

**Meeting of the Federal Open Market Committee on  
May 3, 2005**

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 3, 2005 at 9:00 a.m. Those present were the following:

Mr. Greenspan, Chairman  
Mr. Geithner, Vice Chairman  
Ms. Bies  
Mr. Ferguson  
Mr. Fisher  
Mr. Gramlich  
Mr. Kohn  
Mr. Moskow  
Mr. Olson  
Mr. Santomero  
Mr. Stern

Messrs. Guynn and Lacker, Mses. Pianalto and Yellen, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, 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, Evans, and Madigan, Ms. Mester, Messrs. Oliner, Rosenblum, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

Messrs. Freeman, Slifman, and Struckmeyer, Associate Directors, Divisions of International Finance, Research and Statistics, and Research and Statistics, respectively, Board of Governors

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

Messrs. English and Leahy, Assistant Directors, Divisions of Monetary Affairs and International Finance, respectively, 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. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Brady, Section Chief, 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

Mr. Lyon, First Vice President, Federal Reserve Bank of Minneapolis

Mr. Eisenbeis, Executive Vice President, Federal Reserve Bank of Atlanta

Messrs. Goodfriend, Hakkio, Rasche, Rudebusch, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Richmond, Kansas City, St. Louis, San Francisco, and Cleveland, respectively

Mr. Elsasser, Ms. Little, and Messrs. Peach and Todd, Vice Presidents, Federal Reserve Banks of New York, Boston, New York, and Minneapolis, respectively

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CHAIRMAN GREENSPAN. Good morning, everyone. I'd like to welcome Richard Fisher.

MR. FISHER. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Your colleague, Helen Holcomb, did an exceptionally good job here, and I wish you'd convey that to her. Even though we've done that before, third parties sound so much more credible.

MR. FISHER. I will do that, Mr. Chairman.

CHAIRMAN GREENSPAN. As you know, Governor Bernanke is not attending our meeting today. He has recused himself for reasons that are obvious. We wish him well, and I think he is on his way to being a colleague of a different sort. We are going to miss him.

Let's get started with Dino Kos.

MR. KOS.<sup>1</sup> Thank you, Mr. Chairman. The intermeeting period began with worries about building inflationary pressures but ended with a growth scare, as incoming data were weaker than expected and Street economists fell over themselves to cut their GDP forecasts for the first half of 2005. Meanwhile, the inflation concerns remained, leaving traders and investors with a sense that the risks were higher.

The top panel on page 1 graphs the June and December 2005 Eurodollar deposit futures contracts since mid-February. The December contract peaked around the time of the March FOMC meeting, as the markets interpreted the Committee's statement as opening the way for a more aggressive pace of tightening. But that view was short-lived as weaker retail sales, manufacturing survey data, and a deteriorating trade situation all tempered what had been a more bullish growth outlook. In short, the markets tinkered with the possibility of a more aggressive tightening path but quickly fell back to the baseline scenario of 25 basis points per meeting.

That can also be seen in the middle panel on page 1, which shows the spread between the 2-year Treasury note and the target fed funds rate. That spread

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<sup>1</sup> The materials used by Mr. Kos are appended to this transcript (appendix 1).

contracted sharply at the start of the tightening cycle but then settled into a comfortable range of 80 to 85 basis points. In February and early March the spread widened to about 120 basis points as the probability of more aggressive tightening seemed to increase. But as the growth outlook began to be questioned in recent weeks, the spread reverted to about 80 basis points.

The bottom panel depicts the yield change in basis points of the 10-year Treasury note reset from the start of the tightening cycles of 1994, 1999, and the current one. Following the Chairman's February testimony, 10-year Treasury yields rose to levels where they—arguably—were less of a conundrum. Alas, that also proved temporary as the fall in yields leaves them stuck in a corridor between 4 and 4½ percent. At 4.19 percent this morning, the 10-year yield is only a few basis points higher than in mid-February at the time of the Chairman's testimony.

The next page takes a look at the yield curve and credit spreads. In the past year the search for yield, improved corporate and sovereign fundamentals, and the assurance the Fed was providing regarding the tightening path were common reasons cited for the flattening of the yield curve. As investors moved out the maturity curve, credit spreads narrowed and implied volatilities fell as market participants became more certain that monetary policy would not bring surprises. The past few weeks has seen a reversal, or at least a pause, in some of these trends.

One exception to this has been the behavior of the shape of the yield curve. The top panel graphs the 2- to 10-year spread, which flattened further in recent weeks. However, unlike the earlier flattening, this cannot be viewed as a period when investors were reaching for yield or when they were very complacent about the policy outlook. Nor is there evidence that central banks were unusually active. An alternative, though more unpleasant explanation, is that this sector of the bond market is signaling a further slowdown in activity.

Investment-grade corporate and emerging-market spreads both widened in recent weeks, as investors became somewhat more risk averse and reacted to some unexpected credit events. The recent widening of spreads in these two sectors can be seen on the right side of the page. However, this widening of spreads barely registers in the longer-term charts on the left side of the page. The optimist will look at this situation and be reassured that the markets are not overreacting to events and are still pricing in a fairly benign outlook. The pessimist will argue that the power of the cycle will continue to assert itself and that the period of spreads widening is just beginning, especially as the effects of previous tightening begin to be felt and corporate fundamentals shift from being in a period of improvement to a period of deterioration.

Speaking of deterioration, the top panel on the page 3 graphs the price of 5-year credit default swaps for GM, GMAC, and Ford since January 2004. The price of

credit protection has more than tripled, mostly after GM's earnings warning on March 16.

Meanwhile, spreads have widened, as shown in the middle panel. Although GM has more than \$20 billion in cash on its balance sheet and the company is still investment-grade according to the rating agencies, it is a high-yield bond according to the markets. The blue line graphs the spread of a representative longer-term GM note. GM spreads are now wider than the BB and B indexes and closing in on the CCC index. Ford spreads are also trading like high-yield credits, though not as high as those of GM.

The news from GM appears to have had some chilling effects on issuance in the high-yield sector more generally, though the evidence is inconclusive. The bottom left panel shows the drop-off in high-yield issuance since the GM news. Of course, other events were going on at the same time, such as the changed tenor of the macro data and the fall in equity prices. Still, a plausible contributory explanation is that high-yield managers were unreceptive to taking on new paper with the prospect of a large migration of auto-related debt coming into their sector. One important question mark for portfolio managers is whether the troubles in the auto industry are sector-specific or whether the general period of improving corporate balance sheets is ending, to be followed by a period of higher financing costs, margin compression, and generalized credit deterioration.

The bottom right panel graphs the largest components of one high-yield bond index on a pro forma basis if GM were to be downgraded. Apparently GM would account for about 6 percent of this index. With GM spreads having already blown out, a downgrade may not have that much of an effect—on the theory that markets have already discounted the news. Of course, GM and GMAC are large issuers in the investment-grade sector, which is much larger than the high-yield sector. Therefore, we should not be surprised if there were some indigestion and a period of volatility, as a very large amount of paper is transferred from one set of holders with one set of time horizons and risk tolerances to another group with a different set of preferences.

As I mentioned earlier, implied volatilities were higher, although not in all asset classes. But they were higher for equities. The top panel of page 4 graphs the VIX index since January 2004. After reaching a low near 11 percent, the index shot up to about 19 percent during the recent period of equity price weakness. It has since settled back but in a choppy way. In fact, the volatility of the VIX—the second derivative—is as high as it has been during periods of more generalized market stress.

Fixed income and currency volatilities have been less exciting—in the middle and bottom part of the page—reflecting less anxiety relative to other indicators. I should note that dollar-yen volatilities rose on Friday when a brief flurry of

excitement about a possible revaluation of the renminbi spilled over into dollar-yen and there was a temporary spike in implied volatility.

Finally, I want to return to a subject that was mentioned briefly at the last meeting, namely, the appetite for longer-dated paper in Europe. As you will recall, early in 2005 there was a mini frenzy about the need for pension fund managers to “extend duration.” European issuers have been quite happy to step in and fill that demand at pretty attractive levels. This is despite the watering down of the Stability and Growth Pact and evidence that some countries showed creativity in managing their financials to get into EMU [European Monetary Union] in the first place.

The top panel simply graphs the German and U.S. 30-year yields; German yields have been consistently below those of the United States in 2005. Parenthetically I do need to note that the last U.S. long bond was issued in 2001 so the U.S. 30-year bond actually has a residual maturity of 26 years. While a 30-year Bund yield of just under 4 percent could prompt one to ask what the German word for “conundrum” is [laughter], there is no doubt that the environment has been favorable to issuers—and not just for the most highly rated. As shown in the middle panel, spreads among European sovereign issuers have converged over the last several years, just as promised by the proponents of the Monetary Union. Among the higher-rated issuers, France recently was able to issue a 50-year bond. At the other end, Greece issued an attractively priced 30-year security.

The bottom panel graphs long-dated issuance—that is, beyond 10 years—for euro area sovereigns since 2000. In 2000, all long dated issuance was by three countries: Germany, Italy, and France. Through only the first four months of 2005, such issuance has already exceeded that for the full year in every recent year except 2000. And most of the issuance is by countries other than the three I mentioned earlier.

Mr. Chairman, there were no foreign operations in the intermeeting period. I will need a vote to approve domestic operations. And I also need to talk about swaps.

CHAIRMAN GREENSPAN. It’s sort of sad to look at the composition of the Lehman Brothers high-yield index. I’m looking at some of the names in the context of 30 years ago—General Motors, AT&T, and Georgia Pacific. The world is telling us that there is creative destruction out there.

To what extent do the GM, Ford, and collateral issues, as they move out of investment-grade into high-yield, impact the average yields of, say, BBBs? Clearly, we are getting a huge increase in

the supply of marginally non-investment-grade bonds. We can see the impact all over the place, because auto debt is so much larger than the debt of other issuers in that market. But I've heard very little about the measurement impact, for example, on the BBB or the Baa indexes. Are they affected materially by this shift?

MR. KOS. Well, they will be affected in the short run, as investment managers reprice the GM and Ford paper.

CHAIRMAN GREENSPAN. I'm thinking more in terms of the effect on the averages of these indexes.

MR. KOS. Oh, I see. I'm sure that there would be an effect, but I haven't looked at this. As that paper was taken out, I guess it would tend to reduce the posted spreads. We did see that in the emerging-market indexes, as some countries defaulted and were taken out of the indexes.

CHAIRMAN GREENSPAN. When Argentina came out, it was a huge effect.

MR. KOS. Exactly. So, I would think that one would see the same kind of effect on the index itself, but I haven't looked at the specific question to check it out.

MR. REINHART. It's a question we can answer, Mr. Chairman. The thing I would note is that GM is a smaller component of the BBB index than it would be of the high-yield index. However, you would be taking something that already looks like a high-yield out of the BBB universe. In any event, we can look into that for you.

MR. OLINER. Mr. Chairman, just one follow-up. The staff's constructed BBB index already downweights outliers to try to get a more accurate, smoother index.

CHAIRMAN GREENSPAN. The very process itself would produce an effect. As soon as these issues begin to move off what would be a sort of constant BBB yield, it automatically drops out—

MR. OLINER. Not entirely, but it gets downweighted by a significant amount.

CHAIRMAN GREENSPAN. You're weighting with respect to the position on the spread?

MR. OLINER. Yes.

CHAIRMAN GREENSPAN. As the paper moves from BBB to BB, for example, the weights fall and then they rise again as they cross the border?

MR. OLINER. Yes, exactly.

CHAIRMAN GREENSPAN. That's really quite interesting. I didn't know we did it that way. Other questions for Dino? If not, would someone move to ratify the domestic operations?

SPEAKER(?). So moved.

CHAIRMAN GREENSPAN. Without objection, they are approved. You wanted to discuss the swaps issue next?

MR. KOS. Yes, my favorite issue.

CHAIRMAN GREENSPAN. I didn't want to ask for a quick, routine vote without allowing time for at least a defensive comment.

MR. KOS. It's May, which means that it's the time of year that I come to this Committee and ask for a vote on the renewal of the swap facilities for Mexico and Canada. They get renewed in December, but six months' notice would need to be given if the Committee chose not to renew them. That's why we vote on it at this meeting.

CHAIRMAN GREENSPAN. The arguments in favor remain as valid as they have been.

[Laughter]

MR. MOSKOW. Is that defensive or offensive?

CHAIRMAN GREENSPAN. I refuse to comment further. [Laughter] Would somebody like to move to renew these?



SPEAKER(?). So moved.

CHAIRMAN GREENSPAN. Without objection. You have another year of grace. Let's move on to Dave Stockton.

MR. STOCKTON. Thank you, Mr. Chairman. In reviewing my remarks from the last meeting, I managed to find that at least one of my insights had survived the intermeeting period. If you will allow me, I quote: "While I can easily imagine looking back on these words with regret, the persistent and widespread improvements that we are now witnessing certainly leave the impression that the expansion is more firmly established and less fragile with respect to shocks than it was in early 2004." Unfortunately, as I see it, the surviving insight is that I would come to regret my words. Just how much, I think remains an open question. But the past six weeks have clearly restored a greater sense of two-way risks to the outlook.

Just as the great preponderance of data that became available in the early part of the year had led us to revise up our outlook for the real economy, it seems nearly every major economic release since the last meeting has been to the low side of our expectations. The litany of bad news has been long and varied. Private payrolls increased by just 100,000 in March. In the manufacturing sector, output slipped a bit that month, and our estimates for January and February were revised down. A very weak retail sales report for March held down the growth of overall consumer spending in the first quarter. With orders and shipments for capital equipment having dropped sharply in March, growth of equipment and software spending is looking a bit weaker in the first half of this year than was incorporated in the previous forecast. Moreover, the data on merchandise trade for February suggest that demand for our exports was softer than we had expected and that a greater portion of domestic demand is being met by foreign rather than domestic producers. And, reflecting the softer tone of the economic data, stock prices dropped about 4 percent below our March baseline assumptions. All in all, it has been a pretty downbeat collection of data.

As you know, we lowered our forecast of the growth of real GDP for the first two quarters of the year. We now estimate that growth in the first quarter was about 3 percent, in line with the advance estimate of the BEA [Bureau of Economic Analysis] and more than 1 percentage point below our March forecast. For the most part, we didn't see much to argue with in the BEA's estimate; in comparison with them, we are projecting a slightly larger contribution from net exports and a slightly lower contribution from inventory investment but the same top line. With much of the softness in the data occurring later in the quarter, we also revised down our projection for second-quarter growth of real GDP to 3½ percent, about ½ percentage point below our previous projection. Some of that weakness is projected to carry forward, so that the GDP gap at the end of 2006 is about 1 percent in this forecast rather than being nearly eliminated as it was in our previous forecast. And that

larger output gap occurs despite the fact that we trimmed our path for the funds rate by 25 basis points starting in the second half of this year.

Obviously, the relevant questions at this point are: What are the explanations for the recent spate of disappointing economic reports and what are the accompanying implications for the outlook?

One plausible hypothesis is that what we have experienced has largely been statistical noise that has produced a weak quarter of GDP growth but that should have little or no implication for our assessment of the strength of the economy going forward. There is evidence to support this view. Perhaps most notably, initial claims for unemployment insurance have averaged about 325,000 over the past month—a figure at the low end of the range that has prevailed as the labor market has gradually but steadily improved. And insured unemployment has also continued to drift lower. So there is not much sign of an inflection point in activity here. Moreover, despite last month's weak retail sales report, home sales remained strong, and the reports we have received from the automakers suggest that motor vehicle sales were solid in April. These are developments that don't seem consistent with a view that consumers are in the process of throwing in the towel. And in the business sector, anecdotal reports from our contacts have generally remained favorable both with respect to their order books and their capital spending plans.

Those considerations made us comfortable discounting significantly the recent weakness in the data. But we didn't think it was prudent to dismiss that weakness entirely, either. There simply was too much bad news. In addition, there was corroboration for some of the downbeat statistical readings from other sources. The poor performance of retail sales has coincided with a sag in measures of consumer sentiment over the past few months. Likewise, the reports from purchasing managers are consistent with the slower growth of manufacturing activity that appears to have occurred since the turn of the year.

A second plausible explanation is that the run-up in energy prices is taking a greater toll on activity than we had anticipated. The price of gasoline has soared in recent months. And while I doubt that many households are monitoring far-dated futures prices for oil, there may be a growing realization that the ramp-up in gasoline prices is likely to prove a persistent drain on purchasing power. That, in turn, may be leading consumers to trim spending in other areas. Further evidence that households may be viewing the recent increases in gasoline prices as likely to be longer-lived can be gleaned from the mix of motor vehicles being sold. In contrast to most of last year, we are now seeing signs that households are shifting purchases away from large gas-guzzling models to smaller more fuel-efficient vehicles. Businesses too, no doubt, are feeling the squeeze on their incomes, and, in light of the uncertainty about how households are responding to the recent jump in energy prices, they may be pulling back a bit from hiring and capital spending until the situation clarifies itself.

By our estimates, the depressing effects of the increase of oil prices since December 2003 on the growth of real GDP should be peaking in the first half of this year, so the timing is consistent with our view that energy prices may well have been an important factor in the slowdown in activity that we have experienced. But the weakness seems too extensive to stem from that cause alone.

Accordingly, we have also put some weight on the possibility that the incoming data are signaling that underlying aggregate demand is not as strong as we had earlier anticipated. Of course, one interpretation of that observation is that the degree of monetary accommodation may not have been as large as we had previously gauged.

Over much of the past year, despite gradual increases in the real funds rate, our estimates suggested that we could be very comfortable with the view that policy remained accommodative—a view that seemed consistent with the incoming data on the economy. We still see monetary policy as accommodative, at least from a medium-term perspective, but we recognize that we are now edging into grayer territory. The confidence intervals around estimates of the equilibrium real funds rate that we show in the Bluebook are intended to give you a sense of just how ignorant we are about its precise value, if that wasn't already abundantly obvious to you.

We certainly can't rule out that we have overreacted to the recent news. A rebound in April spending, a few upward revisions to data from earlier months, and this recent period will barely register a ripple on the surface of a solid underlying expansion. But I would note that our reaction has not been idiosyncratic either. Market participants have also marked down their path for the federal funds rate by about as much as we have over the intermeeting period.

Of course, weaker real activity has been only one of the difficulties with which we have had to contend. The news on inflation, for the most part, has also been somewhat disappointing, especially the readings on energy and import prices. In response, we have revised up prices in these two areas noticeably in the first half of the year. The incoming data on core consumer prices were only a tad above our expectation. To be sure, the 0.4 percent increase in the core CPI grabbed considerable attention. But we correctly anticipated that this increase would translate into a milder 0.2 percent increase for the market-based core PCE measure. This was higher than we had projected in the March Greenbook, but by an amount measured in basis points, not tenths.

Taken together, these developments led us to mark up our forecast for headline PCE inflation in the first half of the year by about  $\frac{1}{4}$  percentage point to  $2\frac{3}{4}$  percent at an annual rate, while our forecast for the increase in core PCE prices has remained at about a 2 percent annual rate. The upward revisions in headline inflation in the

first half do have consequences for inflation going forward. Higher consumer price inflation, through a combination of formal and informal arrangements in labor markets and perhaps through some slippage in inflation expectations more generally, seems likely to find its way eventually into wage inflation and back into prices. That was the motivation for the upward adjustment to our projection of core consumer price inflation to 1.9 percent this year and 1.7 percent next year—0.1 percent higher than our March projection in both years. However, the contour of our inflation projection remains the same. As in past forecasts, we expect some slight easing of pressures on inflation as the pass-through of higher prices for oil, imports, and other commodities begins to wane.

Of course, it remains an open question as to whether and when we will get the slowing in oil and materials costs that we are projecting. For the most part, we continue to take our cues from futures markets for these prices. Although I cannot see a clearly superior alternative, I will admit this approach has not been a surefire recipe for success over the past year. During that time, the cumulative upward revision in our forecast for core PCE prices in 2005 has been about  $\frac{3}{4}$  percentage point. As we noted in yesterday's Board briefing, we believe that this revision can largely be explained by the upward surprises that we have experienced in the prices of oil, imports, and commodities. Looking forward, an easing of those pressures remains an important element of our forecast. But it remains just that, a forecast. Moreover, we recognize that, at some point, the consequence of a series of cost shocks could look to many people an awful lot like an accelerating price level. And if that view were to cement itself, the implications for inflation expectations and the feedback into wages and prices could be a less favorable inflation outcome than shown in the Greenbook.

In that regard, we continue to draw comfort from the fact that wage inflation has shown no signs of increase during the past couple of years. Hourly labor compensation from the national accounts increased 4 percent at an annual rate in the first quarter, below both our March projection and the average pace posted last year. More surprisingly, the employment cost index, released last Friday after completion of the Greenbook, showed an increase in hourly compensation of just  $2\frac{1}{2}$  percent at an annual rate in the first quarter—with wages rising at a subdued pace of just under  $2\frac{1}{2}$  percent and hourly benefits slowing to a  $4\frac{1}{4}$  percent pace, the smallest rate of increase we've seen in quite some time. This is certainly good news and suggests that we are not yet witnessing anything that looks like a wage-price spiral.

But it's still the case that we have presented you with a forecast that shows both higher price inflation and a wider output gap, and thus a less attractive set of policy options from which to choose. Moreover, if I were a sensitive, sharing kind of guy, I'd probably admit that the incoming data have raised my anxieties about the outlooks both for activity and for inflation. However, while it wasn't covered in any of my management training, I have made it a strict rule to avoid developing any emotional entanglements with the forecast that I supervise so as not to complicate

my professional or personal life. [Laughter] If I step back and take a more dispassionate look, while recent developments have highlighted reasons for concern, the outlook still remains quite favorable. The economy has been averaging growth at or above potential over the past year despite what has been a huge energy price shock, the removal of massive fiscal stimulus, and the withdrawal of monetary accommodation. And after a dip in the first quarter, growth is projected to return to its above-trend pace starting in the current quarter. Meanwhile, even with sharply higher oil prices, a declining dollar, rising commodity costs, and diminishing slack, core consumer prices are up only 1¾ percent over the past 12 months—a pace that remains low even by the standards of the past decade. And we are projecting core PCE inflation to remain at or below 2 percent over the projection period. By most objective metrics, it remains a bright picture.

Having accumulated another 2,000 words of potential regret, I should probably turn the floor over to Karen at this point.

MS. JOHNSON. The staff forecast for average real GDP growth abroad over the forecast period has changed little from that in the March Greenbook despite swings in global oil prices, nonfuel primary commodity prices, and exchange rates, plus a significant near-term revision to the outlook for U.S. growth. However, the only minor revisions to our projection for average foreign growth mask significant differences across countries and regions—differences that reflect the varying influences of recent developments.

In order to explore further these differences, I will highlight those developments over the intermeeting period that were unexpected and offer our thoughts on their implications for the outlook abroad and our forecast of the U.S. external sector. Despite continued expansion of global activity, long-term sovereign interest rates in the major foreign industrial countries have dropped significantly on balance since the previous FOMC meeting. For example, the German 10-year rate moved down from about 3.7 percent at the time of the March meeting to reach an all-time low of 3.38 percent on April 29 and has remained near that low so far this week. Rates in Canada and the United Kingdom fell almost as much, and even Japanese rates decreased nearly 20 basis points. Although by themselves lower interest rates might be expected to raise equity prices, the major stock price indexes abroad have fallen over the period from 2 to 7 percent.

These asset market developments reflect participants' reactions to the most recent data, which suggest that the foreign industrial countries have encountered some additional headwinds that are impeding growth during the current quarter and likely will do so over the remainder of 2005. Accordingly, we have shaded down our near-term projections for the major foreign industrial countries. Although we cannot be certain, we judge that elevated oil prices are taking a greater toll on these economies than we anticipated earlier. Less favorable news for the U.S. outlook is a factor as well. Both these developments are likely influencing confidence abroad.

Euro-area economic sentiment fell in April to its lowest level in a year and a half. The Tankan survey in Japan dropped noticeably in the first quarter.

In contrast, recent developments in the emerging-market economies, although mixed, are positive on balance, and we have revised up slightly our outlook for average growth there for this year. This outcome reflects the fact that several of the emerging-market economies export oil and/or other primary commodities whose prices have remained high. It also reflects the unexpectedly strong first-quarter growth that was recorded in China. We now calculate that China's GDP grew at a 14 percent annual rate last quarter, almost double our projection in March. Although we expect some moderation in Chinese output growth over the remainder of this year, its robust pace should support somewhat stronger expansion in the region than we previously projected.

Exchange market developments also contained some surprises. The dollar appreciated broadly over the intermeeting period, particularly in terms of the Canadian dollar and the euro. Domestic political tensions appear to be weighing on the Canadian dollar. Although we continue to build into the Greenbook baseline slight real dollar depreciation, the higher starting point for the current quarter leaves us with a forecast path for the dollar that is above that in March throughout the forecast horizon, a change that boosts imports and restrains exports.

Particular focus on the Chinese exchange rate regime and the timing of any modification to that regime emerged at the time of the G-7 meeting in mid-April and again last week when market participants reacted quickly to a short-lived anomaly in the renminbi/dollar rate. Since your March meeting, the amount of appreciation priced into NDF [non-deliverable forward] contracts for Chinese renminbi has risen at 1-month, 3-month, and 12-month horizons. U.S. Treasury officials have made public statements calling for Chinese officials to act soon, and the U.S. Congress has raised the possibility of action on its part if the Chinese do not move. The heightened public debate appears to have raised the sensitivity of markets to any indication that something might be happening. In the absence of any reliable information on when and in what way the Chinese might alter the present regime, we have not incorporated any such change into the forecast. The extent to which other Asian currencies will move against the dollar when the Chinese do act remains an additional major uncertainty.

Trade data for February were another major surprise for us during the intermeeting period. Those data showed a second consecutive month of sizable increases in imports. Part of this increase is accounted for by a jump in the value of oil imports, but non-oil imports, particularly industrial supplies and consumer goods, expanded rapidly as well. First-quarter national income data reflected the strength of nominal imports in January and February in double-digit growth of real imports of goods and services. We now estimate that real imports rose at an annual rate of more than 13 percent in the first quarter, an upward revision of more than 4

percentage points from the figure in the March Greenbook. We estimate that real growth of core imports, non-oil imports other than computers and semiconductors, was about 18 percent—far faster than historical relationships with U.S. activity and relative prices would suggest. No component among real imports stands out, leaving us with no special factors that would explain the rapid growth. This quarter, we look for the pace of core import growth to moderate substantially to one more consistent with historical determinants, particularly given the downward revision of projected U.S. real GDP growth to about 3½ percent. In addition, on a seasonally adjusted basis the volume of oil imports is projected to contract sharply. Accordingly, imports of goods and services are projected to grow only 1¼ percent this quarter and then to expand at annual rates of 6 to 7 percent over the forecast period.

Putting these pieces together leaves us with a first-quarter negative arithmetic contribution to U.S. real GDP growth from net exports of about 1¼ percentage points, about the same as in the fourth quarter. With import growth forecast to drop sharply, the projected contribution swings positive for the current quarter. In the second half of this year and during 2006, the contribution is small but negative.

The near-term fluctuations in imports should be evident in the nominal trade balance as well. By the second half of this year and during 2006, we expect the trade deficit to widen further. Net investment income is also projected to deteriorate. Given current position figures, we see that balance as finally turning negative next year. Together these forecasts imply a current account deficit of more than \$900 billion in the fourth quarter of 2006.

Dave and I will be happy to answer any questions.

CHAIRMAN GREENSPAN. It strikes me that if we're going to get that significant a slowdown in imports, we should be seeing it in some upward pressure on U.S. industrial production, provided the composition of the import change is industrial materials, which theoretically would be shifted to domestic sources—that is, the share from domestic sources would be higher. Do you have any insight into the details at all? Or is it just that the extraordinarily outsized surge in the first quarter—beyond anything reasonable—requires a reversion to the mean?

MS. JOHNSON. Well, we have numbers written down for the pieces, but not ones that I think are ready for exposure.

CHAIRMAN GREENSPAN. It has to affect domestic GDP because, obviously, the imports of capital goods will have an impact on the producers' durable equipment purchases, which theoretically are split into domestic and foreign producers.

MS. JOHNSON. A very big chunk of the Q2 story is oil and relates to the seasonal adjustment procedure that is now in place for describing real oil, which we question. We think that may not translate into real-time evidence of this sort, because it is, in some sense, a statistical treatment of the data as opposed to an actual real-world event. Other than that, consumer goods have been a big piece of the surprise in imports, so I don't think they would immediately have implications for U.S. industrial production. There is nothing specific I can point to, and I admit—in fact, it's one of the reasons I highlighted this—that a change from double-digit growth to 1+ percent growth this quarter is a huge drop. But that is our best estimate.

CHAIRMAN GREENSPAN. It really depends on what the monthly pattern is. It could very well be, for example, that January was up sharply, February was down, and March was down, and the average is still up 15 percent. And you keep going down, so you can't really see the difference.

MS. JOHNSON. The people who construct these numbers write down notional placeholders for the different components for the very, very near term, but I don't think they would regard them as grounded in a lot of information. They do that to see if the number they write down for the longer term is a sensible number.

MR. STOCKTON. We certainly haven't seen any surge in orders to domestic producers that would be indicative of that.

CHAIRMAN GREENSPAN. On the spread that's opening up between average hourly compensation of employees and the ECI [Employment Cost Index], theoretically that is supposed to



mean that the mix is changing. It implies that the mix is changing toward higher-skilled components, presumably. We can check that, I would assume, by looking at least at the ratio of supervisory workers to production workers. Are the numbers moving in line with that ratio?

MR. STOCKTON. I don't think a mix story is explaining the first-quarter divergence there. The big slowdown in the benefits component came from what the ECI is measuring as employer contributions to pension plans; there was a big drop in that component. It doesn't necessarily have to line up, in an accounting sense, with what's happening in the national income accounts. So, I think it's more than the wage mix side that seems to be—

CHAIRMAN GREENSPAN. Well, the interesting point is that it should. Otherwise, the question is whether labor income is calculated correctly.

MR. STOCKTON. They're not measuring that exact same component on a quarterly basis in the same way.

CHAIRMAN GREENSPAN. So the compensation per hour may be overestimated in that respect, if that's true.

MR. STOCKTON. It could be. But also we have seen big discrepancies in the past that haven't necessarily ever been reconciled in later publications of the national income accounts. So it's conceivable.

CHAIRMAN GREENSPAN. Those are the workers who live in that country called “discrepancy” in our world balance of payments accounts! [Laughter]

MR. STOCKTON. Perhaps.

CHAIRMAN GREENSPAN. Any other questions?

MS. YELLEN. I have a question for David concerning investment. At our last meeting, I certainly had the feeling that the outlook for the economy and for demand was a lot more robust than

I had previously thought, and the Greenbook reflected the same view. In large part that was based on rejecting the pothole theory related to partial expensing for investment. We thought that there would be a pothole in January. It didn't occur. January data on orders were strong, and the staff decided, I think, that there was a lot of momentum in investment spending. Certainly the fundamentals seemed quite strong. But for February and March the data are really very weak. It seems to me that the response in the Greenbook this time is to stick with the view that the fundamentals are strong and the investment spending outlook remains quite strong. There hasn't been a lot of downward revision there. I wonder if you'd just talk about that a little bit. One possibility might be that, in fact, January wasn't a perfect test of partial expensing. Suppose that firms could take advantage of that expensing provision if they placed an order by December 30. Maybe some orders were placed and didn't actually show up in the December data. They might have shown up in January. I don't know the details of how that series is constructed. Another possibility is that we may be learning from the February and March data that the outlook for investment spending just isn't as robust as we had thought, but it's not because of partial expensing. In any event, it seems to me that there was not a lot of downward revision in the medium-term forecast for investment spending. I just wondered if you would discuss your thinking.

MR. STOCKTON. First of all, on whether or not we've experienced the pothole, I think you're certainly right that January isn't necessarily the perfect test. But I don't think that the hypothesis you suggested would work, in the sense that the equipment had to have been installed by the end of December to qualify for partial expensing.

MS. YELLEN. Not just ordered?

MR. STOCKTON. Not just ordered. There were a couple of exceptions to that general rule, but the equipment was supposed to have already been installed. So the timing doesn't look good for

the pothole story. But that doesn't necessarily mean, given how noisy those data are, that we couldn't still be seeing some pothole effect now.

To be honest, we took out most of our pothole effect at the time of the last forecast, but we didn't take all of it out. So we certainly think there's some consistency between what we've seen and our assumption that there would be a pothole effect. You're right that we certainly didn't view the March reading as indicating a huge turning point. We just basically fed those data through our near-term statistical filters, and then, beyond the near term, allowed our econometric model to "speak," if you will. And the econometric models still revise down the level of investment spending over this forecast horizon. So it isn't the case that we offset the weakness that we saw; we've actually carried that forward.

MS. YELLEN. It's a level effect.

MR. STOCKTON. It's a level effect. We had a drop in long-term interest rates, which tended to cushion, through the cost of capital, some of the downward revision that we would have had otherwise. And we've allowed a little bit of the accelerator effect to show through. As we look at the situation, it is still the case, if one believes that underlying final sales are continuing to expand at a reasonable clip—and we recognize that that's an open question but that's the view that we have taken in the forecast—that the cost of capital is low. And corporations' balance sheets still look pretty strong to us. Corporations are sitting on a very big pile of liquid assets, so we don't think there's going to be much difficulty financing this amount of investment spending. So, this is one of those areas where we have read the recent news as probably more noise than signal. We have given it some signal, though, and that's why we have the level a bit lower by the end of this forecast than we did last time.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. You now have higher energy prices built into the forecast—significantly higher energy prices—and the futures market does, too. I'm just wondering if you could talk about how that factors into your thinking about potential output going forward.

MR. STOCKTON. The rise in energy prices that we've had suggests to us—and especially as we look at those far-dated futures contracts—that this probably is going to be a drag on the level of potential output going forward.

We made a more discrete adjustment in the fall to reflect that. And when we update our entire supply-side portion of the forecast in June, we're going to have to revisit that issue. We do see this as a factor. While we haven't heard a lot of reports of firms talking about increasing scrapping of capital equipment, given the significant change in relative factor prices that there has been, we'd expect to see some of that going forward. So, we look at the rise in the relative price of energy as a negative for potential output. It would be a small negative, because those effects occur over very long periods of time. It isn't usually reflected as a very large discrete change in the level of potential output, but it could be a factor weighing on it.

MR. MOSKOW. If we had significantly higher energy prices than we have now, what would the sensitivity be?

MR. STOCKTON. You're raising a good question, and I don't know the answer. There could conceivably be some nonlinearity in that process. But I think we're talking about effects that are measured in tenths of a percentage point—not quarters or halves of a percentage point—in terms of the effects on multifactor productivity, or, in essence, capital input going forward.

MR. MOSKOW. Thank you.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN GEITHNER. David, you referred in your remarks to the exercise shown in the package of materials for Monday's Board briefing. I'm looking at the pass-through into core inflation of the rise in energy prices, import prices, and commodity prices. If back in December '03, which is your baseline for this exercise, you had had a forecast for energy prices, commodity prices, import prices, and the dollar that is consistent with what happened, would you have expected your model to show this much pass-through to core inflation prices? Or would this result have been surprising?

MR. STOCKTON. The result of that exercise suggests, if anything, a little surprise that we didn't get a touch more pass-through. Actually, I was surprised when I first saw those results but not after I sat back and thought more carefully. Certainly, if you had told me in late 2003, when oil prices were \$25 to \$28 a barrel, that they were going to be something north of \$50, that the markets would perceive that as being very largely a permanent change, that we would see an ongoing depreciation of the dollar and a very significant acceleration in intermediate materials prices, I think I would have said core consumer price inflation now of just 1¾ percent would be a pretty good outcome. So, as I thought more about it, I was more comfortable with the results that we presented yesterday.

Now, as we indicated in the Greenbook in an alternative simulation, while we are comfortable with our inflation forecast, we could certainly understand it if you were less comfortable with our assessment of the pass-through to core inflation, given that this has been an area where we have made persistent errors. It's very hard to estimate these pass-through effects. I know of work done over the years at the Board and by Reserve Bank staff aimed at trying to estimate indirect energy price effects or import price effects. Sometimes the coefficients are zero and sometimes they are large. It looks to us as if, more recently, the size of those coefficients has diminished, but that

could simply be a function of the fact that many of those variables were relatively stable over a long period of time. It's just very hard to estimate precisely what the effects are. Our alternative simulation, where we doubled the size of those pass-through effects, is intended to give you a sense of how far things could get out of line if we made a rather big error in the size of the pass-through. And, as we noted, there would be a very noticeable effect going forward. So, it does seem reasonable to wonder not only about whether we have the underlying forecast right for oil, imports, and other commodities but also whether we have the pass-through of that correct.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. The first quote of NIPA [national income and product accounts] data showed a large increase in inventory accumulation outside of what we talked about in terms of oil effects. I'm rather curious about the inventory issues. Where are these inventories? Are they in final goods? Are they in intermediate goods? Are the inventories produced domestically or abroad? What is the implication, in terms of the future industrial impact, of this accumulation of inventories? I was just wondering if you could expand a bit on your view of that.

MR. STOCKTON. First, I'd note that we are not necessarily buying into the BEA's March assumption, which showed another very large inventory accumulation. In fact, that's one of the areas where, in writing down our forecast, we differed—to the tune of about \$6 or \$7 billion—with the BEA. We have a lower level of inventory investment. So, that's just their forecast against ours. At least on our assessment, the BEA's figures overstate the extent to which inventories were accumulated in the first quarter.

Now, in terms of looking for areas where there are inventory imbalances, it's quite clear that one problem area is the motor vehicle industry. They're still sitting with a very large days' supply of cars and especially of trucks. We do think the implication of that would be a drag on GDP growth

going forward, and we're already seeing signs that the auto manufacturers are cutting back production. The other problem areas are a little harder to identify. Supplies of some types of chemicals look a little high at this point, and in paper and printing and a few other areas there apparently are some higher levels of inventory–sales ratios. We think that is part of the reason why we're in a bit of a soft period for industrial production. When we look at that flow-of-goods system that we report occasionally in the Greenbook—which doesn't use the Census Bureau and BEA data on inventories but infers inventories from what we think is going on with production and consumption—that shows not much going on at all. If anything, the weakness in industrial production suggests that maybe the inventory investment in the Census Bureau data may be overstated to some extent. So, it's an area we're watching, but it doesn't seem to us as if a significant problem has developed.

I might note also that yesterday's purchasing managers' report showed a drop in the number of purchasing managers who viewed their customers' inventories as too high. That had inched up, and it's come back some. So at this point, we're inclined to think that some of what has happened in the first quarter was probably unintended inventory accumulation. That is a negative for the second quarter's GDP growth, but it isn't what I would call a significant inventory cycle at this point.

CHAIRMAN GREENSPAN. The flattening of industrial production in March in that flow-of-goods system seems to reflect a rather large liquidation, seasonally adjusted, of motor vehicle inventories. I was curious whether there was any awareness of that on the part of BEA, because clearly those data were available at the time when BEA made the GDP forecast. Do they show a separate inventory for motor vehicles?

MR. STOCKTON. They do. I don't actually have that figure in front of me. In motor vehicles, they are basically doing a unit accounting. They use different seasonals than we do, but they should be showing something like that.

CHAIRMAN GREENSPAN. So they're either missing that, or they're showing a significantly larger increase in non-automotive inventories than we have.

MR. STOCKTON. Right.

CHAIRMAN GREENSPAN. President Fisher.

MR. FISHER. I'd like to ask a question of Karen about import price growth, particularly in the retail sector. In terms of imported goods sold through our retail chains and the timing of the increasing price pressures we've seen, is that weighted heavily toward March and recent activity in April? Could you expand on that a little bit?

MS. JOHNSON. We collect import prices at the border, so to speak. So I can't speak to the question of this showing through to retail prices. David might want to comment on that; I don't know.

Import price inflation has been surprising us a bit on the upside, and we have attributed part of that to higher global commodities prices. It shows up in our case in the industrial supplies types of categories, but we've seen some in the manufacturing area as well. When we break out the actual data for how import prices have moved, we're getting contributions from both those pieces into import price inflation. So, relative to the last Greenbook, we have extended the period of elevated import price increases into the second quarter and a little into the third quarter because the global indexes of commodity prices—based on futures at this point for those periods—show the prices not rising further but remaining high, and we think it will take some time for that to be fully reflected in our import prices. But one factor that seemed to cause the timing to be off a little bit in our forecast



last year was that commodity prices tended to be showing up more rapidly in U.S. import prices than our models would suggest is the historical average. We have that as a second term, in addition to foreign prices and the exchange rate and so forth.

So embedded in our story is that import prices were high in the first quarter and will decelerate somewhat in the second and third quarters, but not hugely and not as much as we had thought before. It involves a somewhat more extensive pass-through of high global commodity prices into import prices, and a little bit is probably still the effect of dollar depreciation at the end of 2004. Those things, in essence, go away thereafter, and we have import price inflation dropping down very much—to less than 1 percent in 2006. That is conditioned on two assumptions: the assumption we have been making routinely for the dollar of late—because we don't know a better one to make—which is that it will change only little going forward; and the futures path for commodity prices. So the projection that import prices will decelerate in stepwise fashion through the second half of this year and into 2006 is very much a reflection of these two conditioning assumptions. And we don't have a whole lot of information other than that.

CHAIRMAN GREENSPAN. Any further questions for our economists?

MR. STOCKTON. Mr. Chairman, I would note that I do have in front of me a table showing the BEA's assumptions for March, and the BEA is showing a liquidation of motor vehicle stocks but very large accumulations elsewhere.

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

MR. MOSKOW. Thank you, Mr. Chairman. In our calls this round, we tried to get a sense of the depth and the breadth of the current soft patch and how much of it might be associated with higher energy prices. My contacts report that growth has moderated somewhat in the Seventh

District. While the manufacturing sector is still quite robust, there are some hints of slowing orders and the Big Three auto manufacturers are still hurting.

Our retail contacts note that business is a bit softer, but they don't seem alarmed. Retailers say that higher gasoline prices are affecting sales. Middle-income consumers are switching from specialty stores to discounters, and lower-income consumers are cutting back more noticeably. Gasoline prices are depressing the demand for large SUVs, as David mentioned. I'd add that orders for recreational vehicles are down significantly as well. But air travel continues to be strong despite higher fares.

Business spending continues to be solid. The heavy equipment market is the strongest in years. One manufacturer in this sector said that he was increasing capital expenditures 40 percent this year to alleviate production bottlenecks in existing facilities, though not to build new plants. In contrast, a large diversified manufacturer has started to see some softening in orders in the last few weeks, although business overall remains good.

On the price front, the big story continues to be energy. There is now a more pervasive sense that higher energy prices are here to stay. We're hearing this from the auto industry, from retailers, and from firms in the energy sector. Nonetheless, a major oil company told us that they remain cautious in their investment planning. Despite significantly higher spot prices and elevated long-term futures, they're still using an assumption of \$20 a barrel when evaluating new production projects. So it seems that oil prices will have to remain elevated for a longer period of time before the industry becomes willing to expand supply through aggressive long-term investments.

In addition to energy, we're still hearing about cost pressures elsewhere, notably for construction materials, rubber, and plastics. Some of these pressures may be creeping into expectations. For example, a manufacturing firm told us that entering 2004 they budgeted for a 1

percent decline in material costs, but their actual costs ended up 3 percent higher, and this year they're budgeting for another 3 percent increase. Looking downstream, many manufacturers have been able to pass through cost increases, and, in a few particularly strong sectors, firms have even been able to increase margins.

With regard to labor costs, a major retailer reported that for the first time in two years they had to offer higher starting salaries for sales associates. However, our contacts at temporary help firms see wages increasing at the same rate or perhaps a little more slowly than earlier in the year. And union contracts have been restrained. Union wages are flat or coming down, more contracts include lower pay for new hires, and health care costs continue to be shifted to workers.

Turning to the national outlook, our best assessment is that price pressures remain a concern and that the current soft patch is not the beginning of a major slowdown in the economy. With regard to growth, most of the fundamentals remain strong. Monetary accommodation and the underlying trend in productivity continue to support solid growth. The claims data suggest a firmer labor market than we saw in March, and I don't get the sense from my contacts that consumers or businesses are retrenching in a significant fashion. Accordingly, growth should pick up at a pace above potential in the second half of the year.

With regard to prices, we expect that higher costs will continue to pass through to the consumer level, boosting core inflation to around 2 percent this year. But we expect core inflation to stabilize or edge off a touch in 2006, mainly because we don't think there are broad-based resource constraints. Still, these assessments are uncertain. We're not really sure which shocks are most responsible for the soft spot and what their ultimate impact might be on the output gap. If factors such as increased caution or reduced policy stimulus are the main culprits, then there may be a persistent widening in the gap, as in the Greenbook forecast. To the extent that is the case, it may be

appropriate to remove policy accommodation very gradually, say, along the path that's embedded in futures prices right now. But we need to do more than that if the weakness largely reflects a reduction in potential output due to higher energy prices. Otherwise we would be accommodating an adverse supply shock and would risk unhinging inflationary pressures.

So far, long-term expectations appear to be fairly well anchored, although some measures have crept up slightly in recent months. If we have a few more months of bad price data, we'll need a more aggressive policy response to avoid a pickup in long-term inflationary expectations. For today's meeting, I think we should continue on our current pace of rate adjustments. However, the statement should avoid giving the impression that the recent softness in economic activity diminishes the underlying inflation risk.

CHAIRMAN GREENSPAN. President Lacker.

MR. LACKER. On balance, after hitting a soft patch in March, economic activity in the Fifth District appears to have bounced back somewhat in April. The improvement was centered in manufacturing and retailing, where modest growth replaced flat activity in March. Services firms, meanwhile, continued to report the moderate growth we've seen over the last several months.

District manufacturers suggest that demand generally remained solid, and many indicate that they've successfully passed through higher energy and materials costs. Our shipments and new orders indexes both moved up for April. Most of our manufacturing contacts say that they do not plan to reduce capital spending in coming months and that they remain reasonably optimistic about future prospects. The exception to this picture is, as usual, in the textile, apparel, and furniture industries that compete directly with Chinese producers. They continue to complain of a lack of pricing power, and their capital spending is generally limited to maintaining rather than expanding capacity. Our index of manufacturing wages continues to firm even though the employment index

weakens. The wage gains are being reported in higher-skilled industries, however, while it is elsewhere in the sector that workers are being shed.

The recent bounce in retail sales in the Fifth District appears to be centered in big-ticket items. In our April survey, big-ticket sales posted their strongest reading since July 2003. Sharp upticks were registered in retail employment and wages as well. Housing activity remains solid in our District. Home sales are strong in most areas and quite robust in some, including my own neighborhood where I received six offers in one day on my house!

On the inflation front, our April survey suggests that price pressures remain contained, though the rate of increase in prices paid by manufacturers edged higher. We continue to hear concerns about having to pay higher energy prices, and a few producers also complain that higher energy costs are dampening consumer demand.

Turning to the national picture, the data we've received since March have been disappointing on both the real side and inflation. The slowing in the real side has been broad-based, and although it has been relatively mild overall, the deceleration in capital spending is particularly disappointing given the expectation that business investment would generally drive this expansion. On inflation, core PCE inflation continues to move up. The latest report shows it at a 2.9 percent annual rate over the last three months, considerably above the 1.7 percent rate over the twelve months to March. If this situation were to persist, it would present a classic dilemma for monetary policy: weakening real growth and rising inflation.

At this point, however, there are good reasons to think that it will not. First, the economic fundamentals underlying this recovery appear sound. Prospects for growth in real household income look good, and, although capital spending may not soon replicate last year's strong pace, investment prospects look reasonably good as well. As a result, I share the Greenbook's view that the soft patch

should be temporary. The Fifth District reports of a rebound in April that I mentioned earlier are consistent with this view as well.

Second, weak real data did not change the Board staff's estimate of potential output. Instead, the Greenbook forecast has a more protracted narrowing of the output gap, with a significantly wider gap still near 1 percent to the end of 2006. It seems reasonable to believe that this wider output gap will help push core PCE [personal consumption expenditures] inflation back below 2 percent, and this view gets some support from the gratifying fact that TIPS [Treasury inflation-protected securities] inflation compensation has declined a bit since March, both for the first five years out and the five years after that. Moreover, market participants expect inflation to remain that well contained even with about ¼ percentage point less of expected tightening by the end of 2006 than had been foreseen as of March. That raises the likelihood that actual and expected inflation can be contained without the aggressive type of funds tightening that has been needed to do so in the past.

One might think that with eight weeks to go until the next meeting and with the possibility of the soft patch expiring soon and removing the dampening effect on out-year inflation expectations, we run the risk of being overtaken by events and rising inflation pressures. I tend to think, however, that market participants understand our preferences well enough that the yield curve will react sensitively to the data should inflation risks pick up. We should be sure that our communications don't inhibit that process.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. New England and the nation seem to have hit a couple of bumps along the road to steady growth. We, like the Greenbook, don't expect the bumps to turn into potholes or disturb much except the speed of travel slightly. But we were again reminded that there is a level of uncertainty about a range of economic variables.

In New England, Beige Book contacts were remarkably upbeat in early April, and available data reported a sense of solid growth in the region. However, several recent indicators and a sense of caution suggest the possibility of an emerging slowdown in the region.

On the positive side, employers added jobs in February and March, and the quarterly total was positive as well. Unemployment rose slightly, but this was due entirely to a stabilization in the regional labor force after a period of decline. Unemployment claims moved down, and both the traditional help-wanted index and Monster.com's index of online job postings increased at a solid pace. As the weather brightened, tourism did as well; and business travel in Boston has been strong, at least relative to last year. With average revenue per room rising at a nearly 13 percent pace, hotels looked poised for a good year. Surprisingly, even in this service industry, productivity improvements are possible, as average hotel staffing reportedly has dropped from 80 per 100 rooms in 2000 to 62 per 100 rooms in 2004. This is said to be the result of technological change and the growing popularity of online booking.

Beige Book contacts in retail and manufacturing were, on the whole, rather optimistic. Moderately growing demand and increased pricing power were keeping margins strong, and a continued emphasis on productivity growth and conservative capital spending left most of our contacts confident of meeting their revenue and profit goals for the year. Higher costs for oil and oil-related inputs and for certain types of skilled labor were a concern, and many contacts commented on a generally more inflationary business environment. Indeed, providers of business and strategic consulting services reported strong growth, with one contact stating that cost containment is not as big an issue as it was but that strategic matters were becoming more important.

Overall, confidence seemed good, and that was reflected in the various regional surveys of business confidence. On the negative side, consumer confidence slumped badly in April, reflecting

doubt about both current conditions and the future. This was likely due to concerns about rising oil prices, as local prices for home heating oil rose at a 14½ percent pace, double the national average, and gasoline prices rose sharply, as they did elsewhere.

Residential real estate markets, while still strong, leveled off and softened at high price points. Actually, I think President Lacker is probably not asking enough for his home. [Laughter] I don't find that I'm getting as many offers for mine.

And a regional index of leading economic indicators pointed to slower growth ahead. These tentative indications of a slowdown could well evaporate, however, and some moderation in demand may be good, particularly given the stronger pricing environment.

Data for the nation have been disappointing in April, both on the demand side and on the price side. The latest news in labor markets is three days away, and while that could surprise on the upside, given recent claims and help-wanted data, the numbers for March were more subdued than we had expected. Equally disappointing were durable goods orders and trends in manufacturing output, though as a partial offset to this I found the April loan officer survey data interesting in that they suggested strength in C&I [commercial and industrial] lending. Contractions were also seen in retail sales, with and without autos, and in home building, although from a fairly strong base. Advance GDP data suggest unintended inventories accumulated as the first quarter ended, reflecting a slowdown in final demand and a drag from net exports.

As in New England, this could well be just a bump in the road. And given the unwelcome nudging up of core price data, it might be helpful in curbing further inflation. It does bear watching, however, as we gauge how fast to adjust policy. At this point, my view is that it would be unwise to overreact to the recent indications of softening. They could well be temporary, as many have noted. Indeed, I thought Dave's comments on the resilience of the U.S. economy against a number of



challenges over the past year or so quite important to keep in mind. Whatever its cause, I think the resilience of the U.S. economy has been a hallmark for at least most of the last decade, and I think we would be wise to keep that in the front of our forecast.

Right now, given the uptick in prices, we aren't making much progress in getting back to some sense of neutral as far as policy is concerned. Our forecast in Boston and that in the Greenbook suggest that growth will continue at a pace that will use up at least some excess capacity by the end of the forecast period. Recognizing that estimating precisely when an output gap will close is chancy at best, I believe we need to continue to move policy to a point that is not stimulative by the time that gap closes and that doing so gradually will help to ease the impact on the economy.

If incoming data continue to disappoint, we may find it necessary to pause along the lines that the fed funds markets expect. Conversely, upside surprises, particularly on the price front, are also possible. So I would not rule out a faster pace of upward policy movement if circumstances warrant later in this year. The point is, I think, that our vision of the future is now a bit cloudier than it was. That takes me to the real action at this meeting—not so much what we do but what we say about it. I've been uneasy with our use of the "measured pace" language because it seems to provide a level of certainty to market participants that could encourage inappropriate risk-taking. Indeed, while risk spreads have widened from their low points, they still remain quite low.

However, there has been concern that taking away the "measured pace" language would be disruptive in that it would seem to say only one thing: that policy accommodation would be removed at a faster pace than previously. But weaker-than-expected incoming data may have provided a greater sense of two-sided risk, and that may have offered us a good opportunity. We may now have the chance to drop "measured" from our lexicon, while preserving the flexibility to take any action necessary at our next meetings without the sense that we have somehow not prepared the market.

I think we ought to make the most of this opportunity and get out of what has been perceived as a policy pledge. The economy has become more uncertain. Our commitment to price stability and maximum sustainable growth continues unabated, of course, but we are less certain about the policy path we will need to take to fulfill those goals. Let's go back now to simply saying what we're doing and why and let the market assign its own probabilities to future policy changes. Thank you.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. I interpret what is characterized as softness in some of the recent data releases as an indication that at least the risks to the path of real output growth, which has averaged 3½ percent since the end of the recession and 4.3 percent over the last eight quarters, may have increased. It's my sense that both consumer and business confidence may still be a bit more fragile than we thought, and it seems most likely that the skittishness is more due to the uncertainty about high energy prices and their likely persistence rather than a reaction to higher interest rates.

Recent data and the anecdotal reports I hear from our Southeast business leaders, from both large and small companies, seem to suggest some new caution when it comes to spending and hiring decisions. A director who is a senior level executive of Georgia Pacific Corporation says that recent box sales, which track consumer nondurables fairly well, have tapered off slightly, whereas another director, who is Chief Financial Officer of UPS, reports that business is steady but not spectacular. At a meeting of our Small Business Advisory Council two weeks ago, there was a near consensus among those in the non-services sector that persistently high energy prices were taking a toll on profits and were causing some capital spending plans to be put on hold. Obviously, the earnings problems of the two airlines headquartered in our District were exacerbated by higher fuel costs.

Furthermore, the large gains in temporary employment may be indicative of reluctance to add full-time employees unless absolutely necessary.

Despite the increased uncertainties, however, I view the most likely path for output, as does the Greenbook, to be near or even above potential and, as such, unlikely to require attention from monetary policy. I'm a bit more concerned about the recent price developments which, while not alarming, have now given us several months of upward tilt to measures of inflation—regardless of the index one prefers.

The price pressures we see in our region, while mirroring the general upward drift reflected in the national data, are still uneven, with some intended and actual price increases becoming more widespread and sticking and others being greeted with resistance. For example, our Georgia Pacific executive reported that for the last two months attempts to get price increases on many consumer products were meeting with less success than was the case in late 2004. He indicated that his customers now were more aggressively playing suppliers off against one another. At the same time, he reported that the prices of building materials were now clearly reflecting the higher energy costs involved in their production.

Residential construction in Florida remains white hot, with continuing concern about speculation in those markets as I've been reporting for a while now. And just two days ago, one of our former directors from central Florida reported that one of the area's largest contractors was told that concrete was about to go on allocation and to discontinue Saturday deliveries. That same source also indicated that drywall was about to be in short supply again.

At the same time, our staff's work on disaggregating the CPI inflation data indicates that the largest contributors to increased inflation have come mostly from factors other than the pass-through of energy costs—namely, increases in new and used car prices, lodging costs away from home, and

the rental equivalence measure for housing. Over the past six months, the negative contribution to inflation from goods has been reversed, more clearly exposing the underlying trend in services inflation, which has been rising at nearly 3 percent for the past year.

In short, the various price and real-side data, tempered with anecdotal reports, lead me to the assessment that, while the risks to the real-side economy have clearly increased, the risks to inflation are now clearly to the upside and policy remains accommodative. Markets are expecting another 25 basis points of tightening today, and this seems to me the right path for us to be on. Having said that, I conclude that, with the increased uncertainty about the real economy, we need to think hard, very hard, about just how much we really know and what to say about the path of policy going forward. Like President Minehan, I suggest that it might be time to let some of the policy uncertainty show through. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you. Well, two issues have been weighing on my mind. They're really the two issues that Dave Stockton addressed. First, is the recent reduction in the Greenbook forecast roughly appropriate, or will the economy do appreciably worse or possibly significantly better than that? Second, is the forecast of modest inflation still tenable in the face of the increase in most core measures that we have seen?

I must say that I think there is a danger of over-interpreting and overemphasizing a batch of statistics, all of which became available within several weeks in April, given their reliability or unreliability and given that not all of them seemed to me to be a particular surprise. Still, I wouldn't totally dismiss them, so I am inclined to reduce my forecast of growth, although it's perhaps still a bit above the Greenbook projection of 3½ percent. Plus, for what it's worth, our internal forecasting model grinds out about 3 percent growth quarter after quarter. I'm more optimistic than that and

maybe a touch more optimistic than the Greenbook for three sets of reasons: one, the fundamentals; two, the nature of the anecdotes I've been getting; and three—and perhaps most importantly—history.

As far as the fundamentals are concerned, we have the usual suspects that we've been talking about at this table for several years now: continuing comfortable financial market conditions, underlying expansion in productivity, a general lack of supply-side constraints, and still healthy consumer and corporate balance sheets on average.

As for the anecdotes, discussions with business leaders in our District and an examination of District economic data for the most part yield positive conclusions. Manufacturing is clearly continuing to advance, employment is increasing, and labor markets appear to be gradually tightening, especially in areas where mining and energy activity are strong. Consumer spending activity is continuing to expand, and reports on capital spending and commentary associated with capital spending from directors are really quite strong overall. All of this is balanced a bit by a note of caution, which has crept in among firms with large exposures in the transportation sector, but I would have to say that the anecdotes preponderantly have really been quite positive.

As far as history is concerned, I consider particularly relevant the long expansions of the 1980s and the 1990s. In my view, those expansions were not particularly dependent on good luck nor on astute policies conducted with exquisite precision, although I do believe that policy made a positive contribution. But I think the real lesson of those expansions was that the economy is fundamentally sound, flexible, and resilient. And I don't think those traits have been altered or have diminished just because we're in a new decade. So that gives me a fair amount of confidence that the outlook remains favorable and that the expansion remains well grounded.

As to inflation, I continue to think that moderate inflation will prevail, with the performance of core prices probably at a pace comparable to that over the last five or six years on average. Still, there is no denying that core measures of inflation have been increasing persistently since late '03, and this does give me a bit more concern. And it makes me a little more cautious than I was formerly about the inflation situation currently and about the outlook for inflation. Thank you.

CHAIRMAN GREENSPAN. President Fisher.

MR. FISHER. I realize I'm entering an ongoing conversation midstream, but sometimes it may be useful to have a fresh set of eyes and ears to at least give an interpretation of what he or she is seeing. I went back and read the minutes of the last several meetings. I'm glad to see confirmed, Mr. Stockton, that you do have a sense of humor. [Laughter]

But I do detect something of a noticeable dissonance between the last several meetings and currently in terms of what's in the Bluebook, what's in the Greenbook, and the tenor of the discussion. And I'm going to use a baseball analogy to describe how I see the situation from the perspective of the FOMC as a batter at the plate.

It seems to me that over the course of the last many meetings this Committee saw a fairly consistent delivery from the pitcher's mound. These were fast balls that came right across the middle—in the strike zone between the knees with 1 percent inflation and the letters with 2 percent inflation. It was the predictable pitch coming down the pipe, as they like to say in baseball. And you—I can't say "we" because this is my first meeting—assumed a batter's stance accordingly and managed to continue to round the bases without creating any imbalances.

Now the data and anecdotal evidence indicate that the economy has at least changed pitchers, and we're getting a few curve balls, maybe some knuckle balls, maybe some split-finger fast balls, and an occasional change of pace. The inevitable question is: Do we adjust our batter's

stance or keep what worked for the fast ball pitcher who has been on the mound for the last seven innings? And unlike you, Cathy, I'm going to save that discussion until the second part. But I do want to address myself to the kinds of pitches we see coming across the plate in the Eleventh District and also nationally and globally.

Sitting where I'm sitting and looking at that map on the wall, of course, the District is probably drawn in relative scale to the egos of my fellow country people. But as the second largest manufacturing state, the second largest in terms of employment in the high-tech sector, and a major transshipment point with significant retailing activity, I think there may be some proxy value in our District's performance. So I just want to report that, whereas before we were lagging the economy, we seem to have caught up with the pace. We think economic activity in our region grew at around 3 percent in the first quarter.

Manufacturing activity in general in the Eleventh District, and high-tech manufacturing in particular, has picked up in pace. There has been a notable improvement. As for energy-related activity, which is a stereotype for our District—we do have oil—the best way to summarize it is the way one of our contacts summarizes it: If you can pass a drug test and you can speak Spanish, you can get a job in the oil sector. There are a lot of price pressures from the standpoint of employment.

However, in the petrochemical sector, we haven't had any reports of pass-through activity in terms of pricing power, and I don't think that is unimportant. And we are not hearing reports of increased pricing power generally from our retailers and others—other than for accountants because of Sarbanes-Oxley. Now, I don't know how good a proxy that is. We're a very open economy. I don't know what the output gap of Texas is, for example; it's a very porous economy. But this is confirmed by our contacts with larger global operators. And against my background, having spent the last five years as a strategic advisor to UPS, Exxon, EDS, and Wal-Mart, etc.—and by the way,

particularly with the railroads—I've taken advantage of that to reach out and try to get a feel to see how it corresponds with what we're seeing locally. We've had a couple of confirming impressions.

On the domestic economy, there seems to be an expectation of a 3 to 3½ percent growth rate, and people are adjusting to that expectation. One of our contacts, the CEO of a company, reminded me that we went through a period in the early 1990s when economists lowered expectations for growth to 2½ percent, and we were very happy to see 3 percent against that set of expectations. He went on to say that now everybody is what he called "Eeyore"—down in the chops about growth that's not 4 percent. But in his view, 3½ percent, and I quote, is "darn good growth."

On the energy sector, one can't get a better view than from the companies that operate in our state, the large transnational companies, and if you'll forgive me, from a dinner we had last Sunday night with those CEOs and the Crown Prince of Saudi Arabia. It was a small group that met to discuss what they thought was going on in energy prices, for what it's worth. And it's a fairly good source, I think. In terms of current pricing, the discussion at the table focused on the fact that some percentage of that pricing is due to financial and speculative activity. As summarized by the CEO who will remain unnamed but who runs the largest oil company in the world, the market seems to be pricing in a supply disruption some time this winter. To quote him, "For the life of me, I cannot figure out where it's going to come from and the degree of pricing, but it's not insignificant."

Another company estimated that the amount being priced in for financial speculation and potential disruptive activity is somewhere around \$10 a barrel. But a key point is that the chemical guys are not finding it easy to pass on cost increases at the national level or at the international level either. In addition, there is sufficient refining capacity for current production levels and not a great expectation that there will be significant additions to refining capacity.



They're not able to pass on increases. Neither are the retailers. One retailer noted that an abrupt halt to sales of household goods took place in March, which his firm thinks was driven by the slowdown in new housing starts. One of the nation's largest retailers, which is continuing to build its capacity to source in China, reports that price pressures in constructing new stores is significant because of higher prices for the materials that are going in—steel aggregates and so on. But as to what they sell, and I quote, "Prices have not risen; they've just stopped falling. We can't discount aggressively without hurting our margins and we don't have the leeway to raise prices."

And one last input from the CEO of one of the nation's largest railroads, and by the way the CFO of one of the largest air shippers: their shipments are geared significantly to transoceanic trade. The nation's largest railroad reported to us that they've seen a 21 percent growth this last quarter in their international business. That is particularly geared toward the trans-Pacific trade, and through this lens it appears that our manufacturers and retailers are expecting to continue significantly boosting their investments for sourcing in China. As one of them said, they are ramping up their spending in China and continuing to arbitrage labor with China. From this and our international contacts—mine by the way ended abruptly and happily on March 31 when I joined this organization, for which I'm grateful—we infer that the effects of globalization on our assumptions about resource slack and the constraints on the economy and the tradeoff between inflation and unemployment have yet to run their course. Thank you.

CHAIRMAN GREENSPAN. President Yellen.

MS. YELLEN. Thank you, Mr. Chairman. It has been less than a year since I returned to the policy table, but already there is a sense of déjà vu all over again. [Laughter]

The recent pattern of higher inflation and softer spending seems remarkably similar to the developments we witnessed late last spring and early summer—then, as now, after a spike in energy

prices. The latest data on employment, retail sales, and durable goods orders reveal unanticipated weakness on the real side of the economy. Readings on overall and especially core inflation have been uncomfortably and unexpectedly high. If the current situation persists or deteriorates further, we could face some difficult policy choices ahead, but I remain cautiously optimistic that the slowdown in growth and the uptick in inflation will both prove transitory.

I believe we can draw some lessons for assessing current conditions and for calibrating policy going forward from last year's experience. Last year's jump in energy prices delivered a significant shock to consumers and businesses. For a time, the growth of consumer spending slowed and inflation increased. But after the initial jolt, the growth of consumer spending and economic growth overall rebounded. Higher energy prices again have hit consumers hard in the pocketbook and businesses on the bottom line, but there's good reason to anticipate a similar recovery in spending this year, especially with oil prices having come down of late. So the lesson from last year's experience is that we shouldn't overreact to the present soft patch or short-run fluctuations in real-side data when the fundamentals for growth appear to remain relatively sound.

I, therefore, find myself in agreement with the Greenbook's perspective. Beyond the current quarter, the forecast has been revised only slightly, with the major components of demand projected to continue expanding at a fairly healthy pace. This forecast mirrors the perceptions of our Twelfth District business contacts who, outside of the Bay Area and Los Angeles proper, report that they remain quite upbeat about the economy.

For inflation, last summer's experience similarly advises a cautious policy reaction to the data. The recent uptick in core inflation probably reflects pass-through of cost pressures due to higher energy, commodities, and import prices. If so, the upturn is apt to be transitory, since now,

just like last summer, underlying pressures on core inflation appear to remain subdued. Several of the good fundamentals driving the outlook for inflation are worth highlighting.

First, the data surveyed in Part 2 of the Greenbook suggest that at least some, and possibly considerable, slack remains in labor markets. Corroborating this view, our contacts, even in some of the most rapidly growing areas of the Twelfth District, report little trouble filling job openings except in some skilled trades that are in high demand in construction. I met recently with top executives of SBC West, a major employer in California and Nevada. They indicated no difficulties whatever in hiring at any skill level, with only a few exceptions, such as accounting. Like most of our contacts in the District, they also saw no significant wage pressures. Indeed, nationwide data suggest that labor cost pressures appear quite restrained. For example, as David noted, last week's ECI data showed no sign of any acceleration in private compensation.

The underlying trend in productivity is also solid, and, as I discussed at a previous meeting, I remain optimistic that it will remain so, in which case unit labor costs are likely to remain constrained. Our contacts report continued scope for productivity improvements. For example, the SBC West executives with whom we met explained how new technologies permit tasks to be performed via computers at headquarters that in the past required technicians to make service calls.

Of course, "pricing power" is a phrase that is used frequently by our contacts, but the mention of pricing power is focused exclusively on pass-through of cost increases due to energy, materials, and transportation. In construction, agriculture, and transportation, firms report considerable success in passing these cost increases along. In other sectors, the experience has been more mixed. One director who runs a major clothing retailer reported only limited pass-through to consumer prices in the face of competitive pressures and continued gains in productivity. With markups still high, firms should be able to absorb some cost increases without raising goods prices.

Moreover, to the extent that these costs are being passed through to prices, they appear to provide only one-time boosts to the price level.

In terms of policy, I support a 25 basis point increase at this meeting and retaining the “measured pace” description of the likely path for policy going forward, at least for today. Weak real-side data might suggest a pause to evaluate the extent and likely duration of the slowdown. But incoming inflation data could justify more aggressive action. Given the latest uncomfortably high readings on inflation, I think we have to remain vigilant. The constancy of long-run inflation expectations provides some reassurance, although I worry that if we had similar readings on such expectations in the early 1970s, they would have been slow to rise then as well, as bond markets had grown complacent about inflation.

Last time, we adopted language that many of us thought made our balance-of-risk statement tautological. In fact, it turns out that the statement is not tautological, and I no longer consider it true. [Laughter] In my view, even with appropriate monetary policy action, the risk to the attainment of sustainable growth is unbalanced to the downside, while the risk to the attainment of price stability is unbalanced to the upside. It is the risk to our dual objectives, but not to each individual objective, that I consider balanced overall.

Releasing an unchanged balance-of-risk statement might suggest to some that this Committee has ignored the palpable shift in economic conditions toward higher inflation and slower growth. Indeed, an uncharitable description of the current statement is that it has gone from not serving any purpose to potentially being perceived as factually incorrect. Rather than try to modify the balance-of-risk statement, I think it is perhaps time to retire it, for reasons that I will explain in more detail in the policy go-round.

CHAIRMAN GREENSPAN. President Pianalto.

MS. PIANALTO. Thank you, Mr. Chairman. At our last meeting I said that I was happy to report that the Fourth District was no longer an outlier in the Beige Book and that economic activity in the region appeared to be gradually improving. But that warm glow appears to have been short-lived. Since our last meeting, economic activity in my District has shifted down somewhat, conforming to what we now see in the national economy.

In both the Beige Book process and my conversations with business contacts, I've been especially keen to elicit information about pricing pressures and the reemergence of pricing power. The tone regarding pricing power also appears to have softened. Although I still hear that there's an ability to pass through some higher raw material costs, the majority of my contacts are once again reporting that it is difficult to pass on price increases.

My instinct is to be concerned about the possibility of further inflation creep over the year. After all, most of the inflation surprises have been on the upside for quite a while now. But from my perspective, the issue that we confront is whether to regard the inflation situation as unfortunate but transitory, or unfortunate and persistent.

The Greenbook projection treats energy shocks like rocks thrown into a pond. The energy shock creates a ripple that dissipates over time. The price statistics throughout last year behaved accordingly. When that rock or energy shock entered the pond in 2003, the core rate of inflation initially spiked up but then declined throughout much of the year. Energy markets threw another stone into that inflation pond last year. Without those energy shocks, my guess is that the Greenbook inflation projections for this year would have held up nicely; and I think the current projections are sensible, barring any more ugly supply shocks. That is, I think it is reasonable to expect that core inflation once again will drift back down—in the absence of more rocks entering this pond. There is little evidence that unit labor costs are accelerating or that prices not affected by

energy are problematic. So this gives me some comfort with the Greenbook baseline inflation projection. But I recognize that inflation dynamics could deliver more persistence than that.

Throughout this policy tightening cycle, I've been focused on getting the fed funds rate back into the neutral range. When the pace of economic activity appeared to be more robust, I preferred to be in the higher end of that range. However, the incoming data have made me less certain about aiming that high. And it is possible that the equilibrium real rate of interest could be either notably higher or lower by the time of our June meeting.

For now, I still think that a sequence of small incremental increases in the fed funds rate is the most likely course of action in the immediate future. Nonetheless, greater uncertainty about the outlook for economic activity and inflation does change my view about how policy decisions ought to be communicated. In my view, the "measured pace" language we've been using has served us well. But I think this type of guidance should be reserved for those periods of time when the Committee feels especially confident about what the next few policy actions will be and has reason to believe that its intentions would be misunderstood without that kind of guidance. I do not think that these conditions are present today. For that reason, I do favor removing the "measured pace" language. If the statement were reflecting my own thoughts, I would also insert some words that convey a greater sense of uncertainty about the outlook for real growth and inflation and, therefore, more uncertainty about the timing and magnitude of future policy actions. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I'll start off by repeating the obvious: There have been a couple of surprises since our last FOMC meeting. The economy has lost momentum after the end of the first quarter, and core inflation has continued to rise. The loss of momentum we saw in March in

the first quarter has led me to join others in marking down my forecast for growth this year to about 3½ percent. I expect growth in the second half of this year to be about 3¾ percent and then slow perhaps back to 3½ percent next year. With trend growth of about 3¼ percent, the output gap and labor market slack should continue to diminish, as we've said before.

I would agree with those who attribute much of the slowdown to the persistence of higher energy prices. This is especially the case for consumer spending and confidence, as we see it. Higher energy costs have also reduced growth in other countries, and I think that probably has contributed to some of the worsening in our trade balance.

Obviously, we need a little more time and information to determine whether the recent economic performance reflects temporary factors or is likely to be more permanent. If it is temporary, then, as energy prices level off or perhaps decline somewhat, I would expect the fundamental forces of growth to take over—those being monetary policy that, in my opinion, remains accommodative and financial conditions that are, perhaps, highly accommodative.

I'll digress here by giving you just one anecdote. I talked recently to an executive of one of our major banks that lends across the nation in some of the hot markets. He described a condominium deal, a fairly large one, where the construction cost was about \$100 million. The developers had \$3 million of equity in the project. Those who lent \$97 million lent those funds on a pro forma sale price that finished out at \$140 million. So there is a lot of speculation, I think, in these markets. And that is something that we have to take into account.

But I also see that the labor and capital markets that we talk about here are strengthening. So overall I think the evidence is that the economy will improve. And I would say, from a regional perspective, that the Tenth District mostly provides support for an improving outlook, though I acknowledge that there are issues with respect to energy prices. For example, consumer spending,

including travel and tourism, rose solidly in March and early April, and most retailers said sales were up substantially from a year ago. In addition, housing activity turned up, following a pause in late 2004 and early 2005 in our region. Housing starts and permits rose solidly in March, and home sales were strong in most of our District's cities.

Still, preliminary data from our manufacturing survey suggest some evidence of a slowdown. In fact, in April the production and shipments indexes both fell. More worrisome, though, was the large decline in the six-month-ahead production, shipments, and new orders indexes. This bears watching, since it may suggest a more permanent slowdown than we currently expect.

In addition, a number of contacts expressed concerns to us about higher energy prices. For example, in our April manufacturing survey, some firms said that they were delaying shipments in order to assure full truckloads and thus save on fuel costs. A few firms also said that they expect to cut back on production due to high energy costs. In addition, some retailers were worried that higher gasoline prices would eventually take a toll on their sales. Of course, for our region, higher energy prices are positive for some of our District's states, particularly Oklahoma and Wyoming, where we see nearly boom conditions.

Turning to the inflation outlook, I do expect to see further increases in core inflation, with core PCE inflation averaging almost 2 percent in 2005 and core CPI inflation averaging 2½ percent, similar to the Greenbook forecast. However, unlike the Greenbook, I expect core inflation to remain elevated in 2006 rather than to fall back. I take note of the fact that energy price increases may be a rock in the pond, but I think the substantially accommodative monetary policy we have had is more like a boulder. And it is carrying itself forward, which is what we need to be aware of and alert to.

We continue to see increases in core inflation. Whether measured in 3-, 6-, or 12-month periods, core CPI and core PCE inflation have generally been rising this year. Moreover, core



inflation is now higher than at any time since the second half of 2001. In my opinion it is above comfortable levels. Measured from six months ago, core CPI inflation is about 2½ percent and core PCE inflation is above 2 percent. Clearly, some of the increase represents temporary factors—such as the energy prices we keep talking about and the prices of some commodities—and may be reversed. However, I would take note that the pass-through of energy prices to core inflation is difficult to predict, as we talked about earlier, and may be greater than some suggest. I also believe that there is more to the inflation story than energy prices. Even if we exclude the two largest quarterly rates, core CPI inflation over the last four quarters was 2 percent, which is significantly higher than core inflation over the previous four quarters.

I believe some of the increase is the result of our continued accommodative policy. We've seen inflation rise over the last year in the presence of sizable slack and a rising funds rate. I'm concerned that, with less slack in the economy, we will continue to see higher inflation going forward. In addition, maintaining an accommodative monetary policy poses an upside risk to inflation, with the federal funds rate currently below many estimates of the lower bound of the neutral rate. If we are slow in removing this accommodation, I would be concerned that the increase in core inflation also might be passed through to higher expected inflation.

We're also seeing some evidence of pricing power in the Tenth District, as manufacturers continue to raise their output prices to cover what they've referred to as rising costs of energy and other inputs. In addition, the share of our Beige Book retail contacts who reported to us that they were raising prices this time was the highest in the last five years.

These are my concerns. The one other thing I would mention relates to our statement. I would agree with those who would like to abbreviate our statement today. Since people are, in fact, paying attention to the minutes, I'd rely on them as our communication method. Thank you.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. Economic conditions in the Third District continued to improve in the first quarter, although at a slightly slower pace than in the previous quarter. Retail sales in the region were up slightly in March, with most merchants noting that unseasonably cold and rainy weather dampened sales of spring apparel and other seasonal merchandise. As in the nation, local auto dealers saw a healthy rebound in sales in March, helped by strong manufacturers' incentives. Both retailers and auto dealers expect sales to improve this spring.

Payroll employment continued to increase in the region in the first quarter, and the unemployment rate declined. A large national payroll and benefits administrator in our District reported that in the first-quarter employment growth was stronger at small firms with fewer than 1,000 employees than at large firms. But the positive growth rate at large firms was an improvement over the zero growth they saw last year.

There has been little change in the overall picture in the construction sector. Nonresidential construction in our region remains soft. As in the nation, there has been a sharp drop in the value of nonresidential construction contracts in the first quarter compared to a year ago. The residential sector remains strong. The value of residential construction contracts declined in the first quarter in our three-state region, but remained at a high level. Home sales and the rate of house price appreciation remained robust.

Our business outlook survey indicated that regional manufacturing activity is expanding. We saw a sizable rebound in the general activity index—from 11.4 in March to 25.3 in April—suggesting that the drop in March may have been a random volatility event rather than a signal of a more persistent slowing. About half of the firms reported that they plan to increase capacity in 2005, with the modal increase in the 5 to 10 percent range.

The most troubling regional economic news is the evidence of increasing price pressures in the District. Consumer prices in greater Philadelphia appear to be increasing at a faster pace than in the nation as a whole. After some moderation in February and March, industrial price pressures increased in April. The price indexes in our manufacturing survey rebounded this month across almost all of the industrial sectors represented and are at very high levels. However, while the indexes of future prices paid and received have risen sharply over the past two years, in recent months both indexes have stabilized, albeit at relatively high levels. Also, employment cost inflation in the Northeast region has not accelerated, running at a 3.5 percent annual rate in the year that just ended in March.

In summary, the economic expansion appears to continue at a moderate pace in the Third District. This is what we gleaned from the data we have available and it's consistent with the anecdotal information from our contacts. During April, I typically travel around the region, holding a series of meetings with our bankers and business leaders. They're generally upbeat, with positive outlooks despite the recent negative national economic headlines. This gives me some confidence that the recent softness in the data will prove to be relatively temporary and is not signaling an economy that is taking on a new direction.

My assessment of economic conditions in the nation is similar. Admittedly, higher oil prices likely are having some dampening effect on economic activity, and recent monthly data have come in softer than expected. However, this appears to be a temporary lull, as there is little to point to that suggests we are seeing a persistent deceleration in real economic activity. Last month was reminiscent of the soft patch we hit in June of last year, as President Yellen indicated, after oil prices began to rise. You'll recall that the economy emerged fairly quickly from that lull.

As the expansion continues and the economy approaches a sustainable growth rate, it is to be expected that we will see growth in some quarters above and in some quarters below that sustainable pace. My reading of history suggests that a low quarter or two is fairly typical during the course of an expansion and that some of the concerns based on early measures of economic activity are assuaged by subsequent revisions in the data. The bottom line is that I agree with the Greenbook's assessment that the economy continues to have positive momentum. This suggests that it is premature to be too concerned that the perceived slowdown will persist and clearly premature to alter our policy path based upon the available new data.

Of course, there are downside risks for near-term growth, but there is nothing that monetary policy can do that will affect the real growth in the next quarter or so. Therefore, I think we should be focusing on a horizon over which monetary policy can have an effect. In that regard, the acceleration in inflation over the past year is a concern to me, and that sentiment has been echoed around this table. The first part of the increase in inflation was to get us away from the zero bound, but we are now well beyond that. In fact, over the last six months, the inflation rate has been moving up into the top half of my acceptable range. Of course, these are high-frequency data and the trend still might prove temporary, but it clearly deserves watching.

The Board staff continues to forecast some tempering in core inflation over the forecast horizon, but the starting levels of their forecast have been moving up as new data have come in. The forecasted downward path seems dependent on a good deal of slack remaining in the economy. However, this increase in observed inflation may be evidence that there is less slack than we think. By ignoring the acceleration, we could end up in a situation of having to move rates up more rapidly than we now expect, which could have a negative effect on future growth. So this is certainly not the time to pause in returning to more normal levels and removing policy accommodation.

That said, I've become less certain about the particular speed at which the removal of accommodation should proceed. If the inflation acceleration continues, a steeper path may be indicated. In the event that the softening of activity turns out to be persistent, a slower pace might be more appropriate.

At the last meeting I indicated that I believed the dispersion of likely rate paths going forward was widening. I dare say there was some consensus on this point at the meeting. Given the recent data, I'd guess that not only is the dispersion around my own expected path wider still but that there is likely to be more divergence in the Committee's view of it. Thus, I believe it's important for us to craft our statement in a way that gives us considerable policy flexibility. It would also be useful if we could convey some sense that there is less certainty about policy actions going forward.

I will not get into the specifics of how to do this until the second roundtable discussion. However, I want to point out that sometimes saying less offers more transparency about the Committee's view than saying more. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Thank you, Mr. Chairman. Let me start with information from my contacts at FedEx and UPS. My contact at FedEx says that they've seen no indication at all of any slowing, nor do their customers see any sign of a slowdown. At UPS, both the ground business and express business are coming in a bit below plan. Part of the story on the express business, interestingly enough, is that the number of mortgage refinancing documents they're shipping is way down. [Laughter] Both companies have very impressive expansion plans under way. For its fiscal year beginning June 1, FedEx has planned a 20 percent increase in capital expenditures. That plan actually has been in place for the past six months, and they've now done the final budget. UPS is

hiring 20 to 25 pilots a month, of whom perhaps five are replacement pilots for those who are retiring. So, both companies have very aggressive expansion plans.

My trucking industry contact, on the other hand, says that business is soft. Volume is down 2 percent for April on a year-over-year basis. The intermodal business is down 5 percent, April over April; he notes that it was the first decline ever in the intermodal business in the 15-year history of the company. And he says that the declines are widespread across the country and across industries.

My Wal-Mart contact says that same-store sales are coming in at the low end of expectations. He believes the main reason is that the purchasing power of those in the part of the income distribution that shops heavily at Wal-Mart is simply being drained substantially by high energy prices. I think that's a familiar story.

In almost no case, with scattered exceptions, does anyone report any pressures in the labor market, either on wages or the availability of labor. The exceptions typically are for those with special skills, like accountants, which we've already talked about. Another job category that is in short supply, and has been for a long time, is truck drivers.

On the overall economy, I think the recent inflation data—and I'm echoing what a lot of others have said—have been on the high side of expectations and the output data on the low side of expectations. In my view, our uncertainty about the outlook going forward is somewhat greater than it has been. My best guess of a point estimate does match the Greenbook forecast. I think that's a good central tendency, but, as I emphasized, my uncertainty on both fronts has been rising. I think the inflation risk is clearly asymmetric on the upper side. I'm not so sure that there's all that much asymmetry on the output side.

The fundamentals on inflation appear to be sound. We have continuing modest wage increases, and we seem to have continuing good productivity growth. Financial conditions are not

highly inflationary, at least as measured by the aggregates: M2 growth has been coming in below the growth of nominal GDP; MZM has actually been about flat in the last six months and up 2 percent year over year. So, on the quantity side, I don't think there's evidence of a highly expansionary monetary policy. But I think there are lots of reasons to be nervous about the inflation risks. I would also point out that one of the clearest indications of the increased uncertainty about the outlook is the length of our discussion about the staff's forecast. Thank you.

CHAIRMAN GREENSPAN. Coffee is available, so why don't we take a break?

[Coffee break]

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN GEITHNER. Thank you, Mr. Chairman. We think the fundamentals underpinning a forecast of a reasonably strong expansion with moderate inflation seem reasonably persuasive. However, we are less confident than we were at the last meeting. On the assumption that we continue to move the fed funds rate higher on a path close to that now in the market, we expect the economy to grow at a 3½ percent rate during the balance of this year and in 2006. And we still expect core PCE inflation to come in below 2 percent, although just below, over the balance of the forecast period, but we think it will follow a somewhat higher path. As this implies, we're very close to the Greenbook projection on the overall contour of the forecast, and we're close on the components as well.

We see greater uncertainty in the forecast, with some downside risk to growth and some upside risk to inflation. We think the probability of inflation coming in higher is greater than the probability that growth will be lower. And, of course, that judgment about the change in relative probabilities is the key to one's judgment for monetary policy.

On the growth front, the anecdotal reports we're exposed to are weaker than they have been. They're weaker than the national numbers and may imply some further deceleration ahead. We don't have much basis for confidence that these numbers tell us much about the future, but the sentiment does seem a bit more fragile. The fact that confidence seems to have eroded so quickly in the face of a relatively limited period of weaker numbers might itself suggest greater vulnerability to the forecast.

Despite all of this, though, we think the near-term fundamentals of the economy look fairly good. The resilience of the recent past seems likely to be durable. We think the labor market still looks to be on a path of gradual improvement. Investment growth still seems likely to be pretty healthy, with profit margins high, balance sheets strong, and credit conditions favorable. We think the factors supporting solid investment growth remain compelling. And we still are inclined to believe that structural productivity growth is likely to remain strong, which should provide both continued impetus to investment and continued confidence about future income growth. It's hard to find other constraints out there that could limit the expansion. Of course, we still face some risk of an abrupt change in household saving behavior, and the effects of that could be significant.

On the inflation front, we've been surprised by the extent of the acceleration in core prices and we are a bit concerned about the higher expectations reflected in some surveys. The economy is growing at a rate that seems likely to be sufficient to continue to absorb remaining slack, unit labor costs have moved up, and we hear continued reports of increased pricing power. And some measures of expectations at the intermediate horizon—the horizon over which we expect monetary policy can affect inflation—are above the desirable level of inflation. Accordingly, we see greater risk that inflation will follow a higher path than we are comfortable with. This seems a prudent view of the risks to us, despite the comfort we continue to derive from the fact that compensation growth



has been modest to date—profit margins remain very high, of course—and despite expectations of fairly good future structural productivity growth.

The modest widening in credit spreads and the volatility in equity prices we've seen recently have been absorbed reasonably well. I'd be inclined to view this modest repricing of risk and uncertainty as welcome and healthy rather than as foreshadowing a deeper, more protracted deceleration.

On balance, we believe that monetary policy should continue to be directed at moving the real fed funds rate higher. At our last meeting we introduced a bit more uncertainty into the monetary policy signal by putting in more qualifications about the likely path of monetary policy going forward and about the cumulative amount of tightening. The overall effect of these changes to our statement was to continue to signal that we think the slope of the funds rate path remains positive, implying, of course, that monetary policy is still too accommodative. But we also indicated, through these changes to this statement, that we have less certainty about the slope and shape of that path.

Long-term measures of inflation expectations moderated immediately following the meeting, and some measures of uncertainty about future rates went up. And since then, market participants have demonstrated a very significant degree of sensitivity to incoming data—at least in terms of the fed funds path priced into the markets. To me this suggests that we got the balance about right last time. We bought ourselves the desirable increase in flexibility to respond to a somewhat more uncertain set of conditions going forward, and I think we should try to preserve that balance in our signal today. We need to acknowledge, of course, the moderation in the rate of growth in output and demand we've seen and the higher inflation numbers, but I don't see a good reason to try to alter in either direction the expectations for the path of the fed funds rate going forward.

The increased uncertainty in the market about the forecast reflects some greater dispersion in the likely path of the fed funds rate, and I think it suggests little gap between the market's view and our own view of policy uncertainty going forward. So I don't see a case for altering the statement significantly today in a way that would introduce a greater degree of uncertainty about monetary policy than is already reflected in the markets at this point. Thank you.

CHAIRMAN GREENSPAN. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. Unfortunately, the economic and policy situation became a lot more interesting over the intermeeting period. We thought we had an emerging inflation problem; the issue was how hard to lean against it. In the event, core inflation did come in a bit to the high side, but, in addition, economic activity was appreciably weaker than I thought it would be, with both consumption and investment falling short of expectations.

A greater-than-expected reaction to previous increases in energy prices seems to me the most likely culprit for both the inflation and output surprises. Perhaps the constrained reaction last summer and fall to the previous run-up in energy prices lured us into giving this factor too little weight. People may not change their behavior until prices have been high for some time and they perceive the need to build them into more permanent notions of relative prices and disposable income. Businesses, in cutting back their hiring and capital outlays, may be reacting to their perception that energy prices were in the process of taking a bigger piece out of household spending or at least to increasing uncertainty about the path of that spending.

The tendency for economic activity to be disappointing in several industrial economies in recent months supports the notion of a common global thread and is consistent with the energy price explanation. And on the price side, cost pass-throughs may be easier and more readily accepted by customers when everybody is subject to a similar shock.

I agree with the contours of the staff forecast. If energy prices remain flat, growth should pick up and core inflation should abate. We're most likely looking at a downward adjustment in the level of demand and an upward adjustment in the level of aggregate prices, not more persistent effects on growth rates. Fundamentals continue to favor this outcome. Financial conditions remain quite accommodative and supportive of growth sufficient to resume narrowing the output gap. Foreign demand should also strengthen, as the energy price shock is absorbed.

The damped growth of compensation even in the face of higher headline inflation indicates to me that appreciable slack remains in labor markets. Capacity utilization in manufacturing is still below its long-run average. In this environment, conditions in labor and product markets should help keep a lid on price increases, but the incoming data have elevated the level of uncertainty about the outlook, as many of us have remarked, and raise questions about what accounts for the recent outcomes and suggested skews around this most likely scenario.

It's difficult to identify what, other than energy prices, could be unexpectedly damping demand. But confidence has eroded, which could intensify and prolong energy-related shortfalls. We can see the decline in confidence in surveys of households and small businesses that we saw yesterday and also in financial markets, where volatility and risk spreads have risen and stock prices have fallen. Perhaps markets are better aligned with reality, but financial conditions are a little tighter than they have been, and this will restrain spending at least slightly going forward. The slowdown in the increase in investment spending is especially notable and would be a concern if it were prolonged, since that's what most of us were counting on to sustain solid growth and declining slack over the next few quarters.

The staff has interpreted the recent shortfall as reflecting in some small part more persistent weakness in demand than would be simply associated with an adjustment to higher energy prices.

High-frequency data, such as initial claims, and early indications of consumer demand in April suggest that the economy continues to expand at a moderate pace. But at the least, the recent data point to a greater possibility than I saw at the last meeting that growth will not be sufficient to raise resource utilization as policy accommodation is removed further.

On inflation, the decline in both short- and long-run inflation compensation and in financial markets since the last meeting encourages me to think that energy price increases aren't being propagated through this mechanism. But the surprises in the core inflation numbers do suggest some continuing risk that inflation won't be as contained as one might otherwise have expected at given levels of resource utilization.

The puzzle here in my view is the character of the competitive environment. Given slack in resource utilization and high profit margins, I would have expected businesses to have been driven—by competition and desires to expand market share—to absorb more of the cost increases. But businesses clearly remain cautious about expansion, and they have been able to raise prices to maintain very high price markups.

From a policy perspective, I think we have a situation that is a bit more balanced than it was at the last meeting. Financial conditions still seem too accommodative to be consistent with the economy not overshooting the level of its potential once the effects of rising energy prices wear off. We need to be careful that nominal rates keep ahead of the now slightly higher underlying inflation. But a gradual pace of tightening now seems an even better guess than it might have been at the previous meeting, in the sense of being in the center of a distribution of possible rate paths. And that's because a less robust economy and a larger output gap than expected should provide some greater assurance that inflation will remain contained as we raise rates at a measured pace.

As I tried to suggest, I think the distributions around the outcomes for inflation and output have become more skewed, but in offsetting directions with regard to their implications for policy. As we've been saying in our minutes and speeches, how the actual path of rates evolves will depend on the data and how some of these puzzles are resolved. But for now I would keep on our path, and I would let the public know that that's still our best guess for how we'll be proceeding. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. The short-run monetary choices are getting harder. While the world oil market is suffering a demand shock caused by rapid growth in China and elsewhere, it affects the economy as a supply shock, with simultaneous worsening of inflation and unemployment. Many of us lived through just the reverse of this in the late 1990s, with simultaneous improvement in inflation and unemployment. For us, turnabout is fair play. But while it may be fair play, the choices get harder. Does one look at the inflation numbers and tighten up or at the unemployment numbers and loosen up? The answer depends, I think, on whether the medium-term impact on inflation or unemployment is likely to be stronger and more pervasive.

As the numbers came in over the past six weeks, initially I was on the hawkish side, worried that inflation would come loose from its moorings. In terms of Vincent's Bluebook rhetorical chart [exhibit 6], I found myself over in column C somewhere looking for ways to tighten the statement to express more inflation concern. But as time went on, the dribs and drabs of steadily worsening data have shifted me over to where I am now, which is somewhere in column A, wanting to ease our rhetoric moderately. Given the enormous amount of accommodative policy that we have put in and our fairly elaborate telegraphing operation, it is too late to actually pause in our rate increases at this

meeting. And I guess I've been to too many meetings of this sort to suggest major changes in our rhetoric. [Laughter]

But I would like to lobby for at least some elements of column A in the statement. The reasons for my change should be fairly apparent. As the Greenbook notes, the spending data have been consistently weak over the last six weeks. The first-quarter GDP report was below expectations in a way that is likely to last. Not only was GDP overestimated, but final sales were overestimated by even more. So the future forecast should be scaled down to reflect the lower final sales momentum and perhaps additionally because there might be something of an inventory overhang.

In terms of spending components, there has always been a likelihood that consumption growth would slow as personal saving rates keep dropping to historic lows. And it was always likely that saving rates would revert to more normal, higher levels, slowing consumption growth. The wealth-income ratio was held up by house prices, and it, too, could revert to more normal levels, further slowing consumption growth. Consumer confidence has been dropping for a while now. On the whole, it is quite reasonable to project that consumption will grow less than income for the next few quarters, repressing income growth.

Fiscal policy appears to be roughly neutral over the forecast horizon. I note that the Congress did pass a budget agreement that seems to contain at least moderate fiscal tightening. Whether this fiscal tightening will actually come to pass is still an open question, but we will probably not get much new demand impetus from the fiscal side or from the foreign side. Some parts of the world are growing well, but many of our trading partners are experiencing slowdowns of their own; hence, slackening export growth is likely. The dollar drop may help, but if the dollar

declines sharply, there may be enough dislocations around the world that export growth could still sputter.

This means that over the medium term unusual importance attaches to capital investment. In the staff's own words, in the data report we got, business fixed investment rose at a rate "well below" that in the fourth quarter; "spending on equipment and software decelerated and spending on nonresidential structures declined." I might add that durable goods orders are down sharply. Housing starts are down, and the ISM [Institute for Supply Management] index of factory activity is down. The stock market is sluggish despite pretty decent earnings reports, and measures of small business confidence have plummeted.

Even though this is a lot of data, I do think it's too soon to tell if there's a pattern here, but it wasn't so long ago that we were worried about an investment pothole. Maybe we just got the timing of that a little wrong; with sluggish aggregate macro time series, that can easily happen, I think. Or there could be some other source of impending weakness in investment. It seems as if around this table about every eight months we get worried about a lack of corporate animal spirits. I don't know what the answer is, but I do think that, if investment flags, there is no other obvious source of spending strength. Granted, as Gary says, the economy has shown a lot of resilience, but the spending still has to come from somewhere.

As I said before, it is intrinsically difficult to conduct monetary policy when both objectives are turning the wrong way, but in the medium run I'm going to differ with many of you in at least raising the possibility that the weak spending data may trump the strong price data. Many of the price increases seem to be one-shot increases due to energy shocks and unlikely to pass through into continuing inflation. We talk about the core index, but the core index doesn't purge all influence of energy, and I'm a little suspicious that some of the taints are, if you will, energy taints. I think it's

important to keep our eye on wages, and wages have continued to be moderate, indicating that price pressures do seem to be contained for the longer run. And as many of us have noted over time, if aggregate demand does weaken, output gaps will fail to close and overall price pressures should wane.

So what should we do about all of this? In the short run, I'll go with the crowd. We have invested so much in advertising a climb in rates that we can't back down now. For the medium run, however, I'm beginning to get worried on the negative side. At this meeting, I would like to shade our rhetoric toward the A column in the Bluebook. I guess the only other thing I could say is that I'd like to recommend that over the next six or eight weeks everybody study carefully the simulation that the staff labeled "Sentiment slump with financial spillover." [Laughter]

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. Thank you, Mr. Chairman. In preparation for this meeting, I talked with contacts at two large banks. As all of us are aware, bank asset quality throughout all of 2003 and 2004 continually improved to the point where by the end of last year almost all bankers said in their year-end reports that asset quality cannot get better; it has to get worse. Thus far, the announcements that have been made in the first quarter indicate that asset quality did get better. But I suspect that some of the bankers are looking at the debt spread information and are asking themselves the same question that Dino posed rhetorically: Is there something behind the data that we need to know? And both bankers that I talked to independently believed—because they're in an environment of intense pressure on prices and underwriting standards and in a situation with significant liquidity—that the marginal credits may, in fact, be rewritten. They are circulating, so we have a slight game of musical chairs going on with marginal credits. So, with bank asset quality, we do not yet see the decline as we do with some of the debt spreads, but it may be lurking out there.



That said, it is not significant because, with the very strong performance of corporate America in recent years, there is still very little in the way of troubled assets out there, particularly in C&I loans.

With respect to today's meeting, as I read the Bluebook and the Greenbook information, I was struck by the significant contrast with the last meeting. I was prepared to speak to that in a substantive way until both David and Karen summarized in about three sentences what I would have said in many more. So I don't need to go in that direction.

But what I was not prepared to speak to until I came in to today's meeting was the fact that when I compare the Beige Book reports and the comments of the Reserve Bank Presidents, there is not nearly the wide variance that I noted in the Bluebook or the Greenbook. Now, if the information that we gather in Washington is cumulative data that we were able to pick up, albeit with a lag, and we supplement that with the more contemporaneous data that we get from the Presidents, it seems to me that there ought to be a lesson there. At least we ought to focus on it. In the three-and-a-half years that I have been on this Committee, I don't remember the information always being identical, but I never remember the Beige Book information lagging the Greenbook data. So I suspect that we may be closer to a pothole or perhaps even the head fake that the entire Chicago Bulls went for last night when Juan Dixon went up for his jump shot, which he made consistently.

MR. MOSKOW. That's unfair. [Laughter]

MR. OLSON. It has been 17 years, Michael. It has been a long time.

I'm inclined to support those of you who have already spoken to the strength of the underlying fundamentals and who believe the output gap is continuing to close slightly. I think we clearly communicated in the last meeting—and the market interpreted it correctly—our heightened concern about the level of inflation. With respect to the likely direction of the underlying economy,

I think the information is sufficiently contradictory or unclear that it is difficult to make a positive statement.

However, we may choose to do as Susan and Roger and I did in our announcement with respect to the Basel II QIS4 [Quantitative Impact Study] information. Some of you may know that as we were looking at the QIS4 data, which involved the study of the impact of the new Basel II Accord on the banks, we decided that either the information reflected a wider disparity of risk exposure or that there were some additional fundamental inconsistencies in the underlying data that would require us to postpone the release of our notice of proposed rulemaking. So we did that.

That we simply postpone, actually, would be my first choice for today. [Laughter] Since that is not really being an appropriate option for us, I would suggest that we not significantly revise the manner in which we have communicated our views regarding the removal of policy accommodation until we get a clearer sense of what the underlying data are telling us.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. Thank you, Mr. Chairman. I guess I'm going to repeat a lot of the things that others have said, but I think I will end up in a somewhat different place than some of you around the table in that I'm much more concerned about the risks of inflation than I am about those for the real economy.

If we look at the first-quarter data, and more particularly the information that has come out in the last several weeks, we can really see that the quarter started out very strong and that the more recent data showed some weakness. First-quarter GDP growth at 3.1 percent was much weaker than most folks, myself included, expected. But if one looks at the components of the underlying data, they show that the weakness in the first quarter was primarily in net exports—particularly due to the

surge in imports—and in government spending. In fact, private domestic final sales were really quite good in the quarter, growing by my rough estimate at somewhere in the high 3 percent range.

So how do we deal with that? Well, to the extent that the weakness is imports and is coming from strong consumer and business spending, that's a good sign. So, while I want to get some more data on what is happening in the real economy, I'm not as pessimistic as some of you. Monetary policy is still accommodative, if one looks at the liquidity in the banking system. And while the weaker economic data caused some reaction in financial markets, overall the conditions are very supportive of business expansion and consumer borrowing. Corporate profits for the first quarter, which are still coming in, seem to show continued strength, and first-quarter earnings growth now looks as if it will be in double digits for the twelfth straight quarter.

To me the other remarkable development in the markets is what has happened in reaction to news about compliance with Sarbanes-Oxley. This is the first year-end reporting. Most companies are on a calendar year-end, and a record number of companies have announced that they cannot report in the regular time frame and are doing late filings. Normally, one would expect this to create a disruption in the market, but the market has been very discerning in the way it has taken the news. Many companies that have reported have had to disclose weaknesses in their internal controls around financial reporting. And based just on the anecdotal evidence, the market seems to be behaving very prudently in that it is distinguishing between companies where the reported weaknesses are isolated in one small area and those where the control weaknesses are more pervasive. So, it appears that the sunshine associated with these disclosures is being handled well in the marketplace. We'll see what happens as we go along and those firms that have still to disclose their Sarbanes-Oxley reports do so. I was a little concerned that we might see more volatility in the market as a result of these reports, but that worry has been disappearing in the last few weeks.

Let me turn now to the inflation issue, which does have me more concerned. If we look at the lagging indicators, inflation numbers over the last 12 months are still in the mid-1 percent range, depending on what measure we look at. But one of the things we need to realize is that in the first part of last year inflation rates were very, very low. If I look instead at inflation measures in the first quarter compared to the fourth quarter, I get very much concerned about the trend we're seeing. If I throw out all of the volatile energy and food components, the way we typically do, and look at core measures, core CPI has risen by 1.3 percentage points to 3.3 percent in the last three months. Core PCE is up a full point to 2.6 percent.

As to where we see prices rising, the big turnaround, as some of you have indicated, has been in the goods sector of the market. Prices for services continue to be rising by a bit above 2 percent, but goods prices have gone from declining at an almost 3 percent pace at the beginning of last year to being about unchanged now. That is affecting the aggregate numbers and is something we need to watch. The employment cost index in the first quarter did show a slight slowing to 0.7 percent from 0.8 percent in the fourth quarter. But as David remarked, this is due to the slowdown in pension funding that occurred in the first quarter.

A recent survey of corporate CFOs shows that their number one concern continues to be health care costs. And as they look to pay for the cost of labor going forward, many of them are trying to hold down wage increases because of the significant rise they're seeing in health care costs. Where this will lead in terms of future hiring is a concern. It may impact the real economy, because if employment growth continues at the more subdued pace of the last month, it could affect consumption and the real final sales that are giving me confidence in the real sector. As for the balance of risks, I agree with the comments President Yellen made; I believe the risks of inflation are now clearly on the upside.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you very much, Mr. Chairman. Like everyone else, I've noted with some concern both the incoming evidence of a soft patch with respect to growth and a rough patch with respect to inflation. However, I also believe that the Greenbook has taken these incoming data on board with the usual wisdom and aplomb that I would expect from the staff. I, therefore, think I can easily support the baseline as being a reasonable basis for policymaking today.

Having said that, I'm also quite certain that the baseline will be wrong; I just don't know in which direction. As many have already pointed out, the range of risks is really quite large. I would say that if one looks at the alternative simulations, one can see many of the elements of those risks. Given the fact that I'm the last speaker, I will not go through a recitation of the data. Instead, I'm going to move to the implications of that.

First, I think the outcome of today's meeting is in some sense a foregone conclusion. Anything other than a move of 25 basis points would be folly, and I don't think we want to go down that path. Second, with respect to what we say today, a number of people have raised some questions about whether or not we should keep the word "measured" in our description. Frankly, given the range of uncertainties that we are facing now, to do anything other than to say that policy will be moved at a measured pace, I think, would create more uncertainty than certainty. So inertia in terms of the language might well be a smart move.

Thinking beyond that, though, to the rest of this year and focusing a bit more on strategy, I note that the markets have now marked down their expectation of where the fed funds rate will be toward the end of the year and much of next year to a number close to 3.75 percent as opposed to 4 percent. That leads me to think about exactly what has been driving the unusual data we have seen coming in. Here I pick up a point that the Greenbook raises. The writers hypothesize that there are

two reasons for the softness in the recent data: one is higher energy prices, and the second is that the tightening of monetary policy may have taken a greater toll on the economy than we had anticipated.

Many have already explored the energy price issue and its implications for inflation. Let me now go to the other side, which is the question of whether or not the tightening of monetary policy has had a greater toll on the economy than we had expected. This obviously is another way of saying that the equilibrium real interest rate is somewhat lower than we might have thought previously, and I'd like to explore that possibility.

I think the markets clearly have the view that the equilibrium rate or the neutral rate may have come down somewhat. The Bluebook table indicates that the TIPS-consistent measure on a core PCE basis would put the medium-run equilibrium real rate at about 2¼ percent. Obviously, we cannot observe the rate that would be called for to keep the economy growing at potential without inflationary pressures, but perhaps we can approximate this unobservable by looking at the long-run averages. The average real rate during the period 1991 to 2000 was about 2¾ percent. Thus, the market seems to be signaling that the equilibrium real rate has come down to a level about 50 basis points below what it was in the last decade. David in his remarks indicated that there is obviously a wide band of confidence around that, but it may be somewhat lower as well as potentially somewhat higher.

So let's look at the question of why the rate might be lower or why it is that the market and the Greenbook might be right to suggest that the trajectory for the rate might be somewhat lower than we had thought earlier. I think we all know the litany: the restraint imposed on domestic consumers from the increase in the cost of energy, the lingering hesitancy of businesses to make commitments, and the drag on domestic production from the excess of imports over exports. All

these factors represent forces that are pulling the equilibrium rate down below its perceived long-term rate.

So what are the facts? First, with respect to the first explanation on energy prices, the staff yesterday showed us a simulation that indicates that the run-up in oil prices since December 2003 may have taken  $\frac{1}{2}$  percentage point off growth in 2004 and  $\frac{3}{4}$  percentage point off growth this year. I have nothing to add to the simulation, but it clearly suggests that there is some damping of domestic demand that's coming from these high and consistently high energy prices.

Let's go to the second point, which is the issue of business hesitancy. It's certainly true that equipment and software spending has been growing relatively strongly. However, by historical standards, both nominal high-tech and non-high-tech E&S [equipment and software] expenditures as a share of GDP are somewhat lower than average. I don't have the exact numbers, but as a rough approximation it seems as though non-high-tech spending has accounted for somewhere between  $5\frac{1}{2}$  and 6 percent of GDP since 1980, and now accounts for something lower—close to about 5 percent. High-tech spending has also been trending up for some time, but perhaps it should be about  $4\frac{1}{4}$  percent of GDP now and it's actually about  $3\frac{3}{4}$  percent. These are obviously rough estimates, but they all suggest that there has been a lingering drag on investment following the 1990s.

The third explanation for why the real equilibrium rate may be somewhat lower, obviously, is the drag from trade. That topic has already been well discussed. I won't add much more except to say that in a recent discussion with the ECB [European Central Bank], their policymakers seem to have some concern that the risks to their economic growth are primarily to the downside, suggesting that we should not expect a pickup in demand for our exports overseas.

So the question then becomes this: If, indeed, the markets are right and we are closer to the end than to the beginning of our move toward the equilibrium rate, what happens if we get all of this

wrong? I realize I'm trying to do something here that Gary suggests we can't do, which is to achieve a brilliant policy, exquisitely executed. But if we aren't able to achieve that, what happens? I asked the staff to run a rough simulation from FRB/US to see what would happen if we continue to raise rates 25 basis points today and at each of the following four meetings—in June, August, September, and November. That simulation suggests that we would wind up at the end of 2006 with real GDP growth down at about 3.1 percent, the unemployment rate would have risen to about 5.5 percent, and core PCE inflation would have fallen to 1.6 percent versus the 1.7 percent in the Greenbook baseline. I don't have a longer-run forecast, but I would expect that over a longer time horizon we'd find inflation trailing off even more.

The reason I've gone through the simulation is to suggest that as we think about the rest of this year, we should probably take on board the fact that while we have to continue to tighten—as both the market and the Greenbook suggest—this concept of measured pace is very, very important. And the issue of exactly when and where we stop is also quite important. To put it another way, while I'm comfortable with the strategy for today, I think we're really entering the neutral zone. And for those of you who are Star Trek fans, you may recall that when you enter the neutral zone that's when the aliens are most likely to attack. [Laughter]

It is quite clear to me that we have executed one exit strategy, but unfortunately I think we're entering a mode where we need a new exit strategy from the exit strategy! [Laughter]

CHAIRMAN GREENSPAN. Mr. Reinhart.

MR. REINHART.<sup>2</sup> Thank you, Mr. Chairman. I'll be referring to the materials that were distributed during the coffee break.

Market participants see today as another step in your journey of removing policy accommodation. As shown in the upper left panel, futures prices and survey responses indicate that a ¼ point firming today is a lock, as is the retention in the

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<sup>2</sup> The materials used by Mr. Reinhart are appended to this transcript (appendix 2).



statement of the judgment that the risks to both of your objectives are balanced. Some doubts, however, have surfaced about whether the “measured pace” language will survive the day: One in four of the respondents to surveys by the Desk and by Blue Chip think not.

Market views about your action today were essentially settled by your March statement. As the solid line in the top right panel shows, the May federal funds futures contract has traded at about 3 percent over the entire intermeeting period. But investors also apparently understood that your actions in coming quarters depend on economic prospects, as they revised down the funds rate expected at year-end (the dotted line) about ¼ point—or about as much as the staff has assumed in its baseline.

Some of the twists and turns of that path owed to Committee statements. As can be seen in the middle left panel, the announcement released after your March meeting was viewed as hawkish about inflation and prompted the largest swing in the two-year Treasury note yield in the window surrounding 2:15 p.m. in the past year (the red bar). Some of that was taken back by the more nuanced description of your deliberations provided in the minutes of that meeting released three weeks later. (Note that only the last three pairs of bars cover the new regime of expedited publication of the minutes.)

As can be seen by the bars in the upper of the two panels at the middle right, the two-year yield rose in the windows bracketing major economic data releases, as increases following data on faster-than-expected consumer price inflation more than offset the changes sparked by spending, production, and employment releases with a surprisingly soft cast. That latter information, along with well-publicized problems at a few prominent corporations and declines in equity prices, soured market sentiment about the vigor of the economic expansion. And as can be seen in the panel just below, intraday movements in the two-year note yield were highly correlated with those of the S&P 500.

As shown in the lower left panel, equity prices shed 2½ percent on net over the intermeeting period, and risk spreads on debt instruments widened. Triple-B yields (the solid line in the middle panel) edged lower, but speculative-grade yields (the dotted line) actually rose. With the value of the dollar appreciating slightly on foreign exchange markets (the lower right panel), financial conditions likely tightened on net.

If you believe that these financial conditions—which are predicated on market expectations of policy action today and more to follow—will preserve satisfactory economic expansion while containing inflation, you probably would be comfortable with moving the federal funds rate to 3 percent this afternoon. No doubt, the staff’s assessment of the economic outlook, as summarized in the upper panels of exhibit 2, has moved in an unsatisfactory direction, with the output gap, at the left, narrowing

more gradually than in the previous forecast, and core PCE inflation, at the right, running along a slightly higher path. This fits the bill of an adverse supply shock, likely at least in part the product of sustained higher oil prices. In effect, higher inflation—and probably upside risks to inflation—act as a constraint limiting how fast slack can be worked down. As a result and as many of you have noted, the policy menu available to you looks dourer than it did six weeks ago.

In that brave new world of diminished possibilities, a  $\frac{1}{4}$  point increase in the nominal funds rate would help prevent an erosion in the real funds rate (as the result of the upcreep in inflation and perhaps short-term inflation expectations) and might even close a little of the distance of the actual real rate (the solid line in the middle panel) with estimates of its equilibrium (the swath of red).

Taking as given the wisdom of the crowd about policy expectations, the issue isn't whether you will tighten by  $\frac{1}{4}$  point, but whether you will signal a slower, unchanged, or quicker pace of firming going forward in the words that accompany that action. The staircase plotted in blue in the bottom left panel considers a future in which you tighten 25 basis points at upcoming meetings for as far as the eye can see. That path is not built into markets. The expected federal funds rate (the dark solid line) veers to the south of the staircase and flattens out, implying the expectation of an end to this cycle of firming. Looking at the readings along the vertical line denoting year-end, an expected federal funds rate of  $3\frac{1}{2}$  percent adds up to two more  $\frac{1}{4}$  point increases in the final five meetings of 2005.

The same structure of expected funds rate can be described as averaging over different branches of the probability tree in which the Committee tightens  $\frac{1}{4}$  point at each meeting until it stops for good. The distribution of stopping times, given at the lower right, shows that current futures quotes are consistent with  $\frac{1}{4}$  weight given to the funds rate being on hold starting in June and a six-in-ten chance prevailing that you will be done at some point before the end of this year.

The arguments for pausing sometime soon are laid out in exhibit 3. In particular, as seen by the position of a nominal federal funds rate of 3 percent plotted as the solid line in the upper left panel, standard policy rules mostly call for something south of that target. As shown in the two panels at the upper right, policy rules agree that the nominal funds rate this quarter should be higher than the average of the first quarter. You'd be more comfortable with a funds rate at the level of 3 percent if your inflation goal is a  $1\frac{1}{2}$  percent annual increase in the core PCE (the upper right panel) than if your inflation goal is 2 percent, as noted directly below.

Holding the funds rate at 3 percent for some time would have added appeal if you viewed spending as potentially prone to a negative confidence shock that could spill over to financial markets, perhaps as spelled out in one of the alternative simulations in the Greenbook that turns out to be a favorite of Governor Gramlich. As shown in the middle panels, in that simulation the unemployment rate ends the

forecast period 1 percentage point higher than the baseline, and core PCE inflation moves back into the territory where “unwelcome disinflation” was once a serious concern. Moreover, a signal that policy would be on hold might not provoke particular concern on the part of market participants given that employment compensation (the lower left panel) remains subdued and inflation expectations (the lower right panel) generally seem well anchored.

For some of you, such reasoning may sound uncomfortably like an echo of arguments made 30 years ago, just at the point where people around this table made serious mistakes. Core PCE inflation, the solid line in the upper panel of exhibit 4, is running well above the central tendency of your forecast for this year made just three months ago. And at 5¼ percent, as in the middle left panel, the unemployment rate is within spitting distance of most estimates of its natural rate. In addition, as at the middle right, productivity growth has slowed, perhaps suggesting that less restraint on unit labor costs will be provided in coming quarters. With such an outlook, you might be justified in wanting to pick up the pace of firming sometime soon.

Indeed, as shown in the bottom panel, both the spot price of West Texas intermediate crude (the solid line) and far-ahead futures prices for that resource (the dotted line) have moved up decidedly, implying that more of the “excise tax” an import-dependent country such as ours must pay is permanent, presumably to the detriment of spending and the economy’s potential to produce and posing the risk that inflation expectations will pick up. Putting greater weight on the reduction in supply associated with this run-up in energy prices—which includes both a possible deterioration in inflation sentiment as well as longer-run effects on potential output—presumably would incline members to want to project a firmer stance of policy.

A useful starting point for your discussion of the policy statement might be the one you issued in March, which I have included as exhibit 5. In previous meetings and in comments on the early drafts of potential statements I distributed last week, some of you expressed a clear preference for eliminating forward-looking language from the announcement. It is important to recognize, however, that the forward-looking content comes in two flavors, one explicit and one implicit. The Committee characterizes its future policy action in the next to last sentence, which is typed in red. This is a relatively explicit message, in that the Committee forecasts both the direction and the likely pace of its future action. The implicit forecast is typed in blue. As long as you assert that policy is accommodative against the backdrop of a generally positive depiction of the economy, readers will infer that you intend to raise rates over time.

This opens up the two possibilities for altering the statement to enhance your flexibility that were discussed under alternative C in the Bluebook. You could be asymmetric and trim the explicit description of your future action—the red-typed

language about “a pace that is likely to be measured”—but leave the part where you describe policy as accommodative. Readers will likely view that change as giving the Committee the scope to tighten more quickly than previously expected. Alternatively, you could excise all guidance, both the red and the blue, on the notion that the changes would indicate symmetry about the possible paths for policy.

Whatever may be the merits of a statement that does not restrict your range of future action, the current situation may make you willing to tolerate the status quo for a bit longer. The expansion probably seems less vigorous and more uncertain to you now than it did six weeks ago, and you might be concerned that an adverse market reaction to an asymmetric statement without the “measured pace” language could further dent the economy’s momentum. But despite the recent hesitancy in spending and production, you’re likely to view a 3 percent nominal funds rate as still accommodative. Thus, it risks misleading the public to remove that sense under a symmetric approach to eliminating forward-looking language. If you share that appraisal, you probably would favor, even if reluctantly, alternative B of Table 1, which is repeated for convenience as the last exhibit.

CHAIRMAN GREENSPAN. Questions for Mr. Reinhart?

MR. SANTOMERO. I have just one question on the inflation swap quotes. You talked a little bit about them when you first introduced them in February. How good are those data? Is that market deep? Are the quotes indicative? Are they real transaction quotes? I’m just curious; it’s intriguing stuff.

MR. REINHART. It’s material that was in the last Bluebook, and it is repeated again in this one, where we talk about the changes in forward-looking inflation compensation. In fact, the inflation swap market developed mostly in Europe. That’s where the market is deeper, in part because in Europe apparently there are participants on both sides of that trade—mainly utilities that have legislated rates and, therefore, are willing to pay for getting that protection.

In the United States, the volume of trading has increased over the last year or so, and we do think that it is a useful market. One mystery in that market, which still prevails, is that at least at the front part of the TIPS yield curve and the inflation swap yield curve, there’s a bit of an arbitrage opportunity. Dealers we talk to say that, yes, they know it exists, but to exploit it would involve

basically exploiting their customers, and they are reluctant to do that while the market is still limited; it hasn't deepened enough.

MR. SANTOMERO. Thank you.

CHAIRMAN GREENSPAN. Further questions?

MR. LACKER. I have a comment on process. I appreciate the earlier distribution of Table 1, which is a procedure we decided on at the last meeting. On reflection, I'd like to register some reservations about it. It has the effect of shifting substantive deliberations out of the Committee, and it prevents us as Committee members from benefiting from the reasoning and thoughts of our colleagues on the FOMC. We don't know what other members are communicating during the period leading up to the meeting. I'm not sure exactly the right way to get around this, and I hope we can revisit this topic sometime soon. But one possibility would be to have members submit their suggested changes to Table 1 in writing. Then, after the close of some suitable comment period, the staff could distribute those suggestions so that we could glean what people are thinking when they suggest changes to the language rather than having to reverse engineer via exegesis.

CHAIRMAN GREENSPAN. Certainly some progress can be made in that direction, but let's be careful not to bring it to the table at this point in the meeting, because the length of the discussion is indeterminate, and we still have our 2:15 deadline. Therefore, I think it's critical that whatever we do with respect to enhancing the interaction on the wording of the statement be done before the meeting. And the Internet, especially e-mail appropriately encrypted, is a rather significant vehicle that can readily be employed if the members perceive that there is inadequate interaction on the statement itself. In my view, that can fairly easily be improved upon, if necessary, and I think Vincent is the central point here. So I would suggest that those of you who agree with

President Lacker communicate that, or indicate to Vincent that you think the current process is perfectly adequate, which I always find a difficult position to support.

MR. REINHART. I would note with some irony, Mr. Chairman, that in the December 1999 memo that introduced the balance-of-risk language, it was taken for granted—I think this was on the first page—that draft language for the statement would not be circulated before the meeting because it had the potential to stifle the discussion at the meeting. So, the views of the Committee have changed in this regard. I would say it's an open issue of where the pendulum is now relative to perpendicular. I welcome everybody's comments. I look forward to those e-mails. And one possibility, if there's enough interest, is that we can figure out when to have a Committee discussion.

CHAIRMAN GREENSPAN. You know, there's a difference from five years ago. The difference basically is that the general notion that we can all come here, sit down and have a discussion in a limited number of hours, and in that period come up with a consensus on the best wording for our statement, has proven false. It's a much more detailed deliberation; there's far more involved than merely a statement of where the funds rate is going to be. What we are learning is that the process requires a great deal of deliberation prior to the meeting. So, even though we officially meet only on fixed days, the amount of interaction in the intermeeting period is increasing. It's largely, of course, as a consequence of a statement that is ever more elaborate. I think we're finding that the old notion about not discussing in advance what our views are—that we should just come to the table and work them out—would be fine if we had an open-ended time frame, which we don't. We issue a statement at 2:15 p.m. on the day of our meeting. So, unless we want to change that, which has a lot of consequences, we have to recognize that a goodly part of what we discuss and conclude has to result from our pre-meeting discussions.

Now, to the extent that you wish to enhance the amount of interaction among members, there clearly are vehicles to do that which we do not at this stage employ. There has to be an ultimate arbiter, and it still has to be Vincent in one way or another, because it is conceivable, if we are all interacting and not taking votes, that we could have a stalemate. And a stalemate is not permissible in this Committee, because we have to come to conclusions. So, we can move to a greater degree of interaction, if you choose. And I think that can be done very readily, especially with the marvelous advances in technology that have emerged in the last five years.

MR. GUYNN. Mr. Chairman, I was going to raise this point later, or maybe at another meeting, but I think it's consistent with the discussion we're having. I would hope that we don't foreclose the possibility, long term, of rethinking this entire process. It seems backwards to me to be trying to work on the statement before we have the benefit of a Committee discussion in which we hear each other's views. I don't think we can replicate that in one-on-one discussions.

Don, you know far better than I do the process at the Bank of England, but Bob Eisenbeis and I had occasion to visit there, and I believe their process still involves a meeting that encompasses two days. They meet one day to talk about their views on the economic outlook and on policy. They spend the next day talking about what to do and how to describe it. It seems to me that this work is important enough that at some point—again, not today—we might want to reconsider the whole process. If we to want to craft these kinds of statements, they may be better done by the Committee after we've had our discussion about the economy and policy. I just hope we wouldn't rule that out as a possibility somewhere down the road.

CHAIRMAN GREENSPAN. If a large enough proportion of this membership agrees with that statement, it's an obvious topic for one of our upcoming two-day meetings. The fact that the

Bank of England does it is not, in and of itself, a recommendation. [Laughter] Further questions for Vincent?

If not, let me get started. President Lacker raised an interesting point, which I have been meaning to raise, and I'd just like to repeat it: One of the things we have succeeded in doing through all of this confusion is to communicate to the marketplace what our relative priorities are. The market now pretty much anticipates how we're going to respond to various events or developments in advance of their occurrence, and the market has been relatively accurate. In other words, we come to this table and we find that, lo and behold, expectations of the federal funds rate going forward are not all that different from the general judgment of this group, even though that judgment may have changed significantly from the previous period.

So, while there are problems—and in fact, we have an eight-week spread between meetings in a period of increasing uncertainty—I'm not sure I care all that much. I think the markets will do our work for us until we come and sit at this table and formalize it. So, that takes away one of the problems that I think we have had. And I believe we would be well advised, if we can somehow manage to do so, to continue to convey to the marketplace where our priorities are and what is likely to cause them to change. I say that because to me there is certainly an underlying value to maintaining as little reaction to our post-meeting statement as possible, with the exception of when we very deliberately want to change market sentiment. Indeed, last meeting we did wish to do that. We actually wanted to confront the issues that spreads were getting too narrow and that there was a degree of complacency in the market. So the statement was changed in a manner that pretty much indicated that we were slightly more concerned than the market had anticipated. And we got a fairly significant reaction, as exhibited by the very big blue spike in Vincent's chart. But that's the exception.



We should endeavor whenever we can to make the 2:15 p.m. announcement subsequent to these meetings as uneventful as possible in most cases. In this context, I think we need to consider the fact that the markets are essentially saying that we are going to pause in some of our subsequent meetings. Now, it's one thing to forecast that we're going to pause, but it's quite another to actually do so. The pause can arise in two ways. One, we can literally stipulate that we are not going to act in the current meeting but are likely to act at the next meeting. We've never tried that. I think we'll have considerable difficulty formulating language that essentially says: "We know enough at this moment not to move the funds rate, but we know something that suggests that we are going to move it six weeks from now, or whenever the next meeting is." I would find it very difficult to craft such a statement with credibility.

As a consequence, I think what is likely to happen is that we will continue to increase rates until we actually come to what we perceive to be the end. However, it may very well be that it is not the end and that in later periods we will move. Hence, that will validate what the markets are saying—that we will pause only because we didn't get it right and not because a pause was part of our policy program. That, to me, will almost surely be the case, because, as history tells us—in fact, it's a cliché around this Committee—at the end of a process of either tightening or easing, the last move is a mistake. The challenge basically is to put ourselves into a position, when we make that mistake, where the probability of our creating a significant disruption is minimized.

This leads us to the question that we nearly always confront, which Governor Ferguson raised indirectly earlier. Most of the time we have to ask ourselves: If we take a particular action and it proves to be a mistake, is it more costly than taking the presumed alternative action and having that turn out to be a mistake?

For example, we're confronted currently with the issue of choosing to pause or make a significant change in the statement on the one hand, or of continuing with a move of 25 basis points and keeping the word "measured" without significantly changing the statement on the other. If we choose the first—either pausing or making a significant change in the statement—and that proves wrong, in my judgment that will create a more significant problem for us than if we presume that inflation is the more critical ongoing problem, go 25 basis points, and maintain the language from our last meeting. If we do the latter and we are wrong, it will be far easier to recover from that than to recover from having made a statement which presupposes that inflation is under control and have that prove to be wrong. So, I think we're getting ever closer to where we're eventually going to stop, and we'll be making decisions of this nature until we come to the conclusion that the argument for moving another 25 basis points cannot be sustained.

I happen to think that the current situation is again likely to prove to be a soft patch. There are certain aspects of it that are not consistent with an actual turning point in the business cycle. Indeed, if it is the beginning of a cyclical downturn, it will be one of the most extraordinarily rare events in business history, basically because profit margins are still rising. I don't recall a situation in which the economy literally turns down, unless there is a financial crash, with profit margins at their peak. In fact, I don't recall a financial crash with profit margins at their peak. There are usually long lags and deterioration, but we haven't started to see that yet.

The deterioration that I think is out there involves a slowdown in productivity and, by implication, a rise in unit labor costs. But we're assuming that to be muted, largely because wages are considered to be growing at a fairly stable pace—indeed, if anything, a slower pace. If NAIRU [non-accelerating inflation rate of unemployment] means anything, it suggests that the current unemployment rate has to imply some level of market tightness that, at the end of the day, either has

to stabilize the rate of increase in compensation or—in my view very much more likely—induce it to rise. This suggests to me that the Greenbook forecast of profit margins flattening out and starting down seems the most credible scenario in terms of how market forces are likely to run. But if that is indeed the case, then this is a pause. This is not something that suggests economic activity is going down.

I think we're being helped by recent developments in the oil market. As best I can judge, that is the major factor for the pause here, as it was last year. And I gather that most of the people around this table also believe that is the case. We had a very unusual situation going into what is normally the second-quarter slowdown in oil consumption in the northern hemisphere and, therefore, in world oil consumption. The Saudis increased production, which created a significant but temporary glut largely in the lower-gravity, more sulfurous crude oils that come out of Saudi Arabia. The effect essentially was to throw a lot of crude oil on the market for which there was no immediate demand or need. The Saudis kept saying, "We're producing this oil, but we don't have any customers." There were customers for the light sweet crudes. That's where the real demand was.

In any event, this oil came on the market and pressed the spot price down below the forward prices. And because a futures market essentially spreads the supply/demand pattern not only for the spot market but throughout the whole spectrum of forward markets, we ended up going from "backwardation" in the forward market to effectively a "contango." In other words, the forward prices were at higher levels than the spot prices, which meant that for the first time in a very long time you could accumulate oil inventories profitably. You could buy crude at spot, sell it for delivery six weeks later at the futures market price then existing, and guarantee a spread and a profit.

Judging from the pattern, a lot of that has been going on because crude inventories are rising. This suggests that it is profitable for people to accumulate oil inventories, which was very obviously not the case earlier. But as inventories rise, the spot price falls relative to the futures price, making it even more profitable to hold more inventories. This brings the price down even further, and that process usually doesn't come to an end unless there is a significant pullback in production or an acceleration of demand—or obviously some form of geopolitical problem that creates very grave concerns in the marketplace.

If this pattern continues—and so far it appears to be working—gasoline prices will be coming off reasonably soon. Work that has been done by the staff here suggests that gasoline prices are essentially a function of the weighted average crude, which is 60 percent light sweet crude and 40 percent the heavier, more sulfurous crude. The pattern suggests that we are close to where the margins ought to be, and, therefore, declining crude prices get reflected fairly quickly in gasoline prices. We're going to learn quickly enough whether or not that is indeed undercutting grave concerns about the outlook. We'll know whether or not oil—or the energy issue more generally—is indeed a fundamental problem that has created difficulties over the last six weeks.

I doubt that monetary policy is all that big an issue, because as far as the markets are concerned monetary policy hasn't changed in any measurable way for months. To be sure, we have been tightening, but the markets have been tightening for us. As far as the two-year note is concerned, the market has tightened well in advance of anything that we've been doing. 5

So, I think it's hard to make the argument that it's monetary policy here. Where this leaves us is that essentially we're going to have time to watch what the implications of declining gasoline prices are going to be for the outlook. If this is indeed a soft patch, then continuing with 25 basis points, as in alternative B, and keeping the wording as close as we can to the previous statement, will

turn out in retrospect to have been exactly the right policy. If, however, we choose to make some adjustments, I think we'll have some backtracking to do in the language.

If we begin to soften the language now and this economy starts to pick up again, we'll have to tighten our language, whereas if we keep what we have in alternative B and the economy softens, the markets will soften for us. We will have the ability to change the language, which we may well choose to do eight weeks from now, and we will have had one move from where we have been to where we will be in June, rather than confront the possibility of one move and then another move. And as far as maintaining a stable monetary policy is concerned, usually the fewer moves we make to correct earlier moves, the better. As a consequence, I think the evidence at this point suggests that we should go with alternative B—moving the funds rate up 25 basis points and using the language stipulated in Vincent's presentation on page 6. President Poole.

MR. POOLE. Mr. Chairman, I have an alternative D, which may not be appropriate for today, but it might be helpful in some future meeting, so let me pass this language around. While that's going around, I'd like to say that I agree with Jack Guynn that we have a real problem in terms of the coordination of the statement and the minutes. When the minutes come out in three weeks, they're going to have to reflect the fact that there is widespread uncertainty around the table. And somehow I think that ought to be in the statement, because that is really part of the outcome of this meeting.

CHAIRMAN GREENSPAN. That will appear in the minutes.

MR. POOLE. Oh, it will appear in the minutes. But I'm saying that I think it ought to appear in the statement, because, otherwise, the statement would not truly reflect what happened at the meeting. Anyway, I wanted to make that point—that the minutes coming out in three weeks

could give a different impression from the statement. In my view, coordinating the two is very important. And I think that's the point Jack Guynn was raising a few minutes ago.

Some elements of my alternative D are in the alternative C language in the staff handout. As you know from the memo I distributed, I think the "measured pace" language is becoming less and less useful. And I believe that accurate communication is both terribly important and terribly difficult. I would like to see us come out—if not today, then at some point—with language making it very clear that, depending on the incoming information, we would be open to either a 50 basis point increase, if the inflation environment seems compelling, or a pause. I'm concerned that the market expectation we are creating of a move of 25 basis points at our next meeting is going to get in the way of either of those outcomes. That's essentially my pitch here, and I have tried to craft in alternative D a statement that emphasizes our inflation concern but at the same time leaves open the possibility of a pause. That was my strategy in the way I formulated this.

But I think there is a problem. If we have a statement this afternoon that the market subsequently views as not really consistent with the thrust of the minutes that come out in three weeks, I think that creates a problem for us and for the market.

CHAIRMAN GREENSPAN. Remember, the statement is actually determined after the events that are described in the minutes. So that issue always exists. It existed the last time; it will exist in the future. The point I've tried to make to a number of members of the press is that they should always remember that what is in the minutes, even though they are released later, reflects what occurred before we voted on the statement. So, whatever the Committee votes is the Committee's view at that point. And to stipulate that it is other than that implies that people are saying one thing in the meeting and voting differently at the end. I guess that could happen, but not very often.

MR. POOLE. What I'm saying is that for our present meeting I think the statement needs to take account of the fact that we currently have a greater degree of uncertainty about the outlook for both inflation and output. That's my concern.

CHAIRMAN GREENSPAN. I understand what you're saying, Bill. I must admit that I don't think what you're suggesting is possible. I think that is the dilemma that we are confronted with. We have the advantage of having brought forward the release of the minutes. The issue that I raised at the very beginning of my remarks—namely, that the markets should know where our preferences are and how we will respond to individual data—I think mitigates the problem that concerns you. I, frankly, don't think you can achieve what you're suggesting. That's my opinion. I don't know what the rest of the Committee thinks.

MR. POOLE. I've said my piece.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Well, I'm fine with where you're going on this. I do agree that we ought to talk about this at a future meeting. I'm more in favor of shortening the statement and just relying on the minutes. Others have different views. But with where we are today, with inertia, I think I'm fine with your proposal.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I think we have a conundrum—another one—with a capital C on this language issue. We can't seem to get unstuck from it. I've probably already said enough. I agree with what Bill Poole said, but I'm not sure I understood your response. I think it's absolutely critical that the minutes that are going to come out in three weeks are faithful to the tone of the discussion and reflect the range of uncertainty I heard around the table. And I heard an awful lot of uncertainty today, from people who were on the side of thinking that we need to pause to those who

felt that we need to go faster in raising the funds rate. I also am growing uncomfortable with a statement released after the meeting that doesn't seem to describe that range of uncertainty and the latitude that we need as a Committee. I wish I were smart enough to offer an alternative. I appreciate your concern about our post-meeting statement causing serious, unintended consequences, but I'm not sure the statement we have on the table really does that. Obviously, I'll support it and the 25 basis points, but I don't think we've got this licked yet. We have a lot more work to do to try to get it sorted out. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. We have a lot of time to do that. It's called "eight weeks."  
[Laughter] President Minehan.

MS. MINEHAN. I know I'm in the minority here—not of the last several speakers, but overall in the minority. But I'm starting to feel like Alice in Wonderland with this statement—you know, jam tomorrow, jam yesterday, but never jam today. It's never the time to change the statement. And frankly, I do feel that we have a unique opportunity here, with a situation in which the risks are more two-sided. I think that would enable us to stop giving an implicit pledge about policy going forward.

Now, I'm in agreement on the 25 basis points. And though I'm not a voting member, if I were, I would take your guidance on the language. But I really feel that what you've said is that we have to wait until we're willing to stop raising the funds rate before we change this language. And I'm afraid of what will get embedded in the markets with that sort of guarantee out there.

CHAIRMAN GREENSPAN. Cathy, that's not my view. I've said we have alternatives. We can change the language before we stop raising rates. We don't have the choice to decide at one point to stop raising rates and with the statement hold open the likelihood that we are going to raise



rates at the next meeting. That is not the same thing as saying we can't change the language.

Indeed, we have changed it.

MS. MINEHAN. Well, that's what I interpreted you as saying, and obviously I was wrong.

CHAIRMAN GREENSPAN. I apologize; that was not my intent.

MS. MINEHAN. I apologize as well. In any event, I've probably said enough before on what I'm concerned about. I do think we need to get out of promising to do something about which there is a greater degree of uncertainty at this meeting, and presumably at subsequent meetings, than we felt two or three meetings ago. I don't think that language is serving us well anymore, but one more meeting is not going to kill anything.

I do think the process issue needs further discussion. I communicated with Vincent, probably not adequately, over the weekend. I didn't bring a copy of my suggested language with me. It was different in some ways from what Bill had. I was more or less a "four from column B" and "two from column C" person, choosing as if ordering from a Chinese menu here. Granted, I take the point that this is not the place to get into a discussion of moving this sentence here and that sentence there and trying to get 19 people to agree on it. Given the complexity of the statement, I just don't know what process we should use. I'm not sure, even if we spent an entire two-day meeting, that we'd come up with a statement that is adequate, given all the moving parts we now have in it. As I said earlier, going back to something that's shorter—something that says what we did and why we did it and lets the minutes convey the range of views—is where I think we ought to be headed. But, again, that just may not be in the cards anytime soon.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. I can support your proposal as you laid it out. If my earlier comments had any direction, it was that I think there is some benefit to trying to

shorten up a little what is now conveyed in sentences 5 and 6 and to say a bit less. But we've added words rather than subtracting some. I understand the stability issue and I agree with it, but stability doesn't necessarily mean using exactly the same wording about areas that are in fact of concern to us. Having said that, where we are here on the proposed language is not significantly far from where I would be in the best of all worlds. So, I have no problem supporting it.

CHAIRMAN GREENSPAN. President Fisher.

MR. FISHER. Again, Mr. Chairman, I'm new, and I want to be appropriately humble and respectful. I listened very carefully to what you were saying. The way I interpret the first part of what you said is that we don't want to signal the market that we know something the markets don't anticipate or don't know. Having been a market operator and being sensitive on that front, I agree with that. And I don't think there's an argument for a pause, so I would argue for a 25 basis point increase in the funds rate.

I'm a little worried about later in the statement signaling to market participants what they may interpret as something that we know that they do not know. So I would again suggest that we might consider a change in the "measured pace" language against that background. The idea of maintaining a measured pace implies we will continue along this path; and if we deviate from that path, that might come as an unpleasant surprise to the marketplace.

As to the procedure, I'm too new to have any opinions on that. Like you, Cathy, I too have sort of a Rubik's cube of moving parts to place. I would suggest, against the background of what Janet said, the possibility of just eliminating section 5 entirely in alternative A. That would give us a shorter statement and even reflect a concern about some asymmetries that we're detecting, and I think that might do the job.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. I've already said I support 25 basis points. I also support your broader perspective that we should try to keep the language pretty much unchanged. Given what has already been said, let me just make three or four comments.

First, on the word "measured." I already talked about that, and I agree with your sort of risk-management approach. Second, on the role of the statement, I think the statement is meant to be, as best as it can be, an explanation of what we did and why we did it. I think Cathy said that. But it doesn't have to reflect all the uncertainties noted by the 19 people as we went around the table. I think it is not inconsistent to have minutes that suggest a lot of back and forth and uncertainty and then to have a statement that reflects where we all coalesce—with different degrees of comfort, but we coalesce. I'm not as anxious as others seem to be about the fact that the statement doesn't reflect the give and take and the back and forth, because that's not necessary to explain what we did and why we did it.

With respect to dropping the sentence on the balance of risks, though—unfortunately I'm speaking before Janet and I would love to hear her views—I would be a little cautious at this stage. It's not because I'm in love with it; actually, I think it has outlived its usefulness in this particular mode. There may be better ways to convey our sense of the balance of risks, but I don't think we have a better way right now. And given the uncertainties in the current situation, I think the fewer changes we make in the statement, the better, for the reasons you pointed out.

And, finally, you made some points about where we might go with policy. I know it's impossible to avoid that inevitable overshooting—doing one or two moves too many and regretting it. But I think this really is the time when we have to try very hard to avoid overshooting, because if the outlook is anywhere close to the forecast in the Greenbook, all we're trying to do is to get rates back to neutral. We're not trying to be terribly restrictive. So what I was suggesting earlier was that

overshooting by 50 basis points—while it's not the end of the world and we can come back from it—would be unfortunate. I think we have to start being very sensitive about each one of these moves and be prepared to take a pause and restart, if we have to, though we obviously can't signal that.

On process, I won't take up too much time. Jack suggested longer meetings. I had told David yesterday—and this may surprise you—that while these meetings work extremely well under leadership that has 18 years of experience, we may now be in a position where we need to spend a little more time together. I'm not proposing that formally, that's for sure. Certainly, I've been told that the Bank of England meeting for two days with seven, eight, or nine people—or whatever the number—is a pretty painful process. So with 19 people, it's unlikely to be less painful. [Laughter] But I think your point is well taken that these meetings have become much more interesting and interactive. And trying to do all we need to do in a short period of time might not be the right way to go. I wouldn't propose that as long as you are the Chair, but I suspect we may at some point want to spend more time together as we go forward. I guess that's my range of wisdom on the very wise comments of my colleagues today.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. I agree with your recommendation on both counts—the 25 basis points and alternative B.

I know we always say that we will know a lot more at the next meeting, but this time we really will. [Laughter] We're going to have two sets of price data and two sets of employment data, so I think we will have a much better sense as to whether this is a soft patch or not and how serious the inflation risks are at that point.

I think the statement actually does a good job of pointing out the slowing in the solid pace of spending growth on the one hand and that inflation pressures also have picked up. So, I think that balance is very good.

Going forward, I would just say that I, too, would like to get out of the forward-looking statements if we possibly can. I'd like a shorter statement in the near future. I'd like to drop the balance-of-risk statement, which I don't think adds anything now. I agree that it has outlived its usefulness, as Governor Ferguson said. I just don't think now is the time to do it.

I do think the chances are that this statement really will require major changes at our June meeting. I don't know what those are going to be at this point; it will depend on the data, of course. But I do think it will require major changes, and that's probably the time to look at all of this.

Now, I am not going to respond to Governor Olson's very unfair comment about the Chicago Bulls except to say that we will see how the Washington Wizards do when they lose their home court advantage in the next game and have to face the Chicago Bulls in the friendly confines of the United Center. [Laughter]

MR. OLSON. Let me point out that it isn't how they do but how they communicate what they do. [Laughter]

MR. MOSKOW. Touché.

CHAIRMAN GREENSPAN. Is that the end of your—[laughter]?

MR. MOSKOW. Yes.

CHAIRMAN GREENSPAN. President Yellen.

MS. YELLEN. Thank you, Mr. Chairman. I support, of course, your proposal to raise the federal funds rate 25 basis points, and I think the strategy that you suggest with respect to the language in alternative B also has merit for today. It seems to me advantageous at this point to make

minimal changes in the statement, as alternative B does. I think market expectations are essentially entirely sensible, and it does not make sense today to do a great deal to perturb those expectations.

I think the policy path we're on, as Don put it, likely has a positive slope. I'm comfortable with the term "measured pace" because I think it continues to indicate that whether we call policy accommodative or somewhat accommodative, the likely direction of the federal funds rate is up, and I think we ought to be communicating that. I believe that we retain considerable flexibility to pause or to be more aggressive. We see that, as you pointed out, Mr. Chairman, in the futures path as the market responds to the news.

So, I think we do have flexibility. But I agree with Governor Ferguson that we need an exit strategy from this exit strategy, and my proposal is to get rid of the balance-of-risk statement. Maybe today is not the right day to do it, but as part of our ultimate exit strategy, which we may well need at the next meeting, I would love to see that go. I feel that we do need to communicate something about the future, but in my view crafting a simple English sentence or two to describe the consensus on the Committee is the way to do it. To me the balance-of-risk statement was an attempt to give hints about the future path of policy without saying anything about the funds rate directly but instead about the determinants of policy. And I just don't think that's possible.

I read President Poole's memo and I understand the desirability of having standard language, but we have a Committee that hasn't obtained a consensus on the determinants of policy. We don't have a common definition of maximum employment or price stability. We don't have a common view on the importance of forecasts or an agreement on relative values of gaps versus growth rates in making those forecasts. Without that kind of consensus, we just can't come up with a formulaic assessment about the balance of risks. It might work for a couple of meetings, but then we're going to get ourselves in a situation where it will fail, and that's where I feel we are today.

So, going forward, it may be that the time to change this language is when we do pause and no longer feel certain what the direction of policy is. Maybe at that time a simple statement that says something like this will be the sensible way to go: "Under current conditions, policy seems well positioned to achieve our dual goals and we will respond, as needed, to fulfill our obligations to foster price stability and sustainable economic growth."

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. Thank you, Mr. Chairman. First of all, I will support the ¼ point increase in the funds rate and the language of alternative B. As I read through alternative B, I think it communicates what we want to communicate. It says that the pace of spending growth has slowed and it repeats our concern about inflation. I will have to say that as I get down to paragraphs 5 and 6, I am also of the opinion that they are starting to get a little shopworn and that we do need to think through how we want to communicate our assessment of risk.

Having said that, I think my views are in a significant way impacted by my recollection of the summer of 2003 where, in the course of three meetings, we had three different vehicles of communication, or variations of communication, and by the third one we had confused the markets. And this was after what I thought was the most specifically clear articulation of our policy. That reminds me again that we ought to be very deliberate in terms of how we change our communication.

I think we've done the markets a great favor by accelerating the release of the minutes. That earlier release of the minutes now allows us to go back and look again at the type of statement we release immediately after the meeting. And I would suggest that we look at this issue in that context; it may allow us to alter the method by which we communicate on the day of the meeting.

CHAIRMAN GREENSPAN. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. I support your proposal, both the ¼ point increase in the funds rate and the alternative B language. I think a measured pace of increase in the funds rate is still our best guess of what we'll have to do. I heard one or two people around the table say that we might be closer to a pause than we thought, owing to the recent data, and one or two people around the table say that we might have to accelerate the pace because they're putting more emphasis on the incoming inflation data. But I think the broad center of the Committee is still with the measured pace of increases and, therefore, the broad center of the Committee believes—I think—that we ought to tell the market that we still think rates are too low and will have to rise. And if we tell them that without telling them something about removing accommodation at a measured pace, I think we'll be conveying more uncertainty about our intentions than would be helpful. In my view, it would not be helpful to remove that language at this point.

I agree that the balance-of-risk statement right now is broken and is either meaningless or, if it's meaningful, it's rather distorted. But I think it's going to be very, very hard to remove it without sending a signal that we think we might be behind the curve in one sense or another, and I don't think we are, and I don't think we want to send that signal. So, my guess is that lines 5 and 6 here are going to have to be reworked, but only at the point when we think we're near the pause point, and I don't think that's going to be June, President Moskow. I'd be very surprised if it were. I think it's going to be very hard to rework those sentences before we think we're close to being finished with the tightening process. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Lacker.

MR. LACKER. I support 25 basis points and alternative B. I agree that we should not soften the statement at this meeting. And in fact, when I read alternative B, I interpreted it as tightening somewhat by removing the statement about energy prices not having fed notably through



to core consumer prices. If anything, I was leaning toward a tighter statement, but I think alternative B would serve us well right now.

I want to again endorse President Yellen's notion that we should look for an occasion to remove the balance-of-risk assessment from the statement at the earliest opportunity. We can be clear about what we are doing; I think it is hindering communication now. I also agree with her with regard to President Poole's memo. Unavoidably, we are communicating to the markets. And to expect to do so by devising formulaic language that is going to last beyond a couple of meetings is too optimistic on that score, I think.

I also want to note that on the idea of an exit strategy I agree with you that it's pretty hard to envision a statement to accompany no rate change that would also induce markets to believe that we're sure to increase rates at the next meeting. I don't care that much about the shape of the yield curve between now and six months out, and I would prefer raising rates at the first meeting and not at the second. So, I think putting a fine point on it doesn't make sense.

Now, having said that, when we do get to a point where we pause, I think it's going to be important not to drain the sensitivity out of the yield curve. We do not want to convince markets that we think we're going to be done for several quarters or for a couple of years. We want to maintain in markets some sensitivity to incoming data—to believe that we might move ¼ point either way on the funds rate. And because of that I've tried to avoid using the term "neutral" to characterize the rate at which we will stop moving, but there are other approaches to that I suppose. So, again, I can support what's on the table.

CHAIRMAN GREENSPAN. President Pianalto.

MS. PIANALTO. Thank you, Mr. Chairman. I also support your recommendation for a 25 basis point increase in the fed funds rate target, and I will also take your guidance on the language.

As I said earlier, though, I had a preference for expressing more uncertainty about not only the outlook on inflation but also the timing and magnitude of our future moves. But given what you said earlier, I will support your recommendation.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. First, I support your recommendation to move the funds rate up 25 basis points and to use the language of alternative B. In my remarks, I made some noise about combining some elements of alternative A; I'm not going to press that. Based on the discussion, I think I've lost that debate. And the hour is getting late, so I'm fine with B.

On the minutes, I think I'm with Roger in that I don't really see the problem. We issue a fairly terse statement. Subsequently, the minutes come out and they give a lot of color. The minutes indicate that some people felt this and some people felt that. That is all said; it's faithfully transcribed. I think it just fills in some of the blanks. So, I don't really see what the problem is. I actually do think it's a great assist to us that the minutes are coming out with a three-week lag. I think that's going to be one of the better things we've ever done, though I must say a lot of us had reservations about it at the time.

On the process issue, one thing we've learned is that we can't make major rhetorical changes at the meeting. These statements have to be read probably eight times to figure out all the nooks and crannies in them. If we get a statement circulated at the meeting, it is just too late to assess all the nuances. We're tired, and we're not thinking about the wording from all perspectives. So, I don't think that is a good idea.

Let me suggest one thing that we might consider. I actually think the format that we have developed—where we get alternatives A, B, and C and have a chance to study them—works pretty

well. But I think the domain of the options has gotten rather narrow. Look at the differences between A and B. In line 1, there's a "further" in alternative A and in line 2, there's a "somewhat." In line 3, alternative B has a "somewhat" and in line 4, there's a "while." In line 5 the word "action" is gone in alternative A. [Laughter] This is pretty small potatoes, I think, compared to what some people are talking about. So, one thing that we might consider is to have a little extra material in the Bluebook every now and then—maybe at the January and June meetings or maybe at this critical time when we're going to change our strategy—that gives a broader range of options. The staff could provide a draft statement without this bank of sentences with minor variations—just look at it in a little bigger way. That way we'd still get a chance to study it and we wouldn't be getting a statement late in the meeting.

The last thing I want to say is that I totally agree with Janet that line 5 ought to go. I've been on two committees that have tried to fix that up, and we couldn't do it. At one point I sent some memos around and tried to do it on my own. That didn't work either. I don't think we can fix it. And I think that's when we started on sentence 6 de novo. We had a specific problem, and we worked out language to deal with it. I'm saying "we," but in fact you did that. And I think sentence 6 has worked much better than 5. So, at some point sentence 5 ought to go. Let's just try to come up with some terse language that gives the full dimension in 6. That would be my suggestion. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I, too, think the ¼ point increase in the funds rate target is appropriate, and the language in alternative B is fine with me today. I don't think it's essential to make any major changes in the language at the moment, and it's probably not a good idea.

I do agree with President Yellen and others that the balance-of-risk statements should probably be jettisoned at the earliest opportunity. But I would also say that I think there is value in providing some forward-looking guidance to the markets. More generally, among other things, it helps to assure a certain consistency in policy, and I think that is of value as well.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. Thank you, Mr. Chairman. I support the recommendation to raise rates 25 basis points, and I'll support alternative B. As the Governors know, I've been frustrated with the whole "assessment of risk" piece of this, but yesterday, after thinking about it, I realized that it isn't so simple to craft the alternatives. One of the things that I'm struck by is that sentences 3 and 4 are really the meat of the release each time. They tell how we're looking at the real economy and at inflation, which are our two major mandates. But if we didn't have something tying them together—to convey some conclusion about the risks—that would leave the markets hanging. To me, that's what would happen if we got rid of lines 5 and 6 entirely. So, I think we do need something to anchor that. At first I was leaning toward alternative C, line 6, thinking that would do it. Then the more I read it, I thought: These references to fostering the attainment of sustainable economic growth and price stability are like motherhood and apple pie. Obviously, this is what the Fed is supposed to do. So, is it really saying anything? We could have that sentence in there no matter what—if the rate of inflation were 12 percent or if unemployment were down to 3½ percent. So the question is: What do we need there? I think we need something beyond just the rationale for our decision today. Right now, I think sentence 2 is important because it says that while we get noise in the data, underlying all of this we are still accommodative. And that sets up the notion of a longer-run horizon beyond the next meeting.

So, as we look to replace this, it's almost as if the longer-run horizon is the important point. Maybe, as President Yellen said, this gets back to the way we set our goals and targets overall. But we need a longer-run anchor, and then we need a short-run signal to the market. So I don't think we can just eliminate the risk assessment. We have to say something, especially at times such as this where we have risks on both sides.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN GEITHNER. I think it makes sense for us to raise the funds rate 25 basis points, and I support alternative B. Fortunately, we don't need to decide today whether this statement is going to make sense in its current structure in June or in August or October. We can make the decision at those times. The only thing we need to decide today is whether we want to alter significantly the expectations now priced in the markets for the future path of the fed funds rate. And I agree with what a number of you said—that there's not a compelling case for doing so.

The second thing one can say we need to decide is whether we want to introduce more uncertainty or greater dispersion around the set of expectations that now exists. Again, I don't think there's a compelling case for us to try to do that as a conscious act of signaling today. I think alternative B is actually a pretty good signal for today, and I don't actually know what is going to make sense in June or for the structure of the statement going forward.

CHAIRMAN GREENSPAN. Okay. I think we have a consensus on 25 basis points and the wording in alternative B. Would you read the appropriate language?

MS. DANKER. I'll be reading from page 28 of the Bluebook the language for alternative B: "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 3 percent.” “The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, 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.

MS. DANKER.

Chairman Greenspan	Yes
Vice Chairman Geithner	Yes
Governor Bies	Yes
Governor Ferguson	Yes
President Fisher	Yes
Governor Gramlich	Yes
Governor Kohn	Yes
President Moskow	Yes
Governor Olson	Yes
President Santomero	Yes
President Stern	Yes

CHAIRMAN GREENSPAN. I'd like to call a recess and ask the Board of Governors to convene in my office.

[Meeting recessed]

CHAIRMAN GREENSPAN. The Board of Governors accepted the requests of all twelve Reserve Banks for an increase in the discount rate.

Our next meeting is June 29 and 30. But before we adjourn, Dave Stockton would like to make a few remarks.

MR. STOCKTON. Just briefly, the special topic at the June meeting will be the question of recent developments in housing, with a special focus on whether or not we think a housing bubble

has developed. The lineup is Josh Gallin and Andreas Lehnert here at the Board. They are going to present our views on the probability and potential magnitude of an asset price misalignment in residential real estate markets. And they're also going to talk about how that might unwind if, in fact, there is some overvaluation. They will address the issues of whose balance sheet the risks reside on and what the consequences might be for household and financial institutions should we get a more serious retrenchment in house prices. Dick Peach from the New York Fed is going to offer a more skeptical assessment of those bubble concerns, and Glenn Rudebusch and John Williams of the San Francisco Fed have agreed to discuss what, if any, consequences there might be from conditions in the housing market for your monetary policy. We're going to post the presentations at least a week in advance, and we'll also post any supporting materials as they become available.

CHAIRMAN GREENSPAN. Thank you very much. Luncheon is served.

END OF MEETING