

**Meeting of the Federal Open Market Committee  
August 21, 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., on Tuesday, August 21, 2001, at 9:00 a.m.

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, and Stern, Alternate Members of  
the Federal Open Market Committee

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

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

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

Mr. Kos, Manager, System Open Market Account

Ms. Smith, Assistant to the Board, Office of Board Members, Board of  
Governors

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

Mr. Madigan, Deputy Director, Division of Monetary Affairs, Board of Governors

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

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

Mr. Helkie, Assistant Director, Division of International Finance, Board of Governors

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

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

Mr. Kumasaka, Assistant Economist, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Office of Board Members, Board of Governors

Ms. Browne, Executive Vice President, Federal Reserve Bank of Boston

Messrs. Eisenbeis and Lacker, Ms. Mester, Messrs. Rosenblum and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Richmond, Philadelphia, Dallas, and Cleveland respectively

Ms. Hargraves and Mr. Judd, Vice Presidents, Federal Reserve Banks of New York and San Francisco respectively

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

Transcript of Federal Open Market Committee Meeting of  
August 21, 2001

CHAIRMAN GREENSPAN. Who would like to move approval of the minutes of the June 26-27, 2001 meeting?

VICE CHAIRMAN MCDONOUGH. Move approval.

MS. MINEHAN. Second.

CHAIRMAN GREENSPAN. Without objection, they are approved. Dino Kos.

MR. KOS. Thank you, Mr. Chairman. I will be referring to the charts that were distributed at your places earlier this morning.<sup>1</sup>

The first chart depicts the standard 3-month cash and forward deposit rates from early April through last Friday. As you can see, U.S. short-term rates continued to decline over the recent intermeeting interval. Weak corporate earnings, layoff announcements, and a Beige Book that was perceived as downbeat were among many other factors that affected sentiment during the period. Three-month cash and forward rates declined by about 20 basis points over the period. Nine-month forward rates rose immediately after the June FOMC meeting but then declined quickly and on balance fell about 35 basis points for the period as a whole. While the 9-month forward rate may suggest that the market is building toward a tightening later in 2002, as perhaps does the Eurodollar future strip, other indicators such as the 2-year note are more ambiguous--a subject I'll talk about later.

In the euro area, cash rates have been stable since the last meeting, but 3-month and 9-month forward rates have continued to be pulled lower, by 16 and 21 basis points respectively. Forecasts for the euro-area economy have been trimmed and the market is cautiously building in some additional easing, with many market participants expecting 25 basis points of ease at the end of this month. The largest changes in rates occurred on August 8<sup>th</sup> and 9<sup>th</sup> after the Beige Book was released here and the ECB's monthly report, which was viewed as paving the way for an ease in policy, was released in Europe.

The bottom panel shows the Japanese government yield curve from 3 months out to 10 years. I've highlighted three snapshots coinciding with the last two FOMC meeting dates and this past Friday, ahead of the current meeting. The short end of the curve is below 20 basis points

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<sup>1</sup> The charts used by Mr. Kos are appended to this transcript.

out to 3 years, but the longer end of the curve has proved more resistant to further prodding by the Bank of Japan. The announcement by the Bank of Japan on August 14<sup>th</sup> that it would increase its current account balance target from 5 trillion to 6 trillion and also raise the pace of JGB purchases has not noticeably affected the yield curve. In fact, the longer end of the curve is actually higher than it was on June 26<sup>th</sup>.

Turning to page 2, I've provided a snapshot of asset prices in U.S. markets. All three markets--the fixed income, equity, and foreign exchange markets--reflect a continually shifting sentiment and are discounting a weaker outlook. The top panel shows the 2-, 10-, and 30-year yields along with the fed funds target since April 1<sup>st</sup>. The entire curve has shifted lower and the 2- to 30-year spread has steepened by another 10 basis points, from about 166 basis points at the time of the last meeting to about 176 basis points at the close yesterday.

I would make two points. First, benchmark long-term rates have come down quite a bit in the last seven weeks. The 10-year is down about 40 basis points and the 30-year is down somewhat less, by about 20 basis points. Second, the 2-year note traded as low as 3.64 percent during this period, the lowest rate since the 2-year note began to be regularly auctioned in 1976. By way of comparison, during 1992 and 1993, when the funds rate was at 3 percent for an extended period of time, the 2-year rate never fell below 3.66 percent. Given the sensitivity of the 2-year note to the funds rate, if the markets were building toward a tightening at some point--as suggested by the Eurodollar futures and the forward rate agreements--then one might have expected the 2-year note yield to be higher than it is now. So, its behavior at least raises questions about the signals being given by some of those other indicators.

In the middle panel I've plotted the major U.S. stock indices indexed to 100 on April 1<sup>st</sup>, which also coincides roughly with their lows for 2001. As reflected in the chart, those indices rose through much of the spring but have been coming down--and have continued to come down in the intermeeting period--as the market has adjusted to the weaker outlook.

The bottom panel shows changes in the trade-weighted value of the dollar against other major currencies. The dollar has declined modestly on a trade-weighted basis, but that masks sharper declines against some of the major currencies, especially the yen, the euro, the Swiss franc, and even some other currencies such as the Singapore dollar that have been used as funding currencies in so-called carry trades. In part the decline is probably due to perceptions about the recovery; in part it may reflect some risk aversion. As economic activity seems to be slowing

globally, a little risk aversion may lead to a closing out of some carry trades. And finally, some of the ongoing chatter in markets about the Administration's posture toward the dollar may also be a contributing factor.

Turning to the third page, the top panel depicts the major European equity indices, also going back to early April. They show a similar pattern to that in U.S. markets except that the decline has been more dramatic for European equities, especially over the intermeeting period. In that interval most of these major indices fell between 3-1/2 and 10 percent, in part reflecting revisions in forecasts for growth as well as weak earnings. Interestingly, though, the euro actually had one of its sharpest rallies since its launch, moving from about 85 cents to almost 92 cents during this period for reasons that are not fully clear, given some of the news that was coming out of Europe. One explanation might be that interest rate differentials are finally biting. Those interest rates have been narrowing for almost two years in favor of the euro. The bottom panel shows the differentials between dollar and euro swap rates. These spreads continue to decline modestly but are still slightly in favor of the dollar.

Turning to the next page, the top panel depicts the dollar-yen exchange rate. A couple of noteworthy events have taken place in Japan since the last FOMC meeting. First, the Upper House elections were held and the LDP and Prime Minister Koizumi did quite well--an outcome that is expected to accelerate structural reforms in Japan. Second, on August 14<sup>th</sup> the BOJ announced changes in its operational targets, as I noted earlier. That combination would have been expected to produce a weakening in the yen and a lift to the equity markets. In the event, the yen actually has appreciated from about 125 to below 120 this morning and equity prices have continued their decline, as reflected in the middle panel. The reasons for the yen's appreciation are not fully obvious. Repatriation and the approach of the end of the fiscal half-year have been mentioned yet again. Another possibility is that there may be some risk aversion kicking in that is causing some of the short yen trades to be unwound. But it's not immediately apparent why the yen would be appreciating in this kind of environment.

As I mentioned, Japanese equities have continued to decline with only a brief interruption after the Upper House elections and the BOJ's operational changes. The Nikkei, which was over 13,000 at the time of the last FOMC meeting is now below 12,000 and at its lowest level since 1984. The Topix Bank sub-index has also been falling again, reflecting renewed doubts about the health of the Japanese banking system. As the bottom panel shows, that sub-index is actually lower now than it was during the 1998 banking crisis in Japan.

Turning to the last page, the chart shows monthly growth rates, seasonally adjusted, for currency during 2001. As you can see, we've had elevated currency growth in July and also in August. Most of that is attributed to cash shipments overseas, primarily to Argentina. The growth of currency has been running at roughly double the rates observed earlier this year, translating into deepening reserve needs over the past intermeeting period. Those deeper needs were met primarily by an expansion of the permanent SOMA portfolio and by a modest increase in the amount of long-term RPs outstanding.

Mr. Chairman, there were no foreign exchange operations during the intermeeting period, but I will need a vote to ratify the domestic operations. And I will be happy to take any questions.

CHAIRMAN GREENSPAN. Questions for Dino? If not--

VICE CHAIRMAN MCDONOUGH. Move approval of domestic operations.

MR. PARRY. Second.

CHAIRMAN GREENSPAN. Without objection, they are approved. Now we'll go on to David Wilcox and Vince Reinhart. David.

MR. WILCOX. Thank you, Mr. Chairman. A reader of this meeting's Greenbook could be forgiven, I think, for contracting at least a mild case of sticker shock. After all, we revised down our estimate of growth for the current year--already half completed--by 0.4 percentage point, and for next year by twice that much, to cut 1-1/4 percentage points from the level of GDP by the end of next year. But rather than casting this forecast as a big change from its predecessor, I would like to begin today by making the case that this can largely be seen as a status quo forecast.

Without a doubt, there has been considerable buzz in the last few weeks about the revisions to the national income accounts and how dramatically those revisions have changed perceptions of macroeconomic reality. In a way, of course, that is correct. The revised figures suggest that firms invested much less than previously estimated during the past three years. Accordingly, capital deepening occurred at a slower pace, and that has important implications, of course, for growth prospects. As my colleagues Fleischman, Sichel, and Struckmeyer outlined in their memo to you last week, we have trimmed our estimate of potential GDP growth by four tenths this year and six tenths next year. Obviously, a revision of this magnitude is of enormous consequence for some issues, including assessments of the

trend rate of growth in the standard of living, the long-term outlook for the federal budget, and the solvency of the Social Security system.

But the implications of the NIPA revisions for the conduct of monetary policy could easily be overdone. To a first approximation, the recent history of inflation remains essentially as previously estimated. From that, we infer to a first approximation that the pressures on productive resources probably were about as we had estimated based on the previous numbers. In particular, the gap between actual and potential GDP probably was about as we had it, albeit with lower levels of both actual and potential output.

Previously, we had been attributing a goodly portion of the outstanding inflation performance of the late 1990s to the acceleration in structural productivity. Now, with the productivity boom downgraded a notch, it can obviously do less of the work for us in terms of explaining why inflation has stayed so low during the last five or six years. So what explains the extraordinarily good inflation performance of the late 1990s? The short answer is that we don't know for sure, but something else must have been causing inflation to behave so well despite the low unemployment rate. Often cited candidates include the rise of temporary help supply firms, better job matching facilitated by the Internet, welfare reform, and reduced pricing power due to more intense foreign competition. Before, we were in the slightly awkward position of having no room for any of these entirely plausible explanations to play a role. Now, there is scope for these possible changes in the behavior of labor and product markets to be part of the story. While we are uncertain about the precise magnitudes of the various individual effects, we are assuming they will persist, with the consequence being essentially equivalent to a reduction in the long-run NAIRU from 5-1/2 percent to 5-1/4 percent.

Thus, when all the dust has settled, our assessment is that you are operating in an environment that in some ways looks very similar to the one we saw in June: Inflation is about the same and the pressures on resource utilization look similar. As a result, the stance of monetary policy, as gauged by the gap between  $r$  and  $r^*$ , also looks about the same.

That said, let me now turn up the microscope and point out some of the adjustments that we have made to our outlook in the context of that broadly similar framework. By far the most important of these adjustments is a further marking down of our outlook for business investment. As you know, the data on orders for June were extraordinarily weak, headlined by a 13 percent decline in orders for communications equipment, not at an annual rate. As we could find

little solace either in the Beige Book or in our own informal contacts with members of the business community, we are now assuming that this quarter's decline in real spending for equipment and software will be essentially as steep as last quarter's. We're also assuming that the fourth quarter will show no great improvement either. In addition, we have turned much more bearish on the outlook for nonresidential structures. While the commercial real estate sector seems to have avoided repeating the excesses of the late 1980s, vacancy rates have been rising sharply of late and we foresee several more quarters of declining spending on nonresidential structures. This, too, seems to be supported by the reports summarized in the Beige Book and elsewhere.

In contrast, we continue to be surprised to the upside by the strength of consumer spending. The advance estimate of retail sales for July was noticeably stronger than we had been expecting, and with the tax rebate arriving in most households' mailboxes this month and next, we still anticipate that household spending will provide important support to activity in the months ahead.

The only other notable modification to our near-term outlook is mostly just a matter of timing. By our assessment, automakers have been in the process of building more vehicles--especially trucks--this quarter than we think they can reasonably expect to sell. As a consequence, we think they will need to cut production significantly in the fourth quarter. The resulting swings in production, on our assumptions, add about 1/2 percentage point to GDP growth this quarter and take away about 1-1/4 percentage point next quarter. We may be off on our timing one way or the other but unless sales pick up substantially, a sharp cutback in production from current plans sometime in the next few months seems highly likely. And Ford's announcement last week--which is already built into our numbers--is probably only the beginning.

So from a larger perspective, how should you, as the principals in this process, audit the reasonableness of our projection? As a starting point, I suggest that you consider three basic questions. First, do you find our revisions to potential GDP growth plausible? We now have the growth of potential GDP slowing from 3-3/4 percent last year to 3 percent this year and to 2-3/4 percent next year, reflecting a slower pace of capital deepening. I should note, for those who are trying to gauge the long-term growth potential of the economy, that on our current outlook for business investment we would have the growth of potential edging back up perhaps to about 3 percent after 2002.

Second, do you find it plausible that we have adjusted our forecast for actual GDP roughly in line with the revision to potential, leaving



aside some issues of lags? Our theory in making this adjustment is that households and firms should not be completely oblivious to the change in the outlook. Indeed, households and firms were likely on to this even before we were. In particular, we know that for the most part households tie their spending to the trend in their income. And if the trend in their income slows, then we should have a good deal of confidence that their spending will slow as well, even if with a short lag. We also know that businesses gauge their need for productive plant and equipment to the pace of their current and expected activity. And if they sense that activity is not living up to prior billing, they can be counted on to trim their investment spending accordingly.

I should hasten to say that not everyone is as glum as we are about the near-term prospects for real activity; for example, the most recent Blue Chip consensus is at 2-1/4 percent for growth in the second half. But in the face of a noticeably weaker foreign outlook, unremitting gloom from the industrial sector, continued bad news from the tech sector, and a steady drumbeat of negative earnings and layoff announcements, I am a bit hard pressed to share their optimism.

Third, do you find our cautious optimism about the outlook for inflation plausible? To be sure, as we highlighted in the "alternative simulations" section of the Greenbook, the substantial downward revision to the markup in the NIPA accounts appears to take away a cushion we thought firms had to absorb future cost pressures. If firms move to restore that cushion, the consequence could be several more tenths of inflation as early as next year. However, the environment we see is one of low capacity utilization, increasing slack in labor markets, and earlier retrenchment in energy prices than we had previously been expecting. Moreover, we believe the revised data on compensation per hour for the year 2000 may be importantly distorted by the treatment of options granted by employers, so we have been inclined to discount these data. While margins clearly cannot be suppressed without limit, we are inclined to believe that the plausible limit has not been reached yet, and so we anticipate continued relatively good inflation performance over the forecast period.

Let me conclude by focusing on one of the risks to the outlook that we highlighted in the "alternative simulations" section of the Greenbook--namely, the risk of a major stock market correction. Contrary to my general story line that the NIPA revisions did not affect much of interest, I don't think that's the case here. As you know, there were downward revisions over the last several years to NIPA dividends and earnings. Moreover, our analysis leads us to be considerably more guarded in our assessment of the outlook for the trends in these series based on the downward revised growth in potential output. That

implies that today's level of equity prices is being carried on a shakier foundation of fundamentals. I should add parenthetically that I think this morning's story in the Wall Street Journal reinforces this view, although it doesn't alter the validity of the NIPA accounts because, for all their shortcomings, the NIPA accounts happen to get this aspect of earnings reporting correct. On the whole, this leads us to conclude that whatever our level of apprehension about the market before the release of the NIPA data, it probably ought to be moved up a notch in light of the new information.

MR. REINHART. Perhaps the hardest challenge confronting the staff as we sorted through the incoming data over the intermeeting period to prepare a forecast for the global economy was to avoid falling into a self-reinforcing spiral of pessimism. As the forecasting process unfolded, we marked down the outlook for economic growth abroad in part because of weaker prospects at home. But this translated into the expectation of both lower U.S. net exports and a weaker global market for technological products, trimming the projection for U.S. GDP and creating obvious implications for overseas activity. This iterative process converged at a significantly weakened projection for foreign economic growth relative to what you saw eight weeks ago. Still, we think forces are in place that will foster a revival in growth, albeit a little more delayed and to a somewhat slower pace than thought at the time of the June meeting.

As for the near-term outlook, real GDP in the foreign industrial countries is expected to expand at just over a 1 percent annual rate in the second half of 2001, about 1/2 percentage point slower than forecasted in June. We have also penciled in only modest expansion in the developing economies of Asia and Latin America over the remainder of the year that puts the level of their output at the end of this year 1-1/4 percent, on average, below our projection in the last Greenbook. Three factors mostly account for our more pessimistic take on the pace of global economic activity this year.

First, incoming data on spending, production, and employment have almost invariably disappointed. Output contracted in Germany and Italy in the second quarter, and more forward-looking indicators of household confidence and business purchasing intentions do not bode well for growth going forward in the euro area. While domestic spending in Canada has held up well thus far, employment is beginning to sag. And Japan appears to have slipped into another recession. Real GDP is also declining in the developing countries of Asia that direct much of their exports to the global electronics market and in those countries in Latin America with trade tightly linked to the United States. Meanwhile, the prices of many internationally traded

commodities have continued to tumble, which is probably a sign of falling contemporaneous demand.

That leads naturally to the second source of downward revision to foreign growth--the marking lower of the near-term U.S. outlook. We've pulled down our projection of activity abroad both because some of the adverse effect of more slowly growing demand in the United States falls on foreign markets and because an important drag on our own economy--reduced demands for capital attendant to the re-evaluation of the prospects for the tech sector--is also playing out in many other countries.

Third, it has become painfully clear that the financial crisis in Argentina has already extracted a heavy economic toll there. Output is contracting, unemployment is rising, and prices are declining. Meanwhile, risk spreads remain elevated and deposits in the banking sector are running off rapidly. Indeed, the most obvious vote of "no confidence" in the current situation is what Dino already related--that an estimated \$4 billion of U.S. currency was shipped to Argentina last month. Perhaps it evidences our lack of imagination, but we find it hard to picture how the government of Argentina can extricate itself from this situation in a manner that stanches output losses anytime soon. And without economic growth, its poor fiscal position stemming from its high debt burden will only look more unsustainable than it does today, and the threat of spillovers to Argentina's neighbors will be that much more palpable.

After the forecast was put to bed, we received data on U.S. international trade for June that would not lead us to alter the top-line number we wrote down in the Greenbook but that did serve to underscore our sense of ongoing weakness in global economic activity. The U.S. trade deficit on goods and services, at \$29-1/2 billion, was about what we were expecting and close to the number the BEA assumed in constructing its preliminary estimate of second-quarter GDP. What surprised us, however, was that this deficit was arrived at by shrinking the values of both exports and imports. Particularly of note was the fact that the dollar value of capital goods crossing our borders in either direction was smaller in June than in May, extending the trend of the past few months.

While I've emphasized the downward revision of foreign economic growth in the near term, perhaps the most important feature of the outlook is unchanged. We still believe that economic growth abroad will pick up next year to a rate not very much below that of its potential. This growth revival may be a bit more attenuated than in the prior few Greenbooks, but it still relies on the same four forces.

First and foremost, as David has already described, the expansion of U.S. economic activity is expected to step up in 2002. We think that will be associated with a large positive swing in the growth of U.S. real imports that will benefit activity in our trading partners. Moreover, given that the U.S. growth pickup includes a turnaround in investment, greater demands for capital here will brighten the outlook for the tech sector worldwide.

Second, while data on inventories abroad are spotty and unreliable, we believe that part of the dynamics of the slowing of the past few quarters in many foreign countries has included a production adjustment in response to some stockbuilding that developed as demand weakened unexpectedly. As inventories stop falling next year, that drag on real GDP growth will be lifted.

Third, monetary policy in many industrial countries has already weighed in to support aggregate demand going forward. We think that most of those central banks will continue to ease and that some other central banks will join in. In the case of the Bank of Japan, however, it remains to be seen whether an elevated provision of liquidity, which was announced last week, will bolster spending given that the policy rate is already at its zero floor. The issues are more conventional when it comes to Europe. In common with the net judgment of participants pricing money market futures, we believe that the European Central Bank will ease 50 basis points by year-end, as their task is made easier by declines in headline inflation induced by falling energy prices.

Fourth, with regard to energy more generally, the price of West Texas intermediate oil has fallen about \$4 per barrel over the past three quarters, and our forecast, following oil futures markets, holds that another \$3 per barrel price drop is in store by year-end 2002. We anticipate that this price decline has been and will be shifting income to those residents of the global economy who are more likely to spend it, bolstering consumption in many countries.

Although we're relatively confident about the existence of these forces helping to shape a rebound in spending in 2002, their magnitude, timing, and whether other sources of restraint will more than offset their impetus are far from certain. Two prominent risks emanate from global financial markets.

For one, we assumed in our projection that the real foreign exchange value of the dollar would follow a track tilted slightly downward. But the fact is that the dollar's value fell more in the past week than the decline stretched out over the next six quarters in our

projection. This recent downdraft might be the first sign of a risk factor that we've fretted about for some time--that foreign investors' appetite for adding to their holdings of U.S. obligations will wane. But the foreign exchange market has given us false signals before, so we have treated this latest stepdown as evidence of greater odds on a downside risk rather than as a reason to pull down our baseline forecast. To get a sense of how events may unfold should that risk materialize, we included an alternative simulation in the Greenbook in which the dollar's broad real value drops nearly one-quarter by early next year. From a U.S. perspective, the resulting ratcheting higher of foreign relative to domestic prices encourages exports and pulls down imports to add about 3/4 percentage point to GDP growth in the first half of next year and twice that amount in the second half. The impetus to inflation is even more striking, with core inflation running 1-1/2 percentage points faster by the end of next year. The chief risk to the global economy is that this relative price change off-loads some of our ongoing weakness to our trading partners. With the nominal interest rate already at zero in Japan and the fiscal deficit a source of concern, Japanese policymakers may be poorly positioned to counter such imported weakness and, unless the stronger euro emboldens the ECB, European policymakers may not be willing to do so.

As another risk, our Latin American outlook assumes that the fallout from problems in Argentina will be relatively contained to that nation's immediate trading partners and other Latin countries reliant on international capital markets. That assumption was based on the logic that global investors have seen this coming and that the IMF's stand-by arrangement with Brazil will ring-fence that country. But part of Argentine officials' bargaining strategy of late has apparently been to elevate expectations in the market of the size of a package in order to put pressure on the international financial institutions. If either less new money is forthcoming than those encouraged expectations or what comes fails to cover Argentina's subsequent reserve losses, then the scope and severity of contagion may be more than we've built into the Greenbook. I don't have a simulation to point to mainly because it didn't seem like a productive use of our large-scale macro models, as it would be highly nonlinear and especially dependent on market sentiment. That concludes our presentation, Mr. Chairman.

CHAIRMAN GREENSPAN. Questions for our colleagues? President Parry.

MR. PARRY. David, you mentioned three considerations that we might want to take into account as we look at the forecast. The second was that the variability in aggregate supply gets translated pretty much on a one-for-one basis into the variability in aggregate demand. I

must admit I was a little surprised by that in the sense that although current short-term prospects for earnings and for income are likely to affect demand, I believe that permanent income also plays some role. If that's the case--if there are more permanent influences--in terms of aggregate demand, wouldn't there be less of a response than a one-for-one change?

MR. WILCOX. Let me make two comments on that. First of all, I made an oblique reference to the issue of lags. We translate a downward shift in the trend in incomes to consumer spending with a lagged response of a couple of quarters. We think it takes households a little while to catch on to this change. We brought down potential GDP growth by 0.4 percentage point this year. We think about half of that lower potential growth this year translates into a reduction in actual GDP growth. For next year we took potential down by 0.6 percentage point. And by that time we believe the adjustment process is far enough along so that households will begin to recognize a softening in their income prospects, and indeed in their permanent income, and that will be incorporated into their spending. So we feel that over that kind of time horizon it's realistic to build changes in the fundamental tenor of income into the growth of consumer spending.

MR. PARRY. Permanent income as well?

MR. WILCOX. Yes.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. No further questions? Who would like to start our Committee discussion? President Broadus.

MR. BROADDUS. Thank you, Mr. Chairman. The overall economic picture in our District has not changed markedly over the last several weeks. Manufacturing activity continues to decline, although perhaps at a bit slower pace than earlier. The key issue, of course, as

highlighted in the Beige Book summary, is whether the weakness in the manufacturing sector is going to spill over into other sectors of the economy. I don't think we have any very conclusive evidence regarding that in our District. I read a book recently that talked about a tourist at Fort Sumter asking a guide why so many Civil War battles were fought at national parks [laughter] so I'm very skittish, even more so than usual, about ascribing causality. However, retail sales have weakened in our area in recent weeks, in contrast to the national data, and it seems reasonable to me to speculate that at least some of this weakness reflects the softness in manufacturing. And the problems from high-tech manufacturing and related industries clearly are contributing to what appears to be a growing weakness in commercial real estate and commercial construction activity in parts of our District where high-tech activity is concentrated, such as Northern Virginia and the Raleigh-Durham area in North Carolina.

We don't see in our region any definitive indication that manufacturing is bottoming out yet, but there are at least a few straws in the wind. I have a contact in a sizable trucking company that is based in Richmond but does a lot of business with the furniture manufacturers and others in the Carolinas. His firm does a large volume of business and it's broadly spread, and I think he's a reliable source of information. He tells me that his customers' shipments have been stabilizing most recently and that several manufacturing operations in the Carolinas are telling him that conditions are at least not getting any worse. Elsewhere, revenues in District service industries other than retailing continue to grow at a healthy pace, according to the monthly service sector survey we do. And residential sales and construction activity are holding at their recent high levels.

So to summarize on the District, we have not seen a lot of change except perhaps some negative spillover from manufacturing to other sectors of the economy. But there is a glimmer

of an inflection point in manufacturing, to use a phrase that Jeff Lacker coined the other day.

The Greenbook forecast for the national economy has an inflection point of its own. The forecast calls for the decline in the rate of real GDP growth to end in the second quarter and for growth to reaccelerate gradually this year and next year. There are obviously significant downside risks in this forecast, and David has noted a number of them. One is the projected return of business investment to at least a moderate upward trajectory next spring; it could take longer. Consumer spending could be significantly weaker than projected for any number of reasons, and all the downside risks in the domestic outlook obviously are compounded by the cumulating weakness in the international economy.

But in my view there are also some modest signs of improvement. The retail sales report for the month of July, released recently, got my attention. I think it's quite positive when one digs down into the details. It's only one monthly report to be sure, but it is at least consistent with the idea that the reduction in energy prices--or the anticipation of declining energy prices--and the significant monetary stimulus already in the pipeline may be shoring up household spending. Elsewhere, manufacturing activity as measured in the industrial production index was flat last month after a long series of monthly declines. Even when one abstracts from the strong motor vehicle production, what is left is a decline but a smaller decline than we've seen for a number of months. Job markets are still softening but overall the July report suggests that they may not be softening quite as rapidly as had been feared earlier. And all of these developments are reinforced by the continuing strength in residential construction.

The current view in financial markets, as reported in the media at least, seems to be that a bottoming out in the economy is now further out in the future than most people had thought several weeks ago. The recent information I just cited suggests that the gradual upturn



in the economy, as projected in the Greenbook, is actually a little more plausible now than it might have been at the time of our last meeting, or at least it seems that way to me. The implication of this for policy, in my view, is that the economy could turn up sooner rather than later, although that's certainly not a sure thing. And if it does, with unemployment still relatively low and the real funds rate quite low, we may need to reverse course promptly and remove some of the stimulus that is currently in the pipeline. Historically, this has always been a very difficult thing for the Fed to do. So I think we need to begin to prepare ourselves as well as the public for this possibility, in the absence of a marked further weakening in the economic outlook. Thank you.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. At each of our recent meetings I've expected better news next time, and each time the news has been disappointing. The slowdown is now a year old and shows few signs of coming to an end. Monetary policy easing began almost eight months ago. Fiscal policy has now eased and tax rebate checks are in the mail. More recently, we seem to have escaped a worsening of the energy crunch. These three major factors--monetary stimulus in the pipeline, checks in the mail, and improvement in the energy outlook--should help to produce a turnaround but there is scant evidence that they have started to do so yet. Monetary policy probably has helped to cushion the decline, which has proven to be worse than expected.

Three special sources of strength in the Eleventh District used to be high-tech manufacturing, trade with a booming Mexico, and energy. High-tech manufacturing is in a serious recession. The Mexican economy is declining. And the energy boost seems to have peaked out, luckily. Texas employment growth, which had exceeded the national average in nine of the past ten years, has weakened sharply in every region and sector of the state, but most

sharply in the technology centers of Austin and North Dallas. Because of energy there is continued moderate growth in the Houston area, however. The decline in Mexican manufacturing, especially along the border in the maquiladora plants, is being felt in Texas border towns.

In the energy area, rig counts both in Texas and the nation are below their July peaks. About 80 percent of drilling is for natural gas, for which the price has declined below \$4 per thousand to around \$3 now. That is still somewhat high by recent historical standards but it is back close to its more usual relationship to the price of crude oil. The mood remains dark in most technology sectors, but some anecdotal comments are beginning to be more positive in the semiconductor industry. The U.S. semiconductor equipment book-to-bill ratio has risen modestly since hitting an all time low of 0.36 in April.

At the national level, the Greenbook forecast and the GDP revisions tell us that not only is the current economy getting worse but so has the past. Neither the past nor the future is what it used to be. [Laughter] And the risks to the forecast seem mostly to be on the downside. The main positive in the Greenbook was the slightly improved outlook for inflation over the forecast period, and I'm not very confident about that. One way to look at the situation is that more slack in the economy will produce less pressure on prices. But another way to look at it includes the possibility that supply may be cut back faster than demand, a reversal of the disinflationary consequences of rapid output growth in the late 1990s.

Based only on the state of the economy and its near-term prospects, a large policy action is called for today. But it's a closer call when we consider the lags and the degree of stimulus already in the pipeline. As for the directive and the bias statement, I don't know whether it's better to speak softly and carry a big stick or to be more diplomatic and say "nice

doggy” while looking for an even bigger stick. If the bias statement and the press release weren’t already written, I’d say it’s going to be difficult to write them this time. [Laughter]

CHAIRMAN GREENSPAN. It was! President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. On balance the Seventh District economy has not changed significantly since my report in June, but most reports now seem somewhat more pessimistic than before, at least about the near future. Overall activity has remained quite sluggish and that has been disappointing for many businesses that had expected, or at least hoped, that some evidence of an upturn would be visible by now. The expected improvement in the economy seems further in the future than when we met in June. In fact, most business people we talk to do not expect a significant recovery in manufacturing before next spring. There are few signs that capital spending is about to pick up and there’s growing concern about how long consumers can continue to prop up the economy.

Manufacturing has been our weakest link for about a year now. While some key manufacturing industries have made substantial progress in working down excess inventories, overall production remains very weak. The light vehicle industry is somewhat of an exception; on average inventories are now in good shape. Production nationally has been trending up somewhat since January and capacity utilization is up to 88 percent, about as good as it gets in the auto industry. Of course, even this industry is not out of the woods, as David Wilcox mentioned earlier. So far this year, substantial incentives have been needed to keep light vehicle sales at high levels, and industry contacts indicate that sales have been soft so far in August. And more generally, they expect sales to be lower in the second half than in the first half of the year. In addition, incentive spending is not expected to change much, and that means profits will continue to be squeezed.

Most firms are still attempting to reduce costs and are being very cautious about capital spending. Indeed, the outlook for capital spending is poor in a large number of industries. For example, no recovery is in sight for heavy truck sales. The steel industry has little incentive to increase capital spending, given the significant excess capacity and the lack of pricing power. The gypsum wallboard industry is also plagued with over-capacity despite the fact that the robust housing market has helped keep shipments strong. And high-tech remains an area of special weakness, with most observers indicating that it will be some time before the overhang can be worked off.

One piece of good news came from the paper industry where demand for cardboard boxes improved in the last few weeks. But our contacts emphasized that the improvement really has not lasted long enough to discern a turn. Consumer spending and housing activity are still holding up reasonably well in our District, although many retailers have become less optimistic about the future. Reports indicate softer consumer spending in the Midwest than elsewhere in the country, amid signs that individuals are becoming more price conscious. Discounters and value-oriented retailers seem to be the most aggressive in trying to capture the tax refund business. While sales results are still rather sketchy, it appears that those retailers are the ones that are benefiting the most. Even as the tax rebate checks trickle into the economy, many retailers continue to lower their sales expectations for the fall and for the winter.

Our housing markets remain relatively robust, although some contacts are skeptical about how long such resilience will continue. We've had scattered reports of reductions in asking prices for some higher priced homes in Chicago, although these prices are still above year-ago levels. And I've become increasingly concerned about potential overbuilding in this sector, given the tremendous amount of residential construction near and around downtown

Chicago. So far, however, the housing numbers have remained at high levels and homes that are priced right continue to sell quickly, often with multiple bidders.

Things are not quite so rosy on the nonresidential construction side. Office vacancy rates have continued to increase in many areas as demand has slowed. The REITs tell us that large firms with leases coming up for renewal are consistently cutting back their office space requirements. With these trends visible nationwide as well, there has been a significant adverse impact on the office furniture industry that is concentrated in western Michigan. This industry expects to see the sharpest drop in shipments since records were first tallied in the early '70s.

Since the slowdown began, our labor markets have eased somewhat more than they have in the nation as a whole. District employers are still reporting that it's less difficult to hire and retain workers in most areas and that wage pressures have subsided further. Total payroll employment in our five-state area has been below year-ago levels for two months now, something we haven't experienced since the end of 1991. However, the latest Manpower Survey, which will be released publicly next Monday, August 27<sup>th</sup>, shows a small pickup in the hiring intentions of Midwestern employers for the fourth quarter, which may indicate that the worst is over for our region. The national index declined slightly further, however, taking it to its lowest level since the end of 1993.

Turning to the national outlook, like many of our business contacts we think the pickup in economic growth will be delayed further. We still believe the second quarter will be the worst of this cycle, but growth this quarter looks to be quite anemic as well. In particular, another substantial decline in capital spending should largely offset the positive effects of the tax rebate and consumer spending. We continue to think the most likely scenario has growth returning to its potential by the second half of next year but we certainly can't rule out a worse

scenario. As our business contacts keep repeating, consumer spending and housing activity may falter before the inventory and capital spending adjustments are completed. The outlook for world growth has deteriorated, signs of economic instability are evident in parts of Latin America and Asia, and the international situation could erode further. For the long term, I remain somewhat concerned about inflation, but for now the risks still seem tilted decidedly to the downside.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the economic climate in the Twelfth District has turned negative as the high-tech downturn has intensified and spilled over into other sectors. During the three months ending in July, District employment contracted 0.3 percent at an annual rate for a net loss of about 19,000 jobs. Downsizing among technology firms was especially pronounced. Between May and July, employment at high-tech manufacturers and business service firms combined fell by about 8 percent at an annual rate, substantially above the pace of contraction during the first four months of the year. The intensity of the cutbacks among District technology firms has begun to drag down employment growth in other sectors. Employment contracted in construction and also fell in shipping, trucking, and warehousing during the three months ending in July. And job gains in retail and wholesale trade have slowed to an anemic pace. The general impact of the technology-driven downturn is evident in the District's high-tech centers. For example, the San Francisco Bay area has lost almost 35,000 jobs in the past four months, as both tech and non-tech employers have scaled back. Employment in Portland and Phoenix also has contracted in recent months and job growth in Seattle has slowed substantially. In general, the technology-driven downturn has dramatically altered the regional pattern of growth in the District this year, with last year's fast-growing areas either contracting or moving laterally.

Turning to energy markets, cooler temperatures, sluggish economic activity, and continued conservation have reduced electricity usage in California in recent weeks, easing the demand and supply imbalance that has plagued the state for most of the year. Better market conditions and lower natural gas prices have resulted in wholesale spot electricity prices of around \$50 per megawatt hour in mid-August, well below the \$200 average recorded for May. While lower wholesale prices generally are good news for California, the declines are not likely to reverse the trend in retail rate hikes that took effect in June. A number of factors will keep those rates up. The California Department of Water Resources, which currently is purchasing electricity for California's major utilities, needs the revenue to cover past costs and what have turned out to be relatively high prices on long-term contracts. And the public utilities want assurances that retail rates will allow them to recoup past losses in addition to covering costs going forward. Right now concern on the part of utilities over the adequacy of the current rate structure is holding up the issuance of \$12.5 billion in revenue bonds meant to repay the state for the billions of dollars the Department of Water Resources has spent on electricity this year. At this point, it looks as if the bonds will not be issued before October or even November. Given the delay in issuance, cash flow constraints likely will lead the state to issue revenue anticipation bonds. The state controller has indicated that these bonds, which would be issued after Labor Day, could amount to \$5.7 billion.

Turning to the national economy, the industrial output and retail sales reports for July may raise a glimmer of hope that the economy is beginning to turn around. However, it seems fair to say that the recent data taken together show few, if any, signs of a pickup in activity. Our best guess is for growth of around 1 percent in the current quarter. After that, several factors should operate at about the same time to stimulate faster growth, including the stimulus from

monetary policy and a tax cut that has turned out to be timed almost perfectly. We should have a better idea of how much of an effect it is having on consumer spending by our next meeting. In addition, the substantial turnaround in energy prices this year should help to promote a pickup in activity.

For next year our forecast, which like the Greenbook assumes no further change in the funds rate, shows real GDP growth increasing to more acceptable rates of around 3 percent. Of course, there are some notable downside risks in the economy, having to do especially with consumer spending and developments abroad. Overall, our forecast would leave labor and product markets about in line with their average long-run utilization levels and there would be little upward or downward pressure on inflation next year. We are looking for inflation in the core PCE price index of just below 2 percent both this year and next. While it's obviously good that we don't appear to be facing rising inflationary pressures, I think it's also worth noting that the current period of slow growth could be completed without the kind of reduction in inflation that often accompanies such periods. This outcome would be disappointing since I certainly would like to see a further modest decline in inflation over time. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. Well, what a difference six weeks make! Or maybe I should say what a difference one additional month of data and some revisions of past data make. You will recall that New England's headline economic data had been a bit better than those for the nation as a whole, though anecdotes from regional businesses had been turning increasingly gloomy. That gloom seems now to be justified. With the state and regional employment data that were released last Friday, the region looks considerably different, with levels of employment declining month to month and year-over-year growth at a fraction of its



long-term trend. The unemployment rate also tipped up from month to month by 0.3 percentage point. Add to that the escalating costs in the Boston metropolitan area and the fact that the anecdotes have turned from gloomy to almost ugly and we have a region that no longer appears to be Teflon coated. Where is the downturn occurring? In the usual places--primarily manufacturing, particularly high-tech manufacturing, though retailers also describe consumer activity as anemic.

Several themes run through our discussions with manufacturers. First, most in the high-tech arena are convinced now that the turnaround is not likely to come anytime soon. Some firms don't expect a resumption of "normal" activity, however that is defined right now, until the second half of 2002. In the face of weak demand and no signs of a pickup, the emphasis is on reducing costs. Even the unusual firm that continues to do well is being much more cautious on the cost side. Businesses of all sizes are putting enormous pressure on their supply chains. We've heard this before but demands for price concessions reportedly have accelerated.

The second theme has to do with IT spending. Almost all high-tech manufacturers noted that one major reason IT spending will pick up only very slowly is that many companies are quite a ways from growing into the infrastructure they already own. Also, obsolescence is being carefully managed. Desktops, once obsolete in two years, can be left in place for five years. One of the Bank's directors referred to this as a lack of "killer apps." That is, in the face of slow demand, considerable IT investment already in place, as well as cost pressures, the new technology that will drive new spending has yet to surface and may well be greeted with some skepticism when it does.

Finally, among both large and small firms the availability of bank credit has become a concern. Even when firms have found financing in the bond market not much of a problem,

they've seen credit market difficulties impact partner companies and joint ventures and have experienced difficulties in renewing their own revolving credit arrangements. Big firms with lower credit ratings are reportedly shut out of credit markets and smaller healthy firms are facing higher rates.

There are a few brighter spots in the region. Residential construction and real estate markets have held up well, albeit with some deterioration at the high end of the market. In addition, labor market tightness has eased. This seems to be helping area firms keep costs in check, as there is much less upward pressure on compensation. Firms that are still hiring say they are able to be much more selective; it is easier to get new hires, and the recruits are of better caliber.

Turning to the nation, I think it is possible to read the current economy in two ways. First, some data may be in the process of plateauing. Employment levels seem to be declining at a slower rate. And perhaps some comfort can be taken in the single month of flat, not declining, industrial production. Consumer sentiment is hanging in there, as are residential investment and consumer spending. Businesses are continuing to work on increasing productivity largely by reducing costs, and they have reacted to profit pressures by digging in, not by raising prices. Indeed, at least one source of cost pressures, energy prices, has provided some relief already and should continue to do so going forward. No one knows when high-tech spending will pick up, but one gets the sense that a huge premium is being put on using existing capital to its fullest, which augurs well for future productivity.

Looking back over the postwar period, it's unusual to find two or more quarters of GDP growth at more than 1 percentage point below potential without a recession occurring either immediately or one or two quarters later. Arguably, one of the only times such a period of slow

growth was followed by an enduring pickup was in the 1994-95 period, the so-called "soft landing." With the monetary ease now in place and whatever more is needed and the tax cut as well, this period may turn out to be a similar landing--perhaps not so soft--prior to the takeoff of business investment. It may be that the economy, and particularly the consumer, will continue to muddle through until then.

Certainly that's what the Greenbook expects, as does the Boston Fed's forecast. Our forecast dynamics may be a little different in regard to the stability of structural productivity and the level of the NAIRU, but the overall forecast is remarkably similar. We anticipate slower growth this year than we had expected earlier, a gradual return to growth near potential--growth at 3 percent or maybe a bit lower by year-end 2002--with an uptick in unemployment not as large as in the Greenbook projection, and easing inflation. This isn't a bad outcome. In fact, again historically speaking, it would be unusually positive. But such a forecast does require some confidence in the more positive readings of the situation that I just delineated.

Obviously, the other way to read the current situation is to focus on the worsening profit situation. Unless relieved by slower compensation growth and damped energy costs, profit pressures do not bode well for the stock market, business investment, or job growth. If consumers are hit by rapidly rising joblessness, all bets are off on housing, auto sales, and consumption of services, as a slowdown of manufacturing spreads and becomes a wider slowdown, and economic history repeats itself. Moreover, the other dark cloud--the external situation, with slowing growth and regional crisis conditions--cannot help matters. As I said, the issue is how much credibility one gives to the muddling-through hypothesis. I come out on that side, but I think it's a close call. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. As I've commented before, and it continues to be the case, the District economy for the most part is moving in lockstep with the national economy. The District's economy has slowed further, I would judge, but the slowing hasn't been sharp. As for labor market conditions, reported job vacancies are still considerable but they are shrinking, and meanwhile layoffs are increasing. The weakness is most visibly concentrated in the manufacturing and mining sectors, and participants in those sectors are not expecting any material improvement until sometime next year.

Both housing and nonresidential construction activity in our District remain healthy and positive at the moment, although I think the seeds of some slowing are clearly visible now. Vacancy rates in commercial space are rising. So while there is a lot of current activity, the rising vacancies will weigh on prospects for future projects. And while homebuilding activity and sales also remain healthy, at the upper end of the market the pace of sales is clearly slowing.

As has been the case for several months now, consumer spending and tourism activity are at best mediocre. One exception, where things are a little better, is apparel sales. Why that's the case, I've been unable to determine. But people in that business seem to be pleasantly surprised with the sales they've been experiencing.

One of the two bright spots in the District is the energy sector which, of course, has benefited from price changes. The other is agriculture, where--in parts of the District that have not been plagued by drought--farmers clearly are going to get both good crops and better prices than they had earlier expected. And we are hearing some scattered reports about spending on durable goods by producers in those sectors for which prospects are looking up.

As far as the national economy is concerned, I don't know that I would use the term glum, but I find myself in substantial agreement with the Greenbook forecast. I believe that real

improvement in the pace of economic activity is still some time off and I think the improvement is likely to be anemic, at least initially, when it occurs. I'm hard pressed to identify any significant positive surprises in the latest batch of macroeconomic data that we have received. And the international situation is worse than I had anticipated earlier both because growth abroad seems more sluggish than I had expected and because the recent decline in the dollar raises at least a yellow flag in my mind. I agree that it's too early to reach any firm conclusions about what that might portend but it does suggest to me that we should be paying at least some attention to developments on the international front.

I've commented before and I think it's still the case that the inventory correction process has a ways to go. As best I can judge with the benefit of hindsight, we clearly had a capital spending bubble that has now collapsed. And that's not something that monetary policy is inherently well positioned to deal with.

If I wanted to be a bit more positive--and I think there's something to this--there may be reasons to believe that consumer spending will hold up as long as the rise in unemployment from this point is not too drastic. In that regard, I take some comfort in what's going on in the housing market. Sales of both new and existing homes have been quite healthy for a long period of time and, after all, the purchase of a house is a long-term commitment that people are willing to make. Now, this may involve some asset reallocation, and obviously interest rates are favorable. Nevertheless, the fact that people are willing to undertake those kinds of long-term commitments at the pace that has prevailed in recent months is a development I view as positive.

Finally, I am comfortable with the Greenbook's relatively favorable inflation outlook. But in my view, what we now know about both productivity and compensation suggests that the profit outlook is clearly negative.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. Last time I reported that the head of my regional economics group had suggested that it looked as if it was going to be a “bummer of a summer.” Unless you’re a homebuilder in our region, he was about right. I’m finding it harder and harder to find just the right adjectives to describe the degree of slowing that we are observing in our area. While I had hoped to be seeing at least a few more positive signs by now, the overall situation is not materially different than at the time of our last meeting.

Let me highlight a few recent developments. One strikingly common story now emerging to explain what is keeping sales growth at least modestly positive can be summed up in one word--discounting. All the anecdotal reports on retail sales, auto sales, tourism, hotel occupancy, cruise bookings, and airline traffic indicate that deep discounting is being used to bolster sales, with obvious implications for prices and profitability. Let me cite just a couple of examples to underscore that point. Hotel rooms in Orlando near Disney World can now be booked for \$40 a day. Delta Airlines senior executives tell me that while deep discount leisure traveling is holding up well, there is a substantial drop-off in business travel, which combined with higher energy prices compared with 1999 and 2000 is causing their negative returns. Trucking firms are reportedly engaged in cutthroat competition, slashing mileage charges to get freight business. And concern is now being expressed that a significant number of trucking company failures seems all but certain. Of course, retailers and auto dealers have been resorting to sales discount programs and rebates to liquidate excess inventories.

We are also getting more and more reports that companies are cutting perks and other discretionary expenses to protect profits. Cuts are even hitting executive entertainment. Some of you may know that bird hunting is one of the longtime favorite sports of good old boy executives

in the South; it's a favorite executive ritual when it comes to entertainment. One of the preferred places to go quail hunting is a plantation in Florida that caters to executives of Fortune 500 companies. Occupancy rates at that plantation typically run 98 or 99 percent and reservations are booked a year in advance. Cancellation rates for repeat customers usually are less than 6 percent. But this year I'm told that cancellations have nearly doubled to 12 percent and are reportedly coming from cutbacks by steel and chemical industry executives and their guests. Of course, those two segments have been among the poorest performers and those industries have been particularly adversely affected by the appreciation of the dollar.

While it's true that growth has slowed, it's also true that growth is decidedly more uneven across industries and among different states in our region. Florida's economy is both the largest and strongest and Georgia is holding its own, while Tennessee, Mississippi, Alabama, and Louisiana are suffering. Tennessee is experiencing another year of very serious budget problems and the governor and the legislature can't agree on a budget again this year. Someone recently remarked in frustration that Tennessee is fast becoming the Argentina of the United States.

The District continues to see contraction in technology jobs. This has resulted in additional commercial lease space coming back on the market, adding to an already excess supply. Manufacturing firms continue to cut jobs; and this is especially hurting Mississippi, whose economy is more manufacturing dependent than other states in the District.

Finally, there are indications that our aggressive policy easing moves have had very little impact on business investment spending. At the same time, companies such as Delta Airlines and some of our trucking contacts indicate that they have not curtailed their investment plans significantly in terms of canceling orders for new planes or vehicles. In fact they say they

are using this period of slow sales to accelerate the retirement of older equipment, which suggests to me that the existing stock is becoming more efficient. A similar story holds for utilities in the Southeast, whose investment plans have not been affected so much by rates; however, they have accelerated the phase-out of older plants. More utility capacity is being brought into place than is warranted by prospective new demand, reportedly because regulatory constraints are less than in the West.

Not all is bad, however. Besides the relative strength in single-family housing, we're beginning to pick up some hints--and I emphasize that these are only hints--that the decline in activity may have begun to bottom out. Some bankers, for example, are reporting that their older and more traditional customers are beginning to consider new spending and are making inquiries at least about the possibility for additional funding.

On the national front, it's easy to become impatient waiting for our previous policy moves to have their desired effects. One has to be concerned about the uncertainty regarding where the forecasted rebound in GDP, which as others have said is being pushed back to the first and second quarters of next year, will actually come from. Clearly, with capacity utilization continuing to fall, investment--except perhaps investment in new power generation--is unlikely to make a sharp rebound. Nor does a rebound in inventory investment seem imminent. It's also hard to imagine a sudden spurt in consumer spending, which is already reasonably healthy relative to the underlying fundamentals. Finally, given the slowdown abroad, much of which is itself a fallout from the pause in our own economy, we can't expect much help from the foreign sector. My conclusion is that the risks remain on the downside. The recovery appears to be more gradual than we had hoped and is not likely to be led by any one particular sector.

This brings me to my policy concerns. The near-term outlook is still not pretty and a



good case can, and I'm sure will, be made for further easing. At the same time, I think a good case can be made for patience and caution. I remain bothered by the rapid growth in the monetary aggregates, which is not fully explainable. And I believe that we have already put sufficient liquidity into the system to support sustainable consumer demand and to bring the economy back to a desirable growth rate without too much inflation risk. But my fear is that we'll get trapped into following an implicit policy rule that says we'll keep cutting rates until the real economy turns around.

That is not what I believe we should do for two reasons. First, as we have all reminded ourselves as well as others, monetary policy is a blunt instrument. Accordingly, succumbing to the temptation to try to adjust problems in one segment of the economy--in this case high-tech and other business investment--may in fact over-stimulate other sectors, causing additional imbalances to appear. I interpret the surge in home prices over the last year as an indication that consumers' liquid funds have been shifted toward that sector.

Second, I'm also concerned that a lower federal funds rate and considerable liquidity in the banking system have added to the high proportion of loans leveraged by housing collateral. This lending has been stimulated by the perceived high value of homes and the lower rates on home equity loans. Lowering rates further may simply encourage more home equity lending and more sub-prime lending to marginal borrowers most at risk to lose their jobs should the downside risks in the economy materialize. In short, I believe there is real risk of putting too much ease in the system. And I fear, as others have already suggested, that circumstances may make it difficult to reverse course quickly. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. As the economy transitions from a

period of unacceptably slow growth to a more reasonable pace of activity, we should expect to see the data shift from predominantly bad news to a mixture of some positive and some negative observations on the state of the economy. This ought to be true at both the regional and the national levels. I can report that this is what has characterized our District over the last couple of months. But the ratio of good news to bad news is not improving as quickly as I had hoped. When we met in May, I was able to report a slowly improving condition in the Third District. Since then the news has been decidedly mixed and indeed less positive than expected. Our June indices of economic activity remained flat in Pennsylvania and turned down in New Jersey and Delaware. Our business outlook survey of manufacturers in our region, which had improved in June, retreated in both July and August. The indices of new orders, employment, and the average workweek all took a turn for the worse this month, while the index of shipments showed only a slight improvement but remained negative.

Our manufacturers continue to pare inventories and they do not see the inventory correction ending soon. They expect to continue cutting inventories over the next six months. In contrast, our survey of retailers and other non-manufacturing firms shows that they have successfully worked off any inventory overhang. Yet they remain vigilant in their ordering to avoid a return to excess inventories. In a special question, we asked our respondents to what extent the high value of the dollar had affected their businesses. Almost half of the firms reported that they had been hurt by the dollar's strength, and 18 percent said significantly so.

Labor market conditions in the region have weakened somewhat. Payroll employment edged down in the second quarter in the three states in our District. The unemployment rate moved up but remains below that for the nation. Retail sales, excluding autos, were flat in July. Residential real estate markets remained active, although the sales of both new and existing

homes have been running below last year's pace. Our bankers report that residential mortgage refinancing activity remains at a fairly high level and that they are actively seeking new business borrowers among well-capitalized firms. Loan quality remains relatively good.

The mixed news has caused people to re-evaluate their expectations about the future. Optimism about the outlook has turned down a bit, with business contacts anticipating slow improvement at best during the rest of the year. Our staff's view continues to be that regional economic growth will pick up somewhat toward the end of the year but that the pickup might come later than previously thought.

Our view on the national economy is similar. Manufacturing remains weak as does the broad technology sector. Neither situation is likely to improve soon. By contrast, the housing market remains robust and consumer spending remains moderate to good. And there are signs that labor market conditions have stabilized. The recent data revisions help reconcile some of what we see in the economy: The substantially faster growth of labor compensation than previously thought helps to explain the ability of consumers to continue spending; and the downward revision of profits helps to explain the retrenchment in investment.

On the downside, the economic situation abroad has deteriorated since our last meeting. In many places in the world, economic conditions are proving to be more problematic than expected and clearly less conducive to a world recovery than I would like. Given the interdependent nature of our economies, we must remain cognizant of these external factors and their possible implications for U.S. economic activity going forward.

We know that we should only now be feeling the first 100 basis points of easing we put in place in January, given the lags in the effects of monetary policy. It's too soon to see the effects of the additional 175 basis points that came later in the year. Likewise, the fiscal stimulus

is only now beginning to come on line. Tax rebate checks started arriving in July, with further tax cuts to come later. This plus the fact that the data come in with a lag suggest that it's not unreasonable that the indicators are giving us a mixed view of the economy at this point. That said, I must admit that midway through the third quarter I would feel more comfortable if I could point to some definitive positive signs that a turnaround in the economy is under way.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, the Tenth District's economy continues weak. Manufacturing remains in a slump in our area. According to our Bank's most recent manufacturing survey, activity declined again in July, moving well below year-ago levels. Inventories were also down substantially and a significant fraction of firms said they plan to continue reducing inventories over the next six months. One bright spot is that the capital spending projections did not deteriorate further.

Consumer spending held steady in most of our District, as it has elsewhere in the nation. I continue to hear that consumers are becoming increasingly value conscious, though, so discount stores are enjoying the stronger sales at the expense of other retailers. Residential construction remains stable. Home sales are solid in most of our cities, although inventories of unsold homes are creeping up. Throughout the District there is weakness in the demand for high-priced homes, though, and that is telling in some areas, particularly Denver. Commercial real estate is showing signs of softening further. Office vacancy rates continue to rise in both Denver and Kansas City, as businesses in both cities cut back on their expansion plans. There is still a substantial amount of construction in the pipeline but the surge in vacancies is causing developers to have some second thoughts.

The energy sector remains a bright spot in our District. Even with the recent easing in

oil and gas prices, the rig count grew again in July. Labor markets have eased further. Layoff announcements remain high, although they have come down a bit from earlier in the year. Reflecting the sluggish economy, inflationary pressures continue to subside in our area. Only one of the employers we contacted said that it had granted above-normal wage increases recently.

As mentioned earlier by President Stern, conditions in the farm economy have improved. That sector has been helped not only by some price increases but also by the recent package that was approved for aid to the farm industry. Our projections now show that farm income on the national level will increase about 9 percent this year, so some spending should accompany that.

Let me turn to my views on the national outlook. It is noteworthy that while we continue to adjust our outlook--both the value and the time horizon--our staff as well as the Greenbook staff still see as the most likely outcome that the economy should strengthen toward potential over the next few quarters. Therefore, it strikes me that the issue is: Do we continue with the current easy policy or do we ease further at this time? I say policy is easy as we might measure it, using monetary growth and the real fed funds rate compared to the equilibrium natural rate that has been estimated. I would add that from what I can tell, our last generation of experiences suggests that it takes about four to five quarters from the start of an easing period for the easing to have an impact that we can see in terms of GDP growth.

This suggests that we are probably on track toward eliminating the cyclical weaknesses that now exist. But in our view of the outlook, we obviously have some rather serious risks. The incoming data are clearly mixed and it's hard to do nothing when the data are mixed. I would add that the foreign sector is weaker--and weaker than many had anticipated--

and that most certainly adds to the downside risks for us to consider. I think all this is complicated to a degree by the difficulty of separating out the structural factors in our economy that are weak--and will stay weak regardless of our short-term monetary policy--from the cyclical factors. So in some ways our difficulty today is to determine whether we are being--if I may use this term--cyclically correct. [Laughter]

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. First, a note on agriculture: Corn crops in the region are coming in very strong, as evidenced in the last couple of weeks by roadside signs offering a dozen ears of fresh picked corn for 50 cents. I thought that was a real bargain until I went across Lake Erie to Ontario and saw outside a store large crates of corn with a sign that said "Free fresh picked corn. Take all you want." [Laughter] I don't know what the purchasing power parity of this means!

A year ago at this time we were hearing more quickly about weakness in the area that we serve than I think was the case in other parts of the country. That may have been a reflection of the rising energy prices; we are very energy intensive in many ways in a lot of our sectors and industries. And other factors were at work, certainly in the case of metals. I didn't go back to check but I don't recall that our Beige Book description of conditions in the District was as negative as what I was hearing from directors and advisory council members at that time. But this time I did look at our Beige Book to compare it with the reports I was getting from our directors and advisory councils, and it seemed a bit out of sync. So at the beginning of August I sent a letter to all current Small Business Advisory Council members and to about 15 or so former members who are in manufacturing companies and nonresidential construction to try to get a sense of their views. All of the responses were coming in last week and we also met then

with our directors. The assessment of conditions in the District by these contacts was not as negative as our Beige Book report. Certainly, portions of manufacturing in the District are still weak. Some of the big companies like Timken and Diebold are still reporting weakness. But a lot of the smaller firms are not. Outside of metals, the tone was much more upbeat than what I had been hearing.

We contacted every motor vehicle assembly plant in the District, including those for trucks, as well as every parts supplier and asked: "How does it look, coming into the second half?" Ford is very weak--Ford kept several plants idle, mainly those producing commercial vans and minivans--but the rest are strong. Toyota and Honda are running flat out, well above last year; and both GM and Chrysler are operating at levels above last year and they remain optimistic. So at least from our District's perspective, the motor vehicle sector doesn't look as negative as the Board staff is assuming in its forecast.

Because of the articles I mentioned last time about the corrugated box industry being a leading indicator, we also contacted 14 corrugated box suppliers in the District and asked how things look. Those that supply mainly consumer product companies in the District, such as Proctor and Gamble, are doing quite well. Those that supply motor vehicles or metals-related industries or tech firms are not doing nearly as well, and certainly not as well as last year.

Construction is still strong in our region. Residential construction, of course, is very strong everywhere, but our contacts in the nonresidential sector say that public works and utilities also are continuing to expand. In Kentucky our contacts report about a 5 percent increase for the first half of the year versus a year ago. In Western Ohio and Indiana, nonresidential construction is up 15 percent from a year ago. Our contacts noted that multi-family housing--well, that does get into residential--was especially strong, up 40 percent. But

they say it's the health-care sector that is providing them with a lot of new contracts. As for other nonresidential construction, such as highway and bridge construction, several companies say that their problem is just a matter of getting labor to fulfill their contracts. Mostly their complaints are about the lack of skilled labor to operate the type of construction equipment that they are now employing.

A producer of air curtains in Western Pennsylvania informed us that July was the best month in the company's history by a big margin; both domestic and foreign demand has been strong. We also contacted a company that produces controls for industrial motors and supplies to firms throughout the United States as well as around the world. Their story may be more a comment on technology and what's in store for future capital spending rather than just general business. Our contacts said that for the first half of the year their business was up over 30 percent versus a year ago. They attribute that to the fact that they implemented an e-business on-line ordering system that has allowed them to increase their productivity since the beginning of 2000 by about 25 to 30 percent across all product lines. They say that 80 percent of their operations now involve orders that are coming in on-line for just-in-time delivery. They have been able to decrease their prices across product lines by 7 to 10 percent while increasing their profit margins and they have been expanding their workforce because of the strength of their business. Their expectation is that they won't be able to sustain all of this because they expect their competitors to implement these same kinds of technologies and close the gap that they believe they now enjoy.

Companies that supply equipment for the health-care sector say they are doing very well, as are those that are involved in large, highly automated, and very expensive coal mining equipment. The problem for the latter is getting labor to work the very sophisticated coal mining



machinery, some of which cost \$5 million per machine. Business for a company that produces titanium parts for the aerospace industry is up 25 percent versus last year. And their sales of parts to the medical industry--knee joints and that sort of thing--are up 20 percent. That firm has five openings for machinists but no qualified applicants. Pittsburgh Plate Glass sales to the aerospace and housing sectors are strong but sales to the motor vehicle industry are weak.

The retail sector had been very negative but turned better in early August. Some of our directors--especially from Federated and other retailing companies--were very bearish. They are hopeful now that the back-to-school sales are going to be better than they had planned for coming into the second half of the year.

Representatives from the school districts in North Ohio in particular said that they have a lot of unfilled teacher positions as the back-to-school period arrives--school started last week in our area of the country--and they cite aggressive recruiting of Ohio teachers by California schools as one reason. In response, Ohio schools are going to recruit in India. [Laughter]

On the inflation front, tuition is up 9 to 10 percent at almost all of the public colleges and universities in the District. We might be able to justify some of the increases in medical care costs as quality improvements, but I doubt that's true in higher education. [Laughter]

On the national economy, midway through this third quarter it now appears that from a broad GDP perspective, the second half is going to be slower than had been hoped at the beginning of the year. But it's notable that two very important sectors of the economy, housing and motor vehicles, have been considerably stronger than had been expected at the start of the year. Moreover, employment has held up better than expected. The unemployment rate is lower than had been feared. And what appeared to be a dangerously destabilizing situation in natural gas and electric power six or seven months ago has eased dramatically. Even the current account

deficit in the first half came in much smaller than expected. Now, it is true that inventories plunged much more dramatically than had been expected, but that's not necessarily a bad thing. We were told that steel inventories are down dramatically because of a 25 percent drop in imports.

The biggest miss in most forecasts was in business fixed investment, the same category that accounted for the tendency of forecasters to underestimate the strength in the prior expansion. Risks outside the United States seem to have intensified; Argentina, Japan, and even the euro area are all considerable risks. And there is no doubt that events will occur to which we will have to respond. But the solutions to those developments in advance of their occurrence are not going to be influenced by whether the U.S. overnight interbank rate is a little higher or a little lower. There must come a time when we have to demonstrate confidence that with patience the magic of the marketplace will again produce bigger GDP numbers. Thank you.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The Second District economy has weakened further recently, while both finished goods inflation and input cost pressures have continued to recede. Much of the weakness is still concentrated in manufacturing, but other sectors have shown signs of slowing as well. In July, private sector payroll employment was virtually unchanged in New York State but fell at roughly a 2 percent pace in New Jersey. We can't really allocate that between Tony Santomero's part of New Jersey and my part of New Jersey, so I think we tend to double cover it, but that's the fifth straight drop. While manufacturing has sustained the steepest job losses over the past year, weakness in both June and July was fairly broad-based across industries. Even the construction industry, which had been an engine of job growth, has shed jobs at an annual rate of roughly 5 percent since

peaking in March. Disconcertingly, employment in New York City's critical financial services sector has now declined for four consecutive months, with virtually daily headlines of very large-scale reductions in staff.

Retail sales were described as sluggish in June and July, though the heat wave in early August boosted sales of air conditioners, swimwear, and other hot weather merchandise.

Retailers continue to report a weak pricing environment, with most of our respondents indicating that both selling prices and merchandise costs are flat to lower. While retail wage pressures reportedly remain subdued, contacts continue to note fairly brisk escalation in health benefits and utilities costs. The Buffalo area in New York State is particularly weak. And Siena College's survey of New York State residents, which tends to be reasonably accurate, reports that consumer confidence fell sharply in July both upstate and in the New York City area, more than erasing the gains in May and June. July's level is the lowest in the survey's 2-1/2 year history.

Construction and real estate activity have been mixed. The commercial sector remains sluggish and pockets of weakness have emerged in the residential segment, but the tone remains rather positive, considering that. Manufacturers and purchasing managers report that business conditions weakened in July, while price pressures receded. New York City hotel occupancy rates and room rates fell significantly in the second quarter from a year ago. A lot of tourists continue to come to New York City but they don't seem to be spending as much or staying as long as previously. Inflation in the area receded in July, mainly due to a downturn in energy prices, and it is about on a par with the national average. Bankers report steady loan demand, rising delinquency rates, and tighter credit standards. Conditions appear to be somewhat more favorable in the residential mortgage segment of their business.

On the national level, we think the near-term outlook is for sluggish growth at best.

We expect that third-quarter growth could be about 2 percent, but that's putting a lot of faith in the monetary policy easing in the pipeline and in the checks coming from the U.S. Treasury. With little data so far for the quarter, there is certainly a very great deal of uncertainty about this short-term growth outlook.

Longer term we expect, as does the Greenbook, that the outlook will brighten some, with GDP growth rebounding to over 2-1/2 percent in Q4 and in 2002. We have taken a first look at 2003 and it looks as if growth will remain at about the same pace into that year. That will put growth below what we believe is potential, so the unemployment rate will rise. We think it will go up to about 5 percent by the end of 2002. We have a rather benign forecast for inflation. We expect the PCE deflator to be about 2-1/4 percent in 2002 and to drop down to about 2 percent in 2003. So those who are looking for a minor improvement in inflation may just have their wish fulfilled.

In the short term we think that the downside risks are quite severe and that there really is a significant risk of a recession. Weak household consumption and aggregate demand raise the possibility that the inventory correction will last longer and that business investment will decline even more than we currently expect. Moreover, weakness in foreign economies could exacerbate that situation. We could have a vicious circle that produces a recession in the near term and in the longer term a continuation of the sluggish economy we've seen over the past year. On the other hand, the combination of monetary easing and fiscal policy could have a greater than expected impact, resulting in a surge in aggregate demand. However, we think that prospect is very much less likely.

Let me talk briefly about the international situation, particularly about two areas, Asia and Argentina. You may have noticed in this morning's paper that Chinese Premier Zhu was

making a tour of southern China. You may remember that Deng Xiaoping announced a major change in policy in China by a tour of southern China. I think the most significant thing that Premier Zhu said is that the Chinese should do anything to improve their exports. Now, if true--and he tends not to say things that he doesn't mean--that could very well be the last thing that is needed for non-Japan, non-China countries of Asia. China does not really compete very much with the rest of Asia on tech exports, but tech exports in that area are already decimated. However, the Chinese can clean everybody's clock in every other area of exports because the fact is that they can bring their prices down to wherever they want them to be and are able to compete at any price level. They simply have to move a factory 500 miles farther into interior China and pay close to nothing for the cost of labor. So that plan, if carried forward, is a rather frightening prospect for the already weakened economies of Asia, the former "tigers."

On Argentina, by chance in my State Department years in the mid-1960s I was in the office of regional economic policy and one of the countries I was supposed to look out for was Argentina. So it's a place I've known reasonably well for almost 40 years. I think a crisis in Argentina is likely to be significantly different from most crises. If it would remind us of anything, it would be closer to what we've seen in Indonesia. The reason is this: The currency board was not brought in by President Menem because some economics professor told him that it was an important piece of economic theory. He brought it in because he inherited about 5,000 percent annual inflation. His predecessor had to leave office early as soon as Menem's election was certified. So Menem brought in the currency board because he realized, as a brilliant politician, that he had to import discipline in order to get Argentina functioning. But he engaged in a kind of wishful thinking in hoping that at some stage the economic stars would align themselves so that Argentina could get out of the convertibility arrangement and the peso would

strengthen. Well, that never quite happened. My concern is that if the present regime collapses, which it well might, we're not going to see a Brazilian-type situation where the currency undergoes a significant devaluation and the social situation manages itself reasonably well. I fear that we will see something that is truly chaotic, with rioting in the streets and a very unpredictable outcome in the congressional elections in October.

Now, one of the things that Argentina is extraordinarily good at is blaming other people for its problems. In the course of the last week they've already set the stage for that. According to the economics minister, people in Washington have been espousing default and devaluation for Argentina. The fact that that isn't true is not enormously relevant. And if we have a really good-sized problem in Argentina, I think it is likely to have a much bigger effect on the world economy than the size of the Argentine economy would indicate--rather as Russia, with a GDP the size of Norway, did in 1998. To me the real downside risk is that, despite the greatest possible intentions of everybody involved to help Argentina yet again, if it is deemed not to have worked there will be questions--in this background of a very weak economy--about the quality of the financial/economic leadership in the world. Now once again, that would probably be a bad assessment. There's nothing wrong with the quality of economic management in the world. But with this very weak economic climate, if that perception were real, I think we could have some very chaotic financial markets. Of course, that is not something we can anticipate through monetary policy. However, I think what we ought to do with monetary policy today is rather clear. And in the very short period ahead, I believe we could have some very serious damage control requirements coming our way. Thank you.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. I think the Committee is faced with

the question of whether or not to accept and adopt the Greenbook's baseline forecast, which frankly, given where we are starting is a relatively attractive forecast. It points to a return of the economy to its downwardly revised potential growth for the forecast horizon, with PCE inflation remaining contained. Optimists--indeed some people at this table--have already pointed to some tentative signs that the economy has bottomed. One of those relatively positive signs is the trend in first-time claims for unemployment benefits, which have fallen below 400,000 for four consecutive weeks. Others have pointed to homebuilding, which as measured by housing starts rose at the fastest pace in 17 months. It is true also that retail sales came in surprisingly strong when adjusted for falling gasoline prices. And our own IP data can be and have been read by some as indicating that industrial production has begun to stabilize.

Unfortunately, I do not think any of these data, particularly given the fact that they are only one month's worth, have been sufficiently strong to be indicative of a bottoming much less a likely return to more robust growth. They are certainly not strong enough to give us much comfort or to support the view that we should do nothing at this meeting. An outcome such as the baseline is actually more hope than reality at this stage, and in making policy I think we would be well advised to put significant odds on an adverse outcome for aggregate demand, particularly capital spending. Some of the evidence in that direction includes our own Beige Book, which indicates ongoing weakness, as well as the staff's forecast, which was again revised down in the face of weaker than expected incoming data. Though consumer spending has been a bastion of strength, as others have noted, mounting job losses and a declining stock market performance could indeed threaten to weaken consumer behavior. The profit outlook is certainly not yet firm, which indicates that business investment is unlikely to return to robust growth in the near to intermediate term and indeed may weaken further. While businesses have

opportunistically liquefied their balance sheets, the demand for loans is off, again suggesting that businesses sense no need to invest for an upturn in future demand. And our earlier concerns about weakness overseas are clearly starting to materialize, in part due to weakness here and in part due to the general high-tech retrenchment that is influencing a large number of economies. In my view the forecast of a turnaround overseas is again based more on a question of what should be as opposed to what appears likely.

In the face of all this weakness and the sense that the risks, at least in my mind, are to the downside, some have argued that we should probably do nothing. There could be a number of reasons adduced for not responding to the recent data, which have been weaker than we expected, or for not responding to the downward adjustments in the forecast. One of those reasons is that policy works with long lags and we might be stoking the fires of future inflation. We cannot be complacent here, but for the risk of future inflation to become an immediate and overriding policy concern today we must believe that one of two states is going to emerge.

The first of those states is that the economy is going to rebound so quickly that we'll be unable to adjust policy, which would imply either that we won't be able to read the incoming data or that we won't have the fortitude to respond to them. I think both of those things are unlikely. The second state that would warrant favoring no policy action today is that we are worried that the labor market tightness we have seen is not likely to abate and we believe that inflation is going to rise even in the face of below-trend growth. Now the extreme version of this view is so-called stagflation. I think we've had only one case of stagflation, and that one case was driven by a surprise increase in oil prices. So it seems that we are unlikely to face great stagflation risks because I believe we're unlikely to get a surprise on the oil price front or any other shock that would throw the economy way off in terms of creating pressures for a sudden



uptick in inflation. A third risk is that inflation might pick up gradually over time. At this stage that seems to me far less of a policy concern than that weakness itself will become more widespread and longer lasting.

Now, there is a second school of argument against responding to the incoming data and the downward revision in the forecast. That second school of argument says that frequent rate changes add to uncertainty and that our accompanying statements create a negative psychology. In fact, I think markets have built in an expectation of a Fed easing today and I believe the uncertainty would be greater if we didn't respond to the incoming data than if we moved forward and reduced rates. I would also say that--rather than adding to consumer malaise--honest statements of a central bank, even if they are not reassuring, build credibility far more than would a false sense of optimism. So I think it's quite important that our statements reflect reality as we see it and the risks as we understand them.

A third argument that has been adduced against lowering rates at this meeting is that reducing rates over-stimulates a few sectors. Again, this is plausible; in fact, it's true. It reflects the fact that interest rate adjustments clearly work through their impact on interest-sensitive sectors. When we raise rates, housing is hurt; when we lower rates, housing is helped. By influencing asset prices and activities in interest-sensitive sectors, we influence the entire economy. We should not refuse to act because we do not like the transmission mechanisms of monetary policy. If we were to follow that approach, we would obviously be tying both hands behind our backs.

I believe the final argument against adjusting rates at this meeting is that we may in fact find that rates are too stimulative and thus that we are over-stimulating the economy. In that regard we should recognize, as we think about the range of the estimated equilibrium real rate,

that the actual equilibrium real rate would gradually go down as the economy weakens. So the degree of stimulus actually starts to decrease if we keep rates unchanged in the face of a weakening economy.

Let me conclude by saying that in my judgment the baseline forecast is a hope more than a reality, the risks are certainly to the downside, and the arguments against moving rates down at this policy meeting strike me as far weaker than the arguments in favor of moving them.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Thank you, Mr. Chairman. I'm going to offer a few bits of anecdotal information that complement things that have already been said, but I will try not to duplicate what is already on the table. My UPS and FedEx contacts both reported that much of the world is not doing very well, though they were both fairly optimistic about Europe. My UPS contact said that from January to June UPS business in Europe had grown at double-digit rates. Growth was slowing down a bit now, but they still expect it to be positive. My FedEx contact reported that Europe was the one area where growth continued; he also reported double-digit growth in exports out of Europe and business within Europe. And he was very optimistic that growth in FedEx business was going to continue at an 8 to 10 percent rate in Europe. Both companies are trimming capital spending somewhat. My UPS contact said that major cutbacks are taking place in the airline industry in general and that cargo segments were being cut. From Taiwan to the United States and from Japan to the United States, capacity is being cut. Both companies reported a significant amount of substitution away from the premium express business into the more standard shipping business, which would be consistent with efforts all around to economize.

My contact at Wal-Mart said that his company's preliminary experience with the tax

rebates was that about 25 to 30 percent of the checks cashed at Wal-Mart--Wal-Mart is cashing those checks at no charge--are being spent on the spot at the stores. He also noted that Wal-Mart finds labor market conditions still tight for sales associates. Obviously, that is a minimum wage or slightly above minimal wage position, and apparently the easing of the labor market in the higher paid occupations is not showing up at all in the market for sales associates. He said it's just as difficult as it was a year ago to hire people. Retention is up, but they still have problems filling vacant positions. I thought that was rather interesting. He also emphasized the pressure that Wal-Mart sees from health-care costs; those costs are going to be up 20 to 22 percent this year and the increase may be worse next year. He noted that one development in that area is the spread of legislative restrictions that make it more and more difficult for firms to apply restrictions on pre-existing conditions. So the companies that have relatively generous health-care benefits are finding what I guess might be called "adverse selection" against them. People who know they have pre-existing conditions will try to gain employment in those firms.

On a more general note, for me the issue today is not whether substantial monetary stimulus is in place. I'm convinced that it is. The question is not whether that stimulus is going to have an effect, but when. I think it's a timing issue. I've been interested in the fact that longer-term interest rates have not come down, or have come down only in the last week or two. The ten-year rate is still essentially where it was in December. It's very easy, using the ten-year strips, to decompose that rate into various maturities. So I put together a table showing the 0 to 2-year part of it, the 2- to 5-year forward rate, and the 5- to 10-year forward rate. Let me just read you a few numbers. In August of last year, the 5- to 10-year forward rate extracted from the strips was 5.6 percent. At the end of December, it was 5.6 percent. As of Friday, it was 6.0 percent. The 5- to 10-year maturity has been hanging up there fairly high. What has happened is

that the decline we've seen in the 10-year rate is due almost entirely to declines in the 0 to 2-year part and maybe somewhat to declines in the 2- to 5-year part.

Now, what does one make of a situation where the 5- to 10-year forward rate is unaffected by all that has gone on in the last year? Incidentally, before I try to speak to that question, let me say that a lot of our ideas about the lags come from experiences where the longer rates do follow the short rates to a very significant extent. Looking at the historical data, over a six-month period every percentage point drop in the federal funds rate generally will be accompanied by a drop in the 10-year rate of about 30 or 35 basis points; that's the average experience. So one of the reasons why we're perhaps not seeing as much result as we might expect is that a lot of the effect typically is coming out of housing. Housing remains on a high plateau and mortgage interest rates really haven't come down since December. There was a substantial decline last year but not much this year.

I interpret the maintained level of the 5- to 10-year forward rate--whether it's high or not is a different matter--as reflecting a market conviction that the longer-run growth potential for the economy has not been affected by the events of the last year. The market view is that we are going through a period of adjustment. And after all, this is a position that many people around this table have stated. We have helped to reinforce that conviction. Whether it's right or not, we don't really know. But I think there are lots of reasons to be optimistic about that.

If that view is correct, I think it's logical to expect that the demand for the technological equipment that is necessary for achieving productivity gains is going to have to resume. That demand is going to resume because otherwise we're not going to get the productivity that is implied by this outlook for the economy. There was over-expansion in that industry and there are some backlogs to be worked off. But most of that equipment has a rather

short useful life. A normal depreciation period for a PC is three years or something like that. So the backlog is going to be worked off and that demand will be coming back.

Suppose that view--our outlook and my interpretation of the market's outlook and why the 5- to 10-year forward rate remains as high as it is--is not correct and potential growth in fact goes back more toward the dreary levels that we had from, say, 1972 to 1995. If that happens, then we're going to end up with a lot more inflationary pressure than we currently anticipate. The reason is that we're not going to be getting the productivity growth and there's a lot of inertia in compensation and wage processes.

I just offer those ideas. But I will emphasize that the recent behavior of the long end of the market relative to the short end is a very, very unusual experience. If you look at the data from the Korean War on--just put some columns on a spread sheet--you will convince yourself that this is a very, very unusual period. Thank you.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. A few meetings ago I made the comment that the economy was susceptible to chronic and acute risks--the chronic risk of rising inflation and the acute risk of recession. The comment drew some chuckles and people told me afterwards that they liked the analogy. The only problem is that now, with the wisdom of hindsight, my statement doesn't look so good because the recession risks are also proving to be chronic. For some months now both official and private forecasters have been projecting that a turnaround in demand growth is imminent, that the economy will recover, and that economic growth will get back on track. While there have bright spots this year, for the most part that turnaround just has not materialized. Overall conditions seem roughly as weak now as they did earlier in the year, despite significant expansionary doses of both monetary and fiscal policy and

a cut in energy prices. The forecast recovery has been pushed back and pushed back again; it always seems to be just around the corner but never quite here. No doubt at some point there really will be a turnaround, but our patience is being severely tested.

We've talked about these points of weakness for several meetings now and there's no need to belabor the issues. Probably the most serious question is the profits outlook. Until profit expectations recover, it's hard to see a strong turnaround in business investment. Indeed, the staff showed yesterday that the profits outlook for technology shares in the S&P index has dropped so rapidly that that portion of the S&P is again showing high price-earnings ratios, possibly foreshadowing more declines in stock prices.

The international sector is also growing increasingly worrisome. There seems to be no demand growth driver anywhere in the world. The standard international forecast does show a recovery. But the main source of future strength--if we can call it that--in the world economy seems to be that the United States has such a high income elasticity for imports that if our economy recovers, it will pull up demand for our trading partners. One can be forgiven for considering this a rather weak reed.

The steady beat of disappointing news is taking its toll on expectations--so much so that the Beige Book got lots of play in the press a couple of weeks ago, with reports that economic malaise was beginning to spread from manufacturing to sectors such as office space, trucking, and shipping services. In some sense these reports were not all that remarkable; after all, slowdowns would be expected to spread. But the negative expectations have become so pervasive after these reports that the Beige Book had much more impact than it normally does. Even the GDP revisions had an impact. As David Wilcox pointed out earlier, the GDP revisions did not change inflation or the output gaps, so there was no first-order impact on monetary

policy. But the BEA did write down growth in recent years, taking a big slice out of both capital investment and profits. The profits change could indirectly cause problems on the demand side, given the prevailing weakness in profit expectations. The investment change hurts on the supply side, lowering the capital deepening component of productivity change and estimates of potential growth over the next few years. This is not, to be sure, a true structural productivity change because the alteration was due to capital put in place, which we already knew was cyclically weak. But it's still disappointing to see this productivity growth spurt that we all took such pride in being partly undone with new data.

Let me say a word about lags; a few of you have mentioned those. Lags for monetary policy are long. They are also variable. It strikes me that at this time in this cycle it becomes very difficult to read exactly where we are in the process of monetary lags. Long rates--and this is similar to what Bill Poole just said--actually went down last fall before we started lowering short rates. So if the drop in long rates was going to have some effect, it should be working through the system already. Another channel through which monetary policy works is the dollar. And as was reported earlier, the dollar hadn't really gone down until a couple of weeks ago. The third channel is equity markets. If anybody knows how to interpret the equity markets, please come forward and say your piece! So I think that the question of exactly where we are in this monetary lag cycle is after all rather complicated. I think the notion of just saying "Well, we started lowering rates eight months ago, so the effect ought to be coming through now" is at best oversimplified. On the fiscal side, we have talked a lot about the tax cuts. But there is an offsetting factor involved because a lot of states have gotten into fiscal difficulties as a result of the developments that are going on throughout the country and some states are actually raising taxes, offsetting the Federal tax cut.

There are still bright spots. Housing has been consistently strong. Price-earnings ratios on most stocks have been reasonably stable. Consumption, as has been noted, has held up well. The turnaround could still be right around the corner. Moreover, in my view this has not been a time of policy mistakes. Monetary policy, as I think most of us would agree, has followed roughly the proper path, getting rates down early and significantly. But given the prolonged slowdown--which any day we might begin to call chronic--there does seem to be a need for a monetary booster shot. Thank you.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. The previous Greenbook projected some strengthening in growth in the fourth quarter and a recovery to growth near trend and to a level of output near potential in 2002. And I believe there was a sense of agreement that if the forecast stabilized, that forecast provided a strong case for holding policy unchanged after last meeting's move. On the other hand, the pattern this year has been a continuing series of downward revisions to the forecast, followed by additional easing moves in an effort to restore the earlier forecast for 2002. So the first questions I asked myself as I prepared for today's meeting were: "Has the forecast stabilized?" and "Is the forecast for 2002 still lined up to a reasonable approximation on trend growth and full employment?" The answers will help me to assess both the need for further easing and the room to maneuver--or the threat of overshooting in easing further.

This assessment, however, is complicated, as David Wilcox noted in his presentation, by the NIPA and productivity revisions. The outlook context for monetary policy decisions in my view is best viewed in terms of growth in actual output relative to potential and in terms of utilization rates. From this perspective, the growth rates for 2001 and 2002 in the Greenbook forecast were marked down just about in line with the staff's downward revision to trend growth,



thereby virtually replicating the previous Greenbook's projections for the unemployment rate and inflation. So if the story is still that forces are in train that will move the economy to recovery and that the recovery will put the economy near full employment and trend growth next year, it's hard to see the need for further easing or the room to maneuver.

But to tell the truth, the story doesn't feel entirely right. There remains a tension between the evidence of persistent weakness in the incoming data and the story of recovery. The question we face in each forecast round is how many quarters lie between the data and the story. And what we end up doing again and again is inserting one more quarter that looks more like the previous weak quarters--in this case it's the fourth quarter of this year--before we get a transitional quarter or two on the way to trend growth. At the very least this pattern suggests that there are significantly asymmetric risks on the downside.

In assessing how much easing is appropriate and whether we have done enough, another consideration is important. Declines in the federal funds rate have little or no direct effect on aggregate demand but are an instrument for encouraging a more accommodative overall set of financial conditions, as the lower short-term rates pass through to lower longer-term rates, to equity prices, and the dollar. In fact--and this is an issue that President Poole and Governor Gramlich have just commented on--long-term rates did not fall from their levels at the time we began to ease, at least until very recently. Furthermore, equity prices are significantly lower and the dollar is higher.

I asked the staff to run some simulations with the FRB/US model to assess the effect of the cumulative easing on overall financial conditions. First, they began the simulations in the first quarter of 2001 and they held the real federal funds rate constant in the baseline forecast. In the alternative scenario, they imposed the path of the funds rate in the Greenbook through 2002.

They ran the alternative scenario under two assumptions. In the first case, they assumed the historical regularities for pass-throughs to longer-term interest rates, equity prices, and the dollar. In the second, they constrained the latter variables to follow their actual paths through the last easing. The results indicated that, assuming historical regularities, there would have been virtually no effect on real GDP through the second quarter. But real GDP would have been a percentage point higher by the end of this year and more than 3 percentage points higher by the end of 2002. However, given the actual paths of financial variables, the level of real GDP would be only 1/4 percentage point higher at the end of this year and 1/2 percentage point higher by the end of 2002. That is, instead of providing a powerful stimulus, the easing only about offset the restraint coming from declining equity prices and the appreciation of the dollar, leaving little net stimulus from overall financial conditions.

The problem with this simulation experiment is that it fails to give the Fed any credit for the decline in interest rates in the second half of 2000 in anticipation of Fed easing in 2001. So the staff then redid the simulations beginning in the third quarter of last year. By August of last year, the federal funds futures indicated the absence of expectations of any change in the funds rate over the next year. The decline in long-term rates that followed reflected expectations of subsequent Fed easing. This approach counts the decline in long-term rates in the second half as part of the stimulus from the cumulative easing. But the benefits of the lower long-term rates were more than offset by the effects of the decline in equity prices in the second half of last year. So in somewhat of a surprise, to me at least, on net financial conditions have actually become more restrictive rather than more stimulative if we begin the accounting from mid-2000.

From the standpoint of monetary policy strategy, this raises the question of whether and how monetary policy should be adjusted for variations in the pass-through from the funds

rate to broader financial conditions, episode by episode. If we make our policy judgments on the basis of the forecasts, this adjustment would naturally occur. But it does raise a cautioning note about guidance from outcome-based policy rules that in effect are calibrated off average pass-throughs.

At any rate, this analysis suggests some tension in the forecast. We all point to monetary policy as one of the forces promoting recovery and yet the analysis shows that at best we may be running in place. To be sure, it also suggests that our aggressive easing has prevented what otherwise might have been a slide into recession. However, the recovery in the Greenbook must be based not on improved financial conditions but on other forces in play--for example, the effects of lower energy prices, more stimulative fiscal policy, or perhaps more importantly the natural forces for recovery that follow the end of the inventory correction and the end of the retrenchment in high-tech investment.

While I worry, therefore, whether we are on the path to recovery, I also worry about overshooting as well. It seems to me that the dynamics of expansion suggest an upward instability to growth. In the dynamics of cyclical swings in growth, it's not that the economy returns to trend growth after a slowdown or recession and stays there, but it naturally moves to above trend growth. Therefore, once a recovery is under way we may face the twin challenges of moving monetary policy back to neutrality in a timely fashion and contending with above-trend growth at a time when inflation is a bit above at least my long-run target and the economy is already operating at close to capacity. Further easing today will undoubtedly complicate that adjustment. But the failure to see traction from our moves to date and the resulting downside risks encourage taking some risk of overshooting today and leaving to tomorrow the task of returning to neutrality and avoiding the inflationary consequences of any overshooting.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. As usual, by this time our discussion has thoroughly dissected and evaluated the economy, and little remains to be added. So please indulge a short-timer for a few concluding ruminations.

First of all, it's necessary to acknowledge, as almost everyone here has, significant disappointment in the data that have come in over the intermeeting period. The main driver of this slowdown, capital overhang drying up capital expenditures, looks no better. The inventory correction, to my great surprise, drags on still. The world economic outlook looks even more bleak, with political and financial tensions threatening to exacerbate the situation further. Although housing somehow continues to levitate, recent auto sales may be hinting that the consumer is tiring, which could become a serious concern.

Not everything is negative, of course. Industrial production and labor market conditions may be stabilizing. The tax rebate checks are flowing, Fed easing should be kicking in, inventory balance is coming into view, and energy prices are falling. Nevertheless, on balance one must be concerned. At the last meeting, there was speculation that the balance of risks might be moving toward symmetry. At that time, I expected to be firmly in that camp by today. While I am indeed edging in that direction, I'm not ready yet to drive down the tent pegs and settle in. I'd like to, but I just can't.

Shifting the subject a bit, two strains of recent media comment strike me as wrongheaded. First there has been the suggestion that monetary policy isn't working. Have these people given any thought to what this economy might look like today if policy had not changed this year? If anything, I'd suggest that policy has worked more quickly than usual and precisely where it was needed most, shoring up consumer and stock market confidence. And

now the traditional lagged impact of policy should start to be felt.

Second, one is already starting to hear complaints that a recovery will be weak when it comes. Here again I wonder if our critics have pondered the implications of a strong rebound? Given the very high absolute level of activity that we have even today, I hope and expect that the recovery will be moderate. An early boom beginning from here would lead quickly to major new problems.

Mr. Chairman, in my view monetary policy is not part of the economy's problem today. And going forward, I see monetary policy as having only a marginal role in the solution. At the first of this year a strong policy response was critical and I'm proud of the way this Committee responded at that time. But now I feel that if we visibly but modestly support the natural forces of recovery and remain patient, we can be most effective.

Let me conclude where I began. Obviously, on balance things are still weak. But I continue to believe in the mantra of recovery initiated by tax and interest rate cuts and rebalanced inventory positions, aided by lower energy costs and now, perhaps, a somewhat lower dollar. But we cannot ignore our serious investment collapse, a very dangerous world situation, and the possibility of a tiring consumer. What really concerns me most of all is that we must remain concerned at a time when we expected to be relaxing a bit. It's just possible that we may have problems ahead of us that we do not yet see. At any rate, we're not out of the woods yet.

CHAIRMAN GREENSPAN. Thank you. Coffee is available.

[Coffee break]

CHAIRMAN GREENSPAN. Let's turn now to Don Kohn.

MR. KOHN. Thank you, Mr. Chairman. As many of you remarked at the Committee's June meeting and again today, the special characteristics of the current slowdown are shaping the appropriate course of monetary policy and its likely effects.

In particular, the major driver in this slowdown seems to have been a re-evaluation of the profitability of new capital equipment--especially high-tech equipment. In these circumstances, lower interest rates are likely to cushion the resulting decline in investment demand only very partially. Importantly, though, policy easing works through the household sector, with lower interest rates bolstering asset prices and wealth and giving more direct incentives to spend by reducing the cost of acquiring houses and household durable goods. Policy action may also help to maintain consumer confidence. Judging from the prices of houses and from activity in housing markets, and from the well maintained pace of consumer durable purchases, in this regard to date your easing actions are indeed having much of their predicted and intended effects. And lower interest rates undoubtedly are keeping equity prices from falling much more as earnings disappoint. By bolstering household spending, policy is laying the foundation for a recovery in capital and inventory investment, working indirectly through multiplier and accelerator mechanisms.

But some of the characteristics of the current episode do suggest that the 275 basis points of policy easing so far may not produce the same degree of strengthening in aggregate demand, at least for a time, as a movement of similar size might have in the past. It is not that policy has been ineffective--that you are "pushing on a string." Rather, declines in interest rates have been operating against some powerful and unusual forces of restraint. The re-evaluation of capital profitability seems to be producing a larger and more persistent decrease in investment spending than in most business cycles. And the large revisions to expected profits are reducing equity prices despite lower interest rates. Moreover, because high-tech production is spread widely around the world, so too has been the drop-off in demand, output, and equity wealth. With other economies also threatened, the dollar has not depreciated in response to policy easing so that foreign economies have not absorbed any of the weakening in demand in the United States through the exchange rate channel. Finally, because household spending was never substantially depressed, stocks of houses and consumer durables probably have not dropped below desired levels. This implies that the recovery in spending once the economy starts to firm may be less ebullient than usual, since it will lack the extra push from the so-called pent-up demand from households often seen in the past.

In these circumstances, the federal funds rate may need to be lower for longer than you might have anticipated to produce a return to sustainable growth at around the economy's potential.

These unusual restraining forces are partly impounded in our

measures of the equilibrium real federal funds rate, which as a result have declined appreciably over the last year. Hence, a portion of the decrease in the federal funds rate has been necessary just to keep policy from tightening relative to this yardstick. But our measures of  $r^*$  in general do not reflect the full extent of these restraints on spending. The equilibrium rate we have been estimating is a medium-term concept--the real federal funds rate at which the economy eventually will produce at its potential after temporary shocks have worn off. Thus, temporary shocks, such as atypical asset price movements or weak investment relative to its longer-term trend, tend not to be embodied in some or all of the measures we use. If those shocks are large or persistent, as they seem to be at this time, real rates will need to be held appreciably below the range of estimated equilibrium rates for a while to foster satisfactory economic performance. Moreover, you may have reason to believe that the true range for  $r^*$  is lower than that given in the Bluebook. Most of those estimates rely on the staff's judgment about the NAIRU. If unemployment rates appreciably below 5-1/4 percent are sufficient to contain inflation, the equilibrium rate will be lower and the gap between it and the current real funds rate correspondingly smaller.

A policy that eases substantially and leaves the funds rate well below the estimated equilibrium is not without potential risks and drawbacks that a number of you also noted at the last meeting. Some of you regretted the degree and frequency of variation in the federal funds rate adjustments. You were concerned, in part, that wide swings in the policy instrument would themselves create uncertainty and unsettle markets. But, appropriately calibrated, changes in the funds rate act as shock absorbers, cushioning the effects of real-side disturbances on aggregate output and prices. And the larger the shocks, the larger the necessary movements in your policy instrument. To be sure, policy can be excessively activist, accentuating business cycles by reacting to perceived shocks that in practice ebb quickly or by being insufficiently forward looking. But the most serious problems have occurred when policy has been too sluggish--destabilizing the economy and financial markets by allowing inflationary or deflationary tendencies to cumulate because the central bank acted too little. This is a major lesson that your predecessors took from their experience in the 1970s and that many observers have drawn from the tepid response of the Bank of Japan in the early 1990s to the bursting of the asset bubble.

A potentially more troublesome concern raised by having the real federal funds rate well below its equilibrium level is whether policy can be tightened in a timely enough manner to forestall the emergence of higher inflation. In the current circumstances, inflation pressures that might be difficult to head off could arise were demand to strengthen

very considerably before long or costs begin to push up prices even in a relatively weak economy. Other things equal, the wider the federal funds rate gap, the greater this risk would seem to be. And balancing this possibility against the possibility that the weakness in the economy could be deeper or more prolonged than anticipated or than needed to keep inflation in check would seem to be at the nub of your decision today.

The staff forecast could be seen as describing a rough balance between these two possibilities, at an unchanged stance of policy. In that forecast, policy is accommodative enough to get growth in GDP back to the rate of increase in its potential by next year, with the help of fiscal stimulus, lower energy prices, and the inherent tendency of aggregate demand to expand at its longer-term growth rate. As Dave Wilcox emphasized, though projected growth of actual output has been revised down appreciably in the forecast, so too has been the growth of potential, leaving the output gap and the inflation outlook not much different than in the June Greenbook. While the result is a small margin of excess capacity in the labor markets in the second half of next year, with unit labor costs already having picked up, some slack may be needed insurance to counter the price pressures associated with the more rapid trend in compensation, the recent slowing of structural productivity growth, and the consequent narrowing of profit margins. Core PCE inflation is held about constant in the staff forecast, at a rate a little above that of 1998 and 1999. In your own forecasts last month for the semiannual monetary policy report, Committee members saw much stronger growth and lower unemployment rates than did the staff. Especially if that differential continues to prevail, the Committee may see further easing as incurring enough additional risk of building inflation pressures toward the end of 2002 to offset the added assurance it would give of a reasonable rebound in growth earlier next year.

However, keeping rates unchanged may require more confidence in the forecast--your own or the staff's--than the Committee has at this point. You eased at your last meeting, partly on the assessment that more weight should be put on the reality of near-term weakness than on the projection of longer-term strength. Continuing and persistent shortfalls in actual growth, even relative to downward-revised forecasts, may have reinforced that assessment, arguing for another 25 basis points of easing at this meeting. In effect, the anticipated pickup in the economy is starting from a lower base. Moreover, a number of elements in the current situation could be seen as suggesting that the risks of further shortfalls in economic activity in the next few quarters are greater than the risks of higher inflation later next year. Data and anecdotes on capital spending have yet to indicate any abatement in the pace of weakening in this sector or to allow a confident projection of



just how far the decline in investment will go. As Vince pointed out, revisions to growth in foreign economies, like those for the United States, have been one-sided. And consumption is threatened by the effects of softening job prospects on confidence and by the possibility of a further drop in equity prices if earnings expectations continue to be pared. Indeed, late last week, announcements of disappointing earnings and sales caused a further appreciable decline in equity prices and a widening of risk spreads in credit markets.

In light of near-term weakness, the Committee may see any potential inflation pressures as sufficiently far into the future to allow it to detect early signs that growth was accelerating or prices picking up and take timely steps, even after further easing. This seems consistent with market assessments of your likely actions and their outcome. Market participants have built further near-term easing into the structure of interest rates but also tightening next year. That turnaround apparently is seen as occurring soon enough to keep inflation low, judging from the results of surveys of inflation expectations or from the relatively modest level of longer-term inflation expectations derived from Treasury securities, which in fact have been declining of late. In that regard, both market participants and economic forecasters appear to have marked down their outlooks for growth and inflation in the last month, largely in response to the unexpected weakness in demand and more moderate inflation. The resulting drop in interest rates and the exchange rate should help to cushion the effect of lower equity prices on economic activity. Keeping the stance of policy unchanged at this meeting would tend to lower equity prices further and raise bond yields--a result the Committee might not want to see unless it were of the view that market participants had reacted inappropriately to the developing economic situation.

Given the tenor of the incoming information, with economic activity falling short of expectations and projections of growth revised downward, the Bluebook writers assumed that you would judge the balance of risks as still tilted toward economic weakness, even if you left policy unchanged at this meeting. At some point in the future, when the Committee sees the risk of near-term weakness as balanced by the risk of higher inflation over the longer term, it would presumably want to shift its balance of risk statement and explain its reasoning in the announcement. One path to that point would be a final easing that was perceived to put policy in a sufficiently accommodative posture to throw the risks into balance. Alternatively, the Committee might retain its assessment of unbalanced risks for a little while even after it stopped easing because it was not yet confident that threats of added weakness had abated sufficiently. This latter sequence would be consistent with your behavior in 2000 when you were concerned about inflation. In

effect, by the summer of last year, you still saw the risks as pointing to higher inflation, but not by enough to warrant changing the stance of policy. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Questions for Don? If not, let me get started.

I think it's fairly evident, certainly in retrospect, that we are seeing an absorption of very large capital losses throughout the economic system. I don't know whether one would call this a structural adjustment, but it certainly is not what we have embodied in our standard post-World War II econometric models. It's a different sort of phenomenon and it's clearly being engendered by a set of forces that are largely without historical precedent in the post-World War II period. This does not mean that we're looking at the type of severe business cycle contraction that the economy experienced on occasion in the pre-World War II period, but in many respects the process of adjustment is similar to that in the earlier contractions. As a number of you have indicated, the current weakness is obviously concentrated in the capital goods markets and to a very substantial extent it stems from a downward adjustment of long-term earnings expectations. I suspect that the declines in those expectations are really quite modest. What I believe has happened, as I think I indicated at the last meeting, is that the uncertainties with respect to the change in the outlook have fostered a significant rise in risk premiums in the capital goods markets. This essentially means that the hurdle rate that is required to induce a capital expenditure has increased. Indeed, one can talk in terms of a firm's refusal to invest its cash flow unless the return is realized in, say, 14 months or to change its PCs every year when the latter can obviously remain functional for three or four years. Nothing has happened in the last year to alter underlying conditions except a change in judgments. The PCs haven't changed. The technologies underlying the infrastructure of expanding information systems haven't changed. And indeed all the evidence that we have today suggests that our previous conclusions

about the outlook for capital investment are still basically true, namely that firms have a long way to go in exploiting the total available capital investments that offer significant above-hurdle rates of return. What has happened is simply a fundamental shift in the general degree of confidence. In the same sense that expectations were very clearly overdone on the upside, they are being underdone, if I may put it that way, on the downside; and that will continue to be so until the normal cycle, not of the business environment but of human psychology, runs its course.

One could argue with some obvious evidence, and indeed a number of you have so argued, that economic conditions have deteriorated since our last meeting, and I think that assessment is accurate. But the economy clearly has not collapsed. The fundamental evaluation of the behavior of the economy is still basically the same, and as in the early spring the concerns about a false dawn remain. Indeed, we are looking at aspects of that even today.

As you may recall, I indicated at the June meeting that corporate earnings were going to be a particularly difficult technical issue in the nearer term. The problem is related to the fact that in June security analysts were estimating a double-digit increase in third-quarter per share earnings, seasonally adjusted not at an annual rate, and that estimate was just not credible. The only question was the mechanism by which a downward adjustment would start to emerge. Frankly, it emerged a little differently from what I had expected. I thought that the second quarter was pretty much locked in. After all, by the end of the month, with the information technology systems that firms now have in place, they knew pretty much what their earnings would be with one exception. It's called end-of-quarter adjustments for which there is very considerable discretion. Looking out into the third quarter and seeing less than enjoyable prospects for earnings, firms decided to move some of the bad news into the second quarter. As a result, they reported a very fairly dramatic decline in second-quarter earnings stemming from

downward revisions at the very end of the quarter that were not credibly based on real events. After all, it's not as though we are still in the old quill pen days where business firms were three weeks behind in their bookkeeping.

There has been, of course, a very dramatic downward revision in expected third-quarter earnings. But because second-quarter earnings were revised down, we still have a significant seasonally adjusted increase in expected earnings per share as estimated by the analysts for the third quarter. Those earnings forecasts still have some distance to go on the downside. What is presumed to be a lead indicator of near-term earnings, the so-called profit warnings coming out of the companies, is showing fairly significant evidence that further sizable downward revisions are in the mix. I think one of the key reasons why, I believe quite appropriately, the Greenbook projects capital investment to continue soft in the second half is that, as history tells us, the chances that investment spending will turn around quickly are fairly remote until we get a turnaround in cash flow. It's not an issue of taking out the overhang in capital investment. I think business firms are in the process of doing that; they may even have done it to a very large extent by now. But we have to project that capital spending will fall below sustainable levels, and indeed in a sense build up some backlog. Markets never go from over-extension back to normal. I can't recall any case where that has happened, yet our forecasts always tend to project that it will happen. And when we get close to where we think it is about to happen we realize that it's not turning around because the over-adjustment on the downside has not yet occurred. In a sense this is not a business cycle issue; it's a human cycle issue.

The data, of course, are not as bad as the psychology. Indeed, looking at the profits data, a part of the problem in the national income and product account numbers, which are a lot weaker than the data in the S&P 500, is the fact that those data are reflective of what companies

must report to the IRS. This means that the value of exercised options is reported as compensation of employees and a reduction in pretax profits. In standard FASB accounting, that's not the way they do it; and by that accounting standard, firms have higher earnings numbers. The IRS numbers, by including the very large dollar value of exercised options, have added a big chunk to the reported compensation of employees and have taken out a big chunk of profitability in recent years. Obviously, the value of options is now a rapidly depreciating number. In that sense we are going to see compensation per hour slow down significantly, and we will also see some modest buoyancy starting to occur in the underlying earnings figures, for no matter what companies say, they know that stock options are a game that's being played. And they know that they can't hedge the stock option exercise effectively because the cost of a derivative to hedge against an option grant is usually a fairly hefty sum of money. So what they have been doing in effect is going short on the value of their stock options, and doing that has been very expensive for a lot of companies. But implicitly it is going to help them or has helped them in this cycle. In sum, I think the profit figures probably are unduly depressed at this point. Moreover, with the energy costs coming down but the contract costs of energy still somewhat higher than the spot prices, there is a delayed effect in the impact of high energy costs on profits.

Now, I'm not about to say that we will soon get a recovery in profits. I find that prospect exceptionally unlikely and the reason is that there is no pricing power in markets across the nation. I would suspect that when this whole episode is over we will have a lower rate of inflation, even in the PCE consumption deflator. As I look at the pricing structure, I see very little evidence that discounting is coming to an end, as other members have pointed out, and perhaps that is helpful in the sense that it has been a factor buoying household consumption.

It is household consumption or household demand more generally that clearly is the

source of strength holding this economy together. In this regard I think the evidence is increasingly persuasive that the capital gains realized on the sale of homes are inserting a fairly significant amount of purchasing power into the economy. Indeed, such gains appear to have been enough to significantly offset the negative effects of the decline in equity prices on consumption expenditures. The more I look at the data, the more I am persuaded that the deflationary effect of lower equity prices is concentrated in the capital goods markets. And the lower implicit rates of return that those prices capture are reflected somewhat less than I think we would have anticipated in the household sector. And, as best I can judge, that is wholly a reflection of the fact that the propensity to consume out of realized capital gains on homes appears to be significantly higher than it is on both unrealized capital gains on homes and capital gains in general on equities. This strikes me as a reason for viewing as important the support that housing is providing to the expansion. I suspect that without that support we would be observing much lower levels of economic activity.

The liquidation of inventories continues apace. The rate of liquidation has not slowed appreciably. It does fluctuate from month to month. The book value data are questionable, but alternate ways of estimating inventory change essentially confirm that the rate of liquidation is significant. However, inventory-sales ratios are holding up because the rate of decline in the consumption of industrial production is about in line with the rate of decline in inventories.

In sum, with foreign economies clearly weakening significantly, we are in a situation as best I can judge where the economy is being held up by household demand, which fortunately is running somewhat better than I think many of us would have anticipated. The press reaction to the July retail sales figures I thought was quite startling. When we take out sales of gasoline and motor vehicles, those retail sales figures were really strong, yet the press played them as

tepid. With personal consumption expenditures higher in July, third-quarter expenditures should rise even if they do not go anywhere in August and September. So, insofar as I can judge, the key source of support for the economy is coming from the spillover out of housing into household demand. Of course, strength in new construction of homes is helpful, but I believe the more powerful force on total GDP at this stage is the turnover of existing homes that engenders realized capital gains.

I believe we have some distance to go before we get out of this period of weakness. I think our forecasts at this stage essentially reflect hope. We do not yet see any evidence of the beginnings of a turnaround. It's not that the economy is falling apart; it is not. But economic conditions are continuously eroding and we get that sense in anecdotal reports from around the country. A possible exception is Jerry Jordan's select sample! Clearly, if GDP is still growing at a 1 percent rate, we inevitably will find that a large number of companies are doing very well and that would not be the case were we experiencing a minus 5 percent rate of decline in activity. The widespread anecdotal reports that I am exposed to do not contain very many straws suggestive of an upturn, but that is the way the economy looks at a cyclical bottom. In fact, if we go back and look at previous bottoms, we will find people saying exactly what I have just said. Indeed, a necessary condition for a bottom is the exhaustion of negative psychology that sets the stage for an upturn in optimism.

I believe we will eventually get the projected upturn. I don't think that the Greenbook forecast is wrong by any means. For example, the weekly chain store sales data look quite impressive. The data that we got this morning do suggest that the tax rebates are being spent. And if they are being spent, and we know there are \$36 billion of rebates, then they've got to have a positive impact. Even so, the recovery is likely to be a long process, and the presumption

that the upturn will occur very quickly is in my view just a total misreading of the underlying adjustments to capital losses that are occurring. They are by no means completed, and I don't think we can get a vibrant response out of this economy until these capital losses are reasonably fully absorbed. And because activity in many sectors of the economy is already at relatively high levels, the extent of the recovery cannot be large. Remember, the motor vehicle and housing sectors are still experiencing well above normal levels of activity, certainly for this stage of the cycle. So I think the process of adjustment still has a long way to go.

While the outlook remains subject to a good deal of uncertainty, I do think as many of you have suggested, that the appropriate policy at this stage is to move the federal funds rate a notch lower. A 25 basis point reduction strikes me as appropriate. If we were to go 50 basis points, our action would alarm everyone to an extent that I don't think we can fully appreciate at this point.

I thought the reaction to the latest Beige Book was very interesting. Ordinarily, the market tends to view the Beige Book in terms of its implications for policy, whether the Fed is going to move rates one way or the other, and that's it. This time it was different. The markets took this Beige Book as evidence that the Fed is a credible institution. Our sources were saying that the economy was softening and there was some spillover from the weakness in manufacturing to other sectors. We accepted what they said, and the markets in turn believed what we have been saying. For the first time in quite a while, that credibility is based on what we have done. The credibility of our organization is crucial, and as I said were we to go to 50 basis points today I think we would alarm everyone.

I do think that the risks remain obviously weighted toward economic weakness, but at some point we are going to have to stop our easing process. As I said at the last meeting, my



suspicion is that we will be stopping when the markets in effect are telling us to stop. That will show up, for example, when the Greenbook forecast of a recovery actually begins to materialize --when we distinguish between a forecast and reality. What we need is some real evidence that the capital goods markets are bottoming, that profit erosion has stabilized, that we are seeing signs of an upturn instead of still further negatives whenever we evaluate what individual companies are doing. Instead of getting that, we would start to get reports that say the results this week are mixed. I haven't seen a mixed report in a very long time. I'm referring incidentally to surveys that the staff makes periodically of about 6 to 10 companies on a rotating sample basis. The day that such a report comes in and indicates that these results are mixed will be the first sign I would take that something is happening. But I would say at this point that the real-time surveillance of the economy, especially with what is clearly an acceleration in the deterioration abroad, is one that says we have not as yet completed our easing process. So, I would put on the table a reduction of 25 basis points with the risks weighted toward economic weakness. Vice Chair.

VICE CHAIRMAN MCDONOUGH. I concur with your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, for me the policy choice is a close call. While I can support the proposed easing, I do think there are some reasonable arguments for leaving the funds rate unchanged at this time. First, there appears to be a consensus--supported by our outlook, the Greenbook, and even the lower 10 percent of the Blue Chip panel of forecasters--that there already is enough stimulus in the pipeline to produce a significant pickup in activity in the next year or so. Second, although I certainly hope you are correct in your expectation that

the inflation figures may turn out a bit better than most forecasts indicate, there is a chance that the current period of slow growth will end with little or no reduction in inflation. So we might be missing a chance for a little opportunistic progress on inflation. Third, we will know quite a bit more by our October meeting, especially about the effects of the tax rebate. So an argument can be made that we should wait for more information. While I'm concerned about these considerations, I do support a 25 basis point cut in the funds rate as some insurance against additional downside surprises for economic activity. I also would prefer to retain the balance of risks statement weighted toward economic weakness.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I agree with both parts of your recommendation, for a 25 basis point cut and the balance of risks toward economic weakness. You mentioned that if we did a 50 basis point cut, it would scare people. I would add that if we did zero, I think it would have the same impact. In my view this is a time when consumer confidence and business confidence are extremely important to the economy.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you. My interpretation of the course of policy is consistent with what Don Kohn said at the outset. That is, as best I can judge the situation, we're trying to prop up components of aggregate demand that are interest-rate sensitive until the inventory correction process runs its course and until conditions and attitudes change in a favorable way for capital spending. I don't think that's an unreasonable policy and it's probably the best available policy.

As I've indicated before, I'm concerned about the lags and what they mean for our future course of action. But let me add that I'm not opposed to a quarter point reduction in the funds rate at this stage. I won't get into the lag issue at any great length except to say that I

believe we are going to have to change course and adopt at least a policy of stability before there's totally persuasive evidence that the economy is reaccelerating in a major way. I say that not because I think we're going to be reluctant to change course when it's appropriate but because of what I would call the recognition lag. It's very unlikely that the evidence will accumulate in such a way that it will be entirely convincing that it's time to stop easing policy. My experience with these situations in the past is that the evidence comes in mixed for an extended period of time, so we're going to have to make the best judgment we can as that happens. In addition, if we think about the timing of the published data--the anecdotes, of course, may help--we won't know if the economy has rebounded until well after the fact. Let's suppose, just for illustrative purposes, that the economy really starts to reaccelerate in the first quarter. Well, we won't get all that much data on the first quarter until well into the second quarter and the data are unlikely to be convincing until well into the third quarter. So I'm concerned about that recognition lag going forward.

CHAIRMAN GREENSPAN. I just want to say that I think our techniques of knowing where we are have improved a great deal.

MR. STERN. Well, I sincerely hope you're right but the proof is in the pudding.

CHAIRMAN GREENSPAN. Well said! President Poole.

MR. POOLE. Mr. Chairman, I can support your recommendation.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I think your proposal is just right.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Mr. Chairman, I support both parts of your recommendation.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I support your recommendation, Mr. Chairman. I have had concerns similar to President Stern's and possibly others around the table that we won't quickly recognize when the economy has turned around and that policy will be too easy too long. But given where we are, it seems to me that policy needs to be a little easier in order to provide the appropriate level of support. I was struck by your comment that virtually the whole world economy is supported by consumer spending and the residential housing markets in the United States. It's a powerful thought and one that occurred to me as well. So I am in favor of this move but I think we need to be very careful going forward for all the reasons that President Stern mentioned.

CHAIRMAN GREENSPAN. President Broadus.

MR. BROADDUS. Mr. Chairman, if you'll forgive a personal note, let me make a couple of comments here. After our meeting in June, where I supported a quarter point reduction in the funds rate, one of my FOMC colleagues came up to me and said "Gee, you're really changing stripes. Where is the old inflation hawk I used to know?"

MS. MINEHAN. That was actually me!

MR. BROADDUS. And that's a fair question. But the answer I would give to the question is that I can remember when the Committee did not have full credibility. A lot of us were saying then that if we could ever achieve credibility, that would give us greater flexibility to move the funds rate in the short run in conjunction with changes in economic conditions. And, of course, now I think we do have considerable credibility. And with the downside risks still quite substantial, as you and others have mentioned, I think we need to take advantage of that credibility. To say the same thing a bit differently: Unlike the situation in a number of earlier postwar episodes, we don't need a recession to contain inflation or inflation expectations

at this point. We may have a recession ultimately or we may not. But if we do, I think it's important that the Fed not be perceived as contributing to it--or worse, actually causing it. So I'm not ready to disappoint market expectations today. Therefore, I agree with you and I favor going ahead with the expected quarter point reduction. If we don't, I think it would be a big surprise and quite disruptive.

Having said that, there isn't any doubt, though, that the real funds rate is not very far above zero. And if the economy is near a bottom--and here is where I might disagree with you a bit because it seems to me that there's at least some mild evidence that it could be--I think we need to be prepared to reverse course if necessary and to begin to tighten policy.

But more to the point--and this is really the main point I would make--I think we need to prepare the markets and the general public for that possibility, which I don't think we've done adequately to this point. There are lots of ways to do it. One way would be to go ahead and drop the rate a quarter of a point at this meeting and go to a symmetric directive. However, I agree that that would be pushing it. Nevertheless, I do believe that our statement, which is now an increasingly important signal of what we may be doing down the road, should indicate clearly that there's at least a possibility that the easing cycle may now be approaching an end. Our objective ought to be to try to preempt as much as we can the quick development of market expectations of yet another rate cut at the next meeting, so that we'll have greater flexibility at that meeting. So I would hope that our statement this time might have some language like that.

CHAIRMAN GREENSPAN. Well, at this stage the preliminary statement does two things, both of which it did the last time: One, it mentions how much we have reduced the rate since the beginning of the year; and two, it eliminates any notion of an intermeeting move. But also remember that what we did most importantly last time was that we cut the funds rate by

25 basis points and not 50. And I think that set the pace. Clearly, at the point we see the picture becoming mixed--when the data cease to indicate weakness almost across the board--that's the first sign that the bottom is being hit. We're at least a meeting away from that, maybe two; we really don't know yet. But I do think that we have to be clear that there is a bottom to this. I agree with that.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, if I could comment. I think by saying that we've reduced the funds rate by a total of 300 basis points and by continuing to take out any notion of an intermeeting move, the financial markets will interpret the statement in exactly the way you want.

MR. BROADDUS. I think that helps, Bill. But given the level of the funds rate now, I think an additional phrase might be prudent. I'm not sure I'm selling this to anybody here!  
[Laughter]

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Mr. Chairman, I support your recommendation. I agree with those who think that down the road--in a few quarters or maybe a year--having moved the funds rate down today might complicate our problems. But I think we have to do it. I would also underline something Don said, namely that right now we're in a position where both  $r$  and  $r^*$  are dropping. So we're really not getting as far out of balance as it might seem.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. Given my views of the economic outlook and the risks that we observe, I think both parts of your recommended policy are correct. So I support your proposal.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I can support your recommendation. I think the arguments for another modest easing move have been made around the table. I would say that I --and I suspect others who have offered some arguments on the other side at the June meeting-- had revised those arguments coming in today's meeting. I wanted to make the same point, though, that Gary Stern, Cathy Minehan, and Al Broaddus made. And that is that I'm not comfortable yet, even with your response to Al, that we have quite figured out our exit strategy. We need a way to convey that, not only internally but externally, before we have to do too much explaining. Al, you made a sale with me! I don't know whether the answer is a phrase in the statement or what. But if we continue to ease and continue to have the balance of risks statement the way it has been, I'm not sure how we will get off that treadmill as quickly as I suspect we're going to want to.

CHAIRMAN GREENSPAN. I think the market is going to take us off the treadmill.

MR. GUYNN. I hope that's the way it's done.

CHAIRMAN GREENSPAN. In fact, if we could actually arrange it, that would be the ideal way. In other words, the ideal way would be that we don't shock the market but that suddenly we get the federal funds futures rates flattening out because the data are beginning to look better. And at the moment I see nothing to prevent us from doing that. Governor Meyer.

MR. MEYER. Mr. Chairman, like some others, I do worry a bit about the adjustments that will become necessary as the economy begins to recover on the other side of our current problem. But I support your recommendation. I think it's right for today.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. I support your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you. First, I'll make sure that before the next meeting we do get not only some mixed reports but also some strong reports! [Laughter] Some of my Bank's directors have turned from being very bearish two or three months ago to saying, "Wait a minute, things are starting to improve." So I'll make sure you hear some of those reports, too.

I associate myself with some of the comments of Jack Guynn, Al Broaddus, and Gary Stern. I, too, worry about the concerns they mentioned. But I also believe the risk is high that an external event will materialize that will require us to respond. We're going to have to respond to it from wherever we are, and we may have to respond very aggressively. So I'd rather have some more dry powder to be used because there's nothing that a little adjustment in our domestic policy can do to alleviate the situations external to the United States that we view as most threatening. And I don't see that small adjustments in our policy stance are likely to be very helpful in turning around the psychology within the United States. I think your analysis is right about capital spending; it will start to improve once the risk starts to narrow. So how do we get from where we are to that process where the risk premium starts to narrow and we return to business as usual? I don't know, so I too worry about an exit strategy.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I think the proposal you put on the table is quite reasonable and I would support it. Let me make a couple of comments. I do think our policy is accommodative right now and it will become more accommodative with this move. But in my view it's not just the markets that are nervous and uneasy. Main Street is also nervous and uneasy. Your proposed action serves to address that to an important degree and, therefore, I am supportive of it. I do agree with those who are concerned about the lags and about our ability to reverse course at the appropriate time; that isn't a science but in part it involves our recognizing



when to do so. We have to trust that we'll be able to do that at that time. So I'm very supportive of your recommendation at this point.

One thing I have to say, with due deference to Al Broaddus, is that I do not want an expanded statement. I argued hard for the statement to be shorter and I think it should stay that way. In my view the market has to recognize our stance by our actions and by what is happening in the economy--that is the best way to get the message across--and to react to that information at the appropriate time.

CHAIRMAN GREENSPAN. Before we take a vote, since the press statement is a relevant part of the decision here, I would ask the Secretary to distribute copies of the draft. Let me just say that what was done is as close to a de minimis change from the previous statement as we could come up with. Michelle, did you provide the wording of the last statement as well?

MS. SMITH. Yes, the proposed language is shown, with strike-outs indicating changes from the previous statement.

MS. MINEHAN. Yes.

CHAIRMAN GREENSPAN. Okay, so we can actually see the changes from the previous press release. We took President Hoenig's advice, as you can see.

VICE CHAIRMAN MCDONOUGH. He's a very important fellow.

MR. HOENIG. I'm flattered.

MR. MCTEER. Excellent.

VICE CHAIRMAN MCDONOUGH. Amen!

CHAIRMAN GREENSPAN. Okay, then we can vote on the 25 basis point cut and the risks toward economic weakness. Will you read the directive language, please?

MR. BERNARD. This language is on page 15 of the Bluebook. It's a little hard to

find but it comes after Chart 3, which has the blue-shaded section in it: “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 3-1/2 percent.” The balance of risks statement for the press release reads: “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 continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.”

CHAIRMAN GREENSPAN. Call the roll, please.

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 |

CHAIRMAN GREENSPAN. We will recess briefly so the Federal Reserve Board can meet on the discount rate. The reason we’re going into recess, as you know, is that this press statement presupposes a discount rate action that has not been taken. So until that’s assured we cannot adjourn. May I ask the Board members to go into my office? Hopefully we’ll be back shortly to confirm an action on the discount rate.

[Recess]

CHAIRMAN GREENSPAN. The Board of Governors accepted discount rate requests

from seven banks. This meeting then is adjourned upon confirmation of the date of our next meeting, which is--

MR. BERNARD. October 2<sup>nd</sup>.

CHAIRMAN GREENSPAN. October 2<sup>nd</sup>. As you are aware, that is an interesting day, which may or may not be devoid of conflicts for other than monetary policy reasons. We are monitoring the situation fairly closely and if we need to make any adjustments in the meeting date or location we, of course, will be in contact with all of you immediately.

MR. FERGUSON. Mr. Chairman, you said meeting dates and location. I presume the date would stay the same but the location might change if circumstances warrant.

CHAIRMAN GREENSPAN. Yes, I would assume that. I amend my remarks accordingly. Shall we go to lunch?

END OF MEETING