. Construction activity, while down from a year ago, rose sharply in January following a poor December. Retailers and homebuilders in some of our markets view the slowdown relative to a year ago as a pause and they remain optimistic about the period ahead.

Labor market developments also provide some evidence that the District economy may be stabilizing. Employment continued to grow in January, the latest month for which we have data, and we have seen a noticeable reduction in layoff announcements. Perhaps most importantly, our directors and other contacts tell us that most of the workers who have been laid off are being hired by other firms, so there has not been a great struggle in finding employment given the job vacancies that existed. The supply of labor may not be as tight as it was earlier, but labor also does not appear to be in excess supply.

Energy activity is strong in our area. Shortages of equipment and workers actually have constrained drilling activity. The equipment seems to be becoming available but skilled workers remain in short supply. Conditions in the farm economy are mixed, with livestock producers making a profit while grain producers will have to rely

once again on government subsidies. Inflationary pressures in the District have remained modest, although we've seen some pickup in the general trend of inflation within the region.

Let me turn to the national economy. Recent developments indicate that some broad-based weaknesses from the fourth quarter are spilling over into the first quarter. Like the Board's staff, we also expect growth in the first quarter to be relatively slow--below the 1 percent mark. While this represents a marked slowdown, we also expect the U.S. economy to continue to grow modestly as we go forward, a view that is not inconsistent with the staff's forecast. Moreover, recent inflation developments have been relatively modest, a fact we certainly recognize.

Though the pace of economic activity has been decelerating, as I said earlier recent economic statistics and reports from business contacts in our District--and I think more generally--suggest some stabilization is occurring. I was surprised at the relatively favorable outlook painted by the many directors and business contacts we talk with, but they had to look at the hard economic data and get their focus off the stock market in order to do that.

Sorting through all these data and impressions, I expect the economy to grow modestly this year and into 2002. However, I also recognize that there's a great deal of uncertainty in the near term and some downside risks as well. On the down side, manufacturing is clearly in a slump, problems in the high-tech sector have deepened, consumer confidence has plummeted, and the stock market's performance has nosedived. It has been reported to me that CEOs are putting off new projects and cutting back on some existing projects. While recognizing this, I nonetheless judge that the most

likely prospect for the U.S. economy is that it will move back toward its long-run trend growth. Several factors support that assessment, including our solid productivity trends, our stable inflationary environment, and our sound financial institutions. Those factors will provide a strong foundation as we move into 2002.

Given where we are, I would feel comfortable with a modest reduction in interest rates from where they are now. A lot of momentum has been put into the economy through our easing moves earlier this year. In addition to that easing I would support a further modest move, perhaps for a total of 50 basis points, to insure against the downside risks that we all recognize. Those downside risks stem from the large and growing financial imbalances in the economy, especially the unsustainably low personal saving rate, the high level of consumer debt, and difficulties in the foreign sector. If these imbalances were to worsen, we could see a further deceleration in activity or possibly an actual slowdown in the economy.

In such an environment I would not be surprised if consumers tried to boost their savings, rebalance their portfolios, and offset their losses of net worth, nor would I be surprised if businesses tried to cut back on planned capital expenditures. Such reactions have the potential to magnify the economy's modest slowdown and precipitate a drop in aggregate demand. In my view that possibility is the key risk to an orderly rebound in economic activity. And that's why in the current situation I support a modest policy move for insurance purposes. I would be very cautious about taking more than a modest step because I believe there is a lot of stimulus in the economy that hasn't yet shown through. Monetary policy has long and variable lags, so I also worry about the risk that our easing actions could become procyclical, with further stimulus coming into

the economy as it moves--in the scenario painted by the Greenbook and others around this table--out of its current slowdown. Thank you.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Thank you, Mr. Chairman. Conditions around the Eighth District are very similar to those described by others who have already commented. The situation is mixed, but on the whole activity is flat to okay. The mood is decidedly worse than the reality, but I don't detect a huge amount of concern and fear. The way I would put it is that there's just a sense of uneasiness.

When I called my _____, the first words out of his mouth were that _____ a really bad February. He said that the volume in the domestic express business--that's the air part of the business--was actually below that of February last year, a significant drop. The ground business was up 5 percent year over year, but that was 5 percentage points below the pace it had been running. That slowdown primarily reflects the _____ ships a lot of auto and computer parts, areas where a significant inventory adjustment is taking place. _____ customers believe that the inventory adjustment is mostly complete and they anticipate a return to normal shipping patterns by late spring or early summer.

While my contact started out by saying that the company had a really bad February, he said the declines were not horrific--just a few percentage points. He also indicated that the declines did not seem to be continuing; there was a lot of new business in the pipeline. He pointed out that the ground business is still growing, apparently reflecting some substitution of ground shipments for air shipments because of less need for quick delivery and, of course, a cheaper means of transportation. He also said that

not planning any layoffs nor even reducing employment by attrition. They find no significant wage reductions in the works, but their executive bonuses are going to be down quite a bit. On the whole, labor market conditions are easier, but the firm continues to have problems finding quality entry-level recruits. He noted, however, that almost no IT people have left in the last few months, which is of course consistent with the shakeout we're observing in the dot-com industry.

My pointed in particular to very weak conditions in international business, especially in Asia, which is probably related to the fact that a lot of computer parts are shipped out of Asia. He said that South America is showing a similar trend but that business in Europe remains quite strong. has put a freeze on promotions and new hires. The company seems to be under quite a bit of profit pressure and is reducing employment through attrition. The outlook, however, is not terribly negative, though my contact does see significant pressures on labor costs in the airline industry. The terms of the United Airlines settlement of last year are going to spread through the industry and, calculations, that will add 16 cents per package to . So they're seeing a lot of upward pressure on their operating costs.

I also called a senior official to ask about recent trends in its business. He said that he sees no significant change in the buying customers; the mix of goods remains about the same. Total traffic is down a little but not a lot. He said that decided last June that activity was slowing down quite a bit; it showed up first in stores and later in . However, the company came out of the holiday season in excellent shape on inventories.

There is no inventory overhang at that company. My contact expects sales to remain relatively flat, but he said that his “fallback” expectation was that business was going to get better rather than worse.

He made an interesting comment about the labor market. He said that expecting an increase in the minimum wage and had already put through some wage increases in anticipation of that. Of course, the company is not going to take those raises back even though a minimum wage increase was not enacted, but anticipatory increases of that sort could explain some of the wage numbers we have observed.

One final note: He reported a regular phone survey of about 15,000 of its customers--a significant sample--and detected a lot of fear of being laid off. That seemed to be the main news from that survey.

I want to make three comments about our situation. A number of people have commented about the equity market. My observation is that it's very, very unfortunate that investors in that market keep looking to the FOMC to bail them out. A reassessment of the earnings prospects in the tech business is taking place. That involves a real readjustment, having to do with the nature of that business and judgments on whether excess investment exists that needs to be worked off. I know that a lot of fiber optic cable has been laid all over the country, which may have involved some excess investment. That's a real adjustment, and the equity markets ought not to be looking to us to fix that problem because it is not anything we can fix.

Secondly, money growth has been very high. The current environment is not at all typical of recession environments in the past. If we look at the numbers, the narrow

aggregate that I prefer, MZM, grew at annual rates of 13 percent in December, 22 percent in January, and 26 percent in February. M2 grew at an annual rate of 10 percent in December, 12 percent in January, and 11 percent in February. So, money growth has been quite high. My sense is that credit is somewhat tighter than it was but is still readily available; anyone with a reasonably bankable proposition can find funding.

Thirdly, I would like to see us come out of this meeting in a posture that does not foster widespread expectations that our next policy adjustment will be another reduction in the funds rate. In my view we ought to try to get ourselves in the center of the range so that the odds are more or less equal that the next policy move is going to be an increase rather than a decrease in the funds rate.

Also, I think the balance of risks language for the weighted-toward-weakness option is directional in meaning. To me it implies that we expect the economy to be going down. But the consensus forecast is for continuing very slow growth in the economy, not a decline. That's not to say that a decline will not occur, but the best guess is that real GDP will grow at a rate of about zero to 1 percent. That's the consensus of private forecasters, though obviously the spread involves estimates above and below that range. Nevertheless, that's the average of the Blue Chip forecasts and also what the Philadelphia Fed survey shows.

So, these observations lead me to believe that today we ought to use language indicating that the risks are balanced on either side. If this really is an inventory adjustment and if we're almost through it, then we're going to see a rebound. That's the logic of an inventory adjustment--that we will see a rebound in production. Thank you.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. A number of you have made the point that the picture is mixed. I'm reminded of a statement that an old-time baseball manager, Paul Richards, once made when his team was in the middle of a losing streak. He said, "No team is as good as it looks when it's winning or as bad as it looks when it's losing." There is a sense in which that statement can be applied to the economy. Last year when the economy was on what I'll call a winning streak we--or maybe I should say I--took great pride in the growth of high-tech investment. That growth now appears to have been somewhat excessive and the so-called overhang of high-tech goods may be leading to problems now. This year, when the economy seems to be on a losing streak, things may not be as weak as they seem either.

One gets a very different picture from looking at different sources of data. There's a kind of hierarchy of optimism out there. The strongest readings come from the labor markets where at this point the changes in unemployment and other measures of labor demand have been moderate. Using the unemployment numbers to infer GDP growth leads to an estimated real growth rate in this quarter of about 2-1/2 percent. Next in the hierarchy come final demand markets where the picture is more mixed. Auto spending, as you know, contracted sharply but has turned back up. There is still some real growth in high-tech spending. Housing construction and overall consumption spending have held up fairly well. This all leads to an estimate of real growth in this quarter, I'm guessing, of between 1/2 and 1 percent. The terrible picture, obviously, comes from the stock market. And part of the difficulty involved in interpreting that is to determine whether the recent declines in stock prices are just a stock market phenomenon or whether they foretell a deeper real message that we should be heeding.

As for the Greenbook, the optimistic side of me can actually find two ways in which the baseline forecast is too negative. First, as the Greenbook acknowledges, the monetary assumption underlying that forecast is that the Fed cuts rates 50 basis points at this meeting and then stands pat. If the fed funds futures market is any guide, that is not the most likely outcome. The futures market has the funds rate dropping to 4.25 percent by this fall, with current long-term rates presumably incorporating this expectation. The simulation labeled “easier monetary policy” more closely incorporates the assumptions in the futures market, and the outcome in that simulation is slightly more positive than the baseline.

The second reason I may be slightly less bearish than the staff involves the wealth effect. We've talked about that a lot this morning. My own concern about it is that in the past few years as stocks were rising we attributed the strong growth in consumption largely to the wealth effect. I'm not questioning that attribution, but it strikes me that the wealth effect is not working as powerfully on the down side. Stock values are barely higher than their levels of two years ago. The wealth-to-income ratio has been declining for a while, yet consumption is still very high relative to disposable income, with the personal saving rate this quarter declining further to 0.8 percent. The saving rate may rise from this extraordinarily low level, but the staff has it turning around --I would say reasonably sharply--to 1.6 percent by the end of the simulation period. Basically I am a cheerleader for high saving and I don't necessarily approve of its currently low level. But if all these consumers who were led to consume more by earlier stock increases are now locked into a higher consumption lifestyle, personal consumption may hold up better than the staff is forecasting. Call it a “habit formation” consumption

function. I don't know how much weight to put on this, but I put a little weight on the Greenbook simulation that is labeled "strong demand."

Having made these positive points, I still favor easing monetary policy today. One reason is that we can hardly take solace in low federal funds futures rates and associated long-term rates if we are not prepared to take the steps necessary to validate that expectation. Another reason is that there still are very, very serious downside risks. And a third reason is that even in the more optimistic forecasts, the unemployment rate rises more than I think is necessary to control inflation. That is a point that nobody really has made yet. Even if there is no recession, even if the economy bottoms out at a slow rate of growth, I personally think we should still worry about the growing output gap. And yes, Cathy, I am a productivity optimist in saying that.

Another way to view all this is to look at the funds rate in real terms. The staff has done an exercise that corrects the nominal funds rate by expected core PCE inflation derived from a regression model. This leads to an estimated current real funds rate of about 3.8 percent, which is close to its average for the past five years though still above the average for the past 15 years. Alternatively, in a forward-looking calculation the present real rate of 3.8 percent is about equal to the tax-adjusted real forward rate from the TIPS market. Whether looking backward or forward, by these calculations monetary policy is roughly in neutral posture right now, and I feel strongly that in this environment we should be leaning against the downward risks. So I agree with Paul Richards's dictum in that the situation may not be as weak as it appears, but I do think we ought to be easing monetary policy. Thank you.

CHAIRMAN GREENSPAN. I think we better break for coffee or else it will get very cold.

[Coffee break]

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. The baseline in the Greenbook attempts to paint what I would describe as a middle-of-the-road outlook for the economy, with some signs--maybe premature--that the bottom has been reached. Indeed, as I've heard others around the table say and as I look at the data myself, it's clear that one could read some of the incoming information as indicating that perhaps the pace of weakening in the economy has not accelerated. Retail sales and light vehicle sales still appear to be holding up fairly well. At least one survey of consumer confidence suggests a turnaround, though that survey was taken before the most recent break in the stock market. The housing market continues to show some signs of life. And finally, there is some evidence that the inventory adjustment, while still in train, may have slackened. So there is some reason, perhaps, to be cautiously optimistic.

Having said that, I have a number of concerns. With respect to the baseline forecast, I agree with the point that Cathy Minehan made first and a few others picked up: It seems a bit incongruous that growth is forecast to return to a rate very close to potential and yet the unemployment rate is projected to rise to a somewhat higher number than I think is consistent with noninflationary growth. So I share some of the unease that others have felt about the baseline in terms of the interaction between growth, the unemployment rate, and the monetary policy assumptions in that forecast.

The second point I'd like to make is that while we certainly can be hopeful that the economy may have reached a bottom, we shouldn't let hope triumph over some sense of reality. Beyond my concern about the baseline forecast itself, I am concerned, as are others, about a number of downside risks to the baseline scenario, and I believe they eventually will demand a total policy response greater than that envisioned in the baseline. One of the major risks is that the capital goods overhang is greater than the Greenbook assumes and that investment, therefore, will slow more significantly and for a longer period than is currently anticipated. The Greenbook actually states that "In the staff projection, actual and desired stocks of capital are assumed to be in reasonably close alignment at the present time," implying that investment will hold up well.

I think that's a rather bold assumption, given these uncertain times. Some relatively simple work with the underlying models suggests that we may find that not to be the case. Using some reasonable assumptions, the model equations indicate that the investment in high-tech goods in the fourth quarter could have been as much as 20 percent higher than target levels. And with the standard model parameters that could easily produce a scenario in which high-tech investment might grow in low single digits--below 5 percent--between now and 2003 or 2004. David Stockton indicated in his remarks that there was a range of potential outcomes. Rapidly downshifting profit forecasts, combined with less accommodative financial conditions from a declining stock market and banks that are tightening terms and conditions in the face of monetary easing, make a slower path of investment a strong possibility in my view. That may not be the most likely scenario but it is not one that we can reject out of hand.

Of greater concern, obviously, is that if we do get the slowing in high-tech capital stock growth, it would undermine the increase in productivity that we've experienced of late. And it could lead to an even further falloff in the GDP--a result I think the staff appropriately captures in its productivity slowdown simulation--which, in my judgment, is a terribly unattractive outcome.

A third risk is that the weakness in equity markets might be more severely damaging to consumer confidence--and ultimately spending--than has been the case to date. Many of us have noted the apparent disconnect between confidence measures, which are at close to recessionary levels, and actual data on spending, which are reasonably strong. If this disconnect continues, how this tension will be resolved is as yet unknowable. Clearly we are going to need more data before we can assume that the worst is really behind us. Contrary to the assumption in the baseline, I think the risk is very real that consumer confidence will be undermined further by a jittery stock market--which may or may not soon stabilize--and by the specter of unemployment, which is certainly going to get worse before it gets better. Negative wealth effects will certainly hold down consumption growth both this year and next, making our challenge even greater. The Fed of the early 1990s was confronted with banks that were afraid to lend. We may yet enter a period with consumers who are too concerned to spend.

If any of these outcomes were to come to pass, the growth rate of GDP would be well below potential for several years--too long, in my judgment. And unemployment would rise to levels that are by almost any estimate above the level required to restrain inflation. In this circumstance it seems to me that the best response is one that I would describe as both aggressive and cautious. On the one hand, I think we have to respond

very clearly to the incoming data. We should not be afraid to do what we think is right for the real economy because of some concern about disappointing the markets and not acceding to unreasonable market expectations. On the other hand, we should not be overly cautious in adjusting monetary policy out of some concern that we may be perceived to be feeding the markets. In my view we also will need a great deal of flexibility in the period ahead because, though the incoming data suggest that the economy may be bottoming out, the evidence is still quite mixed, as many of you have asserted.

Such a policy response is not without its own challenges, as I'm sure we will discuss. But we must recognize that we are in a risky environment regardless of what path we choose. We are dealing with both an uncertain real economy and unpredictable psychology among consumers and businesses. We will have to tread very carefully, but I think we should not be paralyzed by the uncertainties that we face. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The Second District economy is holding up rather well, with the labor markets quite strong and continued strength in housing. Despite much gloom on Wall Street, which I will discuss later, employment levels in New York City are holding up extremely well. That may relate to the fact that restaurants are opening in Manhattan at a record pace and some of the staff look less like out-of-work actors and actresses and more like high-tech types!

In the manufacturing sector, purchasing managers in the District report slow growth, though the automotive sector--which is very important in western New York

because of the volume of parts we supply--is showing signs of recovery. The purchasing managers outside manufacturing give an increasingly dreary review of current conditions, which makes me think that their spouses probably work on Wall Street.

The gloom on Wall Street has reached the point of advanced silliness, I think. It reminds me of Dickens' description of a London fog in that it is permeating absolutely everything. The mood is self-perpetuating and contagious, and there's very little that more optimistic or more realistic people like us can do about it except not fall prey to it ourselves.

People in the venture capital community, who tend to be rather realistic--especially those in the experienced firms--are being very cautious. They are reluctant to finance even relatively promising companies that are struggling currently. A lot of those companies are in the high-tech sector, and I think the reticence of the venture capital firms will probably bring down some companies that deserve to survive, adding to the sector's problem of not being able to provide the creative juices that the economy needs.

I believe the downside risks to our economy are considerable and since others have discussed that subject rather thoroughly I won't add to it.

In the last couple of months I have been an international sales manager for the new Basel Capital Accord, and have been around the world literally. So, let me talk a bit about the concerns I have outside the United States. I have already talked about Europe, where the quality of leadership does not seem to be what is needed at the political level and perhaps not in the finance ministries or central banks either. Their neighbor, Turkey, is going through a problem, which was almost purely political in nature, although it became economic very quickly.

Given the questionable future of oil prices, I think we have to keep in mind the issue of political stability in the Middle East. A return to anything like the very low oil prices of a couple years ago would place in real question the stability of some oil-producing countries. Of particular concern are those with aging and not very flexible monarchs and a society that has become quite accustomed to a much higher level of spending than a low oil price can finance. That is a situation on which we have to keep a weather eye.

We talked earlier about Japan. The promising development in Japan is that for the first time its leaders actually are talking in a fairly serious way about reform of the financial sector, which they should have done twelve years ago. The minister in charge of the area, Mr. Yanagisawa, is extremely sound. He's at least as knowledgeable about restructuring a private financial sector as anybody I've ever met, so there's no lack of knowledge regarding what to do. If the country's leaders are getting close to the point of thinking that they simply cannot plot a reasonable future unless they reform the financial sector, it might just get done. It's going to be very difficult. I don't think one would want to take even 50-50 odds on it. But they are closer to talking and to thinking about doing the right things than at any time I recall since the bubble burst at the end of the 1980s.

The Asian tiger economies are at very serious risk in my judgment. There is much talk about their dependence on Japan. Actually, they are not dependent on Japan--they assume that Japan will be in recession or close to it--but they are very dependent on exports to the United States and Europe. Virtually all the countries have accomplished essentially no structural reform since the Asian crisis in 1997 and, therefore, weak

exports could easily result in considerable difficulties in a number of countries whose success is so much tied to exports.

In Argentina there is a little breath of life. The news since our conversation this morning is that Mr. Cavallo is apparently going to be the economics minister. He is meeting as we speak with the governors of the provinces, most of whom are from the Peronista party, which means that he is probably trying to cobble together a political coalition. You no doubt recall that he was the economics minister for President Menem, whose political skills along with Mr. Cavallo's technical economics skills were a very favorable combination for the country. It's important that Argentina emerge from this situation in good shape because the political system in Brazil is looking rather fragile. The number of corruption cases that are getting near the president and his closest ministers is increasing to the point that a political or economic contagion coming from Argentina might find Brazil not terribly capable of dealing with it.

So, I think the downside risk coming from outside of our country is very considerable indeed, with a number of accidents looking as if they could happen. The likelihood of escaping all of them would impress me as quite low. Given that situation, I very much sympathize with what Governor Ferguson just said. I think the stance of monetary policy has to make two things clear to all observers. One is that we will ease when we need to, including today. The second is that in addition to today's move, we are prepared to act if and when necessary. Thank you.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. There's very little that I can add at this point about the economy, so I'll be brief. But let me try to summarize the situation.

It was 100 percent predictable well in advance of the economic slowdown that going through such a period would be painful. We are now in a slowdown and it is painful. It was almost as certain that after a period of slowing a time would come when we would welcome an upturn but would have to go through a very disconcerting stretch of uncertainty about whether an upturn or more decline was in the cards. We seem to be in that stage now. In recent days we've all been studying the data, reading analyses, receiving briefings, and sharing ideas. The bottom line would seem to be this: While there are good reasons to believe that the economy will soon turn up--and I believe that is the highest probability outcome--we cannot know or be overly confident that an upturn is in train. It is still possible that the various negative forces existing today will drag us into further weakness. Our policy choice must be made in the face of this very fundamental uncertainty.

In golf, which I play poorly, club selection before a shot usually presents the player with three options--an aggressive choice, a central tendency, and a conservative choice. [Laughter] Each option usually has its own plausibility. In different situations a player might well go with any of the options, depending on his or her objectives at the time and an assessment of the risks. Shortly I expect Don Kohn to tell us that in this game a conservative choice is to ease 25 basis points, 50 basis points is a central tendency, and 75 is aggressive. Of course, the loudest voices in the gallery want us to go for it, but that doesn't mean that we should. In deference to your request that members not discuss policy positions until the next part of the meeting, Mr. Chairman, I will withhold further comments until then. [Laughter]

CHAIRMAN GREENSPAN. Tell me whether you're using your five iron or your six iron!

MR. MOSKOW. Or is he using his driver? [Laughter]

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Three highly interrelated developments over the intermeeting period have, in my view, strengthened the case for further easing. The first relates to the more powerful negative wealth effect due to the slide in equity prices, the further decline in consumer confidence, the possibility of a more serious shakeout or retrenchment in high-tech investment, and the prospects for weaker foreign growth. All those factors point to weaker consumer and investment spending and weaker exports over the forecast period for a given funds rate path. Despite these concerns, the incoming data are mixed and there is considerable uncertainty about the strength of spending going forward.

A second consideration reinforcing the case for further easing is that broader financial conditions have not eased--at least not appreciably--despite the decline in the funds rate to date and despite expectations in the market for considerable further declines in the funds rate. Instead, the decline in equity prices and the strengthening of the dollar have significantly offset the stimulus from lower short-term interest rates.

Third, and perhaps more speculatively, although David Stockton mentioned this in his presentation, recent developments may be consistent with a decline in the economy's equilibrium real interest rate. The staff, as you know, has been working on estimating a time-varying measure of the equilibrium real funds rate. One of the key drivers of the equilibrium real rate is the equity premium. To the extent that the recent decline in equity prices is a reassessment of fundamental values rather than a cyclical

correction, it implies a rise in the equity premium and a decline in the equilibrium real rate. In this case, the federal funds rate might need to be lowered more aggressively than would be suggested by movements in the output gap or inflation. Of course, this line of analysis has some implications for the appropriate response to a decrease in the equity premium, but that's another story.

Let me turn to the question of why the economy has slowed so sharply and what the implications are for the forecast and the policy response. One hypothesis is that we're in the middle of an IT inventory correction, one that is sharper and faster than traditional inventory corrections but with less persistence. This would be consistent with the so-called V-shaped recovery. I don't disagree that the current inventory correction may be sharper and swifter than traditional corrections, but I do not think that is the most important theme in the story nor even the most important way in which new economy developments are shaping the slowdown. The deeper story in my view is the interaction of a cyclical slowdown and a correction of pre-existing imbalances.

Such a correction of imbalances is quite typical of recessions and, indeed, often contributes to the severity of downturns. I will focus on two interrelated imbalances at the start of the slowdown. One is the valuation of equities, particularly of high-tech firms; the second is the rate of high-tech investment and/or stocks of high-tech capital goods.

First, consider the consequences of the apparent equity correction. The staff estimates that the wealth effect, after adding as much as 1-1/2 percentage points to consumer spending growth in the second half of 1999, will be subtracting about 1 percentage point throughout the forecast period. That will result in growth of consumer

spending at a rate below the growth in GDP. The tax cut assumptions in the forecast make only a slight dent in the short run. As a result, returning to trend growth over the forecast period requires a strong rebound in investment.

Unfortunately, the second imbalance may be in the level of high-tech capital or at least in the rate of high-tech investment. The V-shaped recovery depends on a strong rebound in investment, reflecting continued high structural productivity growth and an associated high expected rate of return on high-tech investment. But we also have to put into the investment mix the legacy of excesses associated with the frenzied pace of investment over the last few years. The result may be a period of shakeout or retrenchment in high-tech investment that weighs against a quick and sharp rebound.

Let me turn now to a critical set of assumptions underpinning the Greenbook forecast. They happen to be very important in assessing the degree of cumulative easing that might be required. Despite very similar paths for output, the Greenbook and Blue Chip forecasts show very different paths for the unemployment rate. This is exactly the issue that President Minehan remarked on earlier and that a number of others also have mentioned today. The Blue Chip forecast, assuming what appears to be a similar policy path to that in the Greenbook, depicts a quite benign soft landing, with the unemployment rate moving just above 4-1/2 percent--close to the short-run NAIRU--and growth near trend in 2002. In contrast, with about the same output path, the Greenbook has the unemployment rate a full percentage point higher and growth still slightly below trend in 2002. As a result, that would call for a more aggressive easing over the forecast period.

The first key assumption behind this difference, as President Minehan noted, is the underlying rate of productivity growth. The staff assumes that structural productivity

growth is almost 1/2 percentage point higher than the assumption implicit in the Blue Chip forecast. This explains a bit less than one-half of the difference.

The second key may be how Okun's Law is being applied. The Blue Chip forecast seems consistent with applying a simple static form of Okun's Law. The staff appears to be applying a dynamic version, taking into account the delayed effect of the slowdown to date, most of which has not yet passed through to employment. It's hard to argue with the Greenbook approach in this case. But there are some considerations that might support a different dynamic in the labor market response to a slowing in growth. One example is the reluctance of firms to lay off workers, given the recent difficulty in hiring them. At any rate, these considerations increase the difficulty of assessing at this point just how much easing will be appropriate and provide a rationale for a gradual, incremental strategy of easing.

CHAIRMAN GREENSPAN. Thank you all. Mr. Kohn.

MR. KOHN. Thank you, Mr. Chairman. Incoming data, while mixed, have indicated that the economy has been growing at best at a sluggish pace. Moreover, a number of signs suggest weakness ahead; downward revisions to sales and earnings forecasts of many firms point to continued restraint on investment spending, and the associated decreases in equity prices along with lower consumer confidence will also be damping consumption demand. Against this background, outside commentators see you debating between a 50 and a 75 basis point reduction in the target federal funds rate at this meeting. Primary dealer economists are split close to 50/50 on which you will choose, and market interest rates now seem to have built in similar odds as well. I thought I would concentrate my remarks this morning on this choice.

Although the staff forecast assumes a 50 basis point reduction in the funds rate at this meeting, elements of that forecast provide good support for the more aggressive action. To be sure, most interest rates--both long- and short-term--already are a percentage point or more below their average levels in December, before you started easing, but equity prices have dropped 16 percent since then

and the foreign exchange value of the dollar has risen 2 percent. As a consequence, the amount of financial stimulus in the pipeline to bolster a rebound in the growth of aggregate demand is much smaller than might otherwise be expected. Moreover, because markets are placing some weight on a 75 basis point move, a further 50 basis point reduction in the funds rate at this meeting is unlikely to boost the stock market, depreciate the dollar, or lower bond yields.

With limited follow-through in financial markets from policy easing, as Dave has explained, economic growth remains below the growth of potential in the staff forecast and the unemployment rate rises rapidly. Although some relief of the labor market pressures of last spring may not be an entirely unwelcome development, the rise in the unemployment rate in the staff forecast may be too rapid and the level too high for you to find desirable. The rate moves above the NAIRU built into the staff forecast, giving a downward tilt to core consumer inflation in 2002 and presumably thereafter. Moreover, the Committee may see high odds on even less inflation pressure than implicit in the staff forecast if it suspects that the NAIRU may be lower than the staff judges it to be and may prefer to conduct policy on that working hypothesis until evidence more strongly suggests otherwise. If you accept the staff's assessment of the strength of aggregate demand but do not put a priority at this time on reducing inflation next year, you might consider the larger, 75 basis point reduction in the funds rate at this meeting to be appropriate.

The argument for such a reduction could be reinforced if the Committee saw the risks around the staff's outlook for aggregate demand to be substantial and asymmetrical toward lower growth. Although the staff forecast incorporates considerable weakness in high-tech investment, the extent of the shortfalls in sales of such equipment and the associated earnings revisions and stock price declines could be indicative of a larger overhang of this capital than in the staff forecast. Moreover, as pessimism about the earnings outlook seemed to spread last week beyond the high-tech sector, it was accompanied by a whiff of a generalized increase in both perceptions of risk and aversion to taking on risk. If that sentiment intensified, credit conditions could tighten substantially for many more U.S. borrowers. Greater risk aversion, and an associated tendency for contagion from one market to another, might also have a marked effect internationally, raising risk premiums and reducing credit availability to governments and private borrowers in countries in which the fundamental outlook is already being called into question. This possibility would tend to accentuate the

downside risks in the global economy, a source of concern that Karen has already highlighted.

It has been unusual for the Committee to give considerable weight to the balance of risks, rather than the most likely forecast, when deciding on its policy stance. In part, that's because such skews don't usually appear large enough to raise significant concerns relative to the already difficult issues presented by determining the central tendency of the economic forecast and settling on an appropriate policy response. Even when the risks are large, the Committee may recognize that buying protection against potential developments can have significant and continuing costs in that such actions foster less desirable outcomes in terms of real activity or inflation if those potential developments never occur.

Finally, there is another approach, albeit not quite as pre-emptive, that can minimize some of the potential costs when you see outsized risks on one side. That is to be prepared to respond rapidly should you get early evidence that the developments that concern you are in fact materializing. In the current circumstances, such an approach might argue in favor of a 50 basis point easing but a willingness to act promptly--even before the next meeting, if necessary--should, for example, demand show signs of weakening further or financial markets tighten substantially.

In addition, a good bit of the recent evidence on demand and economic activity may be read as weighing in favor of the less aggressive 50 basis point alternative. In particular, spending and employment have held up better than anticipated by the staff in the January forecast. By themselves, these data indicate stronger growth than the Greenbook estimate for the first quarter, suggesting the possibility that the risks may not be all on one side--that underlying demands may be stronger than in the staff forecast or the market's perception and the inventory correction closer to being completed. Moreover, January data on core consumer prices highlighted a pattern of acceleration over the last year that could prove troublesome if the economic rebound were significantly stronger or faster than in the staff forecast.

In financial markets, your easing moves may well be having more constructive and supportive effects than is apparent by just focusing on changes in interest rates, exchange rates, and equity prices. Credit markets have accommodated a large volume of borrowing, and decreases in bond and mortgage interest rates have encouraged a considerable lengthening in liability structures, which will leave both businesses and households less exposed to short-run

variations in credit availability. The fact that risk spreads did not widen much--and not at all until very late in the intermeeting period--despite ongoing downward revisions to earnings expectations, may in part be a reflection of declines in long-term interest rates holding down debt-service burdens and hence perceptions of borrower risk. Moreover, money growth has been quite rapid. Some of this growth may be the result of greater demands for liquidity in an uncertain economy. But, in contrast to the early 1990s, depositories seem willing to accommodate this demand and provide credit to borrowers, albeit at somewhat wider spreads. The opposite outcome--low money growth after decreases in interest rates--would have been a worrisome sign that income and spending were falling short of expectations or that depositories were less willing to carry out their intermediary functions.

Finally, the interplay of your actions and market expectations may also argue on the side of holding the easing action to 50 basis points. Market participants see a 75 basis point reduction in the federal funds rate as an alternative partly because, by your actions in January, you raised the bar for what is considered forceful action. The most important aspect of the market's expectations is the overall trajectory of policy actions built into intermediate- and long-term interest rates. If, for now, you are satisfied with the expectations that are likely to be built into the yield curve after you move 50 basis points, you can proceed gradually, even if you suspect that more easing may well be needed at some point. At this time, markets have priced in a decline in the federal funds rate to below 4-1/4 percent by the end of the year. Easing by 50 instead of 75 basis points is likely to raise this expected path some, but it is not likely to change the basic shape. If you think that a decline in the funds rate of this dimension implies low enough intermediate- and long-term interest rates to promote sustainable growth, the less aggressive adjustment should not be a problem.

You do need to consider this assessment in light of the drop in equity prices that likely would follow a 50 basis point easing. Depending in part on the wording of your announcement, it could be substantial inasmuch as equity market participants seem to be counting on you to stop the slide. But you also need to consider how successful an extra 25 basis points is likely to be in that regard. The downward movement in equity prices is primarily a consequence of disappointing earnings and a better appreciation of risk, especially in the high-tech sectors. And it is likely to continue until that disappointment comes to an end, whatever the discount factors used to value earnings streams. If the drop in equity prices is substantial after a 50 basis point move, markets will prevent it

from tightening overall financial conditions to its full extent, because they will also price in more ease later.

CHAIRMAN GREENSPAN. Questions for Don? Let me follow on then.

The one statistic that has not been mentioned today, which in fact I find the most worrisome on the down side, is the persistent downward revisions in weekly forecasts of S&P 500 earnings per share for the year 2001. Those forecasts have been reduced for the first three quarters of this year and, as I recall, for the fourth quarter as well. The downward revisions have persisted through the latest week for which we have data, which was last week. If we look at the year as a whole on a chart, the expected change in per share earnings seems to be going straight down. The main problem is not so much the direction; it's that the slope has not changed. The degree of erosion seems to be continuing, and it's not all accounted for by high-tech industries. Our estimate is that only about half the revisions involve the high-tech sector.

One consequence of the bleak near-term earnings outlook is that we are beginning to see a significant amount of capital investment plans being placed on the shelf. It's not that expectations of rates of return are being materially reduced for the longer term. They are not, and in fact the discussion we had earlier with respect to the outlook for the foreign exchange rate seems correctly suggestive of the fact that longer-term earnings expectations are holding up because the strength in productivity is still there.

What has happened is that the current uncertainties engendered by the sharpness of the slowing in the rate of economic growth have increased discount factors and hurdle rates of return in the markets. In a sense, that has made a lot of projects that were viable in the context of the hurdle rates of a year ago no longer viable in terms of

today's hurdle rates. It doesn't mean that all these projects are canceled, but it does mean that a substantial number are being delayed. In terms of how fast such delays can materialize, one just has to visualize a simple model involving the high-tech sector, where our data show an increase in capacity of 50 percent over the past year. That affects a significantly large part of the economy, and it's clearly a rate of increase that cannot persist indefinitely. I don't know what the relationship is in the high-tech area between outlays for replacement and modernization and outlays for capacity expansion, but if we assume that replacement and modernization expenditures do not change as the growth in expenditures for new capacity falls from 50 percent to, say, 20 percent--a still very dramatic and strong increase--growth of capital investment obviously will decline by 30 percentage points. And when we consider the fact that such investment has been going up very dramatically, the downward spike that we are looking at is very impressive, wholly independent of the question as to whether there has been a fundamental change in the longer-term outlook. It's the acceleration in investment expenditures in 1999 and 2000 that has set up this particular pattern, and the falloff in profit expectations is feeding this whole process. So the possibility that we may end up with a much lower capital investment number for the year than we forecast is not to be readily dismissed. I say that without any expectation that substantially reduced growth in capital investment will continue beyond this year.

Because of the decline in expected earnings and the obviously very sharp contraction in profitability, we are also getting some slowing in expenditures from the wealth effect--not as much as one would expect, but still some. Moreover, the overall slowing in both capital investment and personal consumption expenditures, especially

late last year, induced a fairly significant backup of inventories--actually, disproportionately in the high-tech area. If we look at the inventory-sales ratios in various segments of the economy it's pretty obvious, however we calculate these ratios, that the inventory backup in the high-tech sector has been completely unanticipated and that high-tech firms as a group have run into some difficulties. The difficulties outside the high-tech area initially occurred largely in autos and a lot of intermediate materials. While the book value data have grown faster in nominal terms, I believe, than in real terms, we can get a sense of real inventories from the production data, which by definition is where all inventories come from. From those data we conclude that the decline in manufacturing production through the latter months of last year ended a period of increasing real inventory accumulation. Leaving aside the somewhat questionable January numbers, February and March clearly are a period of significant inventory liquidation. Indeed, the data that we have for motor vehicles show some quite substantial declines. But in comparison with production patterns throughout the economy, consumption in February and March does not seem to be changing as fast. The implication of that from the perspective of a statistical model is that the rate of liquidation in February and March is really quite stark and pronounced.

The overall effect of this on economic activity is stabilization at some point, if all that is involved is an inventory correction. Stabilization would occur reasonably quickly because, judging from past experience, the current rate of inventory liquidation seems to be close to a maximum. What happens when a maximum degree of liquidation is reached is that the economy stabilizes even though the general level of confidence may be very low and indeed people may anticipate that economic conditions will deteriorate

further. They don't. And the reason they don't is that the level of inventories becomes a brake on the extent of the liquidation.

The fact that inventories cannot be negative no matter how uncertain, no matter how bearish people feel, is a fundamental feature of the way the economic system functions. Accordingly, inventory liquidations and inventory cycles are usually of the type that produce change reasonably quickly and can lead to a relatively prompt and pronounced adjustment in the economy. I suspect that we are going to see a goodly measure of that in the months ahead. Maybe. The "maybe" relates to a phenomenon that occurs on occasion but one about which I am quite concerned at the moment. It's called a "false dawn." It occurs when there are a lot of indications that the economy is behaving the way it ordinarily does in a recovery; but then it surprises us, and we get a renewed wave of weakness. One reason I would be concerned about that prospect is that the level of consumer confidence has come down fairly dramatically, even though the University of Michigan numbers did show some improvement in the first half of March. Of course, if we focus on the observations that were collected after the stock market took a sharp swing downward, the number comes down somewhat. So the level of confidence is still an open question.

Far more important is an issue that we have discussed around this table, namely the saving rate. The saving rate has a huge multiplier. All one has to do is add or subtract 2 or 3 percentage points and that does extraordinary wonders to the level of GDP and does so very quickly. I don't know whether the negative wealth effect is going to be a major problem. Conceptually, one has to presume that there is a considerable effect. I don't know whether we are going to learn specifically how its impact is working its way

through to expenditures; but it is not doing so currently at the pace that we would have expected from our models.

The uncertainties surrounding the negative wealth effect, along with the absence of any evidence that the rate of downward adjustments to expected profitability may be stabilizing, make me nervous about the outlook. Nonetheless, the March sales figures, as Mike Moskow mentioned, are not doing all that badly and the liquidation of inventories continues. Moreover, the numbers for steel ingot production came out today. They are still going up, and they are going up at a pace that is very clearly consistent with an inventory turnaround. So, a lot of positive economic information is showing up. Indeed, as I listen to the anecdotal reports around this table, I find encouraging signs that in my view would be consistent with stabilization were it not for the profits and the saving rate problems.

Another significant issue is Japan. Its economy, the second largest in the world, has had virtually no perceivable impact on world economic conditions for a long period of time. For a decade Japan had been a cipher as far as its multiplier effects on economic conditions in other parts of the world were concerned. I feel that that is no longer the case. I think the economic situation is eroding in Japan, and I believe it is eroding at a faster pace than is forecast in the Greenbook. I don't think it's all a political problem. What the Japanese are dealing with are problems relating to a declining labor force, unfunded long-term pensions, very large deficit spending, and an almost nonfunctioning financial intermediary system. Japan, remember, has a bank-only financial intermediary system, and we have seen innumerable examples in a number of the smaller East Asian countries of what happens when that intermediary system breaks

down. We have not yet seen that in Japan, but I think there is a significant danger that we may. More broadly, East Asia, as the Vice Chair has mentioned, is clearly in some difficulty.

Latin America is not a current problem for our economy, but there is a problem of political instability in those countries. We need to remember that a number of Latin American nations, such as Argentina and Brazil, have what might be characterized as American type high-risk economies. Such economies can function only if they operate in the framework of long-term time preferences and a political system that thinks longer term. It's not evident that that's the way the political system works in Latin America. As I have often commented--and Bill McDonough knows this better than I, and in fact Roger Ferguson probably goes to more international meetings than I do--when we sit around these international tables, what we hear are people who think like Western economists. But they are utterly unrepresentative of the government officials who employ them, and we get a false view of how those economic systems work. So there is a degree of shakiness about the economic outlook in many of our important trading partners, and that makes the false dawn issue disturbing.

In addition, of course, there is the stock market about which much has been said today. Some market players behave like addicts convinced a heightened dose would relieve their pain. It does not, and they seek a still larger dose. There is no stability in a regimen based on false pharmacology, [laughter] nor for stock prices from ever-larger doses of liquidity. Short-term rates have only a peripheral impact on expected earnings and risk premiums, and they therefore have limited effects on stock prices. Targeting stock prices themselves cannot be an effective policy. To restrain an upside stock market

surge could require the draining of liquidity to an extent that that would cause a collapse of economic activity, an obviously unacceptable trade-off. Likewise, flooding a depressed market with excess liquidity, unless that succeeds in revving up a moribund economy, cannot revive a deflated stock market.

It is important that the Federal Reserve not follow a flawed strategy. I fear that with a reduction of 75 basis points or even 100 basis points today, which as you know a number of people are suggesting, stock prices could still fall, leading too many observers to conclude that monetary policy is ineffective. This is a potentially dangerous view in my mind especially among the broad array of those who do not participate in the equity markets. If we do 50 basis points and stock prices fall further, as they well might today, it is the central bankers who may be perceived as intellectually inadequate, not policy itself. This is far less dangerous to the economy! [Laughter] At least it leaves open up the possibility that we policymakers can be educated or changed. Beyond that, implying but by no means guaranteeing in our press release that we may well cut rates before our May 15 meeting is a Damocles sword over bear speculators who view the next liquidity fix as more important than higher housing starts.

Ambiguity is rarely useful in monetary policy. Uncertainty usually creates risk premiums, but that depends on the nature of the uncertainty. For those who believe that the provision of central bank liquidity is bullish for stocks, history tells us that an overhang of uncertainty about when or whether the Fed will move to lower rates creates a downside or negative risk premium that may well have a larger sustaining effect than acting to remove the uncertainty. Markets are very often bought on rumor and sold when the rumor proves true, or false for that matter. This is one of the rare periods when in my

judgment calculated ambiguity can serve a useful purpose in minimizing unthoughtful activity. I would propose, therefore, that we reduce the rate by 50 basis points and construct language for the press statement that leaves the door wide open on an intermeeting move. Any intermeeting action would be governed, however, by a judgment that the real economy is in some unforeseen difficulty beyond our current set of probabilities, not by a further weakening in stock prices. I do acknowledge a wealth effect, which we must take into consideration. The wealth effect itself is real in that it has an impact on spending and activity, not just psychology. If we are required to accelerate our downside moves, I prefer to shorten the interval between the moves rather than increase the size of each move. I do not like where I believe relatively large moves may lead us in current circumstances. I believe the cost of a policy of smaller but, as needed, more frequent moves is really quite limited. It does not require us to make the added move, but leaves our options wholly open. This in my judgment is necessary in the present environment.

I would like to put on the table for discussion, then, a 50 basis point reduction with a statement in our press release that the risks are still on the down side but that also suggests that we are focused on what is going on in the economy. Even though we have almost two months to the next meeting, we will be prepared to act when and if necessary, but we recognize that “when and if necessary” does not merely mean a decline in the stock market. Thank you. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I very enthusiastically support your recommendation, including all the nuances. When I was on my most recent long airplane ride, which was last Wednesday, I thought to myself that what we had to do

at this meeting was to be decisive and flexible at the same time. That would require creating a certain amount of uncertainty among the bears in the market who are forever trying to find a new carcass to feed on.

In my view, therefore, a 75 basis point cut in the funds rate would be very, very unwise. The market could interpret that as an indication that we had finished easing monetary policy. We don't know whether we will have finished easing with another 75 basis point reduction. I would note, too, that I think your use of the word "addiction" was absolutely right. It would be assumed that the new "normal" move was 75 basis points; we would be feeding the addict's habit and the next time he or she would want a move of 75 basis points or more. So, such an action would be extremely ill advised. And the peculiar thing is that the end result would be a reduction in our flexibility at exactly the time we need it. Thus, I believe that every part of your recommendation, in particular making it rather clear that we might well move before the next meeting, is appropriate. Thank you.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. Let me comment briefly about each of the choices along the spectrum of alternatives that are most plausible here.

Twenty-five basis points is the most conservative possibility. With inflation quiescent and quite likely to stay so for some time, I just don't see any necessity to keep such a tight hold. Indeed, I perceive that it would be quite risky to do so. So that alternative has little attraction for me at this time.

The most aggressive choice is 75 basis points. While the financial markets are clamoring for it, the data from the real economy seem firmer than such a move might

imply. Most particularly, I fear that the message a 75 basis point move would send would be totally wrong. People in the real economy might perceive us to be in panic, which we are not. Stock market investors might see us as trying to save them, which would not be correct but could nevertheless create a serious moral hazard that might be quite difficult to eradicate. And this move would take short-term rates down toward a low level, which could begin to constrain our options should further easing become necessary. Finally, there is at least some small possibility that a strong, early upturn in the economic expansion could make even this level seem too low in the not too distant future, which would introduce an entirely new set of dynamics.

So, I believe that 50 basis points is the best choice and that asymmetry toward weakness is the correct tilt because I think the risks are still on the down side. Thank you.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, I can support your recommendation, although it is not my first choice. And because it may prove relevant for some future meeting, I'd like to explain briefly a different view.

Let me call option X a 50 basis point cut with the balance of risks toward weakness. I'll call option Y, my preference, a 75 basis point cut with a statement that the risks are balanced. I think the immediate market impact of those two options would be roughly the same because the balanced risks statement is not foreseen by the market. I look at this as a problem of where we are likely to be perhaps four weeks from now. Incidentally, I want to make clear that a balanced risks statement only means that the probabilities of the next move being up or down are equal. I would not be foreclosing

another easing move at the next meeting if the data support such a move in a compelling way. But let's say the incoming data are on the weak side four weeks out. Option X, the one we are likely to vote for today, leaves us in the same situation as we were going into this meeting--that is, with continuing speculation about when and how big our next move will be. Option Y puts us ahead of where we would otherwise be. If the incoming data are flat to strong, option X results in uncertainty about whether we might still be contemplating another downward move. Option Y leaves us "finished" for the time being, which I would view as the correct message. Clearly, option Y positions us to stop easing at forthcoming meetings. That is my best guess of our future policy path, given the forecast, the sentiment, the anecdotal information, and the rapid creation of liquidity in the system at this point.

I am quite frankly opposed to giving a deliberate hint of an intermeeting move. I think that's going to cause us difficulty not only in coming weeks, but well beyond because people will be wondering in the future if an intermeeting action is on our minds. So, I believe that that would be a mistake.

CHAIRMAN GREENSPAN. President Hoenig,

MR. HOENIG. Mr. Chairman, I support your proposal. As I said earlier, I see enough weakness and risk in the economy looking forward beyond this quarter to justify a 50 basis point cut. And I am relieved that we are not doing more than that because in my view that would introduce some of the problems you noted. It most definitely would introduce moral hazard issues with regard to the market and what it would expect from us, which would be inappropriate. So, I am comfortable with your recommendation.

I have two questions. When you spoke of an intermeeting move, did you have in mind a conference call with the Committee to go forward with such an action? Secondly, in the press statement coming out of this meeting, would you anticipate any reference to the market or would the market not be mentioned? If nothing else, we're going to get ourselves in this trap--

CHAIRMAN GREENSPAN. In the draft language, the only reference to the market relates to equity wealth effects. At this stage there is no reference to stock prices.

MR. HOENIG. Okay, thank you very much.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. I agree with your proposition, Mr. Chairman. I think a 50 basis point decrease in the fed funds rate is appropriate at this time. And since I believe the risks are still on the down side, I favor retaining the balance of risks language in the direction of weakness, as you indicated.

I, too, have become uncomfortable with the possibility that observers might get the impression that the Committee's decisions are driven by what the markets expect and by the direction of stock prices. I'd like to dissuade them of that view. Therefore, I think it's important that our press statement indicate that our action was taken to counteract the real economic effects of falling stock prices, as you suggested.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I support a 50 basis point cut in the funds rate and I also support a statement that the risks remain weighted toward economic weakness. I, too, share your concern about a 75 basis point cut at this time. To me the recent data on employment and spending do not suggest that things are as bad as the stock market, or

for that matter consumers in general, seems to think. This makes it likely that at least part of the market's decline represents a return to more rational stock valuations. Under these conditions, a 75 basis point cut in the funds rate now could provide a false sense of security to the stock market. People might be led to believe that the Fed is attempting to validate recent historically high valuations in equity markets. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I support your recommendation. I'm coming at this largely in the way Ned Gramlich described earlier. It seems to me that the real federal funds rate should be moving lower, and a 50 basis point cut seems appropriate. I don't know if that will turn out to be sufficient but I do think it will prove to be constructive.

I share your concerns about the potential of a false dawn here, though obviously none of us can see the future very clearly. But another possibility--and perhaps a better bet at least in my mind--is that rather than a V-shaped recovery we will get initially just a very, very modest recovery. It may be similar to the type we had in the early '90s, when for a time there was a lot of concern about the fragility of the economy and the sustainability of its performance.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. I can endorse your recommendation. I'd like to speak to each of its three parts.

First, a cut of 50 basis points does seem to me to be appropriately targeted at the real economy. Any more would appear to be targeted inappropriately at the stock

market--and I endorse your general concept of why that is not the role of a central bank--and any less would clearly be too little in my judgment, given the risks.

On the balance of risks statement, the language is written in the context of our goals of price stability and sustainable growth. Therefore, if we're seeing growth in the foreseeable future that is likely to be below our estimate of appropriate trend growth, then we can legitimately continue with a statement that says the risks are weighted mainly toward conditions that may generate economic weakness. I believe this is an important element of interpretation. If in fact the economy were growing appreciably but from a very low base and we still thought that growth was unacceptably slow because it was below trend, then it would be legitimate intellectually to say that the risks are toward economic weakness.

With respect to the hint of an intermeeting move in the press release, I am concerned about adding some new language whose presence or absence could be something that the market is looking for after every meeting in the future. We did that in December. I think it worked well. We did not do it at our last meeting and that was okay as well. So I don't think the market has gotten into the habit of looking for this kind of language to indicate future policy moves. However, it is always important, and in fact it's common sense, to suggest that we are attentive to the incoming data. So, given the degree of risk and uncertainty, and given the amount of time between now and the next scheduled meeting, I think it is probably better--though it is not an easy judgment to make--to include a sentence that suggests we will be particularly attentive to incoming data.

CHAIRMAN GREENSPAN. President Minehan.

MS MINEHAN. Thank you, Mr. Chairman. All I can say is “Wow!” Your summary was a real tour de force, especially with respect to the stock market and the undesirability of fulfilling ever-greater market expectations. I agree with the 50 basis points, I agree with the asymmetry, and I share your concern about a move of 75 basis points or something more than that. I'm in agreement largely because, first of all, I think an easing move is necessary and secondly because I believe taking measured steps is appropriate. It may well be that further ease will be necessary, but I'd like to do that also in limited steps. And to me the best part of a measured process like that is that it could focus the “addicts,” as you called them, a bit on saving themselves rather than looking to us to do the job.

I am, however, very worried about your recommended nuances in the statement. In my view we always have the option to move between meetings. We've done so in the past, the quite recent past. That is part of everybody's understanding of how we operate. Everyone knows how long it is between this meeting and the next meeting, everyone knows we're vigilant, and everyone knows we're focused on incoming data. If we add nuances to the statement this time, I think we are going to provide the addicts with even more reason to focus on us rather than themselves for a solution to their problems. And I don't think that would be good at all.

CHAIRMAN GREENSPAN. President Broadus.

MR. BROADDUS. Mr. Chairman, I come out exactly where President Minehan did. I certainly support the 50 basis points move. I thought the reasons you gave at the end of your statement really iced the case, although I have to confess that I

wasn't sure for awhile exactly where you were going to come out. But cutting the funds rate as you proposed is what I think we clearly need to do.

I can support an asymmetric directive. On the economic merits that makes sense to me. But I have very strong reservations and would oppose adding new language about the possibility of an intermeeting move. I just don't think it would buy us a lot, and it could be dangerous in terms of the market dynamics and the expectations it could create. The word that comes to my mind in thinking about it briefly here is "tantalizing." As Cathy Minehan said, everyone knows that we can always make an intermeeting move; we've done it fairly recently. I don't see much to be gained by underlining that. So I would support all of your recommendation except for that element of it.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I can support your recommendation, particularly the first part of it. I must confess to being even more thrown off than President Broadus was in thinking that you were taking us someplace very different than you did. I spent the first three-quarters of your presentation making frantic notes about how to disagree gracefully! I was thinking that a move to validate market expectations and further confirm the moral hazard associated with not letting the market adjust would be the worst possible outcome.

I must admit that I substantially share Cathy's and Al's concern about the second part of the recommendation, namely to hint that we would be inclined to an intermeeting move. I don't view that as necessary. In fact, I believe we could make matters worse for ourselves by doing that, though it's hard to judge without seeing the language you have in mind. So I would hope that either now or after we see the proposed

language we could talk a bit more about the wisdom of including that as part of the decision today. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. I agree with the easing move today of 50 basis points, but I'm troubled by two things. One, when we use the word "weakness," we may think slower growth but others hear decline. And I think that's a troubling message. If what is heard out there is that we expect further declines in economic activity, the question then arises, "Why aren't we doing even more?" I don't know how we can communicate this concept of slower growth. The second part of that concern is that at some point, of course, we will reach a position where we feel that with this move, or lack of a move, the risks are balanced. And I don't see how we say that if the economy is perceived as growing at less than its potential--if it's not at full employment or not at capacity or some such notion. But we're going to have to get to that point, given the lags in the effects of policy actions on inflation, well before it is perceived by the public that what we are observing in fact represents a situation of balanced risks.

Finally, I question putting emphasis on high frequency data reports or giving the public the impression that some information is going to come out in the next six weeks that is going to carry so much weight with us that we may take an intermeeting action. That may well be the case; we've done it before. But I don't see the value of signaling that we're going to be very heavily preoccupied or focused on some report because that just heightens the interest of the Fed watchers. The wire service types will be saying, "Which one of these reports is the one that if it flashes in the right color,

whatever that color is, is going to trigger an action?" At some point we need to think about how we start communicating that we have a long-term focus on maximum growth, which involves sustaining price stability.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, as one of the golfers in this group, I thought the analogy Mike Kelley gave before was excellent. To continue it, I guess I would describe your proposal as hitting a shot to the green. I'm not sure where it landed but we are carrying several clubs with us and one of them surely is a sand wedge.

CHAIRMAN GREENSPAN. On the green? [Laughter]

MR. MOSKOW. I meant toward the green, since that's the way I usually play golf! [Laughter] But, seriously, I thought your statement was excellent. I do think we need to ease. I believe we should be measured in our actions, as I said in my comments and as Cathy Minehan mentioned as well. In my view, 50 basis points should be enough for now. I agree that we need to avoid trying to fulfill the ever more extreme market expectations. We can't hope to keep up with such expectations, and even if we were to cut the funds rate more than 50 basis points today, it's not clear that the markets would be affected in anything but the short run, as you mentioned. Also, I support retaining the asymmetric language. Even with the 50 basis point easing, the risks remain tilted toward weakness.

I am uneasy about the language regarding an intermeeting move. I'm not sure exactly what we gain from it or how it helps us in moving forward. Perhaps we could have more discussion on that.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. My position is very similar to that of Presidents Minehan, Broaddus, and Guynn, a little stronger than President Moskow's. I support your recommendation for a 50 basis point decline in the target funds rate today, along with a statement that the risks remain unbalanced toward economic weakness. But I would very strongly prefer to avoid any direct or explicit hint in our statement of an intermeeting move.

I haven't heard much support for a 75 basis point move, so I won't argue the case for 50 as opposed to 75. A 50 basis point move today along with a statement of unbalanced risks as always, as has been pointed out, holds open the possibility of an intermeeting move. But hinting more directly at such a possibility in the statement, especially if we repeat something like the words in our December 19th statement--in effect using a code that will be interpreted as an inclination toward an intermeeting move --would, in my view, be a mistake. It would leave market participants speculating day in and day out about whether we were in or about to hold an emergency meeting to cut the target funds rate. It could aggravate the market's response to every newly reported indicator and it would leave equity prices continually buffeted by such speculation. This type of uncertainty in my view has no up side.

My preference to avoid a direct hint of an intermeeting move also reflects my preference for policy decisions to be taken at our regular meetings. To be sure, there are circumstances when an intermeeting move is a valuable part of our toolkit and, Mr. Chairman, you have used this tool sparingly and wisely in the time I've served on this Committee. I am confident you will continue to do so. Still, I do not believe it would be

wise to set policy so as to leave the impression that an intermeeting move has a very high probability or to tell the markets that we are so inclined.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. For a while now I've been stuck on the same question that I think the meeting is stuck on. I have felt that from the basics what I'd like to do at this meeting is to move the funds target down 50 basis points and retain the bias, but if there were some way to do a little more, I felt that was appropriate. There are two ways to do a little more. One is to go down 75 basis points. Some have talked about that; I would have gone down 75 and retained the bias toward weakness. The other way is what you suggested, Mr. Chairman, to go down 50 with a hint of more. Let me try to do a benefit/cost analysis on this.

I see two advantages in your approach. One is that it is flexible and decisive, as Bill McDonough described very well, and in that sense more effective than going down 75. Also, it can be more targeted to the real economy and not the stock market, and I think that's an advantage as well.

As for the costs, you've all been very eloquent about the cost side of it. The cost that a number of people have mentioned is the heightened sensitivity to the Fed and what its next policy move might be. I think every one of us feels that there is already way too much sensitivity out there. By hinting of an intermeeting move, we are not making that problem any better, so I do see that as a cost. But I will still support the approach you recommended. Among unsatisfactory alternatives I think it's probably the best.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I support your recommendation and I hope we will be flexible and willing to have an intermeeting discussion if the data suggest the need for that. But I share the reservations of those who would rather leave the reference to that possibility out of the language of our press statement.

CHAIRMAN GREENSPAN. Let me suggest that we take a look at the draft language before we vote, because the language I've chosen does not in my judgment raise precedential issues. This is a very rare occasion. If indeed it got to the point where this kind of wording became a new, separate part of the decision we had to make on an ongoing basis, I would vote against it. I think that would be too much. But I believe current circumstances are very unusual, and in my judgment we gain from the type of statement that is in this early draft. In that regard the proposed language does not in my view set any precedents in that it is unlikely to be used again. I think this is one of those extraordinary periods in monetary policy history where we're at a very important crossroads. And being sensitive to it I think is useful. The cost over the long run, which has been well articulated here and I believe quite correctly, is not something that concerns me because I don't think we're going to be doing this again.

The operative sentence is obviously the last sentence of paragraph three. Has everyone looked at it?

MR. GRAMLICH. Excuse me. Could I ask a question of Don? Do you happen to have the language of the similar sentence in December? People are going to compare the two.

MR. KOHN. Right.

MR. MEYER. This is just a little stronger it seems to me because we didn't say "especially" monitor, we said monitor "closely."

CHAIRMAN GREENSPAN. Well, I purposely didn't want to use exactly the same language for precisely that reason.

MR. GRAMLICH. Was adding "especially" the whole difference?

CHAIRMAN GREENSPAN. Yes. What was the language--

MR. KOHN. I don't think I have the--

MR. KELLEY. I have the language we used in December if nobody else does.

MR. PARRY. Why don't you read it?

MR. MEYER. The discussion will all be on what "especially" means.

MR. KELLEY. Would you like me to read it, Mr. Chairman?

CHAIRMAN GREENSPAN. Yes.

MR. KELLEY. The comparable sentence in the press release of December 19th read: "The Committee will continue to monitor closely the evolving economic situation."

MS. MINEHAN. At the time we put that sentence in our press statement, I know I did not feel that it committed us to--or any way was a formal nuance regarding--an intermeeting move. But the fact is that the sentence exists and we did take an intermeeting action. So it seems to me that the pairing of the two is a lot more powerful now. In my view we can't take any comfort from the reaction to our press statement in December; that is not a valid basis on which to judge what would happen now if we use something close to that sentence in these circumstances.

VICE CHAIRMAN MCDONOUGH. I think the key question is the one the Chairman himself raised: Is this precedential? Does it say that we have to do something in the future? I think the answer to that is no. We are essentially looking at what the market reaction is likely to be. My view is that we need this in our statement in order to show that we are vigilant because I share the Chairman's basic view that we are at a most unusual, maybe once-in-a-lifetime, moment in the course of monetary policy formulation. And that's what drives the need for us to say something along these lines.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. When I spoke earlier, I believe I said this is a judgment call. Clearly, the tone of this discussion suggests that there are judgments on either side. If we look at this language in the context of the whole paragraph, I think it gives us the right kind of flexibility without over-committing us. As I said before, I would be very concerned if we were moving toward having to vote on this sort of additional language at each meeting, but we are not in that mode. You clearly are not putting us in that mode, Mr. Chairman. What you are suggesting, as the language says, is that conditions are evolving very rapidly. And I think it is quite legitimate for a central bank to say that in such a circumstance, with economic conditions evolving very quickly, the financial situation is quite fragile both domestically and internationally. So, guess what? We are going to be vigilant and we are going to be monitoring developments especially closely.

Though it seems to me a judgment call, it is not unreasonable to ask the Committee to communicate that message to the market. On the one hand, it is an obvious statement in that we're always looking at incoming developments closely. On the other hand, given the fragility that we've seen and the interplay of various developments to

which the statement alludes, I think it is really quite intelligent of the central bank of the United States to state clearly that we are watching. It does not commit us to do anything. Indeed, as the data unfold, we may do nothing. But it tells the markets that we are indeed awake. Yes, there is a risk that the markets will look to every number and react to it, but we can ultimately manage that. If we don't react, then the market will learn from that. So, in some sense I think this gives us the right degree of flexibility. Though obviously I'm not downplaying the risk on the other side, by and large to me this is the better option.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, my preference would be to leave out that sentence for several reasons. First of all, we are never relaxed. Quite frankly, I've never relaxed and I don't think anybody else around the table has ever relaxed about the economic situation. We follow developments very closely. If the economic situation does evolve rapidly and it calls for action, then I don't doubt that we will step up to the plate and do what is necessary. But my concern about this language is that lots of routine data come in and if some measures come in a little on the weak side, that may cause a reaction. This language will prime the market to watch every piece of information that becomes available and will increase the market's volatility. All sorts of minor developments that don't call for any action will be looked at from the perspective of whether it will trigger the Fed to act or not.

CHAIRMAN GREENSPAN. But it is up to us to act or not act.

MR. POOLE. Oh, I understand that. But I'm talking about my forecast of how the market will read this.

CHAIRMAN GREENSPAN. I don't disagree with you actually, and I'm not sure that I view that as a bad outcome because in effect what we will be telling the market is that we don't agree with it. In other words, we'll get a lot of those views initially and when we don't act, things will calm down. The other day, for example, I had to make a statement up on the Hill to try to shoot down the view that there was going to be an intermeeting move because one of our former colleagues got exuberant, as has been pointed out, and had forecast such a move. When I made that statement, everything calmed down. In other words, if people want to get stirred up, in my judgment we should let them get stirred up. But the point is that if we don't move on that stirring, it actually reinforces the view that we are not responding--and should not be responding--to the stock market or to people on the street whose basic view is that our role is to bail out their poor investment judgments. I don't think that's the role of a central bank. President Hoenig.

MR. HOENIG. Mr. Chairman, when I was listening to your comments, I thought you were going to put words in the statement that said we might move in the intermeeting period. In reading this draft, I'm quite relieved that you are not doing that. So, I can live with this sentence. I would take out "especially" if I had my choice.

SEVERAL. Yes.

MR. HOENIG. I can live with this sentence because if I can't live with this sentence, I can't live with the sentence that precedes it either. I don't think it says that we necessarily are going to move in the intermeeting period. I would take out the word "especially" so it is more parallel to our statement in December and not less. Other than that, I'm fine with this.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. I agree with Tom Hoenig's comment. I, too, in hearing you, thought that this statement would be much starker about an intermeeting move, but I'm comfortable with this wording. I would also agree with Tom, though, on taking out the word "especially."

CHAIRMAN GREENSPAN. Well, we have a majority now in favor of the statement. Let me see if I can get a vote in effect, not a formal vote, on the word "especially." Why don't I quickly go around the table on that point and then we can close this discussion. Just indicate "yes" or "no" on the word "especially." Vice Chair.

VICE CHAIRMAN MCDONOUGH. Yes.

MR. HOENIG. What does a "yes" vote mean? Does "yes" mean "especially" is in or out?

CHAIRMAN GREENSPAN. If "especially" is in, the word is "yes." If it is out, the word is "no." Okay? I'm sorry, the Vice Chair is yes. Governor Ferguson.

MR. FERGUSON. Yes.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. No.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. No.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. No.

CHAIRMAN GREENSPAN. Governor Meyer? Oh, you're already--

MR. MEYER. I can't vote "no"?

CHAIRMAN GREENSPAN. No. You don't get a vote! [Laughter] You already voted "no" on the whole sentence.

MR. MEYER. Okay.

CHAIRMAN GREENSPAN. The others have already expressed their views so the word "especially" is out. I ask the Secretary to read the appropriate directive and let's vote on it.

MR. BERNARD. This language is on page 11 of the Bluebook: "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 reducing the federal funds rate to an average of around 5 percent." And for the balance of risks sentence in the press statement: "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 weighted mainly toward conditions that may generate economic weakness in the foreseeable future."

CHAIRMAN GREENSPAN. Shall we vote?

MR. BERNARD.

| | |
|-------------------------|-----|
| Chairman Greenspan | Yes |
| Vice Chairman McDonough | Yes |
| Governor Ferguson | Yes |
| Governor Gramlich | Yes |
| President Hoenig | Yes |
| Governor Kelley | Yes |
| Governor Meyer | Yes |
| President Minehan | Yes |
| President Moskow | Yes |
| President Poole | Yes |

PRESIDENT MINEHAN. I'm glad Governor Meyer and I got to vote on this one!

CHAIRMAN GREENSPAN. Well, you had already said "no" on including the sentence. If you vote against the whole sentence, then voting on a word is irrelevant.

MS. MINEHAN. One can't vote against "especially" doubly? I was looking forward to voting. [Laughter]

CHAIRMAN GREENSPAN. Okay, what was your vote?

MS. MINEHAN. No. [Laughter]

SPEAKER(?). For the record!

CHAIRMAN GREENSPAN. I would like to adjourn this meeting temporarily so that the Federal Reserve Board can meet and adjudicate the requests of all twelve Reserve Banks on the discount rate.

[Recess]

CHAIRMAN GREENSPAN. The Board has approved the requests of all twelve Reserve Banks for a 50 basis point reduction in the discount rate to 4-1/2 percent. Finally, our next meeting, as all of you know, is scheduled for May 15th. And that is the official end of this meeting. Luncheon is served and Don Winn will fill us in on a few issues that I think you might find interesting.

END OF MEETING