**Meeting of the Federal Open Market Committee on
November 10, 2004**

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., starting at 9:00 a.m. on Wednesday, November 10, 2004. Those present were the following:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Messrs. Moskow, Santomero, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Guynn, Lacker, and Ms. Yellen, Presidents of the Federal Reserve Banks of Atlanta, Richmond, and San Francisco, respectively

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

Messrs. Connors, Fuhrer, Hakkio, Howard, Madigan, Slifman, Sniderman, Rasche, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

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

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

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

Mr. Brady, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

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

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

Ms. Holcomb and Mr. Rasdall, First Vice Presidents, Federal Reserve Banks of Dallas and Kansas City, respectively

Messrs. Eisenbeis, Estrella, Evans, and Goodfriend, Ms. Mester, Messrs. Rosenblum and Williams, Senior Vice Presidents, Federal Reserve Banks of Atlanta, New York, Chicago, Richmond, Philadelphia, Dallas, and San Francisco, respectively

Mr. Hilton, Vice President, Federal Reserve Bank of New York

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

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CHAIRMAN GREENSPAN. Good morning, everyone. Welcome, Madam Acting President. It's a pleasure to have you here.

MS. HOLCOMB. Thank you very much.

CHAIRMAN GREENSPAN. And we welcome Debbie Danker, an old Fed veteran. You were here when I arrived originally. Lord knows how long you were here to begin with! [Laughter] Anyway, welcome back, and we wish you well.

MS. DANKER. Thank you.

CHAIRMAN GREENSPAN. Incidentally, for those of you who don't have it on your calendar, our farewell luncheon for Bob McTeer is planned for after the next meeting. I just wanted to make you all aware of that. Would somebody like to move approval of the minutes of the September 21 meeting?

MS. MINEHAN. So moved.

CHAIRMAN GREENSPAN. Without objection, they are approved. Officially we need to select Deborah J. Danker as Deputy Secretary to serve until the election of a successor at the first meeting of the Committee after December 31, 2004. Would somebody like to move that nomination?

MR. FERGUSON. I'll move that nomination.

CHAIRMAN GREENSPAN. Without objection, that is approved. Dino Kos, you are on.

MR. KOS.[1] Thank you, Mr. Chairman. I'll be referring to the charts circulated a short time ago. During the intermeeting period, asset prices traded largely in the ranges we have seen for most of the year, though certain trends were maintained, particularly the continued flattening of the yield curve, the narrowing of spreads, and the depreciation of the dollar against some of the major currencies. Until Friday's surprisingly strong employment data, market participants had focused more on signs of a slowdown in growth.

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

The top panel on the first page graphs the three-month deposit rate in black and the rates three, six, and nine months forward in red. Forward rates sagged somewhat after the September employment report that was released on October 8. However, forward rates began to rise again when oil prices began to fall from recent highs of $55 and then again after Friday's October employment report.

Two-year note yields, shown in the middle left panel, have risen more than 35 basis points since the last meeting, with much of the increase coming in the past few days. The longer end of the curve has not responded as much. Ten-year yields, depicted in the middle right panel, rose about 20 basis points and have remained in the 4 to 4¼ percent range. As a result, as shown in the bottom panel, the yield curve has continued to flatten, with the two-year to ten-year spread narrowing further since the September meeting. Some in the market are interpreting this flattening as reassurance that inflationary concerns are contained.

Interestingly, despite the flattening of the curve, TIPS breakeven rates have widened since the September meeting. As shown in the top left panel of the next page, ten-year breakeven rates widened about ¼ percentage point. Part of the recent widening may have been due to the last CPI report, which rose 0.4 points. TIPS, as you know, use the non-seasonally-adjusted consumer price index to determine inflation compensation. That makes the latest widening a bit of a puzzle since the recent decline in oil prices may reasonably be expected to have a damping effect on upcoming CPI reports. Indeed, to add to the puzzle, some have linked the recent widening of breakeven spreads to the recent fall in oil prices on the theory that this is stimulative to growth and later for inflation.

As depicted in the middle panel, spreads have continued to narrow. The investment-grade spread, in the middle left panel, is currently at its lowest level since July 1998. High-yield and emerging-market spreads, shown in the middle right panel, are also at multiyear lows. While some of the narrowing is, no doubt, the result of a search for yield by some investors, the strong cash positions of the corporate sector, the repair to balance sheets since the fall of 2002, and improved situations in some major emerging markets—especially Brazil—suggest that the move can't be categorized solely as a liquidity story. Equity prices have risen in recent days but they are only slightly higher for the year, and implied volatilities are a bit higher but not materially so.

Changing gears a bit, right after the Committee's September meeting, OFHEO released its report on Fannie Mae's accounting methodology. At first, Fannie Mae's stock price fell about 15 percent and sharply underperformed both Freddie Mac's stock and the broader indexes. Fannie's equity price has since regained about half its losses. The effect in spread markets, as shown in the bottom right panel, was fleeting. The green line graphs the spread of Fannie's senior ten-year debt to Treasuries, which widened about 10 basis points initially but has now retraced that move fully and is back to its mid-September level. The blue line graphs the spread to the ten-year swap rate, which is probably more meaningful to Fannie's funding and hedging costs. That spread also widened slightly but has since retraced.

Finally, let me say a few words about foreign exchange markets. The dollar continued to fall during the intermeeting period, though the reasons for its fall are less than clear. The top panel on page 3 graphs the dollar's movements against a selected group of currencies indexed from September 1. Despite some thought that the Japanese authorities might begin intervening again, the dollar has fallen below 106 yen. Meanwhile, the euro has risen to nearly $1.30 and was trading at $1.2975 earlier this morning. These are the euro's highest levels since its launch. The Canadian dollar is at its strongest level since 1992; the Swiss franc is at its highest level since 1996; and the British pound a week or two ago hit its highest level since the ERM crisis of 1992.

In recent weeks the market has focused its attention quite a bit more on the current account deficit. Indeed, some market commentators ascribed part of the dollar's fall to comments by several Committee members speaking about the size and implications of the current account deficit. However, the deficit has been with us for a long time, and it is not clear why it should suddenly capture the market's imagination. Other commentators focused more on what they saw as uncertainties about the growth outlook for the United States in 2005 or the possibility that the election would not have a clear winner. And still others viewed the prospect of a Kerry victory as dollar negative. In the event, of course, the election produced a quick winner. Friday's employment data were far stronger than expected, and on Monday ECB President Trichet dabbled in a bit of verbal intervention when he labeled recent euro–dollar moves as "brutal" and "unwelcome." That the dollar was either sold off or at best held its ground after each of these events has added to the bearishness many traders now have toward the dollar in the near term. Interestingly, some of the same people who previously believed a Kerry victory would be bearish because of trade concerns now see the Bush victory as bearish on the assertion that the budget situation will not be addressed.

Asian currencies also gathered more attention than usual in recent weeks. The move by the People's Bank of China to increase interest rates by 27 basis points and remove the ceiling on bank lending rates was taken as a symbol of the authorities' determination to rein in growth. Several commodity prices, especially metals prices, fell in the days after the decision, though the price of oil did not begin to ease until a week later. Interestingly, some market participants viewed this interest rate move as a signal that the authorities might be more willing to revalue the exchange rate. The middle panel graphs the yuan spot rate, which is fixed at 8.28 to the dollar, and the forward rates implied from one-, six-, and twelve-month nondeliverable forwards. The forwards widened somewhat to a level seen earlier this year during another wave of speculation that a move might be at hand.

While China's exchange rate has stayed solidly fixed at 8.28, some of the other Asian countries have permitted some modest appreciation of their currencies against the dollar. The bottom panel on page 3 graphs the changes in six selected currencies since early August. Although appreciations of between 2 and 5 percent may not seem like much, they have been noted by market participants given how little these currencies had moved previously. The reasons for permitting this appreciation probably differ from one country to the next, but some have probably hit the point where they need to balance competitive issues vis-à-vis China against the inflationary impact on their own economy of continuing to intervene in foreign exchange markets. The balance may

have shifted back somewhat overnight in South Korea, which reportedly intervened aggressively to prevent a further rise of the won. Market participants estimated that the intervention was between $600 million and $2 billion. Other Asian currencies depreciated modestly as well.

Mr. Chairman, there were no foreign operations by the Desk in the period. If you agree, I suggest that we pause for any questions and approval of the domestic operations. Then I could say a few words about the memo that Vincent and I circulated last week about the Desk's domestic operations.

CHAIRMAN GREENSPAN. Why don't you do that?

MR. KOS. Shall we do that now?

CHAIRMAN GREENSPAN. Yes, why don't you get it out of the way?

MR. KOS. Okay, fine. At the last meeting, the Committee asked Vincent and me to be a "committee of two" to review how the Desk operates during a period when the market strongly expects the Committee to change the target fed funds rate. I should say that most of the work was conducted by Spence Hilton, who is sitting to my left, and by Jim Clouse from the Board's staff, who is also here today. I won't repeat everything that's in the memo, which I think speaks for itself, but I'll summarize our primary conclusions. First, we found that the volatility of the fed funds rate does not seem to correlate with any major asset class. Therefore, to the extent that there is volatility in this narrow sector, it has no observable adverse spillover effects. We also believe that over time the Desk has the tools to deal with such circumstances. Indeed, we think we learned something from the August experience that helped us manage the funds rate around the September FOMC meeting. And over time, as both the Desk and bank reserve managers adapt to the new environment, I would expect this type of volatility to dissipate.

If the Committee did wish to change the regime, the choices fall in two categories. First, FOMC meeting dates could consciously be aligned to coincide with the end of the reserve maintenance period. A variation would be for policy changes to take effect in the next reserve period. A second possibility would involve publishing reserve forecasts. Both of these regime-

change options have some disadvantages, and the solutions themselves may create new problems. Thus, at the risk of seeming to push for the status quo, our recommendation is to maintain the current operating framework. Vincent, I don't know if you have anything to add.

CHAIRMAN GREENSPAN. Let me just say up front, since I was the one who raised the issue originally, that I thought you reviewed it quite effectively, and I personally concur with the position that you've come to.

With respect to the TIPS ten-year rate, the oil price has had a very unusual effect on it over the years, and one of the reasons is that the spread of the crude oil seven-year futures has behaved rather differently relative to the spot price in recent years than it had previously. Since the spread between light sweet crude prices, for which the WTI is the best measure, and gasoline and home heating oil prices is reasonably flat, can't we take the forward WTI price, convert it into a gasoline and home heating oil price and subtract that from the CPI—with the CPI weights—to get effectively a judgment as to what core rate is implied in the CPI, presuming that the food component is average? That gets around the question of trying to answer to what extent the recent oil prices affect the forecast of the CPI that is embodied in the TIPS yield. Is that something you can do readily?

MR. KOS. I know I haven't done it.

MR. REINHART. It's something that we regularly do, Mr. Chairman.

CHAIRMAN GREENSPAN. You take the long-term forecast?

MR. REINHART. We take the structure of WTI futures rates, use the 6 percent weight in the overall CPI and apply it to the non-seasonally-adjusted figure, and then subtract off to get a measure of the core.

CHAIRMAN GREENSPAN. You don't take the crude price? You take the crude plus markup, I assume. Is that what you're saying?

MR. REINHART. Yes.

CHAIRMAN GREENSPAN. In that context, how would this very latest run-up since the end of October look?

MR. REINHART. Well, one thing I would note is that because of the backwardation of the futures curve, it's in fact—

CHAIRMAN GREENSPAN. It's lower, but it's less lower than—

MR. REINHART. Yes. So you have the two effects. You have the spot effect of the whole futures curve shifting up, which gives you the immediate increase in inflation compensation, but you also have the forecasted subsequent decline, which actually subtracts from it.

CHAIRMAN GREENSPAN. And because the spot prices have moved so dramatically, though the spreads have not changed all that much, there has been a significant closing of the percentage gap in prices even though the absolute gap has opened up.

MR. REINHART. Right.

CHAIRMAN GREENSPAN. I was curious how all that turns out because it's pretty evident that the ten-year TIPS compensation is giving us a quite significantly different reading. And it would be useful to know whether or not it's merely a statistical issue—with one based on core inflation and the other based on the total CPI—or if there's something more deep-seated there.

MR. REINHART. I would make two observations. One is that I haven't actually seen the time series. My recollection is that it's only a couple of points in the intermeeting period. It's not a large number—on the order of 10 to 15 basis points. The second point is that five-to-ten-year forward inflation compensation is actually lower. So this is something that happened in the first five years of the term structure of inflation compensation. But we can do this adjustment for you in the time series perspective.

CHAIRMAN GREENSPAN. It's terribly important for us to get judgments on what the TIPS is showing. We can always talk about its liquidity or say that it's X or Y. Some day we'll look back and say that the TIPS market was giving us signals and we had too many excuses as to why we weren't looking at it.

MR. REINHART. When we look at these special factors, which included the smaller-than-expected auction and the change in oil futures prices, it really is hard to get those special factors as a large component in the parsing. It's on the order of 10 basis points out of the 40 basis point rise.

CHAIRMAN GREENSPAN. I think that's useful to know.

MR. REINHART. We took some consolation from the fact that the five-to-ten-year forward inflation compensation really just moved sideways. And the ten-year forward rate, given the flattening in the term structure that Dino noted, basically also moved sideways.

CHAIRMAN GREENSPAN. Questions for Dino either on the presentation or on Vincent and Dino's conclusions with respect to the discussion we had last time? Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. I completely agree with Dino's conclusion and your assent that what we've been doing in the conduct of open market operations is about right. The Desk is protesting enough to make it clear that Dino isn't prejudging the outcome of the FOMC meeting but is trying to keep reserves from getting so overabundant that we have a lot of volatility later. As for changing meeting dates, I know from having sat in Vincent's chair that there are a lot of factors vectoring in on the choice of meeting dates, and I don't think we need to have one more. Things are working just fine.

I have a comment, rather than a question, on another thing that Dino said. Dino, you noted that Fed commentary on the current account deficit was a factor in the weakness of the dollar. My perception was that it was more than just commentary on the current account deficit. There was a sense in the markets anyhow that the commentary was leaning toward trying to talk down the

dollar—that the Fed was engaged in actions or words designed to drive the dollar lower. I'm a little concerned about that perception. I agree that we can't avoid talking about the current account deficit. It's a huge imbalance in our economy, and how it resolves will greatly affect how we run monetary policy in the future. And I also agree that a lower dollar sometime, somewhere in the future is probably part of that correction process, but I do think we need to be cautious about making statements that are perceived as talking down the dollar. Commenting on the dollar is the job of the Treasury Department. I think that division of responsibility has been useful to us.

As you've noted many times, Mr. Chairman, we're not very good at predicting where the dollar is going or is likely to be. Even if it has to go lower over the long term, the Lord only knows where it's going to be in the short and intermediate term. And there's not much we can do through monetary policy about the current account deficit. It's more a fiscal policy issue. We'll have to react to developments as they occur. The dollar is already under downward pressure. I think it will fall of its own weight. The odds on a disorderly decline are very, very low, but they're not zero, and I think we need to be rather cautious in that regard moving forward. Treasury Department and bond market people in talking to me noted that there had been feedback from the market that somehow the Fed and the Treasury were at odds on what dollar policy was. I don't believe that's a productive way to go in a very tender market. So, while I don't think we can avoid talking about the current account deficit, I think we need to be especially cautious at this point in the dollar cycle.

CHAIRMAN GREENSPAN. Let's stay on the subject. Are you on this subject?

VICE CHAIRMAN GEITHNER. Yes, I was going to stay on this subject. It's always a pleasure to echo Don.

I don't know that I fully internalize Fed doctrine on imbalances and exchange rate policy and things like that, but let me just say something from the perspective of my previous life. I always had the sense sitting there in my position at the Treasury that U.S. policymakers should

always be careful not to convey the sense that they actually know the desirable direction for the dollar and that they should not in any way suggest that they were going to try to induce that move. I think that's true in general, but it's much more important when we're talking about a prospective decline. Once established, the sense that a decline is desirable is very hard to reverse, and it makes it very hard to manage the risk of a more acute decline causing broader collateral damage to asset prices.

So I just wanted to make the obvious point. Even if we're very careful and even if we allude only very generally and indirectly to our concern about the size of the imbalances and their unsustainability—and that an adjustment in relative prices likely has to come as part of the unwinding—I think our musings in public will make it harder for the Administration to discipline its own ranks, which is always a formidable challenge.

Let me also echo the conclusion of the committee of two. I thought the analysis was nicely framed and did a good job of looking at the alternatives. And those alternatives met that critical test, which was to illustrate why they were not particularly compelling against the regime in which we operate now.

CHAIRMAN GREENSPAN. Let me just say that we have a very delicate problem to deal with. Being involved with monetary policy and, indeed, by tying monetary policy as we do to the global environment, we can't make believe that the current account deficit is irrelevant. And we can't basically argue that it will essentially adjust without market forces being critically involved. Yet there is no question that we have to avoid conveying the perception that we are essentially talking the dollar down because we think that's what would be required to adjust the imbalances. It's a very tricky issue.

I have a tough problem because I was invited by Jean Claude Trichet to appear on a European panel sometime late next week. And the subject matter is the euro. Now, I could get

around the issue very readily in my prepared remarks, but there is a forty-minute Q&A period with a panel of only Jean Claude, me, and one of the Vice Governors of the Bank of Japan. So I'm in the process of writing a speech in which I replicate to some extent what I've said before on the current account balance—where it's coming from, what the issues are, and essentially arguing at the end that there is significant evidence that high current account deficits of developed countries have in virtually all cases adjusted without crisis. What I don't usually say is that invariably a significant element in that adjustment is a decline in the real exchange rate.

Now, I'm trying to put together something that re-emphasizes what I've said before—which is accurate as best we can judge—and that is that the inability to forecast exchange rates in the intermediate period is an extraordinarily robust statistical conclusion. Indeed, one can find all sorts of examples where everybody is projecting that a currency will move in one direction and it goes in the other. I intend to put enough discussion of that in my statement to indicate that there is no short-term issue here with respect to the dollar. And I plan to talk as well about the fundamental questions that, as a practical matter, get down to the government deficit. And that's it.

We have evidently very poor capabilities of addressing private saving. We've tried everything under the sun. Some of it works better than others. None of it obviously works very well, if you just look at the straight downward trend in the household saving rate. So I think what I'm going to try to do, and I hope that the rest of you will try to do so, is to emphasize the one area where it will matter, which is fiscal policy. And I think that we can have some effect. There is a growing awareness in the Administration that this issue really has to be addressed and that it requires a significant turnaround in what has been going on in recent years. I think there is a recognition that that has to be done. If we are out there encouraging that, which we of course have been doing generally for quite a long period of time, I think that could be a positive force.

I would scarcely say to you, " Don't discuss the current account deficit." That's like not talking about the crazy aunt in the closet. You have no choice. It is an element of significance in the outlook, and the forces that are driving it one way or the other are things we have discussed over time. But the one thing we have to try to avoid, to the extent that we can possibly do so, is to imply that an imminent decline in the exchange rate is in front of us. If we do that, then observers will presume that there is either some generalized official view about that on the part of the FOMC or that individually, without an official position, we all believe the same thing. And the credibility of the FOMC, which we take great pride in, will work against us. Everyone will presume, irrespective of their own views, that we understand the markets, and they will behave accordingly. And that could create some fairly significant problems for stabilization. So we now have three subjects on the table. Would anybody else like to comment?

VICE CHAIRMAN GEITHNER. Could I ask Karen a question?

CHAIRMAN GREENSPAN. Sure, by all means.

VICE CHAIRMAN GEITHNER. Karen, I have a question on whether we're seeing a change in emerging Asia in exchange rate policies and practices. I'm curious about whether you think there's a common factor behind it in the following sense: Do we see across these countries a significant change in underlying inflation that has caused them to decide that they want more independence in monetary policy? Or are we seeing something that is more idiosyncratic, with different sets of forces at work?

MS. JOHNSON. Well, as I will repeat in just a minute, I'm afraid, emerging Asia actually is faring comparatively less well than the other regions of the world at the moment on two scores: higher oil prices and a perception that at least for a time there's a bit of a pause in the strength of the high-tech sector. And these countries see themselves vulnerable to the fact that they import more primary products than anybody else in some sense. Few of them have primary product resources

domestically. So the inflation consequences of developments over the last few months have loomed larger for them than for others, and I think in that sense they are reassessing how unfortunate an exchange rate appreciation would be for them. At the same time, their real performance is impaired as well, so there's sort of a juggling act involved, as with any negative supply shock. But I think seeing that they are more vulnerable than most has altered a bit the calculus of how important it is to stabilize the exchange rate vis-à-vis each other and vis-à-vis the renminbi. And they probably are more vulnerable than China, if that's the elephant in the room, because China is a much larger and much more closed economy and it is domestically able to deal with some of these issues better than the smaller satellite emerging Asian countries are.

CHAIRMAN GREENSPAN. Further questions for Dino or Vincent?

MR. POOLE. Mr. Chairman, do we need to move approval of the domestic operations?

CHAIRMAN GREENSPAN. Yes, let's first move approval of the Desk's domestic operations. Would somebody like to do so?

SPEAKER(?). Yes. I so move.

CHAIRMAN GREENSPAN. Without objection, they are approved. Now, we've had three comments on the memo that was circulated and that Dino has discussed. Unless I hear significant negatives, I will assume that those three "votes" so to speak capture the consensus of the group. So if any you would disagree with the recommendation of Dino and Vincent, please speak up. Or if anyone wishes to add something relevant to their conclusion that reinforces it, speak up. [Laughter]

MS. MINEHAN. Other than good job?

CHAIRMAN GREENSPAN. I guess you win on both counts. We will move on then to David Stockton and Karen Johnson.

> MR. STOCKTON. Thank you, Mr. Chairman. I suspect that for many current and former New Englanders, the stirring victory of the Boston Red Sox last month gave hope to other long-deferred dreams. In my case, I mused that if the Red Sox could come from behind to beat the Yankees and then sweep the World Series, wasn't

it possible for the staff one day to get the near-term employment forecast right? [Laughter] Alas, while the dream lives on, the reality of last Friday's employment report left me feeling a lot more like Bill Buckner than Manny Ramirez.

As you know, through the summer and into the fall we had doggedly held to our forecast that a pickup in employment growth was imminent. But after four consecutive sizable disappointments that left reported gains in private payrolls averaging just 77,000 per month since May, our September projection calling for an immediate acceleration to increases averaging 200,000 per month seemed a stretch to us this time around. As a concession to these developments, we marked down our projection for private payroll gains in the November Greenbook to about 100,000 per month in the current quarter and delayed any meaningful acceleration of employment until late winter. Then last Friday, as the ball dribbled between our legs and rolled into right field, the BLS reported that, well, the labor market had not been so weak after all. Private payrolls increased 296,000 in October, and the level of private employment in September had been revised up 81,000. To be sure, the jump in hiring last month got a considerable boost from construction employment, which was likely related in part to rebuilding efforts in the aftermath of the hurricanes. And none of the labor market indicators that we monitor would suggest taking October's gain of nearly 300,000 as the present hiring trend. But the currently estimated average gain of about 175,000 per month over the past three months does not seem an unreasonable estimate of the underlying pace of private employment growth. Ironically, that is pretty close to our forecast back in the September Greenbook.

While recent experience reinforces, yet again, the caution with which one should approach these estimates, the average job gains now reported to have occurred in recent months do fit more easily with other indicators suggesting that a moderate improvement in labor market conditions is under way. Initial claims for unemployment insurance have been moving sideways at a level consistent with the somewhat larger employment increases now reported; the number of individuals exhausting their unemployment insurance has continued to fall in recent months; and surveys of hiring intentions have, for the most part, moved up.

As you know from reading the Greenbook, the weak employment situation was one of the key factors behind our downward revision to real GDP growth over the next couple of quarters. We viewed the meager employment gains and the associated shortfall in labor income as likely to be a drag on consumer spending late this year and into the next. Obviously, the October employment report suggests that this drag will now be smaller than we had anticipated.

But we had other reasons as well for trimming our near-term GDP forecast, including weaker readings on industrial production, a further jump in non-auto inventory investment last quarter, and considerably higher oil prices over the projection period. And these factors, for the most part, still argue for a somewhat weaker outlook than we had projected in September. Although the data in hand suggest that manufacturing IP will bounce back from a hurricane-depressed decline in September, the average gains in recent months have been to the low side of our expectations. The recent softness has been most pronounced in the high-tech sector

but has extended elsewhere as well. We are now projecting factory output to increase 3¾ percent at an annual rate in the fourth quarter, nearly 2 percentage points less than in our September projection.

Some of the slowing that we have observed in industrial production could have resulted from a diminishing impetus to output from efforts by businesses to rebuild previously depleted stocks. Indeed, that impetus appears largely to be behind us. The level of non-auto inventory investment last quarter is estimated to have been much higher than we anticipated in September, and a drop-off in inventory investment is expected to subtract about ¾ percentage point from the growth of real GDP in the current quarter.

Finally, we again had to contend with higher oil prices in this forecast. Last Wednesday, as the Greenbook went to bed, the spot price of West Texas intermediate crude oil was expected to be about $7 per barrel higher on average over the projection period than in the September Greenbook, and the price of imported oil was projected to average about $4 per barrel above our previous projection. Prices have come down noticeably over the past week. But the price of WTI is still about $4 per barrel above our September Greenbook projection, and the price of imported oil is estimated to be about $2 per barrel higher. Those higher prices are taking another bite out of household incomes and are likely to restrain spending somewhat in coming months.

Putting this all together, the events of the past week would lead us to mark up somewhat our November projection for the growth in real GDP over the next couple of quarters to a pace just shy of that which we projected in September. Karen will discuss this morning's trade data shortly, but it looks as though those data would cause us to raise our estimate of third-quarter growth to around 3¾ percent at an annual rate. Moreover, given stronger employment and lower oil prices, we would be inclined to revise up our projection for the growth in real GDP in the current quarter from the 3½ percent figure in the November Greenbook to something closer to 4 percent and to revise up the first quarter of next year from 3 percent to about 3½ percent. These adjustments would probably add a tenth or so to growth in each of 2004 and 2005.

To be frank, after the large downward revision that we made to the projection at midyear, subsequent adjustments have been relatively minor. During this period, the economy has, for the most part, appeared to us to be growing at or modestly above trend. And the prospects seem favorable for a continuation of that performance. To be sure, fiscal policy is projected to shift from providing considerable stimulus to the growth of real output this year to being a roughly neutral factor next year. But monetary policy, at least by our reckoning, will remain reasonably accommodative over the projection period. And the restraint being exerted on the economy by the run-up in energy prices this year should begin to fade next year as prices first stabilize and then decline.

We continue to see some important risks to this admittedly benign outlook. Even with the declines in recent days, by virtually any metric the jump in crude oil and other energy prices this year constitutes a large shock. In the past, most especially in

the 1970s and early 1980s, oil price shocks were accompanied by an unusual degree of restraint on household spending, which is to say that standard linear models seem, on balance, to understate the weakness in spending in these episodes. Despite this evidence, we did not build any appreciable nonlinear effects into the projection. We suspect that the effects of oil price shocks on sentiment and spending in the ’70s and ’80s were amplified by a regulatory environment that resulted in shortages, gas lines, and disruptions that created a great deal more economic uncertainty than households and businesses are now coping with. Moreover, we haven’t yet detected in either the spending data or readings on consumer sentiment any outsized response to this year’s oil shock. Still, it’s probably premature to be confident that such effects will not manifest themselves at some point in the current episode.

Another downside risk is that high-tech equipment spending is on a weaker long-term trajectory than incorporated in the baseline. Third-quarter spending on computers and software was well below our earlier expectation, and the news continues to suggest that spending on tech equipment has remained lackluster. We have weakened this element of our projection through the first quarter of next year, but then we are projecting a reacceleration of these outlays back closer to historical norms. The recent softness combined with smaller declines in the relative price of high-tech capital goods over the past year or so could be signaling that the pace of technical progress and the imperative to invest in this type of equipment is waning. We believe that it is too soon to draw that conclusion, but this possibility does constitute some downside risk to our projection.

The risks in the outlook for capital spending, however, are not one-sided. Outside of high-tech, equipment spending has been growing briskly. We have continued to interpret some of this strength in spending as being stimulated by the partial-expensing provisions. With the bulk of that stimulus scheduled to expire at the end of this year, we are anticipating a drop in equipment outlays in the first quarter and some small restraint on spending in subsequent quarters. But as we have noted on numerous occasions, our calibration of the magnitude of this effect is based more on educated guesswork than on hard science. If the effect has been smaller than we currently estimate, then underlying demand has been correspondingly stronger, and hence there could be greater momentum to equipment spending as we enter next year.

Another key upside risk that we have been pointing to for some time remains that the very low level of real interest rates assumed in our projection will spark a sharp acceleration in activity or inflation. Two obvious channels through which that could occur are the stock market and the exchange value of the dollar. For both of these elements of the forecast, we employ something akin to a random walk with drift. We project the stock market to rise in line with the risk-adjusted yield on bonds, and we project the dollar to fall only slightly from current levels. The shallow trajectory that we have assumed for the federal funds rate could, of course, provoke a steeper rise in the stock market or a larger fall in the dollar than incorporated in the baseline forecast, and by enough to matter. For example, if we were to assume that the dollar resumes declining at the average annual rate observed between its peak in 2002 and early this year—about 6 percent—rather than the 1½ percent annual rate decline that we are projecting, a simulation of FRB/US suggests that the accompanying impetus to

demand would cause output to overshoot potential and inflation to edge higher by 2006. In response to that outcome, a Taylor rule would prescribe a path for the funds rate about 50 basis points higher than in our baseline in 2005 and about 75 basis points higher in 2006—a path for the funds rate similar to that currently built into futures markets. Certainly, such an outcome seems well within the realm of possibility.

Turning to inflation, our projection has changed relatively little over the intermeeting period. Increases in the core CPI for August and September were, on net, a bit higher than we had been projecting. But much of our miss was in prices for used cars and lodging away from home, and we did not attach much signal to these developments. Indeed, core PCE prices have actually been running a bit below expectation, though again not by enough for us to alter our basic outlook. Meanwhile, the recent readings on hourly labor compensation have surprised us to the downside. Figures on comp per hour from the ECI and from the NIPA-based compensation measure both came in at about 3½ percent at an annual rate in the third quarter, about ½ percentage point less than in our previous projection. There really has been no discernable trend in compensation inflation over the past couple of years. Of course, the biggest news on the price front has been the run-up in oil prices that I mentioned earlier. Higher energy prices are projected to boost headline CPI to about 3¼ percent at an annual rate in the current quarter, about 2 percentage points above the September forecast. The indirect effects of these higher energy prices are expected to add another tenth or so to core consumer price inflation over the next few quarters. It is our sense that higher prices for oil, other commodities, and imports are continuing to feed through into core consumer prices.

Going forward, our expectation is that energy prices will edge down, commodity prices will level off, and the increases in import prices will slow. These developments are anticipated to place downward pressure on core consumer prices next year. But in our forecast, these beneficial developments are largely offset by the diminishing margin of slack in resource utilization and by some upward pressure on costs associated with a slowing of structural labor productivity during the next two years. Both the pluses and minuses are relatively small here, and we are anticipating core PCE inflation to move about sideways at its current annual pace of about 1½ percent.

Let me conclude with a brief thought on the uncertainties in the outlook. Obviously the list of risks remains long. There is much we don't understand about why the economy has failed to show even greater vigor in response to massive fiscal stimulus and very low real interest rates. More broadly, geopolitical risk and the threat of terror are almost certain to be permanent features of the economic landscape. And some very daunting long-term challenges—most notably, those associated with large budget deficits, low household saving, and a widening current account deficit—are always a threat to cascade back into the present in unpleasant ways. But on the positive side, those risks now seem to be confronting an economy that is fundamentally less fragile than it has been at many points in the past four years. Karen will continue our presentation.

MS. JOHNSON. Over the intermeeting period, news about foreign economic developments has generally been somewhat disappointing, and we have edged down our outlook for real GDP growth abroad in response. The downward revision is largest for the third quarter, 0.4 percentage point, as growth appears to have been below our expectations in Japan, Europe, and emerging Asia other than China, where we were surprised on the upside as we were also to a slight extent in Latin America. For the current quarter and the rest of the forecast period, we have taken an average 0.1 percentage point off the annual rate of foreign growth.

A major factor behind our decision to shave a bit off prospective growth abroad has been the intermeeting behavior of oil prices. Although the sharp run-up in spot WTI prices attracted much attention, that price significantly retraced its gains in the final two weeks of the period. However, the far futures price for WTI rose on balance $5 per barrel over the period. Accordingly, the entire path of oil futures prices shifted up. To some extent, the elevated WTI prices reflect the premium now being paid for sweet (less sulfurous) crude oil relative to other grades of oil, and we anticipate that this premium will narrow over time as the supply of sweet oil from the Gulf of Mexico is fully restored, refiners shift their capacity, and demand adjusts. However, consistent with the futures markets, we now project that oil prices will be higher for longer than we thought in September, as continued production at current high rates seems less certain and as demand remains strong.

For the industrial countries, small negative revisions to the outlook were widespread as elevated oil prices have eroded confidence to some extent and weakened domestic demand. In Canada, an oil exporter, growth has remained strong although we marked down the forecast a bit in response to changes in the U.S. forecast. For emerging-market economies in Asia, the prospect of sustained, elevated oil prices has more negative consequences than is the case for Latin American countries. The Asian emerging-market economies generally import oil and other primary commodities. Higher global prices for these goods plus a somewhat dimmer outlook for the high-tech sector have led us to become less optimistic about these countries, on average. In contrast, activity so far in 2004 has been strong in Latin America, as primary product exports and energy self-sufficiency—or better—have boosted growth. We nonetheless revised our outlook down slightly in 2005.

We expect that foreign economic activity is rebounding in the current quarter from the slowing that was evident in the preceding three months, particularly in Japan, the United Kingdom, and emerging Asia. But we look for average growth abroad to weaken a bit over the next two years. In part, this projection reflects the need for some of the rapidly growing foreign economies, such as Canada and the United Kingdom, to bring growth in line with potential. Monetary policy has already been tightened in both these countries, and we expect additional moves in Canada. In addition, we look for growth in China to moderate as officials there use both administrative and interest rate tools to slow credit creation and the expansion of investment spending, in particular.

The subdued outlook for growth abroad also reflects the depreciation of the dollar that occurred over the intermeeting period and the further depreciation that we have

again incorporated into the forecast. Since September, the exchange value of the dollar has fallen sharply against many of the other major currencies. In response, we have lowered the projected path for the real value of the broad index of the dollar about 2 percent. Currency appreciation should be a factor restraining growth over the forecast period in the other industrial countries.

In our Greenbook baseline, the combined effect of higher oil prices, the lower dollar, and revisions to output growth here and abroad is a slight easing in the projected drag from real net exports in this quarter and during the next two years. This quarter and for the first half of 2005 we see the external sector as having a largely neutral effect on GDP growth, as imports are restrained by moderate U.S. growth and exports bounce back. Thereafter, the negative arithmetic contribution of net exports is about ½ percentage point, as relatively strong U.S. growth boosts real imports while dollar depreciation works to lessen the gap between real exports and real imports. Nevertheless, the nominal U.S. current account deficit is expected to widen to nearly $890 billion in the fourth quarter of 2006, about 6¾ percent of GDP. This deficit reflects a higher oil import bill throughout the forecast period than previously projected, with the overall trade deficit widening about $60 billion at an annual rate from the current quarter to the end of 2006. In addition, the deficit on net investment income is projected to widen by a comparable amount as rising U.S. interest rates and the growing stock of U.S. portfolio liabilities combine to overwhelm a modest increase in net receipts from direct investments here and abroad.

This morning, we received data on trade in September. The trade deficit, at $51.6 billion, was noticeably narrower than we and the market had anticipated. Contrary to our expectations for a rise, merchandise imports edged down, with most of the surprise concentrated in core goods. In contrast, exports came in stronger than expected, again with most of the miss in core goods. Of note, the surprising weakness in exports in August was revised into a respectable gain. On balance, this morning's data indicate that real net exports made a negative contribution to U.S. GDP growth of 0.3 percentage point in the third quarter, considerably smaller than the minus 0.7 percentage point in the November Greenbook. This revision is pretty evenly split between higher exports and lower imports. Although it is a bit early to draw implications of these data for the current quarter, we remain fairly comfortable with our Greenbook projection. Dave and I would be happy to answer any questions.

CHAIRMAN GREENSPAN. Questions for our colleagues? President Poole.

MR. POOLE. Karen, there are two themes in your discussion that I'd like you to comment on a bit more to try to reconcile them. On the one hand, you say that the increase in energy prices in the last year to year and a half has been driven primarily by increases in worldwide demand. Then on the other hand, you say that the price increase we've seen is a reason to mark down forecasts of demand. So, it's a question really of whether the demand curve is shifting—and prices are high

because the whole demand curve has shifted out as a consequence of higher growth—or whether we're sliding along the demand curve.

MS. JOHNSON. I guess we're learning as we go along the consequences of having global demand push on resource limitations the way it has been. And we are making adjustments of a tenth here and a tenth there. So, it's not as if analytically my demand curves are well enough defined that I can even tell the difference between moving along a curve versus the curve shifting at this point. I think down deep that strong demand is the central factor in explaining why oil prices in particular, but commodity prices more broadly, have been high. There is a self-limiting nature to the price-adjustment process that occurs, but it's hard to say that those higher prices are then a cause for weaker growth. It is just a matter of both growth and prices being resolved in the marketplace.

But I think that recent events, particularly the events in the past intermeeting period, have conveyed an awareness that the supply conditions that this higher demand is confronting are a bit less robust and a little less certain than people previously thought. In the energy case, this mix between sweet and sour oil suddenly seemed more important. Whereas we often talked—I myself did—about total production versus total consumption and questioned where the missing barrels were and so forth, now we need to think about the possibility that the important issue may not be just total production but the composition of production and the composition of refinery capacity. So it may be that the elements of demand in the different economies are going to determine how this works out. We've learned, for example, that hurricanes in the Gulf of Mexico have a much greater potential to disrupt supplies than we understood to have been the case. So I think this extra uncertainty and the somewhat greater volatility and risk on the supply side are leading me in an expected-value sense to say that the outcome of these demand pressures and what I know about supply may involve a little less growth than I had previously thought.

MR. POOLE. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. I had a question on the auto outlook. The people that we talk to in the industry are rather conservative about the outlook for next year. They're expecting relatively flat sales. Now, they're not always right, of course. But the Greenbook has sales going up 4 percent next year to a record level and then going up another 3 percent in 2006. I was wondering if you could comment on the rationale for that and how it compares with the more-conservative forecasts that we're hearing from those in the auto industry.

MR. STOCKTON. Well, our projection is certainly above those forecasts, as you point out. Certainly one feature of our stronger outlook for motor vehicles is that we have lower interest rates—and noticeably lower interest rates—than are currently built into market expectations. So the financing environment that we think is going to prevail is quite favorable. Another factor is that we're still a little more optimistic on longer-term potential output growth than the consensus forecast. So in some sense we think there's going to be greater wherewithal to purchase motor vehicles. Now, whether we have it right in terms of how that splits up between the numbers of units produced and the value per unit could certainly be open to some question. But in general in an economy in which the unemployment rate is continuing to come down, energy prices are reversing some of this year's run-up, and interest rates surprise on the low side, we don't think our forecast is too much of a stretch. We are aware, however, that it is higher than the automakers are currently saying and higher than most other outside forecasters are currently projecting.

CHAIRMAN GREENSPAN. Remember, that a flat forecast—because scrappage is rising—implies a significant slowdown in the rate of increase in the number of vehicles on the road. That probably has to occur at some point because we're running out of space. But that's a forecast that was more confidently made a decade ago, as the market continued to rise. I think it has become

a very tough forecast to make. In my view, David is just as likely to be right as the whole structure of the research operation of GM.

MR. MOSKOW. It is a tough forecast to make, and of course, the automakers may also be running out of room to provide incentives or price cuts and still be viable.

CHAIRMAN GREENSPAN. I'm just worried about running out of street space.

MR. MOSKOW. That's another constraint.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. I just wondered, David, if you would give us some sense of the sensitivity of the baseline forecast to changes in the budget outlook that we made reference to earlier. What happens if the tax cuts and everything else are made permanent? What is the implication of some of the fiscal actions that people have been bandying about? How much does it matter in terms of the forecast?

MR. STOCKTON. Well, obviously, it could matter considerably. We are anticipating the budget deficit basically to remain at $410 billion or thereabouts in fiscal year 2005 and to edge down only to $390 billion in 2006. If one were concerned that the current political configuration were going to result in less fiscal discipline, or at least had the possibility of producing an environment with less discipline, one could imagine more spending. And on the tax side, certainly making the tax provisions permanent would be likely to boost interest rates, and there's already some expectation of that built into current interest rates. So once it happened or if that uncertainty were removed, we might get somewhat higher long-term interest rates coming about from that, but it wouldn't be a complete innovation in the market's thinking at this point.

We are not very good political prognosticators. So in essence, in this forecast we are anticipating continued supplementals to support ongoing operations in Iraq. We have incorporated the tax law changes that have occurred to date, but we aren't anticipating any further significant

cuts, and there is implicitly some restraint on nondefense nondiscretionary spending in here. That is an area where it seems to me the uncertainty could perhaps be the greatest.

Having said that, I must say that I can think of a lot of other things that would have a bigger and more immediate impact on the economy. We have shot a whole lot of fiscal bullets off here, and it's rather hard to imagine another couple of years of stimulus that would average the 1 percent that we've seen over the last three years. One could hope or imagine that there might be more discipline than we've built into our forecast, though I don't see the distribution of risks as strongly supporting worries about too much fiscal restraint at this point. So I think somewhere between the basically neutral fiscal policy that we've built into the forecast and the stimulus that has occurred over the last three years is probably in the right neighborhood. We have something that averages a little less than ¼ point in 2005 and 2006 as extra stimulus from fiscal policy.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN GEITHNER. David, maybe I misperceived this, but your model seemed to have trouble generating a high inflation outcome. What is it that produces a "high inflation" scenario with almost no material increase in inflation? The difference in the monetary policy assumption that underpins that scenario is not that large. So is there some failure of imagination in the forecast that we could correct for?

MR. STOCKTON. I certainly welcome your imagination [laughter] if you wish to apply it to this particular problem. My colleague, David Wilcox, who presented some of this material in his chart show presentation in July, might want to jump in here. But it isn't aggregate demand, as you point out, or policy assumptions because inflation in the United States is very inertial and not terribly sensitive to changes in the output gap. Now I know when telling our stories that, because we have so few hooks on which to produce inflation in the forecast, the monetary policy assumption can often sound as if it features very prominently when, in fact, it doesn't.

There's obviously considerable uncertainty on the supply side, both with respect to things like oil prices or commodity prices that could, if they doubled again in the coming year—and one could imagine such a development—provide significant upside surprise or an even more pronounced slowing in structural labor productivity than we are projecting. We're concerned about that latter possibility as well, and we showed an alternative simulation with a productivity slowdown. Again, one could use even more imagination and think that maybe it would slow even more dramatically than we're showing, in which case cost pressures on businesses are going to manifest themselves more intensely than we're currently anticipating in the projection. So those are a few stories that one could tell.

The honest truth about the width of the fan charts that we show with regard to our forecast is that a lot of that is just unexplained residual in the model. The models are explaining only about 60 percent of the year-to-year variations in the inflation rate. We have been wrong in the past on inflation, and we will be wrong in the future. Our models seem to explain only a portion of the variation in inflation, and we recognize that our ignorance is a big source of uncertainty in the outlook.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Two of the questions I had teed up to ask have been asked and answered. Let me just focus on one. The staff continues to have an assumption of less tightening in the fed funds rate than is expected in the markets. I'm not sure if that has changed a lot since the September meeting on either side. You are saying, I think, that with last Friday's labor market report in hand you would have raised the forecast in this month's Greenbook a bit. I was wondering if you would also suggest a different trajectory for the fed funds rate embedded in your forecast

MR. STOCKTON. Well, I think the employment report would not change our funds rate forecast very much. One of the things that I tried to highlight in my remarks, though, is that there are a couple of really major pieces of the outlook—such as movements in the exchange value of the dollar and movements in the stock market—where as a matter of joint strategy we are embedding in the forecast a pretty neutral assumption. For example, the dollar's path is almost like a random walk, and the stock market will just go up at the risk-adjusted return that one can get in the bond market. Now, it's quite conceivable to me that participants in the market might be factoring in some combination of developments in those areas that, with the kind of funds rate path we've written down, could produce more stimulus either because spending will be more interest sensitive or because the transmission of the funds rate into asset markets could be more powerful than we're assuming in our forecast.

So we write down our funds rate path as sort of a conditioned assumption and, obviously, as developments change, we react to that. But in your considerations as a policymaker and in thinking about the full range of the risks that you're confronted with, you might want to ask, Could it be that the setting of the funds rate would produce either considerably more spending or inflation than the staff has incorporated? I also noted that it's still the case—and it's one of the factors that we are struggling with and don't really have a clear answer to—that we haven't over the past two years gotten as much activity out of very, very low real interest rates as we would have anticipated. As I noted in response to a question by President Yellen last time, some of that is apparent in housing and some in business investment also where, even though the growth rates have recovered, the level of spending as a share of GDP looks to us pretty darn depressed relative to the trends that one might have anticipated in response to these low rates. And in our forecast we're carrying forward some of that unexplained weakness. Obviously, if that unexplained weakness were to diminish more

rapidly than we envision—if we get more spending and more output—we'd have a higher funds rate path associated with the outlook as well.

CHAIRMAN GREENSPAN. Further questions? Karen, I noticed that the unit import price excluding petroleum for the month of October, which was released today, is negative for the first time this year. Do you have any notions as to what that is about?

MS. JOHNSON. I'm afraid you've caught me without an answer. I'm not sure what the elements of that are.

CHAIRMAN GREENSPAN. Could you take a look at that when you have a chance?

MS. JOHNSON. Sure.

CHAIRMAN GREENSPAN. If there are no other questions, who would like to start the Committee discussion? President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. The Seventh District economy has firmed since our last meeting. Many of our manufacturing contacts outside the auto industry report strong orders and sales as well as a growing backlog. The improvements have been broad-based, with particular strength in heavy equipment. Engine producers cannot keep up with strong demands and have put truck manufacturers on allocation. And Caterpillar's CEO told me that business is the best he has seen in his thirty-two years in the industry. In contrast, both Ford and GM were disappointed in their October results and reduced next year's outlook for light vehicle sales slightly, to around 16½ million units. On a positive note, one automaker was pleased that they were able to lock in steel prices for next year below current spot prices.

With regard to the labor markets, businesspeople in our area report more hiring. Our contacts at Kelly, the temporary staffing firm, note that orders are rising more rapidly and that permanent placement fees continue to increase. And they say that it is no longer as easy to find qualified workers. We also hear from other contacts that skilled tradespeople in manufacturing and

even part-time retail help for the holiday season are harder to find. All of this is consistent with the stories that we've heard around this table for several meetings now.

Although growth is more solid, we do not see the kinds of upward pressures on wages and prices that would indicate that we've fully closed the output gap. There are some exceptions. Several contacts do note that wages are rising somewhat faster. Some even say that, for the first time in several years, they occasionally have to pay bonuses to hire and to retain workers. Nonetheless, overall growth in wages remains modest, especially in light of the strength that we've seen in productivity growth.

In terms of pricing, suppliers are finding it somewhat easier to pass higher costs along to their business customers. We're hearing about this in construction materials and heavy equipment. In addition, the weaker dollar is raising the wholesale prices of imported goods, as a large specialty retailer reported to us. However, there is little evidence of a general pass-through of higher input costs to consumer prices. So on balance, we think the economy has a way to go before the output gap is fully closed.

Turning to the national outlook, clearly the economy has emerged from the midyear soft patch. Consumer spending has rebounded. The October jobs figure certainly was long-overdue good news, and our contacts are less skittish about the outlook for demand. But the data and the anecdotes don't seem to point to a widespread surge in growth. It feels more like growth that is only modestly faster than potential, despite the substantial degree of monetary accommodation.

Two factors seem to be holding back growth: The first is higher energy prices, which we've talked about a lot—and we've seen quantitative estimates of their impact—and the second is business caution. Even though businesses seem more sanguine, there continues to be an underlying hesitancy to take on large-scale investment or hiring commitments.

Roger Ferguson discussed business caution in our last meeting, and I'd like to elaborate on one aspect of that phenomenon. I think in part this caution in investing and hiring is related to a continued and even increased level of concern about Sarbanes–Oxley, especially its provisions on internal controls. The more I hear from CEOs and people who sit on corporate boards, the clearer it is that Sarbanes–Oxley is leading to significant, and I think still evolving, changes in decisionmaking. Corporations seem more risk averse. They operate under a veil of caution. I hear repeated stories of companies making decisions much more slowly. In addition, they're discarding projects that they might otherwise have undertaken. Now, quantifying these factors is hard. Statistical models can give us an idea of how higher energy prices are holding back activity, but they give us little guidance on how to calibrate the influence of higher risk aversion. Nevertheless, I believe that it's likely to be significant. So in the context of policy, this uncertainty makes it appropriate to continue being measured in how we remove policy accommodation. Of course, if we see energy prices raising long-run inflation expectations or if we see business caution and resource slack dissipating substantially, then we may need to move more aggressively.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Thank you, Mr. Chairman. I'll start with the report from my Wal-Mart friend. He began by saying that Wal-Mart sees demand as "really weak"—that's the term he used. August same-store sales showed the lowest growth rate Wal-Mart had seen for some time, and September–October sales were also weak. I think the company has announced its October numbers publicly. Year-over-year sales growth in October was 2.8 percent, including the clubs, but for Wal-Mart itself the figure was 2.0 percent. So he believes, given the demographics, that the lower end of the income distribution that typically shops at Wal-Mart is "stressed," as he put it. Going forward, Wal-Mart is projecting increases of 2 to 4 percent in same-store sales; their current point estimate is 2.9 percent.

My contact in the trucking industry said that the economy is doing okay but is not booming. In his view, if the economy had been booming, there would have been real problems in the transportation sector because of problems in both rail and trucking capacity. He noted that a truck assembly plant is now shipping trucks down the assembly line without tires. Apparently there's a shortage of truck tires at the moment. I assume that's just a spot issue. He said that his company itself had not had any difficulties in terms of the availability of tires. He indicated that retailers expect a normal holiday season. He said that the West Coast dock situation is about unchanged and that rail service remains poor but is not getting worse. He also reported that the truck rates they were able to charge in the third quarter were up a little over 9 percent year over year.

On a more optimistic note, my contact at FedEx said that FedEx sees continued strong demand in every sector. The company's ground business is up about 16 percent year over year, and domestic freight is up about 14 percent. And significantly, I think, FedEx is adding substantially to its capital spending plans for next year, anticipating an increase in capital expenditures of 20 to 25 percent. The company has not seen any wage pressures but is expecting to see some. The toughest employee to find at this point is one with accounting skills—a development no doubt related to Sarbanes–Oxley, which is tightening the market for those skills everywhere.

My UPS contact said that the company is hiring aggressively for the peak holiday season. They're even hiring new pilots for the first time in some years. The labor market for IT professionals has tightened according to my contact at UPS. He noted that they are seeing the first significant change in direction in the IT skills market that they've seen for some time. UPS has revised up its volume projections for next year. In fact, they've made two revisions just in recent weeks, particularly in their international business and especially in shipments outbound from Asia, much of which of course comes to the United States.

For the first time I called a contact at a West Coast software firm, and he said that their PC forecast is running at just a modest level, unchanged from where it has been recently. Somewhere in the neighborhood of 7 to 10 percent is probably the easiest way to characterize it. I thought the most interesting thing he said was that in their view the labor market had become "brutally more competitive"—that's the phrase he used—in terms of hiring software engineers and also general management talent. He said that they are getting lots of resumes but maybe only one in forty applicants is worth hiring. And he noted that his firm has been affected by the reduction in the number of visas for talent that can be brought in from abroad. I think that's about all I want to say in that regard.

One issue that I have been spending some time on is trying to understand what we might mean by the "normal" real federal funds rate. If one goes back over history, that rate is extremely variable. But compared with history, I think we're probably getting more or less into the range of what one might call "low normal," though I don't think we're quite at normal yet. I just wanted to say that, if you scan the data since the Korean War, no matter how you cut it, what is most impressive is just how variable the short-term real federal funds rate is. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you very much, Mr. Chairman. The Red Sox win certainly helped. [Laughter] There's no question about that. But after allowing for that, I would say that the economy in New England is expanding even independently of the Red Sox. Employment is growing or is at least stable versus a year ago in all six states, and the unemployment rate is down. Even measured rates of inflation in the District are trending down, and inflation is moderating more in the Boston area than nationally. Consumer and business confidence have picked up and remain higher than they were a year ago. Tourism in Boston has been very strong, though elsewhere in New England it has been affected by cool and rainy weather. Residential real estate markets in all

major metropolitan areas continue to be strong, particularly for low to moderately priced homes, and both manufacturing and retail contacts were for the most part upbeat and projected reasonable to strong demand and revenue growth. Concerns and uncertainty remain, to be sure. And growth is variable, with firms in the health care and defense areas growing more rapidly than others. But overall the expansion does seem to have entered a period in which it is on relatively solid footing.

During the period since our last meeting, we've been rather busy at the Boston Fed. We've held four forums for local bankers and businessmen around the District; we've met with our Academic Advisory Council as well as with a group from local software companies; we've had two meetings of our directors in a relatively short period of time; and we've talked with our regular Beige Book contacts and focused a lot of attention on local manufacturers and their concerns. Pulling the data from all these sources together, I wanted to touch on a few common themes that were evident to us in this period of extensive outreach.

In manufacturing particularly, but elsewhere as well, rising oil and natural gas prices and rising prices for commodities such as copper, aluminum, and resin emerged as a concern. One person in electrical and electronics manufacturing referred to an environment of—and I quote—"hyperinflation," noting that price increases could at times be passed on even to big box retailers. According to this source, rapidly rising input prices have made planning ahead quite difficult. This contact was admittedly an outlier, but most manufacturers and retailers expressed concern about the impact of higher oil prices on both demand and costs.

Contacts continue to be cautious about hiring, even when expected growth and net revenue gains are positive. They report seeing a new employee as an addition to "fixed costs," given the difficulty they had experienced in downsizing during the recession. And I would agree with President Moskow about the impact of Sarbanes–Oxley. That is contributing to a lot more caution on the part of businesses, particularly in the hiring arena and to some degree in the spending arena

as well. Moreover, depending on the business, finding new employees with the right technical skills was seen to be both difficult and expensive. And most contacts also mentioned rising benefit costs as a further deterrent to hiring.

Plans for increased capital spending ranged from modest to relatively strong, with a continued focus on reducing costs and improving productivity. Most contacts expect profit margins to continue to be solid, especially in the biotech area. The region's exporters have benefited considerably from the slowly falling—less slowly than before—dollar. One paper and pulp producer reported record overseas sales and the ability to make price increases stick in high-grade products.

High-tech contacts both in software and in manufacturing reported on what they saw as a large inventory swing this year from which the industry was still in the process of emerging. In late 2003, very short supply chains and rapidly rising demand lengthened delivery times and prompted a degree of over-ordering. When the semiconductor industry, in particular, caught up late in the first quarter of 2004, inventories swelled and orders stopped, giving the impression of a large falloff in demand. Our contacts described this as more of a supply chain phenomenon than a weakening of underlying demand, which they at least believe remains not great but relatively solid.

Finally, in many types of industries concerns were voiced about U.S. immigration policy, which has added to the problem of finding qualified labor even in low-value-added service industries. For small software companies, restrictions on immigration combined with the impending requirement to expense stock options even in a start-up, privately held company will prove difficult as the talent needed will either choose to return to their native countries or never come to this country at all. In sum, New England has had its challenges, to be sure. But overall, economic activity in the District seems to be good—not great as yet, but gaining traction much like in the rest of the country.

On the national scene, data received prior to last week had been good but also not great. Obviously, consumption bounced back in the third quarter from depressed second-quarter levels. Housing investment had remained strong, and purchases of autos had continued to surge whenever incentives were offered. However, new hiring had been slow, and both the Michigan and the Conference Board indicators of consumer confidence had moved down, particularly in the area of future expectations. Business investment was okay, particularly for non-high-tech goods, but some of the strength was likely borrowed from next year, and as I noted before, businesses remained cautious. Rising oil prices seemed poised to take a bite out of both consumer and business spending and to damp foreign demand as well, though as yet such price increases have not had an enduring effect on growth. And we continued to hit new highs in terms of the external deficit, which has been a drag on economic growth and has contributed to a somewhat faster pace of dollar depreciation.

Last week things began to look a bit brighter. Whether you come from a red state or a blue state, you have to be happy that the election is finally over. Results notwithstanding, that has to take one element of uncertainty out of the mix. And of course, Friday's employment news was very welcome. Obviously one month, even with revisions to prior months, does not a trend make, but the news of 337,000 new jobs surely brightened my outlook. Our forecast in Boston is pretty close to that of the Greenbook, and we had made it prior to Friday based on the hope, not the reality, of better employment data in the short run. Now that forecast seems, at least for the present, to have fewer downside risks, and I'm beginning to think about whether we might find ourselves wanting to move a bit faster toward that elusive neutral stance of policy. But that is certainly a discussion for another meeting. For now, matching market expectations seems the sensible thing to do. Thank you.

CHAIRMAN GREENSPAN. President Yellen.

MS. YELLEN. Thank you, Mr. Chairman. The economic situation in the District has changed little since our last meeting. Activity continues to expand solidly but not exuberantly, closely mirroring the nation. Housing markets, with only a few exceptions, remain robust. Consumer spending is solid in both the retail and travel sectors. Our ports are extremely busy and in some cases are even overburdened because of heightened activity on both the import and the export sides. One area where there may be softening is manufacturing, as some of our contacts report slower demand growth than earlier in the year. Finally, job gains remain modest in the District, and unemployment has inched down only slightly. As a result, labor supply remains ample, and we hear little about worker shortages or accelerating wages.

Turning to the national economy, recent data on economic activity have flashed both positive and negative signals, but on balance they suggest that growth is sustainable though trendlike—not nearly as robust as the strength we saw last year. In spite of the small uptick in the unemployment rate, October's stunning job growth raises the odds that labor market slack will decline over time. The October employment report is also reassuring because strong job growth mitigates the downside risk to consumer spending from muted growth in personal income.

The Greenbook forecast, even as revised on Friday, was sobering. It shows only a meager acceleration in activity next year to a rate that is only modestly above potential, despite continued monetary stimulus and a shallow upward path to the funds rate—shallower than markets now expect. This forecast seems plausible to me for several reasons. First, of course, oil prices are surprisingly and persistently high. Second, fiscal stimulus will turn weaker next year. Third, there's a good prospect that the private saving rate will rise from its current low level once housing-price appreciation moderates and the growth in wealth that consumers experience as a consequence starts to taper off. Fourth, it seems likely that the trade gap will continue to drag down growth, even though the dollar has fallen somewhat since we last met. And, finally, we do not see business

investment in equipment and software rebounding at a sufficiently buoyant pace to propel truly robust, above-trend growth.

The high-tech sector poses risks to the forecast. As David noted, the Greenbook forecast for IT investment has been revised down rather significantly in the last two rounds in response to disappointing data that showed real growth of only 4¼ percent in the third quarter. Still, I consider this forecast quite strong. It anticipates that the share of IT investment out of total equipment investment will rise almost to the level reached at the end of 2000. I think it's important to recall that the 2000 peak was bolstered by several special factors, in particular the capital spending binge by telecom service providers and the buildup to Y2K. In addition, it was propelled by a very rapid pace of diffusion of personal computers and networks, a pace which may prove difficult to maintain much longer. As Governor Ferguson noted in a recent speech and in his remarks to the Committee last time, the more moderate pace of decline in quality-adjusted computer prices over the last year may signal a decline in the pace of technological change in this sector. Furthermore, there is some industry opinion that the pace of the development of software is beginning to slow.

On the inflation front, the most recent data have been favorable. Despite the blip in core CPI inflation in September, it appears that core inflation and longer-term inflation expectations are well contained. The Greenbook forecast for the next year of 1½ percent in core PCE inflation and just under 2 percent in core CPI inflation seems quite reasonable, although there are upside risks from oil and the dollar.

Overall, with inflation well contained, output growth that shows no sign of establishing real momentum, and slack still remaining in the economy, I see no reason to presume without further evidence that monetary policy needs to be tightened more rapidly than is assumed in the Greenbook path. In my view, today's move will complete the process of removing the insurance premium that was incorporated into the federal funds rate as an emergency measure. As the Bluebook indicates,

the federal funds rate will have returned to a range that is consistent with the prescriptions of a variety of Taylor-type instrument rules. Future moves in my view should, therefore, be data dependent.

If the Greenbook proves accurate, we will have many opportunities to pause in the process of raising the funds rate over the next year or so, especially if the dollar and the price of oil do not show significant declines. If they do decline significantly, the appropriate path for the funds rate could steepen rather dramatically, but there is little need to anticipate changes in these variables since we can monitor them daily and they take time to play out in the economy. For today's meeting, it seems entirely sensible to raise the funds rate 25 basis points. My comfort level with this move was noticeably enhanced by recent employment gains. But I think the jury is still out on the appropriate move in December, and I believe that we should craft a statement that leaves all options open.

CHAIRMAN GREENSPAN. President Lacker.

MR. LACKER. Thank you, Mr. Chairman. The Fifth District economy continued to expand in recent weeks. Manufacturing growth continues but seems to be slowing a bit. Our shipments index fell somewhat but remains solidly in positive territory. The new orders index, however, slid toward a neutral reading, and our manufacturing employment index remains at neutral as well. Many contacts in manufacturing continue to comment on higher material prices. A manager at Rohm and Haas in North Carolina noted ethylene and propylene price increases, but said he was holding the line on his product prices. And a G.E. manager in South Carolina noted increases in raw material prices but said prices for the turbines he produced were rising even faster.

Our most recent survey still indicates strong growth in revenues and employment in the service sector. Retail activity appears to have slowed since the end of the period covered in our Beige Book report. Big ticket sales in particular seem to have been weak in recent weeks, and most

of the auto dealers we surveyed said sales were down. One of our directors in the energy business said that in his view energy prices were unsustainably high, and he cited several factors that he thought indicated they'd be coming down significantly soon. He also reported that many CEOs he knew were complaining about the expenditures required to comply with Sarbanes–Oxley; they thought it was a major drag on the economy. In particular, he noted a scarcity of the skilled personnel necessary to implement those systems. A North Carolina banker said that, although there are pockets of negativity, his contacts generally thought the business outlook was good there. And a contact in West Virginia reported that railroad shipping is a significant problem for the coal industry. He cited scarcity of labor in that sector.

Turning to the national economy, the October jobs report shows healthier employment growth since the summer, and this suggests greater strength in the labor market than we had previously supposed. Aggregate hours are already more than ½ percentage point above the third-quarter average, and the steadily increasing growth in average hourly earnings that has been in train for months evidently continued into October. The rise in both hours and wages gives a welcome boost to personal income, and that should help support strong growth in consumer spending going forward. Rising wages together with slower productivity growth have pushed the growth in unit labor costs up to or even above the rate of inflation recently so that the disinflation risk continues to abate. All told, with inflation and inflation expectations well anchored, the economy appears to be doing noticeably better than it seemed at the time of our last meeting. And if the economy maintains its strength, we will need to continue to let the funds rate rise.

As I see it, we are likely to be balancing two related concerns going forward. First, there's the continuing weakness in business investment spending relative to what we might have expected, given the strong cash flows and low interest rates we've seen this year. Because of this, I think we are likely to want to keep our real interest rate increases to a measured pace. However, market

participants expect us to raise the funds rate faster than the Greenbook projects is necessary to maintain price stability. The discrepancy between market expectations and the Greenbook forecast suggests a second concern that we might at some point fall behind the curve, as it were, in tightening monetary policy.

If the job market gains momentum in coming months and suspicions about the sustainability of the recovery recede, real inflationary pressures could well develop. In that case, we would want to act decisively to preempt any uptick in inflation rather than await an uptick and then react, and I presume we would do so. But even if inflation remains perfectly stable, we will need to let the real interest rate rise as the economy gains strength. We shouldn't let stable inflation expectations lull us into adjusting the equilibrium real rate less rapidly than is required to resist a real boom-and-bust cycle such as we saw in the late '90s. In the current case, it will be difficult to discern when and how much interest rate tightening will be necessary in the period ahead, just as it was then. But above all, we don't want to encourage the belief that we signal a steeper expected funds rate path only in response to tangible signs of shifting inflation expectations because our ultimate goal is to eliminate such shifts.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. Let me first talk a little about the region, which has continued to show expansion since our last meeting. Despite some tentativeness on the part of businesses and consumers that I think was tied to the election, we're seeing some rather positive developments. Consumer spending edged up a bit during this recent period. Auto manufacturing, as I've heard others say, was a little slow. That was driven very much by whether or not incentives were being offered; as they were pulled off, sales have gone down. So I suspect sales incentives will come back as we move through the rest of this year. Energy activity in our region has risen

rather briskly with the higher oil prices and especially the higher natural gas prices; we've seen a lot of activity develop as a result of that.

As I mentioned, many of our contacts said that the preoccupation with the election was causing businesses and consumers both to do some postponing. With that behind us, they really do expect some pickup in activity. I would also mention that on the manufacturing side we have seen some pretty positive developments continue across our region, particularly in support of small manufacturing. That was very encouraging to us. We've seen indications from a number of businesses that they are more forward-looking than I've ever seen in terms of what they're prepared to do and their expectations for increased business. There is, I think, a change in attitude developing that is worth noting.

Looking at the national level going forward, we judge that the continued accommodative stance of monetary policy and some of the easing of headwinds created by energy prices should now contribute to a healthy pace of economic growth in 2005 and 2006. Specifically, it appears as though growth will remain above trend, in the 3½ to 4 percent range, as others have noted. While I do not want to make too much of one data release, I agree with the point others have made that the payroll numbers do provide some evidence of a significantly more positive forecast than we might otherwise have been thinking about. I would also note that, with this kind of growth continuing, there are some indications that prices could move up maybe a tenth or two in the first part of next year. We will see, of course.

There are some upside as well as downside risks that I think we have to keep in mind. First of all, on the upside, I think the removal of some of the uncertainty that has been in the market is a very important factor going forward. As for the labor markets, I think their strength is evident in more than just this last report. If we look at the revisions that were made to the data for previous months, we're now talking of average monthly increases of about 190,000 over the last four

months, and in my view that's a pretty healthy pace. If it continues, that may point to a more optimistic outlook for consumer spending as we move forward. Also, with the adjustments in the dollar, we may see some reduction in our current account deficit, which will be less of a drag on the GDP numbers. As for the downside risks, I think we may see some increase in personal saving. I believe it will be very modest, but it may be a factor offsetting attitudes toward increased consumer spending. Finally, while energy prices have been backing off, energy is always a wild card and could be a player as we move forward. On balance, though, I think the outlook is favorable, which in my view puts us in a position where we should continue to remove our policy accommodation and move back toward the neutral stance of policy that we'd like to attain. Thank you.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. All things considered, the national economy continues on what I regard as a very acceptable pace. Real GDP for the past six months has advanced at a rate of more than 4 percent. This is above the average rate of 3.6 percent we experienced during the 1990s expansion and with less volatility than we experienced during that period. Furthermore, our models suggest that this growth is above the projected trend growth rate of about 3¼ percent, which implies that there are no significant output gaps. Consumer spending remains solid, and investment spending continues to make a good contribution to growth, while the usual suspects for shocks and worries remain—oil, war, terrorism, fiscal policy, the dollar, and others. I share the sense that there's a high probability that balanced growth at or above trend will continue over the forecast period.

Most of us, like David, have been puzzling for some while over the atypical pattern of job growth in this postrecession period. I see last week's unexpectedly strong number as a bonus. The overall employment outlook now looks more promising, but like several others, I would suggest that we not overemphasize one month's data, nor do I think we should expect a return to the

experience of the 1990s. That experience—the 300,000 plus monthly job growth that some began to think of as the norm—with hindsight may very well have been reflecting a transitory acceleration rather than heralding a shift in the underlying pace of sustainable job creation. And that extraordinary experience may have contributed to an overly optimistic estimate of the NAIRU. Similarly, I'm also reminded, as others have suggested, that a significant portion of the productivity growth we thought was taking place was subsequently revised away as new data came out. The point is that we should not let the job situation play too dominant a role in our policy discussions but should concentrate instead on getting the funds rate back to a more neutral stance.

Much of what I see happening in the national economy is also evident in our District. Consumer spending is good; state government tax collections have been increasing. Housing construction continues at a high level, and much of the structural downsizing in the region's manufacturing sector appears to be behind us.

The hurricanes clearly took their toll on our region, and that impact will show through in the measure of economic activity for a while. Tourism has been especially hard hit. A number of hotels in Florida are still out of commission, but these are mostly small and in secondary tourist markets. Major destination areas like Miami, Fort Lauderdale, Orlando, et cetera, are largely unaffected. Nevertheless, our contacts are reporting that tourists remain skeptical and that advance bookings for next fall are down. In addition, high fuel prices, when layered on top of other structural problems, have essentially brought Delta Airlines to its knees. Our other regionally based airline, AirTran, has also posted a loss for the third quarter as a result of high fuel prices and hurricane-related disruptions to air travel.

Also, notwithstanding the comments I just made about the strength of housing construction, we have seen in anecdotal information just a hint of slowing in the pace of home sales. I don't think we should be surprised to see a leveling-off in that sector as some of the one-time effects of

people shifting from apartments to houses or moving up to larger homes wind down at current interest rates.

Finally, building on a comment the Chairman made, I would note that Hurricane Ivan added to our short-term oil problem by destroying a significant number of oil and gas pipelines in the Gulf of Mexico. Since mid-September some 4½ percent of yearly oil production from the Gulf has been lost, and that region represents, I believe, around a third of total U.S. production. These losses caught refineries by surprise, and the U.S. refineries have struggled to make up for the loss. In the first week of September, refineries were running at about 96 percent of operable capacity. In the last week of September they were at 84 percent, and currently they are running at about 89 percent of capacity.

These issues aside, I believe that if one steps back for a broader look at where we are with the economy, we seem to be on a very acceptable track. Policy remains extremely accommodative. Election uncertainty is behind us. With real growth on what looks to be a good and sustainable path, with inflation still moderate, and with the employment picture at least a bit more promising, I believe that the policy path we have been on is the correct one. I hope we will continue to remove more of the accommodation, as financial markets expect. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. Economic activity continues to expand at a modest pace in the Third District. This is the sense we get from the discussions we have had lately with our various advisory boards and from the general tone of the data we have been gathering about the District.

Manufacturing has held up well and continues to be a strong performer. This is in spite of the dip in the September business outlook survey (BOS) index of general activity to 13.4, which I reported last meeting. At that time I noted that the decline seemed inconsistent with the strength in

new orders and shipments as well as with the positive comments from our respondents. The sharp rebound in the activity index in October to 28 seems to indicate that the dip was a one-time aberration from a longer-term positive tone in the BOS. This view is also supported by the fact that the new orders and shipments indexes have remained at very healthy levels and by the strengthening in the employment index this month. Our survey suggests that respondents see strength in manufacturing through the rest of the year as well. In our special question this month, about 40 percent of the firms surveyed report that they're planning to increase production in the fourth quarter, about 40 percent say they will keep production at the current level, and only 20 percent plan reductions. Roughly the same number of firms plan to increase their inventories of finished goods as to decrease them. If you put all of this together, it suggests that firms expect sales to be increasing. I'd also note that the survey suggests that firms are gaining some pricing power. There has been an increase in the number of respondents who report that they're beginning to increase their prices in response to rising costs of metals and energy.

Turning to the retail sector, sales of general merchandise in our region continued to grow at a moderate pace, which is consistent with retailers' expectations. Our retailers expect Christmas sales to be fairly good but not excessively strong. Home sales in the District remain strong, and housing-price appreciation continues at a high rate in our three states. But residential construction activity continues to moderate from the very strong pace earlier in the year. Nonresidential construction remains soft, but we're beginning to see a pickup in the commercial sector, which includes office buildings and warehouses outside the manufacturing sector. Contracts for commercial buildings are up slightly on a year-over-year basis.

Our employment data are a bit old. The October employment numbers for our three states have not yet been released. However, based on unrevised numbers through September, employment growth in our three-state region was stronger than in the nation. It slowed in the third

quarter from the second quarter but remained in line with expectations. Given the upward revisions in the national employment numbers in August and September, I would not be surprised to see our state numbers revised up as well. The labor markets in New Jersey are the strongest, and those in Pennsylvania the weakest. The weakness in Pennsylvania seems to be distributed statewide, but Philadelphia has been particularly weak. Payrolls declined in Philadelphia over the past quarter. Nonetheless, our business contacts continue to report that they are having difficulties finding qualified workers. This seems to be true for lower-skilled manufacturing jobs as well as for higher-skilled technical positions.

Turning to the nation, incoming data suggest that the economy has bounced back from the soft patch it hit this summer. Now even the payroll employment data are consistent with this view. Despite the rise in oil prices, growth this year is likely to be in the 3½ to 4 percent range, as a number of others have already indicated. Although we saw an uptick in core inflation in September, inflation remains low, and the latest employment data show that payrolls have grown at about 200,000 jobs per month this year. This is a fairly good showing for the economy.

As far as I'm concerned, the course for policy today seems straightforward. We should continue on our path of removing accommodation at a measured pace and maintain most of the language in the Committee's last announcement. This would be consistent with the economic data we have received and is also widely anticipated in the market. Nonetheless, I think we should begin to think about our longer-term policy strategy. The employment report suggests that the expansion may now be on a solid footing. Of course, it is only one data point, as a number have said—or maybe three data points if one considers August, September, and October—so I don't want to get overconfident. Still, I think we may want to begin to question whether a measured pace is an appropriate description of the pace of monetary policy tightening we are likely to need over the next several quarters.

By the way, I recognize that the Greenbook forecast assumes a very slow movement in the fed funds rate. Indeed, one might complain that "measured" may be too rapid a characterization. [Laughter] Nonetheless, we need to consider that at this point two key risks to the outlook—higher oil prices and a sharper depreciation of the dollar—may put pressure on inflation sometime in the future. Given the lags in the effect of monetary policy on the economy, we should be prepared to move rapidly if that becomes necessary. This leads me to think that if the data between now and our December meeting are similar to what we have been seeing so far, the Committee may want to consider preparing the markets and market participants for the possibility of a steeper path of policy tightening going forward. For today, I see no reason to alter either the risk language or the measured pace language in our statement.

CHAIRMAN GREENSPAN. President Pianalto.

MS. PIANALTO. Thank you, Mr. Chairman. Ohio may have decided the country's presidential election last week, but it doesn't seem to be determining the economy's direction. I'm afraid I'm going to be a bit of an outlier in my report on economic conditions. Ohio was the battleground state, and it may be that businesses and people in Ohio are just weary from this long election cycle. [Laughter] But as was evidenced in the Beige Book, Fourth District conditions seemed to be less buoyant than those in the rest of the country. Businesspeople I talked to around our District are reporting only modest growth in production and sales. And in fact, I'm seeing a growing dichotomy in what my business contacts tell me, based on where they sell their goods and services. Those who sell only locally tend to be somewhat pessimistic about business conditions, whereas those who sell nationally and internationally express more optimism.

My local business contacts gave me very little reason to anticipate the strength that we saw in the October employment report. Now, the report could be just another bad exit poll. [Laughter] But our District clearly is going through an industrial realignment that may not be indicative of

developments in the nation as a whole. Notwithstanding the strong overall October employment report, manufacturing shed another 5,000 jobs in October following a decline of 14,000 jobs in September. And Ohio's employment remains 4 percent lower than it was at the peak of the last business cycle, while nationally employment is up only 1 percent. The October employment report does square with the fact that we are seeing an improving national picture, but the experience of this past spring makes me leery of allowing one month's data on employment to unduly influence my thinking about the labor markets. I still hear from most of my business contacts, regardless of where they do business, that they expect to meet rising demand without adding substantially to their payrolls. From these comments, I expect that productivity could be higher than in the staff's baseline forecast, perhaps more in line with the higher productivity scenario shown in the Greenbook.

Businesspeople also continue to report cost pressures, obviously from oil prices but also from higher prices on a wide range of nonpetroleum materials. I have yet to see any convincing evidence, though, that these cost pressures have become a part of generalized inflation. Retail prices and wage growth remain subdued, and inflation expectations seem to be holding steady. This is in part because my business contacts, unlike those of President Moskow, say that they still find it very difficult to pass on these price increases to their customers, especially to customers that produce finished goods. Consequently, they are still busy altering their production processes to substitute away from some of these more expensive commodities, if possible. One of my directors, a very large international producer of vinyl siding and decking materials, stated that her capital investments are all directed at raw material substitution.

Taking all of this into consideration, it seems to me that our monetary policy stance is about right at the moment, presuming an action today. My view on the appropriate policy in the future, though, will be strongly influenced by the incoming data on economic activity. I also want to have

the necessary flexibility to adjust policy as economic developments unfold. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. Let me start with just a few comments about the District economy. Recent reports on consumer spending have been mixed; we had one relatively strong month of spending on autos and in non-auto retail sales, followed by a much more modest pace of sales in the next month. An area that has picked up, though, has been tourism, where better weather late in the summer and in the fall has clearly benefited that sector. Manufacturing has continued to expand in the District, and agriculture appears to be having a good year for the most part.

A little over a week ago, we hosted at the Bank a meeting on housing and residential construction activity. There were several reasons for this. One, of course, was the fact that we hear periodic discussions of a potential bubble in house prices. But second, I've been struck, as I've watched developments in the Twin Cities and as I've traveled around other cities in the last several years, by the absolutely high level of construction activity that seems to be occurring. It's not only new building, but conversions of all sorts of warehouses, schools, and former office buildings to residential property. A change in mix seems to be occurring as well, with more of the construction and renovation yielding townhouses and condominiums rather than the standard single-family home.

I thought it would be a good idea to try to get some other people's perspective on this, so we had at the meeting a group of developers, lenders, consultants, and economists. They brought a national perspective, although they did have special expertise in the Twin Cities market and a few other particular markets across the country. In general, I would say that their comments were positive and largely unsurprising. There was little overall concern about a bubble in house prices

and little anticipation of a major correction in house prices in the near term. There was, however, fairly widespread agreement that the pace of increase was likely to slow going forward.

Let me just note three specific issues that came up because I, at least, found them of interest. The first, which it won't surprise this group to hear, is that they attributed a good deal of the strength in housing to very favorable financial conditions. In this regard they talked not only about low interest rates but also lower down-payment requirements. I might add that a couple of the lenders did say that they thought the credit pendulum had swung too far. They felt that credit conditions had become too easy, and they were anticipating some potential difficulties going forward—presumably in somebody else's shop! [Laughter] Second, they reported that at least in some markets a significant percentage of the purchases of new units were by investors, where the term "investors" means people who don't intend to occupy the property, at least not immediately. As best they could judge, in some markets investors were buying up to 30 percent of the new additions to supply. And finally, they noted that there seemed to be some acceleration of purchases by first-time homebuyers who were concerned that they were going to be priced out of the market if they waited longer. The implications of that, of course, are that at some point such sales will slow because people will have acted if they could. So that's a summary of that meeting.

Let me turn to just a few comments on the national economy. To me, the outlook for the national economy continues to remain favorable. I'd like to think that I would have made that statement even without the October employment report, but of course that's a counterfactual, so we won't be able to observe it. But I do believe that growth is on a favorable trend. I personally think that the economy will grow a little more rapidly next year than the projection in the Greenbook, and I expect inflation to remain low.

I've been asking myself this question: What is the neutral real federal funds rate? I find that a challenging concept, but I've tentatively decided to think about it in terms of what the rate is

that would be consistent with our price or inflation objective over time. Now, of course, we haven't formalized an inflation target, so I'm using the working definition of price stability. That's what I have in mind. And it seems to me, without going out on any limbs here, that it's safe to say that the funds rate continues to be lower than it will need to be in the long run, so the trajectory we're on seems to me to be appropriate. Thank you.

CHAIRMAN GREENSPAN. Shall we take a coffee break and return in fifteen minutes, please.

[Coffee break]

CHAIRMAN GREENSPAN. First Vice President Holcomb.

MS. HOLCOMB. Thank you. I appreciate the opportunity to represent the Dallas Federal Reserve Bank here today. It has given me the opportunity to have some very high quality meetings with our economists over the three short weeks since Bob McTeer indicated that he was leaving the Bank.

First, looking at our District economy, over the period since the last FOMC meeting economic growth in the Eleventh District appears to have continued at a moderate pace. Payroll employment in June, July, August, and September showed quite modest gains. Like the nation, other indicators showed more strength than the payroll numbers. Consumption, as reflected by sales tax receipts, is growing at its most rapid pace since 1998. Personal income is up for the seventh consecutive quarter, and surveys of business leaders across Texas show that business confidence is gaining strength.

However, these positive statistics seem to be somewhat at odds with the anecdotal reports that we have received from our head office and Branch boards of directors. For example, I mentioned that consumption has shown considerable strength, but from our directors we've heard numerous stories about the damping impact of higher gasoline prices on consumption. One of our

El Paso directors is a rancher. He offered a story about how the four cowboys he hires all showed up to work last spring, each driving his own pickup truck and pulling his own horse trailer. The same group showed up a few weeks ago, but all four shared a ride in one pickup and pulled one trailer for all of the horses. [Laughter] They said that the cost of gasoline made the difference. I can assure you that in West Texas no one worries about running out of street space.

CHAIRMAN GREENSPAN. I thought there was more horsepower. [Laughter]

MS. HOLCOMB. That's as close to a Bob McTeer story as you'll get from me. [Laughter]

SPEAKER(?). It's better than some of his! [Laughter]

MS. HOLCOMB. Actually, higher energy prices have had a positive impact on the oil and gas sectors of our District economy. Earlier this year, oil and gas activity had been expanding very sluggishly in response to the higher energy prices. In the last two months, however, we see growing evidence that this is changing. Exploration and improvement projects have been announced in recent weeks by both the majors and the independents. Energy production is even expanding in the Dallas–Fort Worth metropolitan area, a region where output has been virtually shuttered for the last eighteen years. So it is beginning to appear that supply forces are finally responding to today's prices.

Let me note two additional sectors where the tone of the regional economy has improved. The office markets in Dallas and Austin are finally showing declining vacancy rates, confirming a sense of optimism that began last summer. And commercial loan activity at Texas banks has grown nicely in the last two quarters, hopefully reflecting improved business confidence and the beginning of expansion activities.

Finally, our directors and Beige Book contacts report an absence of wage pressures but some modest uptick in price pressures. I'd like to mention one development that we've heard about that may alleviate price pressures over the next few quarters. In 2002, Texas voters approved a

$250,000 cap on non-economic damages in medical malpractice suits. As a result, thirteen companies providing malpractice insurance have reentered the state, and malpractice insurance premiums have dropped by 8 to 17 percent in the last year. This development has the potential to restrain medical cost inflation in Texas as it has done in other states.

In looking at the national economy, we've been struck by how well it is doing and how well it is expected to grow over the forecast period in spite of the long list of headwinds it must overcome. We listed six headwinds that concern us, and I think most of them have been mentioned already. First, consumer confidence has sagged recently. Second, businesses seem somewhat less confident than at the beginning of the year, at least as evidenced by surveys from the National Federation of Independent Business. Third, energy prices remain at a high level. Fourth, we've had four consecutive declines in the index of leading indicators. Fifth, the bonus depreciation of equipment and software will expire at year-end. And sixth, demand growth in the rest of the world, while solid, is expected to slow somewhat. Each of these headwinds exerts a small effect, but in combination they add up. The primary tailwind in the economy is coming from monetary policy. And the strengthened balance sheets of the business sector, along with good profitability growth, provide another tailwind that can and should support higher investment spending in the future.

The inflation outlook is mixed and hard to assess. The decline to a mere 0.6 percent in the annualized CPI inflation rate over the last three months and to an even lower 0.2 percent for the PCE is set against a year-over-year inflation record that is less sanguine. Core measures of inflation are in the 1.5 to 2 percent range and have been on a mild uptrend since the beginning of the year. One-year inflation expectations range from 2.3 percent to over 3 percent, depending on the source, and long-term inflation expectations are anchored at or above 2.5 percent.

In reviewing and evaluating this information with our economists over the last few weeks, we encountered some difficulty in reaching a consensus regarding whether the Committee should

pause in raising rates at today's meeting. Several held the view, as did the majority of our directors when surveyed, that it was the right time to pause. However, after reviewing last Friday's employment report, we have moved from somewhat sitting on the fence to favoring a continuation of measured tightening. The most recent indications of strong employment growth, the level of the real federal funds rate, and market expectations are the more compelling factors in our consideration.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN GEITHNER. We feel reasonably comfortable about the national outlook. Anecdotal reports continue to convey a sense of tentativeness about the strength of demand growth going forward, but the national numbers have been pretty solid. The surveys seem to us to show some softening in expectations about the pace of expansion in the period immediately ahead, but this still looks like a modest decline from reasonably high levels. On inflation, the anecdotal reports still reflect concern about rising costs even beyond energy, despite the substantial deceleration in the price indexes we've seen. On balance, to us the economy appears to have been quite resilient in the face of the sustained rise in oil prices, terrorist concerns, election uncertainty, et cetera. Our forecast for real GDP growth is between 3½ and 4 percent for 2005 and 2006, with core PCE in the neighborhood of 1.5 percent on the assumption that monetary policy follows a path of further measured tightening. We continue to see the risks as roughly balanced around this forecast. Relative to the Greenbook, we are slightly less positive on growth, but the difference is all due to net exports. Our quarterly pattern in the next two quarters is a bit different, but if you average the two, we also show some deceleration.

We have a bit less confidence that the now-prevailing equilibrium rate of interest is as low as many believe, nor are we confident that we should at this stage plan to lean against the range of potential headwinds out there—a higher household saving rate, fiscal contraction over a longer

period of time, negative net exports, sustained business caution, et cetera. By keeping the fed funds rate lower than in the range of more conventional views on equilibrium for a longer period, the Greenbook path is significantly lower than the market path. So we assume a different path for monetary policy, one closer to that now priced into markets.

In broad terms, we still see a moderate expansion in employment and in hours supporting pretty healthy compensation growth and some deceleration of consumption expenditures. Businesses still seem to have the means and the justification for continuing quite strong rates of growth in investment. Growth outside the United States has moderated some but appears to be on a path around estimates of potential. For what it's worth, the governors in Basel this weekend seemed to share a fairly positive view of the strength of the expansion globally. As ECB President Trichet put it, the world economy is somewhat less dynamic but still dynamic.

Back to the United States, we see productivity growth slowing somewhat before returning to what we hope is the medium-term trend of around 2½ percent. The associated rise in unit labor costs in the interim is largely absorbed in shrinking profit margins, as competition holds down pricing power. With output growth close to potential, inflation in our view should stay contained even as the gap narrows.

We're pretty comfortable with this view, but we should recognize that it's an exceptionally benign view of underlying inflation, and there are risks in the other direction. We don't know that much about the size of the remaining gap or the likely path of productivity. We may face more dollar depreciation, and it's possible that pass-through may increase as foreign margins decline. The energy price pass-through could also surprise us; it could prove higher than we expect given the size and persistence of the recent shock and the persistence expected in futures markets. Core finished goods in the PPI, as we know, are still showing fairly high rates of increase. Some models of inflation—time series models—show more-elevated rates of increase and a higher probability of

increases above our comfort range. Inflation expectations at the one-year and up to the five-year horizon have moved up again materially—though, of course, some of that is just the response to inflation in the pipeline from recent energy price increases.

We face the same familiar risks to the outlook, which I won't go through. The dollar's resumed decline has so far come without significant negative effects on risk premiums on other financial assets in the United States or, I think, significant apparent damage to confidence in Europe, Japan, and the other economies that have let their currencies move up against the dollar. I think it's very good to see some modest flexibility arising in many emerging Asian currencies, even though China has yet to move. Perhaps this offers some comfort about the prospects for a benign deflation of the U.S. imbalance, but the magnitudes of these changes in relative growth rates and exchange rates obviously aren't large enough to make much difference now. We live, therefore, with the vulnerability—of an indeterminate but growing probability—of a substantial change in the terms on which nonresidents are willing to finance us. The world's savers may still be somewhat underinvested in foreign assets in general, but they seem to be quite concentrated in U.S. assets. Our productivity growth premium doesn't seem that high relative to the plausible estimates of the dollar decline ahead. We have focused here so far primarily on scenarios that anticipate a very benign adjustment process that's basically positive on net for the United States and not that damaging for the rest of the world. Perhaps it makes sense for us to think a bit more about those scenarios that come with a lot more collateral damage.

I think that we should leave our signal largely intact as we move today. The language of qualified optimism we've used to describe the near-term outlook seems about right. I don't see a strong case for trying to convey more confidence or more concern at this stage. I think it's a good thing for us that the market is now pricing in a greater than 50 percent probability of a move in December. In my view, we should seek to leave unchanged the market's expectation of the path of

the fed funds rate going forward. We don't know enough now to justify trying to talk them into a different view in either direction.

Now, on the questions of when to pause, how to transition to a slower pace of increases, and the slope of the funds rate path going forward, we're obviously approaching a more complicated set of judgments. For now I think we want to continue to convey the sense that we plan to move further over the course of this year toward a more positive real fed funds rate, though of course at a pace that adjusts with changes to our evolving forecast.

I would not be that comfortable with a presumption of a flat fed funds rate for most of 2005 or with that as the presumptive path from which we would deviate only in the event of a very positive shock to growth or a negative upward surprise in inflation. I'd be more comfortable in a world where we keep the presumption of a positive slope for the course of 2005. We can move in either direction from that path depending on how events unfold. I think we would have to have a fair amount of confidence that we are in the midst of a few quarters of significantly below-trend growth to justify pushing expectations in the market down toward a flatter path. I'd rather take the risk in the approach that's now priced into the market than the risk that the fed funds rate would get stuck too low for too long and thus face greater risk of inducing unanticipated changes in the rate in the future. Thank you.

CHAIRMAN GREENSPAN. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. Solid growth, around the rate of the economy's potential, and low inflation seem to have become even more entrenched over recent months. At least so far, accommodative monetary and fiscal policies and firmly anchored inflation expectations have provided a significant counterweight to the adverse effects on both output and prices from the appreciable rise in oil prices since June.

Although the rise in oil prices until recently and a fading fiscal impetus will restrain demand to some extent for a few quarters, the leveling out of oil prices and continued favorable financial conditions should support solid growth over time. In fact, financial conditions broadly defined have become even more accommodative on balance since our last meeting with the fall in the dollar, the rise in equity prices, and a narrowing of credit spreads. And even if we do experience several quarters of slower productivity growth, as in the staff forecast, I think resource slack along with elevated profit margins to absorb rising unit labor costs should continue to keep inflation expectations in check.

I was interested in the fact that the alternative simulations in the Greenbook left both growth and inflation not far from the baseline. I don't think this reflects entirely a lack of imagination on the part of the staff! I do think it reflects the basically sound underlying fundamentals and associated compression in the range of risks around a pretty desirable economic outcome. Dave Stockton characterized this as less fundamental fragility, and I think that's right. But this very favorable outcome does depend on the path of interest rates.

Both the market and, even more, the staff see interest rates rising very gradually and remaining at unusually low levels by historical standards as consistent with solid growth and low inflation. As several of you noted, the staff sees a very shallow incline in rates to only 2¼ percent at the end of 2005 and 2¾ percent at the end of 2006 as consistent with a gradually narrowing output gap and persistent low inflation. Even the market, judging from the futures path, has a structure of rates built in that has a rise in the funds rate to only around 3 percent by the end of next year and to 3½ percent by the end of 2006. This implies actions on our part at fewer than half of the future meetings through the end of next year—in effect a slowing from the recent pace. These expectations not only reflect low inflation expectations but also embody an unusually low and very slow rise in real interest rates. I think that, in turn, is largely a reflection of recent experience in that

the expansion has been damped relative to the degree of monetary ease. Businesses and households have not responded to low interest rates the way history would suggest, even after taking account of the effect of higher oil prices.

I anticipated when I made my projection for much higher growth at the beginning of this year that, as the effects of a series of headwinds abated, the underlying resiliency of the economy to low interest rates would begin to show through more. But despite historically low real interest rates, the output gap has not closed much at all since early this year and is projected to remain around its current level through early next year.

With household saving rates already at historically low levels, spending by this sector is unlikely to be a source of strength in the future, and I don't think we can count on a substantial further strengthening in investment spending either. This might be a function partly of the governance issues that Mike Moskow raised, but in addition businesses don't seem to have been greatly disadvantaged by their cautious behavior, if that's what it is. Profits, productivity, and capacity utilization data don't seem to suggest that sales or profit opportunities are slipping away because firms have been slow to add to labor or capital capacity. And firms probably anticipate only moderate growth in sales going forward, given the low saving rates of households, limited growth in export markets and domestic demand abroad, and a still-elevated dollar. And these are not unreasonable expectations.

Moreover, the marginal returns on new household and business investments may be lower than we've experienced in recent years. It could be that spending on business capital in the 1990s and household capital in recent years has left the level of those capital stocks quite high. And as several of you have noted, the pace of technological change may be ebbing, as evidenced by slower declines in the prices of high-tech goods and by the drop-off in high-tech investment.

If for these or other reasons the effective neutral rate remains low relative to history, policy is not as accommodative as it might appear by comparing current rates to history. And this judgment seems to be built into the markets as well as the staff forecast. In my view, until we see evidence to the contrary, we should expect that the damped response to low interest rates will persist, and we should plan accordingly. I don't know whether the staff's assumption of a policy rate that remains unchanged for some time after today is what will be required. I kind of doubt it, as President Geithner does. But I think we should avoid doing or saying something that would result in a substantial upward movement in intermediate- and long-term interest rates. And those interest rates now build in a very gradual and only intermittent rise in the federal fund rates, a slowdown from our recent pace.

Our problem does not involve whether to raise rates at this meeting. Expectations of an increase today have not impeded keeping intermediate- and long-term rates low. But at some point, and that point may well be soon, even if the data come in roughly along the lines of the moderate growth path in the Greenbook, I think we're going to have to signal the markets—through deeds as well as words—that we are not on a treadmill of higher rates at every meeting. If we don't, we may risk tighter financial conditions and subpar growth at a time when inflation is already low. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Bernanke.

MR. BERNANKE. Thank you, Mr. Chairman. Oil prices notwithstanding, the odds that the economy will continue to grow above trend and that core inflation will remain low and stable seem reasonably good. Growth has been solid this year despite the headwinds created by rising energy prices and a widening trade deficit. By the magic of GDP growth arithmetic, even if oil prices and the trade deficit do not improve at all in 2005, so long as they don't worsen significantly, growth next year will receive a net boost.

Aggregate supply constraints should not be a problem for the expansion either. Job creation last month was substantial, but the increase in the labor force was even larger according to the household survey. The employment-to-population ratio remains low. The number of people working part time for economic reasons remains high, and the number of individuals who are not in the labor force but report that they want jobs increased by a half million last month, according to the Greenbook supplement. Wage growth does not signal much pressure on labor supply either. So in short, I think the economy still has some room to grow.

The inflation fundamentals are likewise generally encouraging. Over the past year, unit labor costs have risen only 0.6 percent, and the underlying trend appears to be consistent with core inflation at current levels. Energy costs are up, of course, but non-energy commodity prices have declined since our last meeting and are up only about 2½ percent for 2004 as a whole, using the CRB spot industrial index. The markup of prices over unit labor costs remains close to its 1997 peak, leaving plenty of scope for businesses to absorb higher labor and energy costs. The recent increase in the TIPS spread puzzles me a bit, particularly as inflation compensation at the five-to-ten-year horizon is down. It's also interesting that, since the last FOMC meeting, both nominal bond yields and TIPS inflation compensation have been negatively correlated with oil prices, suggesting that investors are concerned more about the growth effect of higher oil prices than about any possible inflationary effects.

Looking forward, I think a reasonable goal for policy would be to try to keep PCE core inflation at about its current level in 2005 and 2006. In light of the energy situation and the fact that we are at a stage of the cycle in which inflation pressures sometimes increase, stabilizing core inflation is important to anchor inflation expectations more firmly and to provide a sound basis for the sustained expansion. We should keep in mind, however, that inflation can be too low as well as too high and be aware of overkill. As an illustration of possibilities, a FRB/US simulation provided

to me by David Reifschneider projects that, if the FOMC were to tighten by 25 basis points at every meeting in 2005, we could be back in the disinflation soup by 2006.

What path of monetary policy is most likely to be consistent with both nominal and real stability? I'll just note here that the range goes from two increases in the next year in the Greenbook to about five increases next year in the market forecast. Although policy, of course, will depend on incoming data, it seems not at all improbable that we will choose to stand pat at a number of meetings next year while continuing to remove policy accommodation at a measured pace. If this scenario seems plausible, then we should probably begin soon to signal to the public that pauses may occur. In particular, as we reach a funds rate of 2 percent, it's important not to give the impression that our future funds rate increases will be automatic or that the Committee has some goal for the funds rate that is independent of the state of the economy. Instead, we should focus on whether the overall thrust of monetary policy as reflected in the entire term structure and not just the funds rate is consistent with our objectives. Thank you.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. Thank you, Mr. Chairman. Today, I wanted to focus my comments on inventory levels and productivity, based on some conversations I've had recently with business folks. For the last several years, I've watched the significant structural changes that have been made in inventory management to lower inventories relative to sales. I've also seen the regular small adjustments that firms make to keep inventory levels in line with changing sales rather than incur a large unintended buildup in inventories. As a result of both of these factors, inventories today are a much smaller source of volatility in the economy. In conversations with nonfinancial business executives, I continue to be struck by comments that they expect to be able to reduce inventory–sales ratios further. They are continuing to improve internal information flows. And if they are a manufacturer, they have linked sales, procurement, work scheduling, and shipping so that

they can promptly make real-time adjustments anywhere along the business process. Thus, they expect a much lower likelihood of an unanticipated buildup in inventories for all their various product lines. They also feel that suppliers have improved their processes in order to respond more quickly to changing sourcing orders and thereby enable firms to further reduce inventory needs. Comments by these contacts support the forecast in the Greenbook, which anticipates a further downward trend in inventory–sales ratios. As a result, inventory buildups will continue to provide a smaller share of real GDP growth in the future.

The other area I wanted to comment on is the changing picture of productivity. The Greenbook discusses productivity, including two alternative scenarios—one with higher productivity and one with lower productivity. The baseline forecast for the second half of this year shows productivity growth that is slower than the unusually high levels we've seen over the last year. Recent anecdotal information from my business contacts shows a dichotomy going on with regard to productivity. On the one hand, these business contacts indicated that they are continuing to focus on improving productivity for competitive reasons and for quality reasons, too. I might add that some of the requirements of Sarbanes–Oxley are causing businesses to focus on greater internal controls. Most of the contacts I've talked with were able very quickly to tick off many process improvements that they have under way, including initiatives that they plan to undertake next year. They clearly indicated that this is a component of ongoing business planning; it is no longer a one-off kind of thing to get costs down to meet current competition. It's a fundamental change in the way they do business and the way they approach business planning. The high fixed costs of adding employees for moderate and low salary grades—due primarily to benefit costs—and morale issues that firms have been working through with regard to employees retained after a downsizing are continuing to put pressure on businesses to manage staff additions very carefully. So they are continuing to try to work with as lean a staff as possible. However, as the economy has

continued to expand at a healthy pace, I'm hearing more managers say that they recognize they are reaching the limits of how much they can stretch their existing workforce in some business units. So some companies are beginning to add employees. This again is consistent with the Greenbook notion that we may be at the stage of this economic expansion where new hiring will actually begin to show up in slower short-run productivity numbers.

Finally, let me just make some comments on Sarbanes–Oxley, which has been mentioned by others. I am hearing a lot more focus on it from business contacts. A key trigger on this occurs next week when all the third-quarter 10-Q reports have to be filed. Business executives realize that the first assessments under auditing standard no. 2 related to Sarbanes–Oxley are as of year-end, and when they file their 10-Qs next week, they are within a month and a half of having to say whether their internal control structures are in compliance with that legislation. So I think we will begin to see more companies in their 10-Qs next week start to hint to the markets that some aspects of their internal controls may still need attention, rather than store up the news until the new year. At this point they are far enough along that they already can anticipate whether they are likely to have problems. They want to be clear and open about their internal controls. CEOs are very worried about having to admit a major weakness only six weeks later and having to say, "I didn't know that we weren't going to be ready." That is a risk to them. So I think the 10-Qs next week could be very interesting. Management at all levels is extremely focused on Sarbanes–Oxley as we approach the year-end—I'm hearing a lot of comments about it—and I think we're going to begin to see some references to it in the 10-Qs this time.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. A standard forecast today, well represented by the Greenbook baseline, assumes a minimal decline in the dollar and something close to projected current policy for the federal budget. It has the funds rate rising by roughly half as much

as is suggested by the fed funds futures market and finds an output expansion barely above potential, with a very slow closing of the output gap. Inflation is pretty stable in such a forecast, and it doesn't take much of a negative shock to get the output gap not to close at all. In view of a forecast much like this, many of you have implied in previous comments and also today that there might be pauses in our rate-raising process, that the equilibrium funds rate might not be so high after all, and that of course we will always be looking at the data in our conduct of policy.

I can't disagree with any of that. You've all been very convincing, but it is a little boring if we all say the same thing, so let me talk a bit about the other side of the question and focus on a couple of longer-run reasons that in the end we might be forced to raise the funds rate more than in the Greenbook path. I'm using the whole path here; I don't want to even pretend to be precise about timing. I'm also not commenting on the fed funds futures market; I can't really make comparisons to that because I don't know what market participants are assuming.

My first point involves the dollar. Now, Don, I promise never to say this publicly, but at least let me say it today. It does seem to me that the international co-dependency truce, where the United States is allowed to over-consume while foreign central banks are allowed to print money to buy U.S. Treasuries, thereby supporting the dollar, may be close to becoming unstuck. Dino pointed out a few countries whose currencies have already appreciated relative to the dollar. Japan doesn't seem to be quite as willing to support the dollar as before, and China may have to fight its own inflation by clamping down on its own money growth. The dollar has dropped since our last meeting, and the current account deficit, even with the latest good news, continues at well above the pace that stabilizes the international debt–GDP ratio. The staff has provided a useful memo that finds that it would take a 50 percent drop in the dollar to stabilize the debt-to-GDP ratio. Given previous work of the staff that we've heard about, I did not find that particular result surprising. What I did find surprising in the memo was the fact that this fall in the dollar, by itself, could start

core PCE inflation rates on a steady upward trend. Perhaps I had been deadened by the staff's finding of very low pass-through rates, but I think their deeper message is that international accounts are so far out of equilibrium now that there is a potential for continuing U.S. inflation even with the low pass-through rates. How likely all of this is, I can't say, but I think it could be an important problem we should keep our eye on.

My second issue involves fiscal policy. I've long been a fiscal hawk—or really a national saving hawk. For fiscal hawks, the only redeeming grace in American politics these days is political gridlock. Political gridlock has just taken a big hit in the recent elections. Specifically, there are four budget-conscious Republican Senators who have stood in the way of some of the more irresponsible, in my view, budget-busting policies. These four have just lost their blocking power, and in the strong tax-cut atmosphere, I worry about what will happen next. The tax cuts are almost sure to be made permanent; and while politicians will talk a good game on spending cuts, we all know how likely those are.

The Administration has announced two broader priorities for the next term: Social Security reform and tax reform. There are lots of ways to do Social Security reform, but I think the most likely is that some payroll tax revenue will be diverted to individual accounts, with benefit payments to be cut only in the far future. In principle, recipients of these individual accounts should save exactly the same as before. But if individuals are already saving in eligible assets, will some of their payroll tax reductions show up as consumption increases and national saving decreases? I bet they will.

On the tax side, there will be statements that reform should be revenue neutral. But when loopholes are closed and some people actually have to pay more taxes, how long will that last politically? I bet not long. I would be all for thoroughgoing tax reform, but I greatly fear that tax reform will, in the end, be simply another tax cut—with some taxes going down and none going up.

Maybe I'm being excessively paranoiac, but I worry greatly about the new fiscal atmosphere. We may have a much more expansionary budget than the Greenbook is presently forecasting, and it may happen fairly quickly without the friction of political gridlock. This is another reason that I think we have to be at least thinking about higher rates than in the Greenbook path.

There is also an interaction between these two points. If the budget falls even more out of balance, national saving is likely to drop from its already historically low levels, magnifying the current account deficit and the dollar problems. Monetary policy can't really solve any of these problems, but it can make them worse by letting inflation come loose from its moorings. Obviously, none of this is certain. I am merely trying to point out that, while there are valid downside risks in the forecast, some worrisome upside risks have also recently come into view. Let's remember that the uncertainty distribution still has two tails.

As for policy, I'm perfectly happy to go with the flow this time. In the future, we obviously can't move the funds rate up at every single meeting, and as many of you pointed out, it would be nice to find a way to say or signal that. I'm not quite sure how to do that. I'm also not sure how ready for a more immediate pause I am. The whole pause issue does give me pause. [Laughter]

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. Thank you, Mr. Chairman. I will briefly continue on the same subject that Governor Gramlich just discussed because I'd like to talk about fiscal policy issues for a moment. I've been encouraged even with the absence of gridlock—or at least to a certain extent the loosening of gridlock—that the President and some of his team have focused on fiscal policy issues such as Social Security and Medicare. I take that as a positive sign. But in terms of returning to a budget surplus or even to budget neutral, I think it's important to remember that the last time we were in that area, it was primarily a revenue issue and secondarily a spending or budget discipline issue. Now, there is nothing in our forecast for the immediate future that would suggest an

economy that is poised to generate tax revenue in the 20 percent plus range relative to GDP that allowed for the surplus. But it is possible at least to reinstate some of the spending discipline by a re-imposition of the PAYGO provisions. And as Governor Gramlich is well aware, the PAYGO provisions also apply to tax cuts. I think the reinstatement of that policy would do two things. First, it would impose some discipline on the appropriation process. One cannot be involved in the appropriations process when PAYGO is in effect without being alert to it. Second, it would be a signal of a return to fiscal discipline and to fiscal management policies, which I think could be important. So as the Chairman and others indicated at the beginning of the meeting, we should be out there talking about the need for fiscal discipline. The Chairman a few months ago spoke on the importance of reinstating the PAYGO provisions, and I would encourage others to consider that as you speak to the issue of fiscal policy.

With respect to monetary policy, when we began to move from accommodative toward neutral, we recognized that there were a number of risks associated with it, one of which as you may recall was a concern that rising rates might shut off any improvement in the underlying economy. Also, I think we were a bit gun-shy, given the succession of exogenous factors—terrorism, governance issues, and the like—that had derailed the economy previously. As Dino reminded us earlier and as the charts show, longer-term interest rates have actually declined, particularly the ten-year Treasury yields. So a derailment has not happened. And even the parade of hurricanes and the rising oil prices have not significantly deterred this slow but steady recovery in the economy. I think the jobs numbers will be adjusted marginally, with the unconditional firing of everybody involved in exit-polling a few weeks ago! [Laughter] But even with that, it seems to me that the markets clearly anticipate a continued reduction in the degree of monetary policy accommodation and a return to neutral, and I think we ought to be sticking with that course.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON.[2] Thank you, Mr. Chairman. I'm having some materials handed out here; and while that's happening, let me say that I am in broad agreement with the baseline forecast in the Greenbook. I find it a reasonable basis for making policy judgments at this meeting and going forward. Having said that, however, I think the risks and uncertainties around the forecast are quite large, and I find them very difficult to reconcile. High on the list of upside risks is one that Dave Stockton has already highlighted in his presentation, which is that the dollar may continue to depreciate at a pace faster than in the baseline. Since Dave spent some time in his presentation discussing that, I won't pursue it in my prepared remarks.

While the upside risk from dollar depreciation is clear, the possibility of a more persistent pool of underutilized resources creates a more complex set of risks, and that's what these charts that are being handed out now address. Even considering the October employment surprise, the changes in payroll employment have been remarkably subdued during the course of this turnaround. This observation led me to ask Andy Figura and Bill Wascher to prepare an analysis to explore labor market developments—I don't know if it explains them—in the recession and postrecession period. In particular, I was interested in the question of whether this labor market performance is more easily explained by increased productivity or a shortfall of demand. The first step of the analysis I called for was to identify the industries that have had unusually poor labor market performance since the 2001 business-cycle peak, measuring both absolute net industry employment changes and net industry employment changes relative to changes for a period of comparable length preceding the business-cycle peak.

Four industries at the two-digit NAIC level ranked as noticeable underperformers in both absolute and relative terms, and these are highlighted in table 1. They were durable manufacturing, information, transportation and warehousing, and professional and technical services. Now, it is

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

well understood that one of the unusual features of the recent downturn is the sizable and persistent increase in the share of layoffs that have been permanent. Job destruction increased during the recession and then fell back, while job creation fell during the recession and has remained low. The four underperforming industries that I just highlighted more than accounted for the overall increase in the average pace of job destruction between 1998 and 2000 and in the years 2001 and 2002, whereas job creation was more equally spread across industries. Tables 4.A and 4.B highlight the relative rankings of various industries with regard to job creation and job destruction. The most interesting question is the following: Is the slow net job creation, particularly in these four underperforming industries, due to demand shocks, which would be a negative? Or is it due to supply shocks, which would be a more positive development in these industries? If you turn now to the next page, chart 5 clearly indicates that there's a strong positive correlation between changes in value-added share and changes in employment share. The actual correlation coefficient is 0.77, and it is significant at a 5 percent level. The four underperforming industries—and here we have divided them up into the three-digit level, and they are designated by the "Rs" on your chart—all tend to be clustered in the lower, left-hand quadrant. That indicates that these industries experienced losses in both employment and output shares.

On the other hand, if you turn to the next chart, labeled chart 4, you'll see that there is not a strong relationship between the change in employment share and the change in productivity growth. There's a mild, very small negative relationship; it's significant only at the 10 percent level. And importantly, the underperforming industries are not strongly clustered. There are a few outliers, which are mostly high-tech service industries. I must admit, though, that this analysis is somewhat incomplete since we have productivity data only through 2002.

So, based on this analysis of these four underperforming industries, what do I conclude? First, obviously, the weak labor market performance in this turnaround is more than explained by

just a handful of industries. Second, I tended to conclude that the slow growth of employment in these industries is due mainly to a negative demand shock—and not a positive supply shock—at the industry level. Negative demand shocks at the level of the industry identified, combined with the slow pace of overall job creation, have led to a large pool of underutilized resources. So far, so good. But then the question is, What is the implication for policy? Here, unfortunately, things get a lot more confusing.

Some analysts would interpret this configuration of relative demand shocks as being equivalent to an aggregate negative supply shock—a change in the optimal allocation of labor resources across industries. Unfortunately, this type of aggregate negative supply shock can be problematic and ambiguous for the outlook for inflation and for monetary policy. On the one hand, it is possible that the process of reallocating labor resources is particularly sticky and reflects structural changes, which could confront us with some upside risk. To put it another way, it's possible that the short-term NAIRU could be somewhat higher than the long-term NAIRU and, therefore, we could be confronting some upside risk of inflation. On the other side, it could well be that we have a very large pool of underutilized resources that will decrease only very slowly, and that phenomenon is perhaps undermeasured by the unemployment rate. This is a point that I think Governor Bernanke has made a few times. And that would cause us to face the possibility of continued downside pressure on inflation as household incomes do not keep up.

Now, it's a little hard at this stage to know which of these risks will prevail. But I would say, if one looks at the relatively benign performance of unit labor costs and at other signals from the labor markets more generally, that it seems as though we aren't really confronting the upside risks. I think we're more likely confronting the downside risks. In either case, it seems to me that as we go forward, labor market indicators broadly defined—not just the unemployment rate but also job creation, unit labor costs, and other measures of both resource utilization and cost pressures—

are likely to be a reasonable sign of economic health and also an important indication of emerging risks. Therefore, I will continue to repeat the usual statement that Ned Gramlich referred to, which is that I think our policy approach should be heavily influenced by incoming data, with a particular eye on the broad range of labor market developments.

Having said all that, I would also note that, like a few others in the room, I recognize that as we go forward we are going to be confronted with the need to take a pause. I agree with Ned to some degree in that the question of pausing also gives me some pause. But I'm also certain that as we get new data—and if we're careful about what we say—the markets will soon come to recognize that their expectations and ours may not be fully aligned. How this will get resolved, obviously I cannot foresee. But I am really quite comfortable with the relatively modest upward trend in the federal funds rate that is built into both the markets and the Greenbook forecast. Thank you.

CHAIRMAN GREENSPAN. Mr. Reinhart.

MR. REINHART.[3] Thank you, Mr. Chairman. Carol Low is handing out some materials I'll be referring to. This was one of those intermeeting periods that served to remind me of the ephemeral nature of my work here. Not long after the Bluebook was distributed, the Bureau of Labor Statistics reported that it found 450,000 new payroll jobs—337,000 in October and back revisions worth 113,000—and the document we struggled over would be read, or at least skimmed, in a different light. In particular, the shifting up of policy expectations following the employment report brought the net intermeeting rise in federal funds futures rates, shown in the chart at the top left of exhibit 1, to 10 to 40 basis points. The 3 percent funds rate expected for the end of 2005 is consistent with the belief that you plan to tighten policy in ¼ point increments at about half of the FOMC meetings between now and then as Governor Kohn noted. I take that to mean that market participants have apparently come to define "measured" as "carefully calibrated" rather than "regular and rhythmic."

As for today, as shown in the middle left panel, respondents to the Desk's survey of primary dealers universally predict that the Committee will firm policy ¼ point, will assess the risks to its goals as balanced, and will retain the "measured" language in the statement. A minority of dealers still expect a marker in the statement indicating that you're likely to pause in December in the process of removing policy accommodation, although the number that actually expect such a pause dwindled after Friday morning.

[3]The materials used by Mr. Reinhart are appended to this transcript (appendix 3).

With this revision to policy expectations, the nominal Treasury yields shown at the top right gained 14 to 38 basis points over the intermeeting period, with the largest increases posted at shorter maturities. But this should not be read as a tightening in financial market conditions, as indexed debt yields fell; more broadly, equity prices gained 4¼ percent, and the dollar depreciated 6 percent against a basket of major currencies.

Fluctuations in oil prices dominated the chatter among participants in global financial markets during much of the period. Although the price of West Texas intermediate crude ended yesterday about $1 above its level at the time of the September meeting, it varied in a $10 range. There are three main channels of influence of energy prices on the economy. First, a rise in oil prices makes a direct arithmetic contribution to consumer prices, which should be of concern primarily to the extent that it prompts an increase in underlying inflation expectations. Second, as the United States is an oil importer, a rise in prices amounts to an increase in an excise tax, which tends to restrain aggregate demand. Third, since energy is a factor of production, an increase in its price tilts the production mix toward other inputs, lowering their marginal products; down the road, this leads to a lower level of labor compensation. But given adjustment costs, this latter effect emerges only slowly over time. In consequence, as long as inflation expectations are well contained, market participants might expect policymakers to focus mainly on the effects of energy prices on aggregate demand—that an increase in oil prices is associated with lower aggregate demand and hence with lower interest rates. As shown by the three bar charts in the bottom right of the exhibit, that seems to be what happened over the intermeeting period, as Governor Bernanke noted. Day-to-day changes in oil prices were inversely correlated with share prices and ten-year Treasury yields—and statistically significantly so. Moreover, inflation compensation over the next five years (as derived from the Treasury market) was not correlated with oil price movements, at least at a daily frequency.

As discussed in the top left panel of your next exhibit, the case for firming policy today may rest on the view that economic data, including solid gains in employment (the red bars), on balance indicate that financial conditions are supporting a durable economic expansion. As those financial conditions are predicated on firming policy today, you may feel it appropriate to validate those expectations. You may also be concerned that pressures on inflation may soon emerge. While longer-term inflation compensation (plotted as the black line at the right) has been well contained, there has been a notable updrift in the shorter-term measure (the red line). As shown in the middle panel, raising the nominal funds rate to 2 percent today would put it at about the midpoint of the range of standard policy prescriptions. As shown in the bottom panel, a ¼ point hike would also turn the real federal funds rate more decidedly positive and raise it further above the lower limit of estimates of its equilibrium value.

The more difficult part of your decision would seem to be how to describe your future action, which is the subject of the third exhibit. In the staff forecast, a variety of factors combine to make it possible to hold the funds rate at 2 percent for about one year without exhausting resource slack and putting upward pressure on inflation. Even if you don't anticipate waiting that long before firming policy, you might see merit in

contemplating the possibility of sitting on the sidelines in December and letting the world know of that likelihood now. A pause would give you the opportunity to assess the durability of the expansion—an opportunity that might seem to be particularly attractive if some of the recent strength in spending has been borrowed from next year in anticipation of the end of partial expensing. Signaling that intent would limit the risk that market participants, extrapolating from four consecutive tightenings, mark up their rate expectations inappropriately.

Let me say a bit more about this point. The chart at the top right plots FOMC rate decisions over the past five years as hollow bars and shades the relative surprise (as judged from futures quotes) from that action. Being more explicit in your statements over the past year or so has allowed market participants to peg precisely the past three tightenings. But it may also have led them to expect such guidance going forward. In that case, silence about a pause might very well be taken as a signal that no such pause was being contemplated. That said, you might, as discussed in the middle panel, view the "measured pace" language as already encompassing enough scope to allow you to keep the funds rate at 2 percent in December if you see fit. The extent to which the outlook for policy has changed in the past few days may underscore the need to remain flexible. Indeed, as shown by the probability density function implied by options prices at the right, market participants already place a wide band of uncertainty around where the funds rate will be just six months from now, suggesting that you already have latitude in the pace with which you remove policy accommodation without surprising markets.

Alternatively, you might view yourselves as unlikely to pause in December. As noted at the bottom left, with oil prices higher and the dollar weaker, inflation pressures may emerge relatively quickly. They could do so especially if we are in the midst of a slowing in the rate of growth of structural productivity that will put upward pressure on unit labor costs. As plotted at the bottom right, the four-quarter growth rate of output per hour in the nonfarm business sector (the black line) has turned down, whereas at the same time, unit labor costs have picked up (the red line). As an alternative scenario presented in the Greenbook attests, monetary policy choices will be much less attractive should structural productivity growth ratchet down permanently.

For your reference, the last exhibit repeats the table of alternative statements that staff circulated on Friday with one change noted in bold. Consistent with the view that the aggregate demand effects of the oil shock seemed to have been relatively more important, the phrase "despite the rise in energy prices" has been moved to refer to output growth. That concludes my prepared remarks.

CHAIRMAN GREENSPAN. Thank you. Questions for Vincent? President Minehan.

MS. MINEHAN. I just had a quick question. Have we given some thought to whether by being clearer about what we expect to do in the future we are, in effect, getting information back from the market that is what we told them, as opposed to what the market's own expectations are?

Do we know what the market thinks with regard to the need, in this case, for an increase in interest rates? Or are we involved in a self-fulfilling situation here where we are clear and, therefore, the market says, "The Fed is saying this, so we're going to give them back the same information they're giving us," without a lot of added market intelligence?

MR. REINHART. That's the reverse of what we used to talk about as "looking in the mirror." That was the issue of whether we were being guided by market signals because, if the market was guided by our signals, then again there was this positive feedback question. Also one worries that market participants are not investing independently in the effort to forecast the economy and to decide what is the appropriate monetary policy. In that regard, I think a good example is not this intermeeting period but the prior two where data came out that seemed to suggest that aggregate demand would be weaker than previously thought. Market participants didn't change their view of the monetary policy actions over the next five months because the Committee's statements seemed to suggest that you would be removing policy accommodation. Everything that moved was at a further-ahead time horizon. So the whole structure of the term structure of fed funds futures rates shifted down past four or five months out, whereas the near-term track of tightening seemed to be baked in the cake.

That said, volatilities are low, but market participants seem to understand the conditioning nature of the Committee's decisions. In support of that notion, as we've noted in past briefings, implied volatilities are low but the reaction to surprises in the data have been much larger than in the prior decade. So if you look at the reaction to surprises in the employment report or consumer prices, you see that markets are repricing their expectations for policy action. There just seems to be less idiosyncratic noise about where policy will be.

CHAIRMAN GREENSPAN. Further questions? If not, let me get started. We are seeing what appears to be the first indication in this Committee of an increased variance of opinion which,

if you go back over the previous meetings, you will find was virtually nonexistent. The reason that our opinions are only now beginning to spread is that the policy stance we've taken over the last year or two has been very unusual. During this period, we have had a very substantial and surprising growth in productivity, which drove unit labor costs down and created a view that inflation had very little probability of emerging. Therefore we could be fairly well convinced that a low funds rate, a highly accommodative funds rate, could be maintained for quite a significant period of time. As a result, our general policy and the variety of terminology that we began to use, including "patient" and "considerable period," became the central mantra of this Committee.

I think that period is coming to an end. It's not that we suddenly found some extraordinary capability to communicate to the markets our views, which would then craft their general expectations. It's that the last couple of years were a very special and unusual period and not likely to be continued into the future. We're going to move back, I suspect, far closer to our more general position, which at one point was that we never projected the future, we merely tried to give a sense of the balance of risks. That assessment often didn't convey very much because we didn't behave as though we really viewed it as a projection; we responded largely to the data as they evolved. My suspicion is that we're moving back in that direction, and we're beginning to see the reasons for that in the context of structural productivity gains.

If, indeed, structural productivity growth is 2¾ percent and if the general response of the wage market to the unemployment rate continues where it is, we will end up with, as the projection in fact implies, a 4 percent increase in compensation per hour and around 1¼ percent for the core inflation rate. Were we able confidently to project that indefinitely into the future, we could be fairly well convinced that inflation will be contained.

The only problem is that our ability to make judgments about separating cyclical from structural output-per-hour changes is questionable or, I would say, modest at best. This issue is

coming forward, for example, in the context of the slowdown in high-tech investment, which a number of people have mentioned. Now, if there is, indeed, a slowdown in high-tech investment or, as the Vice Chair of the Board of Governors indicated publicly, if the slower rate of decline in high-tech prices is suggesting a reduction in the extent to which the high-tech area is contributing to productivity, then we have to ask where we should place the long-term productivity number. And what is our confidence level for that number? It's quite likely at this stage that 2¾ percent may well be the right number. I say that in part because, despite the 337,000 increase in employment in October, if you examine the hires less separations, which theoretically should be coming from the same data source, that series is showing a smoother trend of gradual decline in the rate of job gains. The latest data we have on that obviously are for September. That series shows less volatility than the payroll numbers but, on average, is not terribly different from the payroll series since the beginning of the year; both indicate a gradual slowing. If that were, indeed, the trend, then the productivity outlook is better. If it is not and we are looking at an acceleration of employment, then chances are we are getting closer to a level of structural productivity growth that is lower than 2¾ percent.

Now, the reason I raise this issue is that, although we may choose 2¾ as our number, the argument that 1¾ may actually be what we're looking at is not readily dismissible. Making the distinction between what is happening short-term in output per hour and what is happening to underlying productivity is very difficult. Indeed, the data for the numerator of output per hour come from a source wholly different from that of the denominator. I think we felt a sense of comfort that a goodly part of the productivity growth had to be structural when we had this very high rate of growth. That was almost certainly the case because the numbers were so high. As a result, what we were observing was definite downward pressure on inflation, to the point in fact where we were at the edge of being really quite concerned about the onset of deflation. That is no longer the case.

And I think we’re beginning to confront problems that really bring us back to the way we used to do forecasting, which had much wider areas of variance. Clearly, the variance of the views of this group is beginning to reflect that.

Earlier we discussed the issue of the dollar. We’re not sure exactly how to translate the exchange rate into unit import costs. Indeed, for those of us who were in Basel the last couple of days, the startling new piece of information was that the fascinating decline in the rate of pass-through of exchange rates into unit import prices, a decline that is progressing in the United States at a fairly remarkable pace, is exactly what they are finding in the United Kingdom, according to Mervyn King at the Bank of England. When he raised that point and I mentioned our findings on that, everybody looked around, and there was general agreement that we were all seeing the same phenomenon. It all started, as you may recall, in the failure of the devaluations in Brazil and Argentina to create increased inflation, which they did not. Something very unusual is going on with respect to the exchange rate translation issue. And this is obviously a very important question for how we view currency depreciation and inflation and, therefore, what the implications are for monetary policy.

We have very significant problems with private saving. The household saving rate has come down very dramatically and now is close to zero. We have to resist the notion that there’s some floor at zero, which the saving rate can’t go below, and that therefore it must flatten and turn up. The idea of having a negative personal saving rate is not out of line with the way the world works. Remember, the average household does not look at the book value of its equity holdings, which is what the saving rate is. The average household looks at the market value. And we can readily have, as our data have shown in the past, a negative saving rate with a significant part of the population believing that they are saving at a fairly pronounced rate, which has been the experience of recent years. We don’t know how that is going to come out.

We do know that Australia, as I understand it, has had a negative saving rate for a while. Our flow-of-funds accounts here do not show a negative saving rate, but they indicate that almost all of the change in the saving rate in the last decade has been in the upper quintile of the income distribution, and there it is driven very substantially by asset values. People in the upper quintile look at the market value of what they own. Adjusting their saving behavior in response to the book value of their net worth would never enter anybody's mind. Hence, this is a synthetic number, and let's be careful not to presume very much about what it is telling us.

The fiscal issue is very critical because it is the only issue in which policy per se has a clear positive contribution to make. It is going to be very interesting to see how this plays out. I must say that I've turned a little optimistic in the last week or so listening to some of the Administration people in this respect. I'm not sure whether it will translate into something of significance or whether in fact, Ned, as you put it, "we all know how likely" that is.

When it comes to policy, with the increased uncertainties that we have about how the economic situation is evolving, we have to acknowledge to ourselves that our forecast is going to be wrong. It always is. We expect it to be wrong. The question is, Where do we want to take the risks? If we project continued low core inflation because of a 2¾ percent projection for structural productivity growth and that growth is in fact at 2 percent or less, inflation expectations will rise, bond yields will rise, and asset prices will fall, as, of course, will the dollar in that context. We could face problems of balance sheet losses if the change is rapid. Our ability to separate cyclical from structural changes in output per hour, as I said before, is modest at best. Should inflation expectations rise, the higher the funds rate, the better position monetary policy will be in to address unexpected inflation increases.

If we signal today a pause for December, the ten-year note yield will decline, engendering an even larger correction should underlying inflation unexpectedly rise in the months ahead.

Capital gains do not impair balance sheets. Capital losses do, however, especially if they are rapid. If rates move up and the economy slows, the ten-year yield will decline and possibly equity prices as well, but balance sheets will not be impaired. The structural damage obviously would be quite limited in that regard. Should the economy weaken, of course, we always have the option of moving rates lower.

It strikes me, therefore, that even if we believe the risks are symmetric with respect to how the economy is going to emerge, a cost–benefit analysis of the consequences of our taking various actions leads me to conclude that we would be far better positioned today not only to move 25 basis points but also to signal nothing about December. The best thing that can happen is for the market to perceive that we are implying another rate increase in December because the further beyond the 1 percent range and into a positive real rate that we can get, the better off I think we will be.

I want to repeat that we don't know very much about the interaction of very large productivity gains, wage rates, unit labor costs, and the NAIRU. We've been experiencing these gains only in recent years. I personally would feel a lot more comfortable if the federal funds rate were back in a range that is consistent with much of our historical data rather than on the edges of a number of our econometric functions of how the economy works. The edges are significant in the overall picture, but I wonder how much emphasis we can put on the outer edge. Their significance depends on whether or not the functions are bending in one way or another, whether they are still linear, or what their nature is at those points. Therefore, overall, I think we are far better positioned to get the funds rate up as fast as we can this year and then recognize that we have time to discuss pausing as we get into next year. Now, in the December meeting we may want to suggest a pause for February 2, which I guess would be the particular day of the meeting. That will very much depend on what is evolving. If, for example, the weakness in the high-tech area continues into next year, I'm not sure how to read that. If it says that we're getting much less in the way of

technological advance, it suggests that the productivity growth rate is lower. If it is suggesting that capital investment is going to slow, we get a potential decline in the outlook for real GDP.

How we should play this is going to depend very much on how these numbers evolve, and at this particular stage, I think that we have to start preparing for a communication transition as we get into the early weeks and months of next year. We do have our semiannual report on monetary policy in which to make a very broad statement. But we may have to decide something in December about how we want to position ourselves for February, especially if, as now seems likely, we move another 25 points in December.

What I'd like to propose is that we move 25 basis points today and have a statement that is as little changed as possible, so we seem neutral with respect to the move we might or might not make in December. Then we can proceed to observe how the data evolve over the next number of weeks. It is very unlikely to turn out that an upward move in December will be inappropriate and yet the markets will not have made that judgment already. If we deem a move in December inappropriate, it will be because of the types of evidence that will move the federal funds rate and indeed the whole financial structure. So the concerns that we would have about moving in a manner that would shock the market would not be relevant. I don't think that is going to be a problem, but I do think we have to start thinking of the word "measured" as having a fairly short life expectancy. We have to begin to reflect on how to approach our communications in a way that will be more consistent with an increased variance of opinion in this Committee in coming months, as I think is going to be the case. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. I agree with your recommendation. I wanted to say, notwithstanding your comments on productivity, with which I don't disagree, that the fact is that the real fed funds rate today is zero. I'd be more inclined to the view that we need to pause if the real fed funds rate were in fact positive—or to put it another way if the nominal rate were in the

2½ to 3 percent range, which is what I think you may be suggesting. So as long as the rate is below what I would consider a reasonable, neutral rate—and zero fits that criterion—then I don't think we should be pausing. That's not to say that we should move every time we meet next year—I realize that's not the case—but I think the rate needs to be at a positive level, as you're suggesting. In my view, the discussion at our meeting in February of next year will be important, and I think changing the language at that point will be important as well.

CHAIRMAN GREENSPAN. Maybe we ought to circulate the potential statement so that, if you find that any of the language is inconsistent with your views, you can comment on it. Why don't we do that? It's the one labeled B′. People may misinterpret what is actually being proposed, so let's not leave that to chance. President Minehan.

MS. MINEHAN. Thank you very much. I'm in strong agreement with what you have proposed, Mr. Chairman, both the move of 25 basis points and the selection of the language that does not attempt to signal anything for December. I understand the logic in the Greenbook. We in Boston have the same kind of perspective about the future. So I realize that there is an identifiable—maybe even baseline—probability that even with a relatively flat fed funds rate over the next year or so, we'll still have an output gap. I recognize all that economic logic. But my basic instinct says that we need to get out of the zero zone on the real fed funds rate and to a positive rate for any number of reasons, which you've done a better job of touching on than I ever could.

I also would like to say that I think our use of language over the last year or so was prompted by a set of extraordinary circumstances. Whether one views those circumstances as related to the extraordinary productivity performance or to the unusual market volatility when deflation concerns were very prominent, we needed to do something to calm things down. We did calm things down for a good period of time. I really feel that in our communication we now need to move back to something that says what we did, why we did it, maybe gives some perspective on

the balance of risks, and leaves it at that. Whether we move there in December or in February—or in March, April, or May of next year—I don't care, but I'd like us to move there. To be explicit, I'd get rid of paragraph 6. Thank you.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Thank you, Mr. Chairman. I support your recommendation both for the increase in the funds rate and the statement. I'd like to offer just a couple of other observations. The reason the communications process is so important is that it's highly desirable that the market and the Federal Reserve read incoming data the same way and that the interpretation is a correct assessment of the significance of the incoming data. That's not so easy to do but, as Cathy Minehan pointed out earlier, we certainly don't want to run the risk that the market's assessment is simply flowing from what we have said about future policy actions, which when we get to the point of taking action may not reflect our own assessment of the data that have come in. I think that the statement will have to evolve, as you suggest.

I'd also like to mention that I think the greater diversity of views around the table reflects the fact that the probability distribution of where we're going to go has become considerably more spread out. Or I'll state it this way: My own probability distribution is considerably more spread out. If I think about where we were six months ago, I thought it was extraordinarily unlikely that we were going to remain at 1 percent on the funds rate. But my own view of where we're going to go has become more spread out, and where we're going to end up six months from now, I think, is going to depend much more on the data that we get in the next six months than anything that I can now put into my forecast. So I think that that divergence of views probably reflects each one of us becoming more uncertain as to where we're going to go.

CHAIRMAN GREENSPAN. A divergence of both the mean and the aggregate variance. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. I agree with your recommendations on both the 25 basis point move today and also language that doesn't hint very much one way or the other about future policy. There are a couple of other things I'd like to add, though. One is that I don't want to forget what exhibit 2 in Vincent's presentation showed or what President Yellen talked about, which is that, if we move to 2 percent today, we are well up into the range of estimated equilibrium real rates historically. So while, yes, the rate is low, let's not get ourselves too wrapped up in the thought that we are outside an acceptable range. We may be in the low part of it, but we seem to be in the range.

Second, obviously having thought about this issue of a slowdown in productivity and in high-tech investments—I've talked about it here and publicly—I'd make a couple of other points. One is that what we do with respect to the possibility of a slowing of productivity growth depends very much on how quickly the market picks it up and it is reflected in asset prices and other things. If, in fact, the market doesn't pick this up and if asset prices continue to rise inappropriately, we have to do something to slow aggregate demand down to the new expectation of slower increases in aggregate supply. On the other hand, if the markets pick it up relatively quickly, asset prices won't move up as quickly, aggregate demand won't be out of line, and we still may be in a mode where we want to raise rates for a variety of reasons, but we may not feel as pressed because of the productivity uncertainty you talked about. So I think in both cases we need to recognize the probable direction, but I at least am still very much open minded, as I think President Poole suggested we should be, about the pace at which we're going to move in this direction. In essence, I don't think that the market necessarily has it wrong, nor do I think that the Greenbook has it wrong either. So I am very much of a pragmatic view about what our policy stance next year might be.

CHAIRMAN GREENSPAN. President Yellen.

MS. YELLEN. Mr. Chairman, I support your recommendation to increase the funds rate 25 basis points, but I am concerned about adopting the proposed statement. When I opened the Bluebook this time, I was actually pleased to see in alternative B what I thought was a well-crafted statement that hinted at a possible pause in a way that was rather artful and subtle, without foreclosing any option in the future whatsoever. And I thought the reasoning in the Bluebook in support of "B" was strong and convincing. As Vincent stated, both before and after the employment report, market participants expected some hint in the statement of a possible pause.

After we received the employment report, there was an update to the Bluebook that contained alternative B′ as the proposed statement. So I took B′ as a response to the employment report, and to my mind that was an unwarranted shift. I would note that the Greenbook assessment of the appropriate path for the funds rate had not changed as a consequence of the employment report. But we observed a large and, if the Greenbook is right, excessive market response to the employment report. We saw that in the immediate move in the fed funds futures. I suppose if one interprets the employment report as a very strong signal—and perhaps this is the view that you were expressing—that structural productivity growth is lower than we had been assuming, then this B′ statement would be an appropriate response. But it seems to me that the Greenbook has already incorporated an expected decline in productivity growth. I suppose in the Greenbook the decline is cyclical not structural, but it is built into the Greenbook forecast. The employment report simply confirmed what the staff had earlier been expecting when they had been surprised by the low employment growth. So it seems to me that adopting B′ reinforces the market expectation about the future path of monetary policy in a way that I would not like to see it reinforced. My own preference would be to move today but to adopt alternative B rather than B′.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. I agree with your recommendation in all parts. I'm madly looking around for the sentence that Janet is referring to, and I can't find it.

CHAIRMAN GREENSPAN. It's the first sentence that relates to alternative B—the very top one.

MR. GRAMLICH. Oh, they're putting in a reference to the cumulative increase.

CHAIRMAN GREENSPAN. In other words, by stipulating how much we have done already, it suggests that that may be enough.

MR. GRAMLICH. Right. So I'm for B′— the statement that was passed out. But I agree with some combination of the views expressed by Janet, Cathy, and you that soon we should change this sentence that says, with inflation expected to be low, "the Committee believes that policy accommodation can be removed at a pace that is likely to be measured." At some level, that statement is inoffensive and all-inclusive, but the problem is that the more we move up 25 points per meeting, the more we define what measured is. We've now done that four times, so we are coding that sentence, and we probably have to change it pretty soon. I wouldn't want to change it this time; I have at least some hawkish elements in my head, as you heard before. I think next time may be the time to change the sentence in a way that undoes the coding we have given it.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. I support the two parts of your recommendation, Mr. Chairman. I think alternative B′ is preferable to B. I appreciate your observation on the diversity around the table, and I think President Poole is correct that it's because each of us has a wider distribution in our heads regarding what is likely to happen. We're just talking about where our mean is, I guess, or maybe where our insecurities are. In reality, my thought is that there is a good deal of uncertainty on both sides, as I pointed out in my formal comments. There is uncertainty on the weak side as well as the strong side, for the reasons you noted. Accordingly, I think it is time for us

to look at this language issue again. We enjoyed it so much the first time, and the second, and the third. [Laughter]

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I support the recommendation of B′. It seems to me that there is no need to change the language, at least at this point, because I think market participants understand the conditional nature of what's going on here. So in that sense, I think we're positioned rather well. I remain open as to when we may want to change the language and how we may want to change it, but for now I think we're still reasonably well positioned.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I support your recommendation to increase the fed funds rate by 25 basis points. On the language question, I think it is time to start moving away from the term "measured." It has worked well—quite frankly, better than I thought it would. I was concerned about it when we started using a series of forward-looking statements. So I would like to move away from the forward-looking statements—obviously not at this meeting, but possibly at the December meeting. At the same time, however, we should also seriously consider the balance of risk statement that we had previously. After two task forces working on this with Roger Ferguson, I'm not going to suggest a third task force. But the balance of risk language has evolved over the ten years that I've been here. It has been useful at times, but I think it is getting increasingly difficult to craft a balance of risk statement, given the complexity of the economy.

CHAIRMAN GREENSPAN. Governor Bernanke.

MR. BERNANKE. Thank you, Mr. Chairman. I support both parts of your recommendation. I have just two comments. One is that I think you overstate a bit the idea that the current funds rate is outside the range of historical experience. As President Poole noted, it's not so unusual in real terms—

CHAIRMAN GREENSPAN. I'm sorry—I was referring to the 1 percent.

MR. BERNANKE. Oh, the 1 percent, okay. I don't think there's a basis to move just on an allergy to a 2 percent funds rate; I think it should be based on the data and on the economy. I would just note additionally that the economy responds most directly to overall financial conditions, and there I don't think we're anywhere close to the border of what has been experienced in history.

My second comment is on communications. As everyone knows, I disagree with President Minehan; I think we should be trying to provide guidance. In my view it has worked very well the last couple of years. I don't think it was surprising that it worked well. Precisely because we are assessing such complex matters—for example, we're trying to assess the course of productivity—it's very difficult for the market to read our minds. We need to provide some kind of guidance; whether it's conditional or whatever it may be, I think we should. I'm personally comfortable with dropping the "measured" language or modifying the language, but I hope we do not go back to a completely uninformative statement, at least without some thorough discussion of what the options might be. Thank you.

CHAIRMAN GREENSPAN. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. I support both parts of your recommendation, raising the funds rate and keeping the statement essentially as it was last time. I also hope we reconsider the language in December. To some extent I may have a different focus than some others who want to do that. I hope we leave open the possibility that we could pause from needing to move—that we're not locked in to tightening at each meeting. My concern about "measured" and about the current language is that it does seem to lock us in one meeting ahead, but I don't think it has really constrained the market when it looks much beyond the next couple meetings. I think we see that we're getting good feedback from the market; our "measured" language hasn't impaired that feedback except for the very short term maturities because market participants see our

announcement as triggering the next action. So I believe we need to think about how to do this in December, if we're going to keep an open mind for February. If we remove "measured," I hope we don't do so in a way that suggests we're on an even steeper upward track and our pace of tightening is not going to be measured. I don't think that's consistent with the economic outlook. You seemed to imply that the inflation risks were quite skewed because of the productivity risks, and I admit that productivity growth may be slower than we had anticipated. The staff has a slowdown built into the Greenbook and it could—

CHAIRMAN GREENSPAN. I'm not saying that. I'm saying that the cost of a mistake in policy is skewed, which is a different statement. I'm acknowledging that the probability distribution is symmetrical on the outcome of the event, but the cost–benefit analysis on a mistake is not.

MR. KOHN. Perhaps. I think there is a cost to being too high as well as being too low.

CHAIRMAN GREENSPAN. Absolutely.

MR. KOHN. Maybe the cost of being too high is that we have a more sluggish economy with fewer people put back to work and too low an inflation rate if some of these upside risks to inflation don't occur. So I think there are costs on both sides here. If we take out "measured," I hope we give some sense, even if it's a balance of risk sentence, of our assessment looking forward, as Governor Bernanke said. I hope we don't induce people to raise intermediate- and long-term rates by a considerable amount because they think we're no longer going to be measured in removing policy accommodation. I think that would be a problem, given the outlook. Thank you.

CHAIRMAN GREENSPAN. President Pianalto.

MS. PIANALTO. Thank you, Mr. Chairman. I also am in strong agreement with your recommendations both to increase the fed funds rate and on the statement. My thinking on how we would remove our accommodation has evolved over the past few months, along the line that

President Poole has already articulated, and I'm just not certain when a pause may be necessary. So I am supportive of language that gives us that flexibility. And I was encouraged by Vincent's comments that some market participants do think that the current language gives us that flexibility. So I'm in support of your recommendations.

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. Thank you, Mr. Chairman. I also support both parts of the recommendation. With respect to the statement, I also think it is appropriate at this time to make as little change in the statement as is necessary, for a couple of reasons. First of all, the markets understand that the absence of change is not a result of inattention; they know it is the net result of a great deal of thought and consideration. So any change whatsoever is interpreted, and occasionally over-interpreted, and I don't think we are at the point yet where we need to open that possibility.

With respect to communication in the future, I'm with Governor Bernanke. I don't think we can go back to communicating in the fashion that we were doing even a year ago. I think we have set an expectation that we will make a real effort to communicate some of our underlying sense of what's happening with the economy, and I think we will be called on to continue that trend.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. I support your recommendation, Mr. Chairman, including the language.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. Thank you, Mr. Chairman. I support your recommendation, including the language, for this meeting, but I do share some of the concerns that several of my colleagues around the table have expressed. I think some of the language may not be seen as particularly consistent with our policy of improved communications. If the words are seen as boilerplate every time, in a way it may take away from our flexibility going forward. So at the December meeting, I'd like us

to look at some alternatives. If the word "measured" continues to be part of our statement, I think, as others have said, it will end up tying our hands.

Another part of the statement is the second sentence, in which we've talked about this "robust underlying growth in productivity." We saw in the '90s that we moved to a different level of long-term productivity growth, but as I said in my comments, we may be in a part of this business cycle or stage of the recovery when productivity growth is going to look weaker. We need to think about how that is worded. I think that language could raise some questions about what productivity we are focusing on—the long-term versus the cyclical—if productivity turns out to be weakening, as the forecast in the Greenbook lays out. So as the recovery continues to move forward, there are aspects of the statement that we have to be careful about in terms of leaving in some of the language for such a long period of time. We need to think through and begin to anticipate prior to a meeting how to make those kinds of changes in order to give us flexibility.

CHAIRMAN GREENSPAN. President Lacker.

MR. LACKER. I agree with your proposal, Mr. Chairman, about raising the rate and about the statement. My own sense is that the funds rate is more likely to lie on the path of the market's forecast than that in the Greenbook, and I don't think it's the right time to pull down the yield curve. With regard to our statement, I agree with Governor Bernanke that we shouldn't be looking to turn back the hands of time and increase the variance in the market's forecast for the future fed funds rate.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN GEITHNER. I support your recommendations. I wish I knew what I thought about the desired statement! [Laughter] I would just point out not only that the market now expects us to slow the pace of increase significantly from what we've been doing but also that the minutes from our last meeting have some nice artful language near the end—which is probably

relevant to some of the concerns many of you expressed—saying that the market has not misinterpreted us as signaling a steady reflexive march up at 25 basis points per meeting. I think the minutes are helpful against that risk of being misinterpreted, and I look forward to a discussion about the future structure of the statement in December and beyond.

SPEAKER(?). You may be the only one! [Laughter]

CHAIRMAN GREENSPAN. Are you volunteering to be the chairman of a committee to look at that issue? Do you want to make a statement, Ms. Holcomb?

MS. HOLCOMB. Well, I thought maybe my silence could serve as assent, but I do support your recommendation. And our expectation is that there will be a need for pause and that at the next meeting the language might need to be changed.

CHAIRMAN GREENSPAN. Would you read the appropriate language?

MS. DANKER. This is from page 13 of the Bluebook, on the directive: "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 2 percent."

And then the risk paragraph from the press release on the assessment of risks: "The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal. With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

CHAIRMAN GREENSPAN. Call the roll, please.

MS. DANKER.

Chairman Greenspan	Yes
Vice Chairman Geithner	Yes
Governor Bernanke	Yes
Governor Bies	Yes
Governor Ferguson	Yes
Governor Gramlich	Yes
President Hoenig	Yes
Governor Kohn	Yes
President Minehan	Yes
Governor Olson	Yes
President Pianalto	Yes
President Poole	Yes

CHAIRMAN GREENSPAN. I want to confirm that the next FOMC meeting is scheduled for Tuesday, December 14. Before adjourning, the FOMC will go into recess while the Board members join me in my office to discuss discount rate requests.

[Recess]

CHAIRMAN GREENSPAN. The Federal Reserve Board has just voted to raise the discount rate at the request of ten of the Reserve Banks. This FOMC meeting is now adjourned.

END OF MEETING