Records

Record of Policy Actions of the Board of Governors

Regulation B
Equal Credit Opportunity

Regulation E
Electronic Fund Transfers

Regulation M
Consumer Leasing

Regulation Z
Truth in Lending

Regulation DD
Truth in Savings

March 19, 2001—Interim Rules

The Board approved interim rules to provide uniform standards for the electronic delivery of disclosures required under Regulations B, E, M, Z, and DD, effective March 30, 2001, with mandatory compliance by a date to be designated in the final rules.[1]

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

Several federal statutes and the implementing regulations administered by the Board require that written disclosures be provided in connection with certain consumer financial services transactions. Under the Electronic Signatures in Global and National Commerce Act (E–Sign Act), electronic documents and signatures have the same validity as paper documents and handwritten signatures. In this light, the Board approved interim amendments to Regulations B, E, M, Z, and DD to accommodate electronic disclosures if the consumer has affirmatively consented in accordance with the E–Sign Act. The amendments also provide guidance on complying with the regulations' timing and delivery requirements when electronic disclosures are used, to ensure that consumers have an adequate opportunity to access and retain the information. In addition, the Board requested public comment on the interim rules.

Regulation D
Reserve Requirements of Depository Institutions

October 9, 2001—Amendments

The Board amended Regulation D to decrease the amount of net transaction accounts at depository institutions to which a lower reserve requirement applies (low reserve tranche) and to increase the amount of reservable liabilities exempt from reserve requirements (reserve exemption level) for 2002, effective for the reserve computation period beginning November 27, 2001, for institutions reporting weekly.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

NOTE. In voting records throughout this chapter, Board members, except Chairman Greenspan and Vice Chairman Ferguson, are listed in order of seniority.

1. The interim rules originally required mandatory compliance by October 1, 2001. Because it is considering adjustments to the rules to provide additional flexibility, on August 1, 2001, the Board lifted the mandatory compliance date for the interim rules.

Under the Monetary Control Act of 1980, depository institutions, Edge corporations, agreement corporations, and U.S. agencies and branches of foreign banks are subject to reserve requirements set by the Board. The act directs the Board to adjust annually the amount of the low reserve tranche to reflect changes in net transaction accounts at depository institutions. Recent declines in net transaction accounts warranted a decrease in the low reserve tranche from $42.8 million to $41.3 million, and the Board amended Regulation D accordingly.

The Garn–St Germain Depository Institutions Act of 1982 establishes a zero percent reserve requirement on the first $2 million of an institution's reservable liabilities. The act also provides for annual adjustments to that exemption amount based on increases in reservable liabilities at depository institutions. Recent growth in reservable liabilities warranted an increase in the amount exempted from reserve requirements from $5.5 million to $5.7 million, and the Board amended Regulation D accordingly.

For institutions reporting weekly, the amendments are effective with the reserve computation period beginning November 27, 2001, and the corresponding reserve maintenance period beginning December 27, 2001. For institutions reporting quarterly, the amendments are effective with the reserve computation period beginning December 18, 2001, and the corresponding reserve maintenance period beginning January 17, 2002.

To reduce the reporting burden on small institutions, depository institutions having total deposits below specified levels are required to report their deposits and reservable liabilities quarterly or less frequently, while larger institutions must report weekly.[2] To reflect increases in the rate of growth of total deposits at all depository institutions, the Board increased the deposit cutoff levels used in determining the frequency and detail of reporting from $101 million to $106.9 million for nonexempt depository institutions, beginning in September 2002.

Exempt institutions (those with total reservable liabilities not exceeding the reserve exemption level of $5.7 million) that have at least $5.7 million in total deposits may report annually, and exempt institutions that have less than $5.7 million in total deposits are not required to file deposit reports.

Regulation E
Electronic Fund Transfers

February 27, 2001—Amendments

The Board amended Regulation E to require disclosure of certain fees associated with automated teller machine (ATM) transactions, effective March 9, 2001, with mandatory compliance by October 1, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Meyer, and Gramlich. Absent and not voting: Mr. Kelley.

The Electronic Fund Transfer Act, which is implemented by Regulation E, was amended by the Gramm–Leach–

2. All U.S. branches and agencies of foreign banks and Edge and agreement corporations are required to submit the Report of Transaction Accounts, Other Deposits, and Vault Cash (FR 2900) weekly regardless of size. In addition, depository institutions that obtain funds from non-U.S. sources or that have foreign branches or international banking facilities continue to be required to file the Report of Certain Eurocurrency Transactions (FR 2950/FR 2951) at the same frequency as they file the FR 2900 report.

Bliley Act to add certain requirements for ATM transactions. The amendments to Regulation E implement these provisions by requiring ATM operators that impose a fee to post a notice to that effect on or at the ATM and to disclose the amount of the fee either on the screen or on a paper notice before the customer is committed to completing the transaction. Financial institutions are also required to include in their initial disclosures to a customer contracting for electronic fund transfer services a notice that a fee may be imposed by an ATM operator not holding the customer's account or by any national, regional, or local network used to complete the transaction.

Regulation H
Membership of State Banking Institutions in the Federal Reserve System

January 17, 2001—Amendments

The Board approved a final rule that provides an alternative to the debt-rating requirement for certain large state member banks that propose to own a financial subsidiary, effective March 5, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, and Gramlich. Absent and not voting: Mr. Meyer.

The Board and the Department of the Treasury jointly approved a final rule that establishes an alternative to the debt-rating requirement that certain large banks may meet when they seek to acquire a financial subsidiary and thereby engage in expanded financial activities. The final rule is substantially similar to the interim rule adopted in March 2000.

Under the Gramm–Leach–Bliley Act, a national or state member bank that is among the 100 largest insured banks may control or hold an interest in a financial subsidiary if the bank has at least one issue of outstanding eligible debt that is rated in one of the three highest rating categories by a nationally recognized statistical rating organization. Banks among the second 50 largest insured banks may also qualify under an alternative standard that the Board and the Secretary of the Treasury determine by regulation to be comparable and consistent with the debt-rating requirement.

The final rule, which for state member banks is incorporated in Regulation H, provides that a bank qualifies under the alternative standard if it has a current long-term issuer credit rating from a nationally recognized statistical rating organization that is within the organization's three highest investment-grade rating categories. A long-term credit rating is defined as a written opinion that assesses the bank's overall capacity and willingness to pay in a timely manner its unsecured, dollar-denominated financial obligations that mature in not less than one year.

March 7, 2001—Delay of Effective Date

The Board extended, from April 1 to October 1, 2001, the effective date for a new rule that provides consumer protections in connection with insurance sales by state member banks.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

The Board, jointly with the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, approved a six-month extension of the effective date of a new interagency final rule on the sale of insurance by depository institutions that had been published on December 4, 2000. The new joint rule implements the consumer protection provisions of the Gramm–Leach–Bliley Act applicable to the retail sale, solicitation, advertising, or offer of an insurance product or annuity by a depository institution or by a person engaged in such activities at an office of or on behalf of a depository institution. The agencies provided the extension to give institutions sufficient time to ensure implementation of the new protections.

August 8, 2001—Amendments

The Board approved a final rule amending Regulation H to permit qualifying state member banks to engage in expanded financial activities through financial subsidiaries, effective September 17, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

The Board approved a final rule implementing the provisions of the Gramm–Leach–Bliley Act that authorize qualifying state member banks to control or hold an interest in a financial subsidiary, which may engage in certain activities that are financial in nature, or incidental thereto, but that the parent bank may not conduct directly. The final rule is substantially similar to the interim rule approved by the Board in March 2000 and to the rule adopted by the Office of the Comptroller of the Currency for financial subsidiaries of national banks.

The final rule provides a streamlined prior-notice procedure for acquiring an interest in a financial subsidiary; incorporates the capital, managerial, Community Reinvestment Act (CRA), and other qualifying criteria for a state member bank to own a financial subsidiary; and describes the procedures and restrictions that would apply if a state member bank or an affiliate ceased to meet these criteria. It also provides guidance on how the act's capital deduction and CRA requirements apply to a state member bank having a financial subsidiary.

Regulation H
Membership of
State Banking Institutions
in the Federal Reserve System

Regulation Y
Bank Holding Companies and
Change in Bank Control

October 15, 2001—Amendments

The Board approved amendments to Regulations H and Y to revise the regulatory capital treatment of securitization transactions by state member banks and bank holding companies, including financial holding companies, effective January 1, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

The Board, jointly with the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, amended the regulatory capital standards to address the treatment of recourse obligations, residual interests, and direct credit substitutes related to securitization transactions that expose banking and thrift institutions to credit risk. The amended standards better reflect the institutions' relative exposure to credit risks and provide a more consistent regulatory capital treatment for certain transactions that involve similar risk. They also increase consistency among the supervisory agencies in the area of regulatory capital requirements. For transactions entered into before the effective date, institutions may either adopt any portion of the final rule that would reduce their capital requirements or defer adoption until December 31, 2002, if complying with the rule would increase their capital requirements.

December 10, 2001—Amendments

The Board amended the capital guidelines in Regulations H and Y to establish minimum capital requirements for equity investments in nonfinancial companies by state member banks and bank holding companies, including financial holding companies, effective April 1, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, Meyer, and Gramlich, Ms. Bies, and Mr. Olson. Absent and not voting: Mr. Kelley.

The Board, jointly with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, adopted special minimum capital requirements for equity investments in nonfinancial companies by banks and bank holding companies, including financial holding companies. The final rule imposes a series of marginal capital charges on covered equity investments that increase with the level of the banking organization's overall exposure to nonfinancial equity investments relative to its tier 1 capital. The new capital requirements apply symmetrically to equity investments made by banks and bank holding companies in nonfinancial companies. The new charges apply to equity investments held under the merchant banking authority of the Gramm–Leach–Bliley Act, the authority to acquire up to 5 percent of the voting shares of any company under section 4(c)(6) or 4(c)(7) of the Bank Holding Company Act, the portfolio investment authority under Regulation K (International Banking Operations), the authority to make investments in small business investment companies (SBICs) under the Small Business Investment Act, and the authority to make investments under section 24 of the Federal Deposit Insurance Act (other than section 24(f)). The rule exempts from the new capital charges any individual investment made by a bank or bank holding company before March 13, 2000. In addition, the new charges do not apply to investments made in or through SBICs to the extent that such investments, in the aggregate, represent 15 percent or less of the banking organization's tier 1 capital.

Regulation K
International Banking Operations

Rules Regarding Delegation of Authority

October 10, 2001—Amendments

The Board approved amendments to Regulation K to eliminate unnecessary regulatory burden, increase transparency, and streamline the approval process for U.S. banking organizations seeking to expand their operations abroad and for foreign banks seeking to expand their U.S. operations, effective November 26, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Meyer, and Gramlich. Absent and not voting: Mr. Kelley.

Consistent with the Riegle Community Development and Regulatory Improvement Act, the Federal Reserve Act, and the International Banking Act, the Board approved amendments in connection with its review of Regulation K.

The amended provisions regulate the foreign investments and activities of all member banks, Edge and agreement corporations, and bank holding companies (subpart A); U.S. activities of foreign banking organizations (subpart B); and export trading companies (subpart C). The Board also requested public comment on proposed amendments to provisions on international lending supervision (subpart D).

The amendments provide streamlined foreign branching procedures for U.S. banking organizations, authorize expanded activities by foreign branches of U.S. banks, and implement recent statutory amendments that permit member banks to invest up to 20 percent of their capital and surplus in Edge corporations. Regulation K's provisions governing permissible foreign activities of U.S. banking organizations, including securities activities, and investments by U.S. banking organizations under the general consent procedures also were amended. Other revisions streamline the applications procedures for foreign banks seeking to expand operations in the U.S., modify provisions concerning the qualification of foreign banking organizations for exemption from the nonbanking prohibitions in section 4 of the Bank Holding Company Act, and implement provisions of the Riegle–Neal Interstate Banking and Branching Efficiency Act that affect foreign banks.

The Board also delegated authority to Board staff and the Reserve Banks to approve certain transactions.

Regulation Y
Bank Holding Companies and Change in Bank Control

January 10, 2001—Amendments

The Board approved a final rule on the merchant banking activities of financial holding companies, effective February 15, 2001, replacing the Board's interim rule on this subject, which had become effective on March 17, 2000.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

The Board and the Department of the Treasury jointly approved a final rule incorporated in Regulation Y to implement the merchant banking provisions of the Gramm–Leach–Bliley Act. Like the interim rule it replaces, the final rule defines the scope of permissible merchant banking activities and implements the limitations in the act on the potential mixing of banking and commerce. The rule contains provisions designed to protect the safety and soundness of depository institutions. It also contains streamlined recordkeeping and reporting provisions to assist in monitoring compliance with, and to prevent evasions of, the Bank Holding Company and Gramm–Leach–Bliley Acts.

The final rule differs from the interim rule in several key respects. It modifies the interim rule's provisions defining prohibited routine management and operation of portfolio companies and provides three situations in which financial holding companies will not be presumed to control portfolio companies for purposes of applying sections 23A and 23B of the Federal Reserve Act. In addition, the final rule broadens the definition of "private equity funds," clarifies the rule's application to such funds, and expands the types of financial holding companies that may engage in merchant banking activities. The final rule also adopts a sunset provision for the aggregate investment thresholds included in the interim rule and eliminates immediately the dollar-based investment threshold for the review of a financial holding company's merchant banking activities.

Regulation Z
Truth in Lending

December 12, 2001—Amendments

The Board amended Regulation Z to expand the applicability of the Home Ownership and Equity Protection Act, effective December 20, 2001, with mandatory compliance by October 1, 2002.

> Votes for this action: Messrs. Greenspan, Ferguson, Meyer, and Gramlich, Ms. Bies, and Mr. Olson. Absent and not voting: Mr. Kelley.

The Home Ownership and Equity Protection Act amended the Truth in Lending Act to address potentially abusive practices in connection with closed-end home-equity loans that are not home-purchase loans. It imposes substantive limitations, such as restrictions on short-term balloon notes and prepayment penalties, and additional disclosure requirements on these types of loans if annual percentage rates or fees exceed specified threshold amounts. The Board is authorized to expand the act's applicability and to prohibit certain practices.

The Board approved amendments that make more home-equity loan transactions subject to the act by lowering the rate-based threshold for first-lien loans and by including certain charges for optional credit insurance and credit-protection plans in the calculation of the fee-based threshold. The amendments also restrict certain acts and practices, such as refinancing a covered loan within one year unless the refinancing is in the borrower's interest and wrongfully documenting a covered loan as an open-end credit transaction to evade the act. In addition, the amendments strengthen the act's prohibition on loans based on homeowners' equity without regard to their ability to repay the loan and revise the consumer disclosures that must be provided before a loan closing.

Miscellaneous Interpretations

Applicability of Sections 23A and 23B of the Federal Reserve Act to Derivative Transactions with Affiliates and Intraday Extensions of Credit to Affiliates

May 2, 2001—Interim Amendments

The Board adopted interim rules on the applicability of sections 23A and 23B of the Federal Reserve Act to derivative transactions and intraday extensions of credit involving insured depository institutions and their affiliates, effective January 1, 2002.

> Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

The interim amendments implement provisions of the Gramm–Leach–Bliley Act that require the Board to adopt rules under section 23A to address credit exposure arising out of derivative transactions between insured depository institutions and their affiliates and intraday extensions of credit by insured depository institutions to their affiliates. The interim rules require insured depository institutions to adopt policies and procedures reasonably designed to monitor, manage, and control credit exposures in derivative transactions with their affiliates and in intraday extensions of credit to their affiliates. In addition, they clarify that these transactions are subject to section 23B. The Board also requested public comment on the interim rules.

Applicability of Section 23A of the Federal Reserve Act to the Purchase of Securities from Certain Affiliates

Applicability of Section 23A of the Federal Reserve Act to Loans and Extensions of Credit Made by a Member Bank to a Third Party

May 2, 2001—Amendments

The Board adopted rules regarding the applicability of section 23A of the Federal Reserve Act to certain transactions involving securities affiliates of insured depository institutions, effective June 11, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

Section 23A restricts the ability of a member bank to fund its affiliates through investments, loans, asset acquisitions, or certain other transactions, including transactions that involve a member bank and a nonaffiliated party to the extent that the proceeds from the transaction are used for the benefit of or are transferred to an affiliate of the bank. The amendments provide that certain transactions involving securities affiliates of insured depository institutions are not covered under section 23A.

The Board adopted an interpretation that expands the types of asset purchases eligible for exemption under the provision in section 23A that exempts the purchase from an affiliate of an asset that has a readily identifiable and publicly available market quotation. The interpretation increases the ability of insured depository institutions to purchase securities from their registered broker–dealer affiliates while ensuring that the transactions are conducted in a manner consistent with safe and sound banking practices.

The Board also adopted an interpretation and provided exemptions applicable to certain loans made by insured depository institutions to customers who use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution. The interpretation confirms that section 23A does not apply to such loan and purchase transactions as long as the affiliate is acting exclusively as a broker in the transaction and the affiliate retains no portion of the loan proceeds. The Board also exempted from section 23A any portion of the loan that an affiliate retains as a market-rate brokerage commission or agency fee. In addition, the Board provided exemptions for transactions in which loan proceeds are used by a customer to purchase a third party's security through a broker–dealer affiliate of the institution that makes the loan if the affiliate is acting as a riskless principal in the securities transaction. Finally, the Board provided an exemption for extensions of credit used by customers to purchase securities from a broker–dealer affiliate of the institution extending the credit under a preexisting credit line not entered into in contemplation of the securities purchase.

Rules Regarding Equal Opportunity

January 2, 2001—Interim Amendments

The Board approved interim amendments to its Rules Regarding Equal Opportunity, effective January 25, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

The Board's Rules Regarding Equal Opportunity require a workplace that is free of discrimination based on race, color, religion, sex, national origin, age, physical or mental disability, or retaliation and provide a procedure for processing discrimination complaints. The rules, which were adopted under the Federal Reserve Act, are substantially similar to the Equal Employment Opportunity Commission's regulations for federal sector employment. In November 1999, the Commission amended its regulations, and the Board's interim amendments implement the changes that are applicable to Board employment. In addition, the interim amendments revise provisions in the rules that prohibit discrimination on the basis of disability and address the employment of noncitizens, which are not covered by the Commission's regulations. The Board also requested public comment on the interim amendments.

Policy Statements and Other Actions

April 4, 2001—Policy Statement on Payments System Risk

The Board rescinded the third-party access policy for Fedwire transactions in connection with its review of the Federal Reserve's Policy Statement on Payments System Risk, effective April 9, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

In 1987, the Board, as part of its policy to reduce payments system risk, approved a set of conditions under which Fedwire third-party access arrangements could be established. The Board allowed institutions meeting the conditions to establish third-party access arrangements under which a sending or receiving institution ("participant") designates another depository institution or other service provider to initiate, receive, or otherwise process Fedwire funds transfers or book-entry securities transfers that are posted to the participant's account at the Federal Reserve. The Federal Reserve's experience with the Fedwire third-party access policy indicates that, properly managed, such arrangements pose little additional risk to the Federal Reserve. Supervisory guidance on outsourcing, issued by the Board and the other federal banking regulators in 2000, addresses domestic and foreign arrangements and sets forth basic supervisory expectations for outsourcing of Fedwire and other information- and transaction-processing activities conducted by banking organizations. Fedwire outsourcing arrangements will continue to be reviewed as appropriate during the normal supervisory process. In this light, the Board concluded that the administrative burden on participants of complying with a separate third-party access policy warranted its rescission.

May 29, 2001—Policy Statement on Payments System Risk

The Board rescinded its interaffiliate transfer policy, effective January 1, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

In 1987, the Board modified its Policy Statement on Payments System Risk to include a policy on interaffiliate transfers that addressed potential risks arising from credit decisions among affiliates that are not at arm's length. The Board has rescinded the interaffiliate transfer policy because the risks addressed by the policy are appropriately addressed through the existing supervisory process and the Reserve Banks' credit-risk-management controls.

May 29, 2001—Policy Statement on Payments System Risk

The Board approved an interim policy statement that gives depository institutions access to intraday credit from the Federal Reserve Banks above their self-assessed net debit caps, effective May 30, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

Controlling depository institutions' use of intraday Federal Reserve credit, commonly known as daylight overdrafts, is an integral part of the Board's Policy Statement on Payments System Risk. The interim policy statement promotes risk-reduction efforts while minimizing disruptions to the payments system. It allows depository institutions having self-assessed net debit caps, which are maximum limits on their daylight overdrafts, to pledge collateral for additional daylight overdraft capacity above their net debit caps, subject to Reserve Bank approval. The interim policy statement reflects the Board's ongoing efforts to ensure that the payments system functions effectively and efficiently. The Board also requested public comment on the interim policy statement.

December 7, 2001—Policy Statement on Payments System Risk

The Board approved revisions to its Policy Statement on Payments System Risk, effective December 10, 2001, except as noted below.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.

The Board adopted, with minor modifications, the interim policy statement on depository institutions' use of Federal Reserve intraday credit, or daylight overdrafts, that was approved on May 29, 2001, and is discussed above. In addition, the Board approved modifications to the criteria for determining foreign banking organizations' U.S. capital equivalency measure for purposes of calculating their net debit caps, effective February 21, 2002. The Board also approved modifications to the posting time for electronic check presentments to a depository institution's Federal Reserve account for purposes of measuring daylight overdrafts; the modifications, made in order to remove a potential impediment to the use of electronic check presentment, became effective April 1, 2002. Finally, the Board decided to retain the $50 million limit on the value of book-entry securities transfers.

Discount Rates in 2001

During 2001, the Board of Governors approved twelve reductions, totaling 4¾ percentage points, in the basic discount rate charged by the Federal Reserve Banks. These actions lowered the basic rate from 6 percent at the start of the year to 1¼ percent in December. There were no rate increases during 2001. The rates for seasonal and extended credit, which are recalculated biweekly in keeping with market-related formulas, exceeded the basic rate by varying amounts during the year.

Basic Discount Rate

The Board's decisions on the basic discount rate were made against the background of the policy actions of the Federal Open Market Committee (FOMC) and related economic and financial developments. These developments are reviewed more fully in other parts of this Report, including the minutes of the FOMC meetings held in 2001.

Reductions in the Basic Rate during 2001

From January 3 to December 11, 2001, the Board approved twelve reductions in the basic rate in conjunction with similar decreases in the target for the federal funds rate set at meetings of the FOMC. As the year began, information relating notably to sales and production suggested that the expansion had begun to weaken considerably in late 2000. Against that background and given indications that inflation pressures remained contained, the FOMC lowered the target federal funds rate by 50 basis points and the Board decided that an equal reduction in the basic discount rate was also appropriate. Over the months that followed, evidence of a marked slowdown in the growth of economic activity intensified. Businesses substantially reduced their investment spending in response to weakening demand for their goods and services, an oversupply of some types of capital, and declining profits. Many business firms also sought to reduce what they viewed as excessive inventories, fostering a decline in manufacturing output and an upturn in unemployment. Concurrently, business and consumer confidence eroded, although household spending continued to grow, albeit at a somewhat reduced pace. Against this background, the Board and the FOMC eased monetary policy aggressively in a series of coordinated 50 basis point rate reductions over the first five months of the year.

In late June and again in August, lesser reductions of 25 basis points in the basic discount rate and the federal funds rate were made in the context of continuing indications of a softening economy characterized by further weakness in capital spending, inventory liquidation, and deteriorating export markets. However, household spending was being well maintained, and Federal Reserve officials took account of the considerable easing of monetary policy undertaken in recent months, whose effect had not yet been fully felt, and of Congressional approval of tax cuts that would help to support the economy in coming quarters. Even so, the risks were seen as still tilted toward further economic weakness that called for some added easing in monetary policy.

Despite cumulative reductions of 3 percentage points in the basic discount rate and the federal funds rate by August, the economy appeared to remain vulnerable to further deterioration, with more-widespread indications of weakness and mounting job losses. Against this background, the terrorist attacks on September 11 posed a severe threat to financial markets and the economy. The uncertainty created by the attacks depressed equity prices, raised risk premiums, and further restrained economic activity. In these circumstances, the Federal Reserve acted promptly to provide massive amounts of liquidity on a temporary basis to facilitate the functioning of financial markets and took several actions to reduce its policy rates further. Three reductions of 50 basis points were made in the basic discount rate and the federal funds rate from mid-September through early November. By the first part of December, there were signs that the weakness in aggregate demand might be abating, though those indications were still quite limited and tentative. Over the closing months of the year, efforts to liquidate inventories and reduce capital spending continued to induce production cutbacks. However, after displaying some weakness immediately after the events in September, household spending subsequently appeared to have returned to a moderate growth trend. Low interest rates and widespread price discounting, among other factors, were helping to hold up expenditures on household durables and residential construction despite a high degree of consumer caution. Moreover, stock prices reversed their post-attack losses and an upturn in new orders for capital goods suggested that business confidence might be returning. In this situation, while the risks to the economy were still viewed as tilted toward weakness, the Board and the FOMC agreed that further reductions in their policy rates should be limited to 25 basis points. At year-end, the key policy rates were at their lowest nominal levels in four decades.

Structure of Discount Rates

The basic discount rate is the rate normally charged on loans to depository institutions for short-term adjustment credit, while flexible, market-related rates generally apply to seasonal and extended credit. The flexible rates are calculated every two weeks in accordance with formulas that are approved by the Board.

The objective of the seasonal credit program is to help smaller institutions meet liquidity needs arising from a clear pattern of intra-yearly movements in their deposits and loans. Funds may be provided for longer periods than those permitted under adjustment credit. Since its introduction in early 1992, the flexible rate charged on seasonal credit has been closely aligned with short-term market rates; it is never less than the basic rate applicable to adjustment credit.

The purpose of extended credit is to assist depository institutions that are under sustained liquidity pressure and are not able to obtain funds from other sources. The rate for extended credit is 50 basis points higher than the rate for seasonal credit and is at least 50 basis points above the basic rate. In appropriate circumstances, the basic rate may be applied to extended-credit loans for up to thirty days, but any further borrowings would be charged the flexible, market-related rate.

Exceptionally large adjustment-credit loans that arise from computer breakdowns or other operating problems not clearly beyond the reasonable control of the borrowing institution are assessed the highest rate applicable to any credit extended to depository institutions. No loans of this type were made during 2001.

At the end of 2001, the structure of discount rates was as follows: a basic rate of 1.25 percent for short-term adjustment credit and rates of 1.80 percent for seasonal credit and 2.30 percent for extended credit. During 2001, the rate for seasonal credit ranged from a high of 6.45 percent to a low of 1.80 percent; that for extended credit ranged from a high of 6.95 percent to a low of 2.30 percent.

Board Votes

Under the Federal Reserve Act, the boards of directors of the Federal Reserve Banks must establish rates on loans to depository institutions at least every fourteen days and must submit such rates to the Board of Governors for review and determination. The Reserve Banks are also required to submit on the same schedule requests to renew the formulas based on short-term market interest rates for calculating the rates on seasonal and extended credit. Votes on the reestablishment of the formulas for these flexible rates are not shown in this summary. All votes taken by the Board of Governors during 2001 were unanimous.

Votes on the Basic Discount Rate[3]

January 3, 2001. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of New York, Cleveland, Atlanta, Kansas City, Dallas, and San Francisco to reduce the basic discount rate by ¼ percentage point, to 5¾ percent. The same decrease was approved for the Federal Reserve Bank of St. Louis, effective January 4, 2001. The Board also indicated that it stood ready to approve Federal Reserve Bank requests to lower the basic rate further, to 5½ percent.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich. Votes against this action: None.

January 4, 2001. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to lower the basic discount rate by ¼ or ½ percentage point, to 5½ percent. The Board also approved an action taken by the directors of the Federal Reserve Bank of St. Louis to reduce the basic rate by ¼ percentage point, to 5½ percent, effective January 5, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich. Votes against this action: None.

January 31, 2001. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of New York, Philadelphia, Cleveland, Atlanta, Chicago, Minneapolis, Dallas, and San Francisco to reduce the basic discount rate by ½ percentage point, to 5 percent. The same decrease was approved for the Federal Reserve Bank of St. Louis, effective February 1, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich. Votes against this action: None.

The Board subsequently approved the same reduction for the Federal Reserve Banks of Boston and Richmond, effective January 31, 2001, and the Federal Reserve Bank of Kansas City, effective February 1, 2001.

March 20, 2001. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to reduce the basic discount rate by ½ percentage point, to 4½ percent. The same reduction was approved for the Federal Reserve Bank of St. Louis, effective March 21, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich. Votes against this action: None.

April 18, 2001. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Atlanta, Minneapolis, Kansas City, Dallas, and San Francisco to reduce the basic discount rate by ½ percentage point, to 4 percent.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich. Votes against this action: None.

3. There were two vacancies on the Board of Governors from the start of the year until December 7, 2001.

The Board subsequently approved the same actions taken by the directors of the Federal Reserve Banks of Richmond and Chicago, effective April 19, 2001, and by the directors of the Federal Reserve Bank of St. Louis, effective April 20, 2001.

May 15, 2001. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of New York, Richmond, Chicago, and San Francisco to reduce the basic discount rate by ½ percentage point, to 3½ percent. An identical decrease was approved for the Federal Reserve Bank of St. Louis, effective May 16, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich. Votes against this action: None.

The Board subsequently approved the same actions taken by the directors of the Federal Reserve Banks of Boston, Atlanta, Kansas City, and Dallas, effective May 16, 2001, and by the directors of the Federal Reserve Banks of Philadelphia, Cleveland, and Minneapolis, effective May 17, 2001.

June 27, 2001. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Atlanta, Chicago, Dallas, and San Francisco to reduce the basic discount rate by ¼ percentage point, to 3¼ percent.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich. Votes against this action: None.

The Board subsequently approved identical actions taken by the directors of the Federal Reserve Banks of Cleveland, Richmond, Minneapolis, and Kansas City, effective June 28, 2001, and by the directors of the Federal Reserve Bank of St. Louis, effective June 29, 2001.

August 21, 2001. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Richmond, Chicago, Kansas City, Dallas, and San Francisco to reduce the basic discount rate by ¼ percentage point, to 3 percent.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich. Votes against this action: None.

The Board subsequently approved the same actions taken by the directors of the Federal Reserve Bank of Minneapolis, effective August 22, 2001, and by the directors of the Federal Reserve Banks of Cleveland, Atlanta, and St. Louis, effective August 23, 2001.

September 17, 2001. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to reduce the basic discount rate by ½ percentage point, to 2½ percent. An identical decrease was approved for the Federal Reserve Bank of St. Louis, effective September 18, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich. Votes against this action: None.

October 2, 2001. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Cleveland, Richmond, Atlanta, Chicago, Kansas City, Dallas, and San Francisco to reduce the basic discount rate by ½ percentage point, to 2 percent. A similar decrease was approved for the Federal Reserve Bank of St. Louis, effective October 3, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich. Votes against this action: None.

The Board subsequently approved the same actions taken by the directors of the Federal Reserve Banks of Minneapolis and Philadelphia, effective October 3 and 4, 2001, respectively.

November 6, 2001. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of New York, Richmond, and San Francisco to reduce the basic discount rate by ½ percentage point, to 1½ percent.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich. Votes against this action: None.

The Board subsequently approved identical actions taken by the directors of the Federal Reserve Banks of Philadelphia, Chicago, St. Louis, and Minneapolis, effective November 7, 2001, and by the directors of the Federal Reserve Banks of Boston, Cleveland, Atlanta, Kansas City, and Dallas, effective November 8, 2001.

December 11, 2001. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Chicago, and San Francisco to reduce the basic discount rate by ¼ percentage point, to 1¼ percent. An identical decrease was approved for the Federal Reserve Bank of St. Louis, effective December 12, 2001.

Votes for this action: Messrs. Greenspan, Ferguson, Meyer, Gramlich, Ms. Bies, and Mr. Olson. Votes against this action: None. Absent and not voting: Mr. Kelley.

The Board subsequently approved the same actions taken by the directors of the Federal Reserve Banks of Cleveland, Richmond, Atlanta, Minneapolis, Kansas City, and Dallas, effective December 13, 2001. ■

Minutes of Federal Open Market Committee Meetings

The policy actions of the Federal Open Market Committee, contained in the minutes of its meetings, are presented in the ANNUAL REPORT of the Board of Governors pursuant to the requirements of section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each policy action, and that it shall include in its annual report to the Congress a full account of such actions.

The minutes of the meetings contain the votes on the policy decisions made at those meetings as well as a résumé of the information and discussions that led to the decisions. The summary descriptions of economic and financial conditions are based on the information that was available to the Committee at the time of the meetings rather than on data as they may have been revised later.

Members of the Committee voting for a particular action may differ among themselves as to the reasons for their votes; in such cases, the range of their views is noted in the minutes. When members dissent from a decision, they are identified in the minutes and a summary of the reasons for their dissent is provided.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market operations, the Federal Reserve Bank of New York operates under three sets of instructions from the Federal Open Market Committee: an Authorization for Domestic Open Market Operations, Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues, and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Committee operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations. These policy instruments are shown below in the form in which they were in effect at the beginning of 2001. Changes in the instruments during the year are reported in the minutes for the individual meetings.

Authorization for Domestic Open Market Operations

In Effect January 1, 2001

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the

United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $12.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 90 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

(c) To sell U.S. Government securities and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 90 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding but that in no event shall be less than 1.0 percent per annum of the market value of the securities lent. The Federal Reserve Bank of New York shall apply reasonable limitations on the total amount of a specific issue that may be auctioned, and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 90 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat

in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues

In Effect January 1, 2001

1. System open market operations in Federal agency issues are an integral part of total System open market operations designed to influence bank reserves, money market conditions, and monetary aggregates.

2. System open market operations in Federal agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

Domestic Policy Directive

In Effect January 1, 2001[1]

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 6½ percent.

The Committee also approved the sentence below for inclusion in the press statement to be released shortly after the December 19, 2000, meeting:

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Authorization for Foreign Currency Operations

In Effect January 1, 2001

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Canadian dollars	Mexican pesos
Danish kroner	Norwegian kroner
Euro	Swedish kronor
Pounds sterling	Swiss francs
Japanese yen	

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

1. Adopted by the Committee at its meeting on December 19, 2000.

D. To maintain an overall open position in all foreign currencies not exceeding $25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements (“swap” arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada	2,000
Bank of Mexico	3,000

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non–market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account (“Manager”), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

Foreign Currency Directive

In Effect January 1, 2001

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

Procedural Instructions with Respect to Foreign Currency Operations

In Effect January 1, 2001

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $300 million on any day or $600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding $150 million, or $300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

Meeting Held on January 30–31, 2001

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., beginning on Tuesday, January 30, 2001, at 9:00 a.m. and continuing on Wednesday, January 31, 2001, at 9:00 a.m.

Present:

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

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

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

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

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

Mr. Fisher, Manager, System Open Market Account

Mr. Winn,[2] Assistant to the Board, Office of Board Members, Board of Governors

Ms. Johnson,[3] Secretary of the Board, Office of the Secretary, Board of Governors

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

2. Attended Tuesday session only.

3. Attended portion of meeting relating to a staff study of the Federal Reserve asset portfolio.

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

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

Messrs. Morton,[2] Rosine,[2] and Sack,[2] Senior Economists, Divisions of International Finance, Research and Statistics, and Monetary Affairs respectively, Board of Governors

Mr. Reifschneider,[4] Section Chief, Division of Research and Statistics, Board of Governors

Ms. Garrett,[4] Economist, Division of Monetary Affairs, Board of Governors

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

Mr. Lang, Executive Vice President, Federal Reserve Bank of Philadelphia

Messrs. Beebe, Eisenbeis, Goodfriend, Kos, Ms. Krieger, Messrs. Rosenblum, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, New York, New York, Dallas, and Cleveland respectively

Mr. Weber, Vice President, Federal Reserve Bank of Minneapolis

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 2001, and ending December 31, 2001, had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

William J. McDonough, President of the Federal Reserve Bank of New York, with Jamie B. Stewart, Jr., First Vice President of the Federal Reserve Bank of New York, as alternate

Cathy E. Minehan, President of the Federal Reserve Bank of Boston, with Anthony M. Santomero, President of the Federal Reserve Bank of Philadelphia, as alternate

Michael H. Moskow, President of the Federal Reserve Bank of Chicago, with Jerry L. Jordan, President of the Federal Reserve Bank of Cleveland, as alternate

William Poole, President of the Federal Reserve Bank of St. Louis, with Robert D. McTeer, Jr., President of the Federal Reserve Bank of Dallas, as alternate

Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City, with Gary H. Stern, President of the Federal Reserve Bank of Minneapolis, as alternate

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first regularly scheduled meeting of the Committee after December 31, 2001, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee:

Alan Greenspan	Chairman
William J. McDonough	Vice Chairman

4. Attended Wednesday session only.

Donald L. Kohn	Secretary and Economist
Normand R.V. Bernard	Deputy Secretary
Lynn S. Fox and Gary P. Gillum	Assistant Secretaries
J. Virgil Mattingly, Jr.	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Karen H. Johnson and David J. Stockton	Economists

Christine M. Cumming, Jeffrey C. Fuhrer, Craig S. Hakkio, William C. Hunter, David H. Howard, David E. Lindsey, Robert H. Rasche, Vincent R. Reinhart, and Lawrence Slifman, Associate Economists

By unanimous vote, Peter R. Fisher was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.

Secretary's note: Advice subsequently was received that the selection of Mr. Fisher as Manager was satisfactory to the board of directors of the Federal Reserve Bank of New York.

By unanimous vote, the minutes of the meetings of the Federal Open Market Committee held on December 19, 2000, and January 3, 2001, were approved.

The next item on the agenda encompassed issues relating in part to the discount window and other matters that are within the legal purview of the Board of Governors. Accordingly, a Board meeting was formally convened and this item was considered in a joint Board–Federal Open Market Committee session. The Board members voted unanimously at the outset to close the Board meeting.

At its meeting in March 2000, the Committee asked the staff to undertake a broad study of alternative approaches to the management of the System asset portfolio in the current and prospective environment of large budget surpluses and rapid associated declines in the amount of Treasury debt outstanding. Such paydowns were having favorable effects on the macroeconomy and would not impair the Committee's ability to pursue its overall economic objectives. But the FOMC's historical reliance on purchases and sales of Treasury securities to implement monetary policy would be difficult to maintain if steep paydowns of debt were, as seemed likely, to continue. To prepare for such a contingency, the Committee needed to identify and explore alternative instruments for the conduct of monetary policy.

In their discussion at this meeting, the members agreed that continuing paydowns of Treasury debt outstanding could create complications for the implementation of monetary policy well before the full repayment of marketable federal debt. In particular, the Treasury market could be expected to become less liquid over time, making it more difficult for the Federal Reserve to accommodate the trend growth of currency through outright purchases of Treasuries without unduly affecting market prices. Reduced activity in the Treasury repurchase agreement (RP) market could complicate the use of such obligations to respond to seasonal and unexpected variations in the aggregate supply of reserves.

In reviewing the possibilities, the members noted that relative to investments in Treasury securities, all of the options could entail significant drawbacks, including increases in credit risk, reductions in liquidity, and potentially distorting effects on relative prices in financial markets. In light of these potential issues, the Committee agreed that it should proceed cautiously and maintain the current emphasis on Treasury securities in the SOMA portfolio, especially the portion of the portfolio held outright, for as long as practicable. In that regard, some members suggested that the Committee look carefully at whether it could loosen the limits it currently imposes on holdings of individual Treasury issues without causing undue market distortions. Some felt it would be desirable to consider buying and holding Ginnie Mae mortgage-backed securities, which are guaranteed by the full faith and credit of the United States. A few members suggested that consideration might be given to the possibility of continuing to rely on Treasury securities, even as the publicly held debt is paid down, by acquiring such securities through special arrangements with the Treasury.

In the near term, the members agreed that it would be useful to extend for at least another year the temporary authority, in effect since late August 1999, of the Manager to supplement repurchase agreements in Treasuries and direct agency debt with repurchase transactions in mortgage-backed securities guaranteed by a federal agency or a government-sponsored enterprise. They also asked the staff to investigate the possibility of authorizing the Desk to engage in RP operations using assets that could be purchased under existing legal authority but were not currently authorized by the Committee—specifically, certain debt obligations of U.S. state and local governments and of foreign governments. Making a wider range of assets available for RP operations would reduce the potential for distortions to the pricing of instruments collateralizing RPs, but would entail resolving a number of issues. The Congress and market participants would need to be consulted before the Committee decided to undertake any such operations.

From a somewhat longer-term perspective, Committee members identified several alternative issues for further study. One involved the appropriate degree of reliance on outright purchases of a broader array of assets relative to greater use of temporary short-term transactions undertaken through intermediaries. A number of members saw advantages to the greater reliance on the latter—RPs with security dealers and discount window loans to depository institutions—especially when they involved a wide range of underlying assets. It was noted that such instruments would afford the Federal Reserve considerable protection against credit risks, could be structured to provide substantial liquidity to respond to unanticipated changes in the supply or demand for reserves, and, relative to outright purchases of the underlying collateral, could help to mitigate potential distortions to asset pricing and credit allocation. Many members indicated that a potentially attractive approach to expanding the role of the discount window might involve auctioning such credit to financially sound depository institutions. Some members expressed reservations about this option, noting that such a program would have to be carefully structured in order to avoid situations in which some institutions might become heavily dependent on such credit or engage in excessive risk taking. But extremely heavy reliance on temporary transactions could itself influence credit flows, suggesting that approaches to staying longer with Treasury securities or adding new assets not currently allowed by law to the permanent portfolio would also need to be studied.

The use of private securities for temporary transactions or permanent portfolio holdings had a number of risk-management and accounting implications that would need to be examined carefully. Another aspect that required further examination was the approach to diversification of the System portfolio in order to minimize any effects on credit conditions. In this context, the members compared the merits of an incremental approach in which classes of private securities were gradually added to the RP pool or the permanent portfolio, with the safest and most liquid being used first, to an alternative approach in which very broad diversification was sought quickly through investment in diverse pools of assets.

In view of the importance of these issues and their complexity, the Committee determined to explore various means to seek the input of the public and the Congress to develop and refine alternatives and to investigate all the associated policy issues.

By unanimous vote, the Committee approved amendments to paragraphs 1(b), 1(c), and 3 of the Authorization for Domestic Open Market Operations to permit temporary operations with a maturity limit of 65 business days.

Authorization for Domestic Open Market Operations (Amended January 30, 2001)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $12.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account;

(c) To sell U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an

overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding but that in no event shall be less than 1.0 percent per annum of the market value of the securities lent. The Federal Reserve Bank of New York shall apply reasonable limitations on the total amount of a specific issue that may be auctioned, and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities in 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

By unanimous vote, the Committee approved until the Committee's first scheduled meeting in 2002 an extension of the temporary suspension of paragraphs 3 to 6 of the Guidelines for the Conduct of System Operations in Federal Agency Issues. For the year ahead, the Guidelines therefore continued to read as follows:

Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues (Reaffirmed January 30, 2001)

1. System open market operations in Federal agency issues are an integral part of total System open market operations designed to influence bank reserves, money market conditions, and monetary aggregates.
2. System open market operations in Federal agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

By unanimous vote, the Foreign Currency Authorization was reaffirmed in the form shown below.

Authorization for Foreign Currency Operations (Reaffirmed January 30, 2001)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Canadian dollars	Mexican pesos
Danish kroner	Norwegian kroner
Euro	Swedish kronor
Pounds sterling	Swiss francs
Japanese yen	

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding $25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements (“swap” arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada	2,000
Bank of Mexico	3,000

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non-market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported

promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account (''Manager''), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

By unanimous vote, the Foreign Currency Directive was reaffirmed in the form shown below.

Foreign Currency Directive (Reaffirmed January 30, 2001)

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency (''swap'') arrangements with selected foreign central banks.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

By unanimous vote, the Procedural Instructions with Respect to Foreign Currency Operations were reaffirmed in the form shown below.

Procedural Instructions with Respect to Foreign Currency Operations (Reaffirmed January 30, 2001)

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $300 million on any day or $600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding $150 million, or $300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

On January 22, 2001, the continuing rules, regulations, and other instructions of the Committee had been distributed with the advice that, in accordance with procedures approved by the Committee, they were being called to the Committee's attention before the January 30–31 organization meeting to give members an opportunity to raise any questions they might have concerning them. Members were asked to indicate if they wished to have any of the instruments in question placed on the agenda for consideration at this meeting. The Guidelines for the Conduct of System Operations in Federal Agency Issues were placed on the agenda and an extension of their temporary amendment was approved as noted above.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period December 20, 2000, through January 30, 2001. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting indicated that the expansion of economic activity had slowed appreciably over the fourth quarter. Consumer and business spending decelerated further, with outlays for consumer durables and business equipment particularly weak. Housing construction remained relatively firm, though significantly below its brisk pace of earlier in the year. The slower growth of final spending resulted in inventory overhangs in a number of industries, most notably those related to the motor vehicle sector. Manufacturing production declined sharply as a result, and overall employment gains moderated further. Price inflation was still relatively subdued.

Labor demand softened further in December, with private nonfarm payroll employment continuing to increase slowly and the average workweek to decline. Nonetheless, the labor market remained very tight and the unemployment rate held at 4 percent, its average for the year. Reduced labor demand in manufacturing accounted for much of the slowdown in nonfarm payroll gains in the fourth quarter, with factory payrolls falling sharply further in December, but in addition sizable cuts in net new hires were recorded in the help-supply and construction industries.

The contraction in industrial production that began in October, largely in the motor vehicle sector, deepened and broadened in November and December. For the fourth quarter as a whole, the drop in production was concentrated in manufacturing; mining activity fell by less while utilities output surged late in the year in response to unseasonably cold weather. Most of the initial weakness in manufacturing output was related directly or indirectly to the slowing in the motor vehicle sector, but by year-end all major market groups had registered steep declines in production. Weaker factory activity in December resulted in a sizable drop in the rate of capacity utilization in manufacturing to a level further below its long-run average.

Against a background of slowing growth of disposable personal income and abrupt declines in consumer sentiment, consumer spending decelerated substantially in the fourth quarter. Purchases of motor vehicles slumped and outlays for other goods increased only a little. However, spending on services picked up somewhat in November (latest data), reflecting at least in part higher expenditures for heating services owing to unseasonably cold weather.

The decline in mortgage rates since the middle of last year had provided some support to residential building activity. Total housing starts increased slightly further in December, with single-family starts recording a brisk rise that might have been, in part, a response to the lower mortgage rates. By contrast, multifamily starts slowed, more than reversing November's run-up. Sales of new homes jumped in December to a very high level, but sales of existing homes dropped considerably.

Business fixed investment contracted slightly in the fourth quarter, reflecting a sizable decline in business spending on equipment and software that was offset in part by a large increase in nonresidential construction. Data on nominal shipments of nondefense capital goods in the fourth quarter indicated a drop in office and computing equipment, only a small gain in communications equipment, and a decline, on net, in non-high-tech equipment. By contrast, investment in nonresidential structures increased briskly further in October and November (latest data). While spending for new office buildings was rising less rapidly, outlays for other commercial structures picked up, and investment in industrial structures remained robust.

Business inventories on a book-value basis mounted further in October and November. Despite production cutbacks, stockbuilding in manufacturing remained rapid and sizable inventory overhangs had emerged in some industries, particularly those related to the motor vehicle sector. As a result, the aggregate stock–sales ratio for the manufacturing sector continued its upward drift that began early last year. Sizable inventory buildups and associated overhangs also were apparent in portions of the retail sector, and the aggregate inventory–sales ratio for the sector remained at the upper end of its range over the past year. At the wholesale level, inventory accumulation was moderate in October and November, but the sector's inventory–sales ratio continued to be at the top of its range for the last twelve months.

The U.S. trade deficit in goods and services fell slightly in October and November after having posted a new record high in September. Nevertheless, the average deficit for October and November was larger than the rate for the third quarter. The value of exports declined in both months, and the average value for the two-month period was below the third-quarter level; the weakness in exports was spread across a number of trade categories. The value of imports for the first two months of the fourth quarter was slightly above the third-quarter average. Economic growth in foreign industrial countries moderated in the second half of last year. The pace of economic expansion in the euro area softened somewhat further in the fourth quarter, as consumer spending remained weak. In Japan, available indicators suggested that economic activity had stagnated in the fourth quarter. Economic growth in Canada and the United Kingdom seemed to have slowed somewhat in the fourth quarter. In addition, the latest data for the major developing countries pointed to reduced expansion in many of those countries.

By most measures, price inflation had remained moderate in recent months. Judging by the consumer price index (CPI), total and core consumer prices rose mildly over November and December, but both accelerated somewhat on a year-over-year basis. In terms of the personal consumption expenditure (PCE) chain-type price index, however, core consumer price inflation was modest in both November (latest data) and the twelve months ended in November, and there was essentially no change year over year. At the producer level, core prices edged up over the November–December period, and the rise in core prices over the year was minimal as well. With regard to labor costs, the employment cost index of hourly compensation for private industry workers (ECI) decelerated noticeably in the fourth quarter, with both the wage and benefit components recording smaller gains. However, growth of ECI compensation picked up somewhat in 2000 from 1999, probably owing in large part to the upward trend in productivity growth. Productivity improvements also showed through to the average hourly earnings of production or nonsupervisory workers, which exhibited a roughly similar acceleration.

At its meeting on December 19, 2000, the Committee adopted a directive that continued to call for maintaining conditions in reserve markets consistent with an unchanged federal funds rate of about 6½ percent. At the same time, however, the members concluded that the balance of risks had shifted sufficiently that they had become weighted toward conditions that could generate economic weakness in the foreseeable future. Indeed, very recent information had seemed to signal sudden further weakness, but it was largely anecdotal and most of the aggregate data on spending and employment suggested continued economic expansion, albeit at a relatively slow rate. As a result, most members believed that it would be prudent to await further confirmation of a noticeably weaker expansion before implementing any monetary easing, particularly given the current high level of resource utilization and the record over the last several years of strong rebounds from brief lulls in growth. If, however, incoming data were to reinforce the recent anecdotal indications, the Committee would be prepared to respond promptly.

Open market operations during the intermeeting period were initially directed toward maintaining the federal funds rate at the Committee's targeted level of 6½ percent. However, information that became available in the weeks after the December meeting tended to confirm the earlier indications of weakness in spending, and at a telephone conference on January 3, 2001, the Committee approved a ½ percentage point reduction in the federal funds rate, to 6 percent, and also agreed that the risks remained weighted toward economic weakness. The federal funds rate remained close to the Committee's targets over the intermeeting period, and interest rates on short-term Treasury securities and high-quality private debt obligations declined over the period almost as much as the funds rate. The Committee's action seemed to help ease some concerns about the longer-term outlook, and risk spreads on lower-grade bonds fell substantially while broad indexes of U.S. stock market prices rose on balance over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar changed little on balance over the intermeeting interval in terms of an index of major foreign currencies. The dollar lost ground against the euro as market participants took note of the deterioration of near-term prospects for economic growth in the United States relative to those for Europe. However, that decline was roughly counterbalanced by a rise in the dollar against the yen, reflecting continuing economic stagnation in Japan. The dollar posted a small gain against an index of the currencies of other important trading partners, largely reflecting expectations that some emerging economies might be adversely affected by slower growth in the United States.

The broad monetary aggregates accelerated sharply in December and apparently strengthened further in January. The pickup in M2 growth evidently reflected a flight from heightened equity market volatility late last year to the safety and liquidity of M2 assets along with a recent narrowing of the opportunity costs of holding funds in M2 accounts. M3 grew even faster than M2, boosted in part by stepped-up issuance of large time deposits to fund a pickup in bank credit. The expansion of domestic nonfinancial debt increased in November and December (latest data), reflecting greater business borrowing, perhaps to finance growing inventories and smaller contractions in the amount of federal debt outstanding.

The staff forecast prepared for this meeting suggested that, after a pause associated in part with an inventory correction, the economic expansion would regain strength over the next two years and gradually move to a rate near the staff's current estimate of the growth of the economy's potential output. The period of subpar activity was expected to foster an appreciable slackening of resource utilization and some moderation in core price inflation. The forecast anticipated that the expansion of domestic final demand would be held back to some extent by the decline in household net worth associated with the downturn that had occurred in equity prices, the remaining effects of prior monetary restraint, and the continuation of somewhat stringent credit terms and conditions on some types of loans by financial institutions. As a result, growth of spending on consumer durables was expected to be appreciably below that of the first half of last year and housing demand to be about unchanged from its recent level. Business fixed investment, notably outlays for equipment and software, was projected to resume relatively robust growth after a comparatively brief period of adjustment of capital stocks to more desirable levels; growth abroad was seen as supporting the expansion of U.S. exports; and fiscal policy was assumed to become more expansionary.

In the Committee's discussion of current and prospective economic developments, members commented that while a slowdown in the expansion over the second half of 2000 was not unexpected in light of the previously unsustainable rate of increase in output, the speed and extent of the slowdown were much more pronounced than they had anticipated. Consumer spending and business capital investment had decelerated markedly, partly in association with a sharp decline in consumer and business confidence. This weakening, which was especially evident in durable goods producing industries, had led to large cutbacks in manufacturing output as numerous business firms attempted to pare what they now viewed as excessive inventories. The eventual degree and duration of the softening in economic conditions were difficult to predict. In particular, it was unclear whether the pause in the economic expansion would be largely limited to a relatively short inventory correction or would involve a more extensive cyclical adjustment.

In general, members saw favorable prospects for an appreciable recovery in overall business activity as the year progressed. Members referred to indications that both residential and nonresidential construction activity had remained relatively robust and to fragmentary data and anecdotal reports suggesting that consumer spending had steadied or possibly turned up early this year. Several commented that the sound condition of the banking system was another supportive factor. Some also observed that, counter to the experience generally associated with the onset of earlier recessions, monetary growth had been well maintained in recent months, and a few noted that long-term interest rates currently were appreciably below their peaks of the past year. The prospect that fiscal policy might begin to move in an expansionary direction later in the year was cited as another factor in the outlook for stronger economic activity. A decline in energy prices, should it materialize as anticipated in futures markets, would have a positive effect on both business and consumer spending by lowering business costs and raising disposable consumer incomes adjusted for energy costs. Perhaps the most critical element in this outlook was the persistence of elevated growth in structural labor productivity, which seemed likely to play a vital role in supporting growth in incomes and aggregate demand while also helping to limit inflation pressures.

At the same time, members also saw considerable downside risks to the economic expansion. Energy prices remained elevated and were continuing to depress business and household purchasing power; the overhang of excess capital stocks in some sectors could turn out to be sizable, depressing investment spending for some time; consumer confidence could worsen appreciably more in the face of weaker expansion of incomes and higher job layoffs; and investor concerns about earnings could increase further, sparking lower equity prices and tighter standards and terms on credit.

Except for prices of energy and medical services, the currently available information indicated relatively subdued rates of inflation, and recent surveys pointed to little change in inflation expectations. Looking ahead, members anticipated that somewhat reduced pressures in labor and product markets would foster some softening in consumer price inflation over coming quarters, a development that would be abetted should prices of oil and natural gas ease during the year in line with current market expectations.

In preparation for a semi-annual report to Congress, the members of the Board of Governors and the presidents of the Federal Reserve Banks provided individual projections of the growth in nominal and real GDP, the rate of unemployment, and the rate of inflation for the year 2001. The forecasts were concentrated in ranges of 4 to 5 percent for the growth in nominal GDP and 2 to 2½ percent for the expansion in real GDP, implying some strengthening of economic activity as the year progressed. With growth in business activity falling short of the expansion in the economy's potential, the rate of unemployment was expected to rise somewhat to an average of about 4½ percent by the fourth quarter of the year. Forecasts of the rate of inflation, as measured by the chain-type price index for personal consumption expenditures, were centered in a range of 1¾ to 2¼ percent, reflecting declines from the inflation rate last year largely stemming from the projected reductions in energy prices.

The marked deceleration in final sales experienced late last year was concentrated in consumer spending for motor vehicles and other durable goods and in business expenditures for equipment and software. In the household sector, rapidly declining consumer confidence, apparently associated in important measure with increasing worker layoffs and growing concerns about future job prospects, had contributed to generally disappointing retail sales during the holiday season. There was some evidence that sales had stabilized and possibly risen slightly in January, though a part of the improvement could reflect steep price discounts for the purpose of reducing inventories. Other negative factors cited by the members included the adverse wealth effects of the decrease in stock market valuations, relatively high consumer debt service burdens, and possible retrenchment by consumers after an extended period of large increases in purchases and related buildups of consumer durables. Nonetheless, in the absence of possible developments leading to further deterioration in consumer sentiment, the members saw reasonable prospects for strengthening consumer spending this year even assuming some decline in such expenditures relative to income. An important factor in this outlook was the expectation of some reduction in energy prices, which would boost disposable incomes available for nonenergy expenditures and likely provide a fillip to consumer sentiment in the process. Moreover, with the relatively high rate of growth in structural productivity showing little or no signs of waning, the longer-run prospects for household incomes remained positive. On balance, the various factors weighing on the outlook for consumer spending later this year seemed favorable, though substantial downside risks clearly would persist for some interim period of uncertain duration.

The depressing effects of lagging final sales on business investment spending, notably for equipment and software, were reinforced by deterioration in the financial balance sheets of some business firms, tighter supply conditions in segments of the credit markets, and a buildup in excess capacity that had eroded profitability. In this regard, members referred to earlier unsustainable rates of investment by many high-tech firms that were now obliged to retrench despite still high rates of growth in the demand for their products and services. With regard to the nonresidential construction sector, members provided anecdotal reports of continued high levels of activity in several parts of the country and little evidence of the substantial overbuilding that had characterized the construction industry in earlier periods of developing economic weakness. On balance, while the business investment outlook seemed vulnerable to somewhat greater than projected weakness in the short run, the members were persuaded that, against the background of large continuing gains in structural productivity and cost savings from further investment in equipment and software, business firms were likely to accelerate their spending for new capital after a period of adjustment.

Concerning the outlook for housing activity, recent statistical and anecdotal reports indicated that housing sales and construction were being well maintained and indeed were a bright spot in several regions. Reduced mortgage interest rates appeared to be largely offsetting the marked decline in consumer confidence. Accordingly, and contrary to the experience in earlier periods of softening economic activity, the stabilization of housing activity at a pace near its current fairly high level was seen as a reasonable expectation.

The outlook for inventory investment was more uncertain. The drop in final sales during late 2000 evidently was much faster than generally expected, and inventories rose considerably over the fourth quarter as a whole despite sharp downward adjustments in manufacturing output. In keeping with just-in-time inventory policies, which had been furthered in recent years by advances in technology that allowed faster and more complete readings on sales and adjustments in orders, efforts to reduce inventories were continuing in recent weeks and net inventory liquidation was anticipated in the current quarter. Looking further ahead, a number of members commented that they expected a period of inventory correction that would be relatively sharp but short by historical standards. Improvements in inventory management and related indications that inventory overhangs were small compared to earlier historical experience were factors in this assessment. At the same time, members recognized that the inventory correction had just begun and its duration would depend importantly on the ongoing strength of final sales. In this regard, developments bearing on business and consumer confidence and willingness to spend would play a crucial, though at this point uncertain, role.

Members expressed some divergence of views regarding the outlook for foreign economic activity and the implications for the domestic economy. Some emphasized that most of the nation’s important trading partners had growing economies that were likely to provide support for expanding U.S. exports. Other members were concerned about indications of growing weakness in a number of foreign economies that might increasingly inhibit U.S. exports and add to competitive pressures on U.S. producers in domestic markets. The large current account deficit was seen as a factor pointing to potential depreciation of the dollar over time, with adverse repercussions on domestic inflation albeit favorable effects on exports.

In their comments about the outlook for inflation, members noted that current indicators continued on the whole to point to subdued price increases, with lagging demand and strong competitive pressures in many markets severely limiting the ability of business firms to raise their prices. Labor markets were described as still tight across the nation, but reports of layoffs in specific industries were increasing and numerous business contacts indicated that openings were now much easier to fill in many job markets. There were some related indications that wage pressures might be easing. Against the background of a sluggish economy in the near term and forecasts of only moderate economic growth, the members anticipated that inflation would remain contained over the forecast horizon. A key factor in this assessment continued to be their outlook for rapid further gains in structural productivity that would help to hold down increases in unit labor costs. Other factors included the prospect of some decline in energy prices and the persistence of generally benign inflation expectations. On balance, with pressures in labor and product markets ebbing, the outlook for inflation was a source of diminished though persisting concern.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal calling for a further easing in reserve conditions consistent with a 50 basis point decrease in the federal funds rate to a level of 5½ percent. Such a policy move in conjunction with the 50 basis point reduction in early January would represent a relatively aggressive policy adjustment in a short period of time, but the members agreed on its desirability in light of the rapid weakening in the economic expansion in recent months and associated deterioration in business and consumer confidence. The extent and duration of the current economic correction remained uncertain, but the stimulus provided by the Committee's policy easing actions would help guard against cumulative weakness in economic activity and would support the positive factors that seemed likely to promote recovery later in the year. Several members observed that the evolving nature of the domestic economy, including the ongoing improvements in inventory management and the increase in managerial flexibility to alter the level and mix of capital equipment, associated in part with the greater availability of information, appeared to have fostered relatively prompt adjustments by businesses to changing economic conditions. As a consequence, monetary policy reactions to shifts in economic trends needed in this view to be undertaken more aggressively and completed sooner than in the past. In current circumstances, members saw little inflation risk in such a "front-loaded" easing policy, given the reduced pressures on resources stemming from the sluggish performance of the economy and relatively subdued expectations of inflation.

All the members agreed that the balance of risks sentence in the press statement to be released shortly after this meeting should continue to indicate that the risks would remain tilted toward economic weakness even after today's easing action. The members saw substantial underlying strength and resilience in the economy and they remained optimistic about its prospects beyond the near term in light of the monetary policy stimulus that was being implemented and the persistence of rapid advances in productivity. In this regard, some members commented that the upside risks could not be totally dismissed. But with the adjustments to the stock of capital, consumer durable goods, and inventories to more sustainable levels likely only partly completed and with investors in financial markets remaining skittish, the risks that growth would persist below that of the economy's productivity-enhanced potential continued to dominate the outlook.

At the conclusion of this discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 5½ percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Messrs. Moskow and Poole. Votes against this action: None.

By notation vote completed on March 15, 2001, the Federal Open Market Committee voted unanimously to select Dino Kos as Manager for Domestic and Foreign Operations of the System Open Market Account to serve in that capacity until the first regularly scheduled meeting after December 31, 2001, subject to the understanding that in the event of the discontinuance of his official connection with the Federal Reserve Bank of New York he would cease to have any official connection with the Federal Open Market Committee. It also was understood that this selection needed to be satisfactory to the Federal Reserve Bank of New York. Advice subsequently was received that the selection of Mr. Kos as Manager was satisfactory to the board of directors of that Bank.

It was agreed that the next meeting of the Committee would be held on Tuesday, March 20, 2001.

The meeting adjourned at 10:50 a.m. on January 31, 2001.

Donald L. Kohn
Secretary

Meeting Held on March 20, 2001

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., beginning at 9:00 a.m. on Tuesday, March 20, 2001.

Present:

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

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

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

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

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

Mr. Kos, Manager, System Open Market Account

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

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

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

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

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

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

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

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

Ms. Orrenius, Economist, Federal Reserve Bank of Dallas

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

Mr. Haubrich, Consultant, Federal Reserve Bank of Cleveland

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on January 30–31, 2001, were approved.

By unanimous vote, David Wilcox was elected to serve as an Associate Economist for the period until the first regularly scheduled meeting of the Committee after December 31, 2001.

The Manager of the System Open Market Account reported on developments in foreign exchange markets. There had been no operations in foreign currencies for the System's account since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in U.S. government securities and federal agency obligations during the period January 31, 2001, through March 19, 2001. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that economic activity continued to expand very slowly in the first quarter. Growth of final spending apparently picked up slightly, with consumer expenditures recording another moderate gain, business purchases of equipment and software increasing sluggishly after a fourth-quarter decline, and homebuilding remaining relatively firm. However, inventory overhangs were still apparent in some industries, and manufacturing production was cut sharply further. Overall employment gains were relatively well maintained, and labor markets were still tight though showing signs of softening. Price inflation had picked up a little but, abstracting from energy, had remained relatively subdued.

After a sluggish fourth quarter, private nonfarm payroll employment rose at a slightly higher rate on average in January and February, though still considerably below the pace of the first three quarters of 2000. Manufacturing and related industries, notably help-supply and wholesale trade, experienced further large declines in payrolls in the January–February period. However, hiring elsewhere held up relatively well, especially in construction, which recorded a surge in employment in January. While the labor market remained tight on balance, the unemployment rate increased to 4.2 percent in February, and other indicators such as initial claims for unemployment insurance suggested that pressures in labor markets had begun to abate.

The contraction in industrial production that began in October accelerated and broadened in the first two months of the year. In manufacturing, output fell further in the motor vehicle sector, and production continued to decelerate in high-tech industries. The rate of capacity utilization in manufacturing dropped noticeably in January and February to a level further below its long-run average.

Against a background of slowing income gains and a sizable pullback in consumer sentiment since last autumn, consumer spending evidently grew only moderately on balance in January and February. Purchases of motor vehicles picked up in response to increased marketing incentives put in place by Chrysler and General Motors, and retail sales of items other than motor vehicles climbed moderately. Spending on services was held down in January (latest data) by reduced expenditures for heating services as winter temperatures returned to more seasonal levels following unusually cold weather late last year; excluding heating, however, spending on other services rose slowly.

The decline in mortgage rates that began around the middle of last year continued to provide support to residential building activity. Total housing starts rose somewhat further in January and February, reflecting net increases in both single-family and, especially, multifamily units. Sales of new homes dropped sharply in January (latest data), after having surged in December, but remained quite robust by historical standards. Sales of existing homes rebounded in January after having fallen considerably in December and were up slightly on balance over the two months.

The limited available information suggested that business fixed investment was firming early this year after a decline in the fourth quarter of last year. Nominal shipments of nondefense capital goods other than aircraft and parts changed little on balance in December and January, while prices of high-tech equipment continued to fall. Moreover, orders for nondefense capital goods turned up briskly in January after a sharp fourth-quarter drop. Nonresidential construction activity continued its robust rise early in the year. Strength in building activity was widespread across the sector, most notably in new office construction.

Business inventories on a book-value basis increased in January at about the rapid fourth-quarter pace; inventory positions appeared to be especially large for construction materials, metals, electrical equipment, paper, chemicals, and textiles. In the manufacturing sector, overall stocks jumped in January while shipments fell, and the aggregate inventory–shipments ratio rose to its highest level in two years. In the wholesale trade sector, aggregate stocks fell again in January and the sector's inventory–sales ratio edged down to the middle of its very narrow range for the past year. Retail stocks continued to climb in January, but sales rose by more; the sector's inventory–sales ratio also edged lower, but it remained near the top of its range for the past twelve months.

The U.S. trade deficit in goods and services changed little in December but posted a new record high for the fourth quarter. The value of exports dropped substantially in that quarter, with notable declines occurring in agricultural products, aircraft, automotive products, computers and semiconductors, consumer goods, and telecommunications equipment. The value of imports remained at the high level recorded in the third quarter. Lower imports of automotive products, chemicals, computers and semiconductors, and steel were offset by higher imports of consumer goods and telecommunications equipment and smaller increases in other categories of trade. Economic growth in the foreign industrial countries was at a moderate rate on average in the fourth quarter. Expansion in the euro area picked up, while growth in Canada and the United Kingdom slowed significantly. The Japanese economy rebounded in the fourth quarter but was little changed on balance over the second half of the year, and recent indicators suggested a sharply weaker performance in the early part of this year. In addition, growth in the major developing countries slowed markedly in the fourth quarter, with the slowdown in most of those countries reflecting weaker demand for their exports.

Price inflation had picked up a bit recently. The consumer price index (CPI) jumped in January (latest data), reflecting a surge in energy prices; moreover, the index increased considerably more during the twelve months ending in January than it did during the previous twelve months. The core component of the CPI also accelerated in January and on a year-over-year basis, but by lesser amounts than did the total index. The increase in the core personal consumption expenditure (PCE) chain-type price index in January matched that of the core CPI; on a year-over-year basis, however, the pickup in core PCE inflation was a little smaller than that for the core CPI. At the producer level, core finished goods retraced in February only part of the sizable step-up in prices recorded in January, and core producer price inflation was up somewhat on a year-over-year basis. With regard to labor costs, recent data also pointed to some acceleration. Compensation per hour in the nonfarm business sector advanced appreciably more rapidly in the fourth quarter of 2000 and for the year as a whole. That trend also showed through to the average hourly earnings of production or nonsupervisory workers through February, which exhibited a roughly similar acceleration.

At its meeting on January 30–31, 2001, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with a decrease of 50 basis points in the intended level of the federal funds rate, to about 5½ percent. This move, in conjunction with the easing on January 3, was intended to help guard against cumulative weakness in economic activity and to provide some support to a rebound in growth later in the year. In the existing circumstances, the members agreed that the balance of risks remained weighted toward conditions that could generate economic weakness in the foreseeable future. Though rapid advances in underlying productivity were expected to continue, the adjustments to stocks of capital, consumer goods, and inventories to more sustainable levels were only partly completed, and financial markets remained unsettled.

Open market operations were directed throughout the intermeeting period toward maintaining the federal funds rate at the Committee's reduced target level of 5½ percent, and the funds rate stayed close to that target. However, incoming economic data, a steady flow of disappointing corporate earnings reports, related sharp declines in stock prices, and a notable drop in consumer confidence led market participants to conclude that more monetary easing would be required. Yields on Treasury securities, both short- and long-term, moved appreciably lower. However, rates on high-yield private debt obligations fell only a little, and banks further tightened standards and terms on business loans, given the weakening outlook for profits. Broad indexes of U.S. stock market prices moved sharply lower, with the tech-heavy Nasdaq experiencing an especially large drop. Nonetheless, the trade-weighted value of the dollar rose somewhat over the intermeeting interval in terms of many of the major foreign currencies. The dollar strengthened most against the currencies of countries that were seen to have the greatest potential for economic weakening, notably Japan. The dollar also posted a small gain against an index of the currencies of other important trading partners.

The broad monetary aggregates continued to grow rapidly in February, though at slightly lower rates than in January. The strength in M2 was concentrated in its liquid components, apparently in response to the further narrowing of opportunity costs, the yield advantage of money funds relative to longer-term investments, and the appeal of a safe haven from volatile equity markets. M3 grew somewhat less rapidly than M2; a pullback in the issuance of bank-managed liabilities, particularly large time deposits, was associated with slower expansion of bank credit. Growth of domestic nonfinancial debt decelerated noticeably in January (latest data), reflecting reduced expansion of debt in the nonfederal sectors coupled with a larger contraction in the amount of federal debt outstanding.

The staff forecast prepared for this meeting suggested that, after a period of slow growth associated in part with an inventory correction, the economic expansion would gradually regain strength over the next two years and move toward a rate near the staff's current estimate of the growth of the economy's potential output. The period of subpar expansion was expected to foster an appreciable easing of pressures on resources and some moderation in core price inflation. The forecast anticipated that the expansion of domestic final demand would be held back to an extent by the decline in household net worth associated with the downturn that had occurred in equity prices, the lingering effects of last year's relatively high interest rates, and the continuation of relatively stringent terms and conditions on some types of loans by financial institutions. As a result, growth of spending on consumer durables was expected to be appreciably below the rapid pace in the first half of last year, and housing demand would increase only a little from its recent level. Business fixed investment, notably outlays for equipment and software, was projected to resume relatively robust growth after a period of adjustment of capital stocks to more desirable levels; growth abroad was seen as supporting the expansion of U.S. exports; and fiscal policy was assumed to become more expansionary.

In the Committee's discussion of current and prospective economic developments, members commented that the recent statistical and anecdotal information had been mixed, but they viewed evolving business conditions as consistent on the whole with a continued softness in economic activity. Members noted that consumer spending had strengthened early in the year and housing activity had remained at a relatively high level. These positive developments needed to be weighed against an appreciable weakening in business investment spending and the near-term restraining effects of a drawdown in inventories. Looking ahead, while sales and production data suggested that excess inventories were being worked off, the adjustment did not appear to have been completed. Beyond the inventory correction, the members continued to anticipate an acceleration of the expansion over time, though likely on a more delayed basis and at a more gradual pace than they had forecast earlier. They noted a number of favorable underlying factors that would tend to support a rebound, including solid productivity growth, stable low inflation, generally sound financial institutions, lower interest rates, and relatively robust expansion in many measures of money. However, the members saw clear downside risks in the outlook for consumer and investment spending in the context of the marked decline that had occurred in equity prices and consumer confidence, and in expected business profitability, and they were concerned that weaker exports might also hold down the expansion of economic activity. With regard to the outlook for inflation, some recent measures of increases in core prices had fluctuated on the high side of earlier expectations, but apart from energy prices and medical costs, inflation was still relatively quiescent. With the growth in output likely to remain below the expansion of the economy's potential for a while, members anticipated that inflation would remain subdued.

Mirroring the statistics for the nation as a whole, business conditions in different parts of the country displayed mixed industry patterns, but members reported that overall business activity currently appeared to be growing at a sluggish pace in most regions, and business contacts were exhibiting a heightened sense of caution, or even concern, in some industries. In their review of developments in key sectors of the economy, members indicated that they saw favorable prospects for continued moderate growth in consumer expenditures, though considerable uncertainty surrounded this outlook. Downside risks cited by the members included the substantial declines that had already occurred in measures of consumer confidence and equity wealth, and the possibility that consumer sentiment might be undermined even further by continued volatility and additional declines in the stock market and by rising concerns about job losses amid persistent announcements of layoffs. Members also referred to the retarding effects on consumer expenditures of elevated levels of household debt and high energy costs. Against this background, consumers might well endeavor to boost their savings, and even a fairly small increase in what currently was a quite low saving rate would have large damping effects on aggregate demand that could weaken, if not abort, the expansion. To date, however, overall consumer spending had remained relatively strong and seemingly at odds with measures of consumer confidence and reduced equity wealth. How this divergence might eventually be resolved was a significant source of uncertainty and downside risk. On balance, while there were reasons to be concerned about the outlook for consumer spending, members believed that recent spending trends and the outlook for further growth in employment and incomes pointed to continued expansion in this key sector of the economy, though likely at a relatively sluggish pace.

Another major source of downside risk to the expansion was business fixed investment. Spending for equipment and software declined in the fourth quarter, and the available statistical and anecdotal reports pointed to weakness during the first half of this year, largely reflecting developments in high-tech industries. Substantial downward adjustments to expected near-term business earnings had persisted, suggesting that firms saw investment as much less profitable than they had before and that cash flows would be constrained. Many businesses also were inhibited in their investment activities by less accommodative financial conditions associated with weaker equity markets and tighter credit terms and conditions imposed by banking institutions. As a consequence, a substantial volume of planned investment was being postponed, if not canceled. The capital stock had grown at an unsustainable pace for a time, so some downshifting in investment was inevitable. Moreover, those earlier very substantial investment outlays seemed to have created excess capacity in a number of industries, and how large an adjustment in spending for business equipment might now be under way was still unclear, especially with regard to high-tech industries. At the same time, the information available for the first quarter indicated considerable strength in nonresidential construction activity, including large outlays on public-sector infrastructure projects in some areas. On balance, business spending for plant and equipment was likely to pick up only gradually this year. Over the longer term, however, a return to more robust business investment seemed likely, and indeed business earnings forecasts beyond the nearer term had not declined very much, reflecting continuing expectations of substantial profit opportunities related to persisting strong gains in productivity.

Housing activity was generally holding up well across the country, as the effects of appreciably reduced mortgage interest rates apparently compensated for the negative effects of declining financial wealth on the demand for housing. While housing construction was generally described as elevated, some members referred to overbuilding or weakness in some local housing markets. It was noted that homebuilders were generally optimistic about the prospects for the year ahead, given their current backlogs and expectations of further growth in employment and incomes.

The ongoing adjustments in business inventories had played a significant role in curbing the growth of economic activity in recent months, but such adjustments seemed likely gradually to become a more neutral factor over the balance of this year. In the motor vehicle industry, inventory liquidation had been especially pronounced and the process now seemed largely completed. However, the inventory-correction process in high-tech industries apparently was not as far along. In the absence of renewed weakness in overall final demand, which could not be ruled out given current consumer and business confidence, production would need to pick up at some point to accommodate ongoing final demand. Some members observed that the adjustment in inventories might require more time than they had anticipated earlier. In any event, completion of the process clearly would foster an upturn in manufacturing activity.

Members commented on the downside risks to U.S. exports and the U.S. expansion from what appeared to be softening economic conditions in a number of important foreign economies. In some countries, the risks were exacerbated by the apparent inability or unwillingness of government officials to address underlying structural problems in their economies and financial systems. Members noted anecdotal reports of weakening business conditions in a number of Asian and South American nations. The potential impact on exports of less vigor in the global economy would be augmented, of course, by the strength of the dollar in foreign exchange markets.

Although labor markets in general remained tight throughout the nation, anecdotal reports of less scarce labor resources were becoming more frequent in some areas or occupations. Some price increases had been noted; however, apart from the energy and health care sectors, price inflation had remained relatively subdued, evidently reflecting the combination of diminished growth in overall demand and strong competitive pressures in most markets. With regard to the outlook for wages and prices, members commented that the prospects for an extended period of growth in demand at a pace below the economy's potential should ease pressures on labor and other resources and help to contain inflation.

In the Committee's discussion of policy for the intermeeting period ahead, most of the members preferred and all could support a further easing of reserve conditions consistent with a 50 basis point reduction in the federal funds rate, to 5 percent. The members agreed that a strengthening in the economic expansion over coming quarters was a reasonable expectation, but absent further easing in monetary policy that pickup was unlikely to bring growth to an acceptable pace in the foreseeable future. Business investment would be held back by lower earnings expectations and a capital overhang of unknown dimensions; consumption was subject to downside risks from previous decreases in equity wealth and declining confidence; and the strong dollar and weaker foreign growth would constrain exports. Inflation was likely to be damped by ebbing pressures on labor and product markets. While many of the members generally believed that additional policy easing might well prove to be necessary at some time, the easing favored by most members incorporated what they viewed as an adequate degree of stimulus under current economic conditions and represented an appropriately calibrated step given the uncertainties in the economic outlook. It was noted in this regard that in combination with the two easing actions earlier this year, the Committee would have implemented in a relatively short period a considerable amount of monetary easing whose economic effects would be felt over time. However, some commented that the amount of financial stimulus was much smaller than might otherwise be expected from policy easing of this cumulative amount because it had been accompanied by further declines in stock market prices, more stringent financing terms for many business borrowers, and a stronger dollar, all of which would be holding down domestic spending and production. Indeed, financial markets had come to place some odds on a larger move of 75 basis points in recent days, importantly reflecting the possibility of a presumed policy response to the sizable declines in equity prices that had occurred as earnings prospects proved disappointing. Most members agreed, however, that in the context of their focus on the economy, smaller, possibly more frequent, policy adjustments were appropriate to afford them the opportunity to recalibrate policy in rapidly changing and highly uncertain circumstances.

A few members expressed a preference for a 75 basis point reduction in the federal funds rate. In their view, a more forceful action was justified by current and prospective economic conditions.

The members agreed that even with a further 50 basis point reduction in the federal funds rate, the risks to the economy would remain decidedly to the downside. This conclusion would be reflected in the press statement to be released after today's meeting. The statement also would emphasize the need for close monitoring of rapidly evolving economic conditions. The members anticipated that in the relatively long interval before the next regularly scheduled meeting on May 15, 2001, economic developments might suggest the desirability of a Committee conference call to assess business conditions across the nation and to consider the possible need for a further policy adjustment.

At the conclusion of this discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 5 percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

> Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Messrs. Moskow and Poole. Votes against this action: None.

The Chairman called for a recess after this vote and convened a meeting of the Board of Governors to consider reductions of one-half percentage point in the discount rate that had been proposed by all the Federal Reserve Banks. After the recess, the Chairman informed the Committee that the pending reductions had been approved.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 15, 2001. The meeting adjourned at 1:15 p.m.

Telephone Conferences

On April 11, 2001, the Committee reviewed economic and financial developments since its last meeting and discussed the possible need for some further easing of monetary policy. The data and anecdotal information were mixed: They did not indicate that the economy had been weakening further, but they raised questions about the potential strength of a rebound in growth over coming quarters. In particular, heightened business concerns about future sales and further downward revisions to expected earnings threatened to restrain capital spending for some time. In the circumstances, the members could see the need for a further easing of policy at some point, though some had a strong preference for taking such actions at regularly scheduled meetings. They all agreed that an easing on this date would not be advisable, inasmuch as the attendant surprise to most outside observers risked unpredictable reactions in financial markets that had been especially volatile in recent days, and additional important data would become available over the near term.

A week later, on April 18, 2001, the Committee held a telephone conference meeting for the purpose of considering a policy easing action. The members noted that the statistical and anecdotal information received since the last conference call had supported their view that an easing of policy would be appropriate. In addition to the continuing concerns about business plans for capital investment, consumer spending had leveled out and confidence had fallen further. In these circumstances, lower interest rates were likely to be necessary to foster more satisfactory economic expansion. With financial markets more settled, and with nearly a month until the Committee's May meeting, an easing move was called for at this time.

Although a few preferred to wait until the next scheduled meeting, all the members supported or could accept a proposal for an easing of reserve conditions consistent with a reduction of 50 basis points in the federal funds rate to a level of 4½ percent. The Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 4½ percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Messrs. Moskow and Poole. Votes against this action: None.

Chairman Greenspan indicated that shortly after this meeting the Board of Governors would consider pending requests of eight Federal Reserve Banks to reduce the discount rate by 50 basis points.

Donald L. Kohn
Secretary

Meeting Held on May 15, 2001

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 15, 2001, starting at 9:00 a.m.

Present:

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

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

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

Mr. Kohn, Secretary and Economist
Mr. Gillum, Assistant Secretary
Ms. Fox, Assistant Secretary
Mr. Mattingly, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

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

Mr. Kos, Manager, System Open Market Account

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

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

Messrs. Connors,[5] Madigan, Oliner, and Struckmeyer, Associate Directors, Divisions of International Finance, Monetary Affairs, Research and Statistics, and Research and Statistics, Board of Governors

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

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

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

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

Mr. Connolly, First Vice President, Federal Reserve Bank of Boston

Messrs. Beebe, Eisenbeis, and Goodfriend, Mses. Mester and Perlmutter, Messrs. Rosenblum and Sniderman, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, Philadelphia, New York, Dallas, and Cleveland respectively

Mr. Sullivan, Vice President, Federal Reserve Bank of Chicago

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

5. Attended portion of meeting relating to staff briefings.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 20, 2001, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period March 20, 2001, through May 14, 2001. By unanimous vote, the Committee ratified these transactions.

By unanimous vote, the Committee approved the extension for one year beginning in December 2001 of the System's reciprocal currency (''swap'') arrangements with the Bank of Canada and the Bank of Mexico. The arrangement with the Bank of Canada is in the amount of $2 billion equivalent and that with the Bank of Mexico in the amount of $3 billion equivalent. Both arrangements are associated with the Federal Reserve's participation in the North American Framework Agreement. The early vote to renew the System's participation in the swap arrangements maturing in December relates to the provision that each party must provide six months prior notice of an intention to terminate its participation.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the economic expansion remained very sluggish. Household spending, especially for housing and motor vehicles, had held up relatively well, but business investment was quite weak and appeared to be decreasing further. Persistent inventory overhangs in a number of sectors had led to additional substantial cuts in manufacturing production. Reflecting in part the downtrend in manufacturing output, labor demand had weakened considerably and unemployment had risen. Price inflation had picked up a little but, abstracting from energy, had remained relatively subdued.

Private nonfarm payroll employment fell sharply in April after a small drop in March. Manufacturing, construction, and the service sector recorded large payroll declines in April, and gains elsewhere were small. The unemployment rate increased further, to 4.5 percent in April, and initial claims for unemployment insurance averaged over the four weeks ended April 28 were at their highest level since 1993.

Industrial production declined appreciably further in April. Manufacturing output registered a seventh consecutive monthly drop, while a robust boost to mining activity associated with strong gains in crude oil and gas production was offset by a decrease in utilities output in a period of unusually warm weather. In manufacturing, the production of motor vehicles and parts was unchanged in April after having surged in February and March, but the output of high-tech equipment continued to trend steeply downward, and there was widespread weakness in the manufacture of other industrial products. Reflecting the production cutbacks, the rate of utilization of manufacturing capacity fell even further below its long-run average.

Consumer spending had held up relatively well thus far this year despite the deceleration in personal incomes, reduced household net worth, and deterioration in consumer sentiment since last autumn. After a solid first-quarter gain, nominal retail sales rose briskly in April, reflecting strong outlays at general merchandise and apparel stores, building and material outlets, and automotive dealers. Growth of spending on services slowed in the first quarter (latest data), partly because of a weather-related drop in consumption of energy services.

Low mortgage rates continued to provide support to residential building activity. The first-quarter average for total housing starts was the strongest quarterly reading in a year despite a March decline in starts that might have been exaggerated by unusual weather patterns. In addition, sales of new and existing homes remained brisk through March. New home sales reached a new high in March, and sales of existing homes were only a little below their record high in June 1999.

Against the background of a sluggish economy and deteriorating earnings, business capital spending on equipment and software declined somewhat further in the first quarter. Increased purchases of cars and trucks were among the few areas of strength in business equipment expenditures; elsewhere, outlays for high-tech equipment decreased on a quarterly basis for the first time since the 1990 recession, and spending for equipment such as industrial machinery changed little. Moreover, recent data on orders for nondefense capital goods suggested that some further slippage in future spending for equipment was likely. By contrast, nonresidential construction continued to expand briskly; expenditures for oil and gas exploration surged in the first quarter, and nonresidential building activity continued at a rapid pace, with sizable gains recorded for most major categories of buildings.

Business inventories on a book-value basis fell steeply further in March, with roughly half of the decline reflecting a runoff of motor vehicle stocks at the wholesale and retail levels. Despite the sharp liquidation of inventories in the manufacturing sector in February and March, the aggregate inventory–shipments ratio for that sector edged higher in March to a level well above that of a year ago. In the wholesale trade sector, aggregate stocks dropped somewhat on balance in the first quarter and the sector's stock–sales ratio edged lower; nonetheless, the sector's ratio in March also was above its level of a year earlier. Retail inventories ran off in February and March after a small January rise, and the sector's inventory–sales ratio decreased somewhat on balance to around the middle of its range for the past twelve months.

The U.S. trade deficit in goods and services narrowed considerably in February, reflecting a further rise in the value of exports and a sharp drop in the value of imports. The average deficit for the first two months of the year was smaller than that for the fourth quarter. Nonetheless, exports for the January–February period were below the fourth-quarter average, with notable declines occurring in automotive products, industrial supplies, and semiconductors. The slowdown in imports in January–February was broadly spread across trade categories, with the largest decreases occurring in automotive products, high-tech goods, and oil. Recent information indicated that economic activity in the foreign industrial countries had decelerated since the fourth quarter. Expansion in the euro area, the

United Kingdom, and Canada appeared to have slowed significantly, while the Japanese economy seemed to have faltered after a brief rebound late last year. In addition, economic growth in the major developing countries had softened markedly, with the slowdown in most of those countries reflecting weaker external demand.

Overall inflation had been held down thus far this year by a deceleration in energy prices, but by some measures core price inflation had picked up a bit. The total consumer price index (CPI) increased moderately in February and March (latest data), and the increase in that index during the past twelve months was smaller than that during the previous twelve-month period, reflecting reduced increases in energy prices. By contrast, core CPI inflation picked up slightly in the February–March period and on a year-over-year basis. However, inflation as measured by the core personal consumption expenditure (PCE) chain-type price index, though also running a little higher in February–March, recorded a small decline on a year-over-year basis. At the producer level, core finished goods inflation was subdued in March and April but moved up somewhat on a year-over-year basis. With regard to labor costs, growth in the employment cost index (ECI) for hourly compensation picked up noticeably in the first quarter of this year; however, the gain in compensation for the four quarters ended in March was a little below the large increase for the four-quarter period ended in March 2000. By contrast, average hourly earnings of production or nonsupervisory workers rose more briskly in April and on a year-over-year basis.

At its meeting on March 20, 2001, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with a decrease of 50 basis points in the intended level of the federal funds rate, to about 5 percent. This action, in conjunction with a further easing of ½ percentage point on April 18, was intended to help promote a more satisfactory economic expansion going forward. Under then-current conditions, the members agreed that the balance of risks remained weighted toward conditions that could generate economic weakness in the foreseeable future.

Federal funds traded at rates near the Committee's target levels over the intermeeting period. Other short-term interest rates generally fell somewhat less than the reduction in the federal funds rate because the markets had anticipated the easing in policy, though only in part. In contrast to the declines in short-term rates, longer-term yields rose on balance as investors apparently became more confident of a pickup in output growth, supported in part by improved prospects for substantial federal tax reductions. The more optimistic assessment of the economic outlook and the unexpected intermeeting easing action apparently contributed to a narrowing of risk premiums on lower-grade private debt obligations and to a rise in equity prices. Better-than-expected first-quarter earnings also boosted stock prices, and broad indexes of U.S. stock market prices moved substantially higher.

In foreign exchange markets, the trade-weighted value of the dollar in terms of many of the major foreign currencies changed little on balance over the intermeeting interval. A number of major foreign central banks cut their policy rates during the period, but by less than the two easing steps in the United States. The dollar's appreciation against the euro was offset by its decline in terms of the yen and the Canadian dollar. The dollar also was essentially unchanged in terms of an index of the currencies of other important trading partners. The value of the Mexican peso rose appreciably against the dollar as monetary authorities maintained their tight policy stance and as spreads on Mexican debt narrowed. In contrast, concerns about potential spillovers from Argentina's worsening financial difficulties depressed the value of the Brazilian *real* relative to the dollar.

The broad monetary aggregates continued to grow rapidly in March and April. In addition to the effects of lower market interest rates, extensive mortgage financing activity and a flight to safety from volatile equity markets likely added to M2's strong upward trend. The expansion of M3 was bolstered by robust growth of institution-only money funds and by greater issuance of managed liabilities included in this aggregate to help finance faster growth of bank credit and a shift in bank funding from foreign to U.S. sources. The debt of domestic nonfinancial sectors had grown at a moderate pace on balance through April.

The staff forecast prepared for this meeting suggested that, after a period of slow growth associated in part with an inventory correction, the economic expansion would gradually regain strength over the next two years and move back toward a rate near the staff's current estimate of the growth of the economy's potential output. The period of subpar expansion was expected to foster an easing of pressures on resources and some moderation in core price inflation. Despite the substantial easing in the stance of monetary policy, the forecast anticipated that the expansion of domestic final demand would be held back to an extent by some of the developments in financial markets—in particular, the decline in household net worth associated with the earlier downturn in equity prices, the continuation of relatively stringent terms and conditions on some types of loans by financial institutions, and the appreciation of the dollar. Partly as a result of the decline in household wealth, growth of consumer spending was expected to remain relatively low for some time, and housing demand would increase only a little from its recent level. However, business fixed investment, notably outlays for equipment and software, would resume relatively good growth after a period of adjustment of capital stocks to more desirable levels; a projected recovery in the growth of foreign economies was seen as providing increased support for U.S. exports; and fiscal policy was assumed to become more expansionary.

In the Committee's discussion of current and prospective economic developments, members commented that the slowdown in the expansion to a now quite sluggish pace was likely to be more prolonged than they had anticipated earlier and indeed, with the economy displaying some signs of fragility and inventories still appearing excessive in some sectors, it was not entirely clear that the slowing in the growth of the economy had bottomed out. Despite the crosscurrents and uncertainties that were involved, members saw an upturn in the economic expansion by later in the year as the most likely outlook. This view was premised in large measure on the lagged effects of the Committee's relatively aggressive easing actions this year, including any further easing that might be adopted at this meeting, growing prospects of some fiscal policy stimulus later in the year, and more generally the favorable effects of still substantial productivity gains on profit opportunities and income growth and hence on business and household demands for goods and services. As business profits stabilized and final demand firmed, inventory liquidation would come to an end, adding to the upward momentum of economic activity. The members were uncertain as to the degree and timing of the strengthening in final demand, and although a relatively prompt and strong rebound could not be ruled out, many saw a variety of factors that pointed to the possibility that the upturn could be weaker or more delayed than the central tendencies of their expectations. With regard to the outlook for inflation, a number of members expressed concern about a tendency for some measures of inflation to edge higher this year, but many members expected that the easing of pressures in labor and product markets that already had occurred, and that was likely to continue in the months ahead, would damp inflation going forward.

In their review of developments across the nation, members referred to quite sluggish economic conditions in many parts of the country. Weakness remained especially pronounced in manufacturing, but as reflected in the employment data for April and in widespread anecdotal reports, softening had spread to other sectors of the economy as well. At the same time, pockets of strength could be found in a number of industries, notably in energy and construction, and overall business activity continued to display considerable vigor in a number of regions. Members noted that business confidence had deteriorated, but some also observed that the pessimism tended to be limited to the nearer term and was accompanied by favorable expectations regarding the outlook later in the year and in 2002.

With regard to the outlook for key sectors of the economy, a number of members commented that consumer spending had held up reasonably well in recent months despite a variety of adverse developments including the negative wealth effects of stock market declines, widely publicized job cutbacks, heavy consumer debt loads, and previous overspending by many consumers. A recent survey had indicated that consumer sentiment had firmed a little, but the survey results had yet to be confirmed by additional surveys and the level of consumer confidence was still well below earlier highs. As in the past, consumer spending attitudes likely would depend importantly on trends in employment and income, and further increases in unemployment in the period just ahead along with the negative wealth effects of earlier stock market price declines and the persistence of high energy costs were likely to constrain the growth in consumer expenditures over coming quarters.

Household expenditures on home construction had been maintained at a relatively robust level in recent months, evidently reflecting the cushioning effects of very attractive mortgage interest rates. Housing activity was described as a source of strength in many regions. Housing prices had tended to edge higher across the nation, though there were signs that the price appreciation had eased in some parts of the country, notably on the West Coast. While the prevailing negative influences on household spending might spill over a bit more to housing activity during the year ahead, there were few current developments in housing markets that might be read as signaling any marked weakening in this sector of the economy.

A softening in business demand for capital equipment had accounted for much of the slowdown in the growth of final demand in late 2000 and early 2001. The latest available data on new orders pointed to further, and possibly larger, declines in business spending on equipment and software over the months ahead. Members cited anecdotal and survey reports that indicated many business firms were canceling, cutting back, or stretching out planned capital expenditures. It was difficult to see any signs of a significant near-term turnaround in business spending for equipment and software, and the timing and strength of a subsequent rebound would depend importantly on the outlook for sales and profits. With regard to profit expectations, the most recent data showed continued markdowns, but the pace of downward revisions was diminishing. It was too early to conclude that the outlook for profits might be approaching a degree of stability or be near the point of turning up, and in any event it was clear that business sentiment currently was quite gloomy. Looking to the future, however, members anticipated that continuing gains in efficiency engendered by new technologies would provide substantial profit opportunities and likely strengthen investment spending during the course of the year ahead. In the meantime, nonresidential construction and energy-related investments were a source of some support to investment spending, but they provided only a very partial offset to widespread weakness in other business spending.

Ongoing efforts to reduce excess inventories were continuing to curb output in manufacturing industries and to restrain growth in overall economic activity. A number of members commented that anecdotal and other evidence suggested that considerable progress already had been made in scaling down unwanted inventories, notably of motor vehicles, but substantial further progress probably would be needed in high-tech industries where sales were still falling. How long inventory cutbacks would continue to exert a significant drag on the economic expansion remained a key uncertainty in the economic outlook. In the view of many members, the adjustment process might not be substantially completed until much later in the year and could take even longer for high-tech firms. This evaluation assumed continued sluggish growth in final demand during the period immediately ahead. Stronger growth, which could not be ruled out, would of course bring inventory–sales ratios to desired levels more quickly.

Members also expressed concern about the potential implications for U.S. expansion from developments abroad. To some extent, economic difficulties in foreign nations had occurred in concert with softening activity in the United States, and notable weakness in world high-tech markets along with the downward adjustment in equity prices globally represented a downside risk factor worldwide. The anticipated recovery in this country would help to strengthen many foreign economies and in turn improve prospects for U.S. exports. Members noted, however, that in some nations persisting structural problems presented threats to national economic prosperity and international trade. On balance, while the external risks to the U.S. economy clearly were to the downside, at least over the nearer term, the prospective rebound in U.S. economic activity and stimulative macroeconomic policies abroad were expected to contribute to strengthening growth worldwide and to improving prospects for exports during the year ahead.

The nation’s fiscal outlook was seen as supportive of aggregate demand. While the exact structure of tax cuts was still being negotiated, passage of new fiscal measures seemed imminent and likely would help bolster consumption spending beginning later in the year. Whatever its precise timing, the expansionary fiscal package would undoubtedly join at some point in coming quarters with the lagged effects of the System’s policy easing actions to foster strengthening economic expansion.

A number of members commented that the persisting updrift in some key measures of core inflation had become increasingly worrisome. In this regard, they noted that some of the recent increases in bond yields could represent a rise in long-term inflation expectations. Such a rise would not be entirely unexpected in the context of improving sentiment about the strength of the expansion, the potentially adverse implications for costs of the cyclical weakness in productivity, and the possibility that high energy prices and their passthrough effects might persist longer than had been anticipated earlier. To a considerable extent, however, any uptick in inflation expectations likely represented a reversal of anticipated declines in inflation earlier this year when economic prospects had seemed weaker and survey data did not confirm any increase in long-term inflation expectations. Moreover, not all measures of core inflation had accelerated; in particular, core PCE price inflation had been quite stable on a twelve-month basis for some time.

Looking ahead, most members did not foresee a significant rise in inflation as a likely prospect. They cited the prevalence of highly competitive conditions in most markets, which continued to make it very difficult for business firms to raise prices despite pressures to do so in a period of rising labor, energy, and other costs. Widespread evidence of some lessening of pressures in most labor markets across the nation had not yet resulted in lower wage inflation, but the members expected that recent and anticipated ebbing of pressures on labor and other resources and associated slack in product markets in a period of continuing subpar economic growth, along with projected declines in energy prices, would hold down inflation over the forecast horizon. Nonetheless, there were some risks of rising inflation. An unexpectedly strong rebound in economic growth could begin to put added upward pressure on prices at a time when labor markets were still tight by historical standards and accelerating productivity no longer held down increases in unit labor costs. Given the lags in the effectiveness of monetary policy, such pressure might materialize before the effects of countervailing actions by the Committee had a chance to take hold.

In the Committee's discussion of policy for the forthcoming intermeeting period, all but one of the members indicated that they could support a proposal calling for further easing of reserve conditions consistent with a 50 basis point reduction in the federal funds rate to a level of 4 percent. One member expressed a strong preference for a 25 basis point reduction and two others indicated that they could have accepted that more limited easing move. Despite their somewhat differing preferences, all the members agreed that further easing was desirable in light of what they viewed as the continuing weakness in the economy, the absence of evidence that growth had stabilized or was about to rebound, and still decidedly downside risks to the economic expansion. Some members noted that, although policy had been eased substantially, it might still be considered to be only marginally accommodative in relation to the forces that were damping aggregate demand. Accordingly, the action contemplated for today was needed to provide adequate stimulus to an economy whose outlook for significant strengthening remained tenuous in a climate of fragile business and consumer confidence. Members noted that the lagged effects of the monetary policy easing implemented earlier this year were still very hard to discern, though they should be felt increasingly over the year ahead. In this regard the risks of rising inflation could not be dismissed, and while those risks appeared to be quite limited for the nearer term, excessive monetary stimulus had to be avoided to avert rising inflation expectations and added inflation pressures over time. Members who preferred or could support a 25 basis point easing action gave particular emphasis to the desirability at this point of taking and signaling a more cautious approach to policy, relative to the 50 basis point federal funds rate reductions the Committee had been implementing, given the lagged effects of the substantial reduction in the federal funds rate to date, the accompanying buildup in liquidity, and the related risk that a further aggressive easing action would increase the odds of an overly accommodative policy stance and rising inflation pressures in the future.

All the members accepted a proposal to include in the press statement to be released after this meeting a sentence indicating that the Committee continued to regard the risks to the economic outlook as being tilted toward weakness even after today's easing action. Forecasts of growth in business earnings and spending continued to be revised down, and until that process ended, weakness in demand seemed to be the main threat to satisfactory economic performance. At the same time the members anticipated that a neutral balance of risks statement could be appropriate before long, probably well before substantial evidence had emerged that economic growth had strengthened appreciably, once the Committee could see that policy had eased enough to promote a future return to maximum sustainable economic growth. Indeed, it was not clear how much more the federal funds rate might have to be reduced after today in the absence of further significantly adverse shocks, and some members noted that the end of the easing process might be near. Even so, with the economy perhaps still in the midst of a process of weakening growth in aggregate demand of unknown persistence and dimension, the members generally agreed that, given prevailing uncertainties, it would be premature for the Committee to shift its balance of risks statement at this time.

At the conclusion of this discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 4 percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

> Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Kelley, Meyer, Ms. Minehan, Messrs. Moskow and Poole. Vote against this action: Mr. Hoenig.

Mr. Hoenig dissented because he preferred a less aggressive easing action involving a reduction of 25 basis points in the federal funds rate. While the risks of weaker economic growth still tended to dominate those of rising inflation and called for some further easing, the Committee had added significant liquidity to the economy this year through its cumulatively large easing actions. The lagged effects of those actions should be felt increasingly over time. Moreover, following the rapid and aggressive policy actions already taken, a more cautious policy move at this point would in his view appropriately limit the risks of producing an overly accommodative policy stance and rising inflation over time.

The Chairman called for a recess after this vote and convened a meeting of the Board of Governors to consider one-half percentage point reductions in the discount rate that had been proposed by a number of Federal Reserve Banks. After the recess, the Chairman informed the Committee that the pending reductions had been approved.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, June 26–27, 2001.

The meeting adjourned at 1:15 p.m.

Donald L. Kohn
Secretary

Meeting Held on June 26–27, 2001

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., beginning on Tuesday, June 26, 2001, at 2:00 p.m. and continuing on Wednesday, June 27, 2001, at 9:00 a.m.

Present:

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

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

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

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

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

Mr. Kos, Manager, System Open Market Account

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

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

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

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

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

Messrs. Freeman[6] and Whitesell, Assistant Directors, Divisions of International Finance and Monetary Affairs, Board of Governors

Ms. Kusko[6] and Mr. Sichel,[7] Senior Economists, Division of Research and Statistics, Board of Governors

Mr. Nelson,[6] Senior Economist, and Ms. Garrett, Economist, Division of Monetary Affairs, Board of Governors

Mr. Fleischman,[7] Economist, Division of Research and Statistics, Board of Governors

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

Ms. Pianalto, First Vice President, Federal Reserve Bank of Cleveland

Messrs. Beebe, Eisenbeis, and Goodfriend, Mses. Krieger and Mester, Messrs. Rolnick, Rosenblum, and Steindel, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, New York, Philadelphia, Minneapolis, Dallas, and New York respectively

Mr. Altig, Vice President, Federal Reserve Bank of Cleveland

Mr. Fernald,[8] Economist, Federal Reserve Bank of Chicago

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on May 15, 2001, were approved.

The Manager of the System Open Market Account reported on recent developments relating to foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period May 15, 2001, through June 26, 2001. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that economic activity continued to grow little, if at all, in the second quarter. Employment fell somewhat over the first two months of the quarter, industrial output dropped sharply, and the limited available information suggested that both probably continued to decline in June. Expansion in consumer spending appeared to have slowed and business purchases of equipment and software had fallen appreciably, though homebuilding had been well maintained. Energy prices had been relatively flat recently, at a high level, and core price inflation had moderated a little.

Private nonfarm payroll employment fell slightly further in May after a sharp drop in April and lackluster growth in the first quarter. Manufacturing recorded

6. Attended portion of meeting relating to staff presentations.
7. Attended portion of meeting relating to productivity developments.
8. Attended Tuesday's session only.

additional widespread job losses in May, and there were signs that weakness in employment was spreading to related sectors, notably wholesale trade and help-supply services. By contrast, construction employment rebounded in May, retracing part of its large April loss, and hiring in finance, insurance, and real estate remained brisk. The unemployment rate edged lower in May, to 4.4 percent, but initial unemployment insurance claims and other data suggested persisting softening in the labor market in that month.

The rapid contraction in industrial production continued unabated in May, with manufacturing output registering an eighth consecutive monthly drop. Moreover, output from electric utility plants fell, and mining activity slowed further in May following a strong first-quarter gain. Within manufacturing, decreases in output were widely spread across sectors, and the production of high-tech equipment continued to plummet. The motor vehicle industry was one of the few sectors to record a rise in production. The further contraction in production in May brought the rate of utilization of manufacturing capacity to its lowest level since 1983.

Growth of consumer spending seemed to have slowed in the second quarter, reflecting the deceleration in personal income, the rise in unemployment, and the earlier decline in household net worth. Nominal retail sales were up only slightly in May after a brisk rise in April, and the average rate of increase over the two months was somewhat slower than that of the first quarter.

Low mortgage rates continued to provide support to residential building activity in April and May despite a weakening labor market and sluggish growth in personal income. Total housing starts in April–May remained at the high first-quarter level, as stronger single-family starts offset a slower pace of multifamily starts. Sales of new and existing homes slipped in April (latest data) after both reached near-record levels in March.

Business spending on equipment and software declined further early in the second quarter in response to sluggish sales, an erosion of earnings and corporate cash flows, and an uncertain outlook for future sales and earnings. Shipments of nondefense capital goods slumped in April, and the weakness in incoming orders suggested that shipments would fall further in coming months. Fleet sales of cars and trucks, which had been among the few areas of strength in business equipment expenditures in the first quarter, also slowed. By contrast, nonresidential construction remained robust, though the level of activity slipped a little in April and slightly higher vacancy rates and smaller increases in rents suggested that the profitability of new nonresidential investment might be lessening. Strength was particularly evident in outlays for industrial structures, partly reflecting construction of electric power plants and facilities for cogeneration of power by industrial companies, and in continuing strong oil and gas exploration activity.

Business inventories on a book-value basis edged higher in April after a sizable runoff in the first quarter. Excluding motor vehicles, manufacturing stocks were little changed in April, but shipments were down sharply and the aggregate inventory–shipments ratio for the sector remained on a steep upward trend, with many industries facing sizable inventory overhangs. In the wholesale sector, inventories rose in step with sales; the sector's inventory–sales ratio was unchanged in April and remained at the top of its range for the past twelve months. Retail inventories continued to decline in April, and the sector's inventory–sales ratio decreased further and was near the middle of its range for the past twelve months.

The U.S. trade deficit in goods and services continued to shrink in April. The value of exports fell, with most of the drop occurring in capital goods, notably computers and semiconductors. The value of imports also decreased but by slightly more than exports, reflecting sizable declines in capital and consumer goods that were partly offset by increases in oil and automotive products. Recent information indicated that economic growth in the euro area and the United Kingdom in the first quarter was at about the reduced pace seen in the fourth quarter, and growth likely stayed relatively slow more recently. Expansion in Canada appeared to have weakened recently after a slight pickup in the first quarter. In Japan, the contraction in economic activity that began early in the year appeared to have continued into the second quarter. Most of the developing countries, with the notable exception of China, also were experiencing an economic slowdown that was related at least in part to weaker external demand.

Core price inflation had moderated a little recently after a pickup earlier in the year. The core consumer price index (CPI) rose relatively slowly in April and May, and the increase in that index during the past twelve months was about the same as that during the previous twelve-month period. The core personal consumption expenditure (PCE) chain-type price index presented a similar picture, with inflation in April and May a little lower than earlier in the year and no change in inflation on a year-over-year basis. Core producer price inflation for finished goods also was subdued in the April–May period but edged higher on a year-over-year basis. There also were indications that upward pressures on energy prices had abated somewhat. In particular, the return of some domestic refineries to operation after maintenance or breakdowns and a surge in imports had replenished gasoline stocks, and as a result wholesale and retail gasoline prices had retreated recently. With regard to labor costs, average hourly earnings of production or nonsupervisory workers continued to rise in April and May at the relatively brisk rate that had prevailed over the past year.

At its meeting on May 15, 2001, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with a decrease of 50 basis points in the intended level of the federal funds rate, to about 4 percent. The members generally agreed that this action was necessary in light of the continuing weakness of the economic expansion and the lack of evidence that output growth had stabilized or was about to rebound, coupled with a climate of fragile business and consumer confidence. In addition, the members believed that the balance of risks remained weighted toward conditions that could generate economic weakness in the foreseeable future.

Federal funds traded at rates near the Committee's target level over the intermeeting period. Other short-term market rates declined somewhat following the Committee's announcement of the easing action and subsequently moved down noticeably further in response to weaker-than-expected news on economic activity and corporate earnings. Yields on long-term Treasury and investment-grade corporate securities fell appreciably during the intermeeting interval, but rates on speculative-grade bonds rose sharply in response to the adverse earnings news. The pessimistic earnings reports also weighed on equity prices, which edged lower on balance.

In foreign exchange markets, the trade-weighted value of the dollar in terms of many of the major foreign currencies increased slightly over the intermeeting interval, as the dollar's appreciation against the euro and other European currencies more than offset the U.S. dollar's further decline against the Canadian dollar. European currencies weakened in response to disappointing data on economic activity, with inflation concerns seen as constraining countervailing monetary easing actions. The dollar also was up slightly on net in terms of an index of the currencies of other important trading partners. The *real* was adversely affected by Brazil's internal problems and spillovers from Argentina's financial difficulties, while the Mexican peso benefited from continued foreign interest in Mexican investments and from high oil prices.

The broad monetary aggregates continued to grow rapidly in the second quarter, reflecting the effects of lower opportunity costs of holding liquid deposits and money market mutual funds, a buildup in deposits associated with extensive mortgage financing activity, and a flight to liquidity and safety from volatile equity markets. The debt of domestic nonfinancial sectors expanded at a moderate pace on balance through May.

The staff forecast prepared for this meeting suggested that after a period of very slow growth associated in large part with an inventory correction, a sizable decline in capital spending, and a related sharp contraction in manufacturing output, the economic expansion would gradually regain strength over the forecast horizon and move back to a rate around the staff's current estimate of the growth of the economy's potential output. The period of subpar expansion was expected to foster an appreciable easing of pressures on resources and some moderation in core price inflation. Despite the substantial monetary easing that had been implemented already and the fiscal stimulus, including federal tax rebates, that was in train, the forecast anticipated that sluggish hiring and the decline in household wealth would restrain the growth of both consumer spending and housing demand. Business fixed investment, notably outlays for equipment and software, would be weaker for a while but would return to relatively robust growth after a period of adjustment of capital stocks to more desirable levels. The gradual strengthening of investment, together with a projected improvement in foreign economies that was seen as providing some support for U.S. exports, would foster the pickup in growth of demand and output.

In the Committee's discussion of current and prospective economic developments, members noted that by some measures overall economic activity remained at a reasonably high level. However, recent data indicated that growth of spending and output was quite sluggish and below the pace many members had anticipated at the time of the previous meeting. Weakness in business spending for equipment and software, efforts to reduce excess inventories, and the ongoing adaptation to lower equity prices in the United States and around the world were likely to hold back economic activity in the short run. Nonetheless, the members continued to anticipate a strengthening as the year progressed and during 2002, fostered to a large extent by the lagged effects on spending of the substantial easing in monetary policy since early this year, the stimulus from recently enacted tax cuts, and the positive effects on household and business purchasing power of some recent reductions in energy prices. In addition, the abatement and eventual turnaround of the downward adjustments to capital spending and inventories would add impetus to economic growth going forward. It was noted, however, that the unique characteristics of the current cyclical experience, including the heavy concentration of weakness in business expenditures and manufacturing output, increased the uncertainty that surrounded any forecast. Most of the members believed that the risks to the expansion, notably for the nearer term, remained to the downside of current forecasts. Potential sources of shortfalls included the effects of possible further increases in unemployment on consumer and business confidence; the risks of disappointing business earnings that could damp investment and, through lower equity prices, consumption; and the growing indications of weakness in foreign economies that could limit demand for exports. In an environment of diminished pressures in product and labor markets and of lower energy costs, members commented that price pressures were likely to remain contained, at least over the near to intermediate term.

In preparation for the midyear monetary policy report to Congress, the members of the Board of Governors and the presidents of the Federal Reserve Banks provided individual projections of the growth of GDP, the rate of unemployment, and the rate of inflation for the years 2001 and 2002. The forecasts of the rate of expansion in real GDP had central tendencies of 1¼ to 2 percent for 2001, suggesting at least a little acceleration in the second half of the year, and 3 to 3¼ percent for 2002. The civilian rates of unemployment associated with these forecasts had central tendencies of 4¾ to 5 percent in the fourth quarter of 2001 and 4¾ to 5¼ percent in the fourth quarter of 2002. Forecasts of the rate of inflation, as measured by the chain price index for personal consumption expenditures, were centered on a range of 2 to 2½ percent for this year and 1¾ to 2½ percent in 2002.

Continuing softness in the expansion of economic activity was mirrored in anecdotal reports of business conditions in much of the nation. Typical regional reports referred to slowing increases in economic activity from an already reduced pace or to the persistence of sluggish business activity and generally downbeat business sentiment. Manufacturing continued to display particular weakness. However, actions to reduce excess inventories or to address problems relating to overcapacity in some sectors of the economy, including telecommunications and other high-tech industries, were under way and were likely to exert a decreasing drag on economic activity over coming quarters as corrective adjustments were completed. Financial conditions, while generally supportive of greater spending, presented a mixed picture in some respects. Short- and intermediate-term interest rates had fallen substantially this year, and long-term yields had moved down late last year. But equity prices were only holding their own after a substantial decline earlier and the dollar had appreciated. Though lenders were cautious about marginally creditworthy firms, most businesses were finding ample credit available at attractive terms.

In their comments about developments in key sectors of the economy, members noted that overall business activity had been supported, at least to this point, by the relative strength of household demand. Growth in consumer spending for goods and services, while moderating appreciably since earlier in the year, had nonetheless held up unexpectedly well given the adverse wealth effects associated with the declines in stock market prices, relatively high levels of consumer indebtedness, and job losses in a growing number of industries. Members referred in particular to the persisting strength in demand for light motor vehicles, which evidently was boosted by continuing sales incentives and attractive financing terms. Looking ahead, the outlook for consumer spending was subject to a number of downside risks that included the possibility of rising unemployment and further weakness in the stock market, which could damp consumer confidence as well as income and wealth. However, some further growth in consumer spending remained the most likely prospect for the balance of the year in light of the impetus provided by monetary and fiscal policy and the apparent stabilization in consumer sentiment in recent months after its earlier decline.

Housing activity remained at a high level as attractive mortgage interest rates evidently continued to counterbalance the negative effects on consumer attitudes of somewhat weaker labor markets and reduced stock market wealth. While housing activity in a number of areas continued to be described as fairly robust, members noted that residential sales and construction had slipped in some parts of the nation. Even so, given existing backlogs and the continued availability of attractive mortgage rates, nationwide housing construction was expected to remain near its currently elevated level.

The near-term outlook for business fixed investment seemed less promising. The weakness in spending for new equipment and software had played a key role in the softening of the overall expansion of economic activity in recent quarters, and a material pickup in such expenditures did not appear likely until the latter part of this year or early next year. Indeed, anecdotal reports from many business firms indicated that they were delaying at least some equipment and software outlays until evidence of an upturn in their sales and earnings began to accumulate. Caution was especially pronounced among high-tech firms, many of which had experienced major cutbacks in the demand for their products and services. An analysis prepared for this meeting suggested that in the aggregate the apparent overhang of excess capital might not be large, but the dimensions and duration of the adjustment in spending on capital goods were a major source of uncertainty in the outlook, and there was some risk of substantially greater weakness in investment spending than was forecast for coming months. Beyond the nearer term, however, the prospects for an upturn in investment outlays seemed favorable in the context of profit opportunities associated with expectations of continued elevated rates of technological progress and rapid declines in the prices of new equipment. In this regard the members reviewed several staff reports that generally concluded that the growth of productivity in the years ahead was highly likely to remain appreciably stronger than it had been from the mid-1970s to the mid-1990s, though how much stronger was an open question. With regard to the outlook for nonresidential construction activity, members referred to signs of developing weakness in some commercial real estate markets, but there were few reports of overbuilding and the construction of commercial facilities was being well maintained in other parts of the country. On balance, further modest growth in nonresidential construction, though well below the average pace in recent quarters, was seen as a likely prospect.

Business efforts to bring their inventories into better alignment with sales were a key factor in the deceleration of overall economic activity in recent quarters and in forecasts that the upturn in economic activity would be relatively limited over the balance of the year. Net inventory liquidation appeared to have diminished in the current quarter from its pace earlier in the year, but inventory–sales ratios had risen further in recent months, especially for high-tech equipment. Accordingly, liquidation was not likely to abate substantially further for some time.

With regard to the foreign sector of the economy, members commented that economic activity had softened more than anticipated in many nations that were important trading partners, with clearly negative implications for U.S. exports. Major Latin American countries were experiencing particularly severe economic difficulties, but growth was slowing or economic activity declining in many industrial countries as well. At the same time, a number of important U.S. industries were subject to increased domestic competition from foreign imports. While growth abroad could be expected to rebound next year, responding in part to faster expansion in the U.S. economy, the nearer-term outlook for U.S. and indeed world trade was less favorable.

In their review of the outlook for inflation, members generally anticipated that increases in consumer prices would remain relatively subdued over the next several quarters. Factors underlying that assessment included the emergence of less taut conditions in labor markets, relatively low capacity utilization rates in manufacturing, and the persistence of highly competitive conditions in most product markets that made it very difficult for business firms to preserve or increase their profit margins by raising prices. Moreover, energy prices recently had declined appreciably, and the earlier inflationary effects of energy price increases on a broad range of costs and prices appeared to have begun to subside as a result. Inflation expectations that currently appeared by various measures and survey results to be essentially flat or even to have declined a bit were reinforcing the factors holding down price increases. Some negatives in the inflation outlook also were noted, such as some increase in labor compensation including rapid advances in health care costs, and a consequent squeeze on profit margins that was exacerbated by a cyclical decline in productivity gains. Labor pressures on business costs might persist for a time in lagged response to earlier advances in headline consumer price inflation and labor productivity, but their effects would tend to diminish or to be offset over time if, in line with the members' forecasts, pressures on labor resources continued to ease. Some members expressed concern about the longer-run prospects for wages and prices if the stimulative stance of monetary policy was maintained too long and allowed demand pressures to outrun the economy's potential.

In the Committee's discussion of policy for the intermeeting period ahead, all but one of the members supported both some further easing of reserve conditions consistent with a 25 basis point reduction in the target federal funds rate and the retention of the Committee's public statement that the risks were weighted toward excessively soft economic performance. The information received since the May meeting suggested a somewhat weaker economic performance than most had anticipated, and the members were persuaded that in the absence of firm evidence that the deceleration in the economic expansion had run its course a further easing action was needed at this point to help stabilize the economy. With greater slack in labor and product markets, and with inflation expectations contained, an added easing ran very little risk of exacerbating price pressures, provided the Committee was prepared to firm the stance of policy promptly if and when demand pressures threatened to intensify. One member was persuaded that policy had already become so expansionary that further easing ran an unacceptable risk of exacerbating inflation over time.

A smaller easing move than those the Committee had been making earlier this year was deemed desirable by the members in light of the substantial easing that already had been implemented since the start of this year. By a number of measures—including the level of real federal funds rates, the robust growth of the monetary aggregates, and the ready availability of finance to most borrowers—policy had become stimulative. Such a policy stance was appropriate for a time to counter the various forces holding back economic expansion. But much of the lagged effects of the Committee's earlier easing actions had not yet been felt in the economy, and they would be supplemented in coming quarters by the implementation of the recently legislated tax cut stimulus. In these circumstances, a smaller move than those undertaken earlier this year would have the advantage of reducing the odds on adding to inflation pressures later and of underlining the Committee's assessment of its policy stance. In the view of a number of members, the Committee might well be near the end of its easing cycle. At the same time, several emphasized that they did not want to rule out further easing later if warranted by the tenor of incoming economic information.

All except one of the members accepted a proposal to retain the Committee's press statement that the risks would continue to be weighted toward economic weakness after today's easing move. The member who opposed additional policy easing expressed strong reservations about such a statement because in his view it likely would be interpreted as an intention to ease policy further, which was contrary to his own assessment that a more neutral outlook regarding the future course of policy was desirable. In the view of most members, however, the weakness of the recent information relating to the performance of the economy was consistent with unbalanced risks at least insofar as it pertained to the outlook for the rest of this year, and their primary policy concern at this point remained the strength of economic activity rather than potentially worsening inflation over the longer term.

At the conclusion of this discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 3¾ percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, and Mr. Moskow. Vote against this action: Mr. Poole.

Mr. Poole dissented because he believed that FOMC actions this year had already established a highly stimulative monetary policy stance. The M2 and MZM measures of money had risen at annual rates in excess of 10 percent and 20 percent respectively over the past six months, and the real federal funds rate was very likely below its equilibrium level. Other more qualitative information on financial conditions pointed in the same direction. Economic forecasts were that the economy's growth would resume later this year and the fact that long-term interest rates had not declined since December also indicated that the market anticipated a revival of faster economic growth before long. Given the lags in monetary processes, he believed that adding further monetary policy stimulus raised an undue risk of fostering higher inflation in the future. Moreover, against this background, he was especially concerned that a statement that the Committee continued to view the balance of risks as weighted toward weakness would be read in the market as a sign that the Committee was likely to ease further in the near term. He thought future developments were equally likely to warrant an action in either direction, and he did not think the Committee should take a step that probably would cause expectations of further easing to become embedded in market interest rates.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 21, 2001.

The meeting adjourned at 12:25 p.m.

Notation Vote

By notation vote completed on August 16, 2001, the Committee members voted unanimously to elect Vincent R. Reinhart to the position of economist for the period until the first regularly scheduled meeting in 2002, with the understanding that in the event of the discontinuance of his official connection with the Board of Governors he would cease to have any official connection with the Federal Open Market Committee.

Donald L. Kohn
Secretary

Meeting Held on August 21, 2001

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 21, 2001, at 9:00 a.m.

Present:

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

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

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

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary

Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Reinhart, Economist
Mr. Stockton, Economist

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

Mr. Kos, Manager, System Open Market Account

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

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

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

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

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

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

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

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

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

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

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

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

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

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

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on June 26–27, 2001, were approved.

The Manager of the System Open Market Account reported on recent developments relating to foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in U.S. government securities and securities issued or fully guaranteed by federal agencies during the period June 27, 2001, through August 20, 2001. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below.

The information reviewed at this meeting suggested that economic activity exhibited little, if any, upward movement in midsummer. Increases in household expenditures on consumer items and housing appeared to have been relatively well maintained, but business capital expenditures had weakened substantially since early in the year. Efforts to reduce inventories were continuing, and manufacturing activity had decreased further. Employment had declined over recent months. With energy prices having turned down, overall consumer price inflation had eased slightly in recent months, while core measures of consumer prices showed mixed changes on a twelve-month basis. Measures of labor costs had decelerated on balance.

Private nonfarm payroll employment, after declining appreciably during the second quarter, fell further in July, led by additional job losses in manufacturing and help-supply services. Labor demand remained weak in other sectors, with employment in most industries flat to down. The unemployment rate edged up to 4.5 percent in June and remained at that level in July. Although initial claims for unemployment insurance had declined in recent weeks, on balance data suggested persisting softening in the labor market.

Industrial production edged lower in July after larger drops in each of the previous three months. Motor vehicle assemblies rose markedly, but production of high-tech equipment continued to plummet, registering its largest one-month decline in more than a decade. Outside those two industries, manufacturing production either moved sideways or fell slightly. The rate of utilization of manufacturing capacity was little changed in July and remained well below its long-run average.

Growth in consumer spending slowed somewhat in the second quarter, but except for automotive dealers, retailers reported sizable gains in July. Consumer confidence appeared to have stabilized at moderately favorable levels in recent months. Supported by low mortgage rates, residential building activity had held up well this year. In July, single-family starts increased slightly from a strong pace in the first and second quarters, though permits fell marginally. Sales of new homes rose in June (latest data), and sales of existing homes edged down but remained only slightly below their historical peak.

Business spending on equipment and software declined substantially in the second quarter after falling somewhat in the preceding two quarters. The weakness stemmed from sluggish growth in business sales, significantly reduced corporate cash flows, and continued uncertainty about prospects for future sales and earnings. Shipments of nondefense capital goods declined in June after a modest increase in May, but for the second quarter as a whole they contracted at more than twice the first-quarter pace. Moreover, orders data for June were extraordinarily weak, led by a steep decline in communications equipment. Those data, as well as numerous anecdotal reports, suggested further weakness in spending for equipment and software going forward. Nonresidential construction, which had held up well in the first quarter, was down substantially in the second quarter, as spending for office, industrial, and lodging facilities contracted sharply. Vacancy rates, particularly in high-tech centers, had increased significantly in recent months, as demand for office space and data centers plunged. In contrast, expenditures for drilling and mining equipment soared further in the second quarter.

Business inventory liquidation was sizable in the second quarter, at a pace estimated to be a bit more rapid than in the first quarter. Manufacturing stocks, particularly of computers and electronic products, were reduced substantially;

however, shipments of those products also plunged and the inventory–sales ratio in the computer and electronics sector rose further from an already high level. Elsewhere in manufacturing, the ratio of stocks to sales held steady, with stocks remaining high in a number of manufacturing industries despite aggressive production cutbacks. Inventories rose in the wholesale sector and, given sluggish sales of late, the ratio of inventories to sales moved sharply higher in the second quarter. Stocks in the automobile sector declined over the quarter and moved lower in July. Retail inventories, excluding motor vehicles, fell moderately and the sector's inventory–sales ratio edged lower.

The U.S. trade deficit in goods and services narrowed over the May–June period and was about $20 billion smaller at an annual rate in the second quarter than in the first. The value of imports dropped sharply in the second quarter. The value of exports also decreased significantly, with most of the decline in capital goods, primarily computers and semiconductors. Recent information on foreign industrial economies suggested that growth weakened further in the second quarter. The Japanese economy contracted in the quarter, and growth in the euro area appeared to have weakened substantially. Among the developing countries, economic and financial conditions had deteriorated further in Argentina. In most other developing countries, the pace of economic growth continued to decline.

Consumer price inflation had eased in recent months, as energy prices turned down and increases in core consumer prices subsided after a pickup early in the year. The core consumer price index (CPI) rose in July at about the same pace as in the second quarter, but the twelve-month change in that index had increased slightly. However, revised data indicated that the core personal consumption expenditure (PCE) chain index had decelerated on a year-over-year basis. At the producer level, prices fell in July, leaving the twelve-month change in the producer price index for finished goods somewhat below the twelve-month change of a year earlier. With regard to labor costs, the employment cost index (ECI) increased at a somewhat slower pace in the twelve months ended in June than over the preceding twelve months.

At its meeting on June 26–27, 2001, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with a decrease of 25 basis points in the intended level of the federal funds rate, to about 3¾ percent. This action was deemed appropriate in light of incoming information indicating somewhat weaker economic performance than most members had anticipated and the absence of firm evidence that the deceleration in the economic expansion had run its course or that output growth was about to rebound. With greater slack in labor and product markets and with inflation expectations contained, the members agreed that the balance of risks continued to be weighted toward conditions that could generate economic weakness in the foreseeable future.

Federal funds traded at rates near the Committee's reduced target level over the intermeeting period, and other short-term rates also fell. Market participants became less optimistic regarding the economic outlook over the intermeeting period, inducing widespread declines in longer-term Treasury yields over the period that were most pronounced at the shorter end of the coupon maturity spectrum. Except for the obligations of the most troubled sectors, declines in investment-grade corporate bond yields were about in line with those on Treasury issues of comparable maturity, leaving most risk spreads little changed on balance. A spate of weak second-quarter earnings reports and sizable reductions in analysts' earnings projections for the remainder of the year took a toll on equity markets, however, and broad stock market indexes moved down appreciably over the intermeeting interval.

The trade-weighted value of the dollar, after an extended period of strength, fell against most major foreign currencies, with much of the decline occurring in the days just before this meeting. The decline was particularly marked against the yen, the euro, and the Swiss franc. In contrast, the dollar was little changed against the currencies of some major trading partners, including Canada and Mexico.

Growth in the broad monetary aggregates remained strong in July but was below the average pace over the first half of the year. Despite some recent slowing, deposit growth was held up by a flight to liquidity and safety in light of the poor performance and substantial volatility in equity markets. Foreign demands for U.S. currency also boosted money growth in July.

The staff forecast prepared for this meeting suggested that, after a period of very slow growth associated in large part with very weak business fixed investment and to some extent with an inventory correction, the economic expansion would gradually regain strength over the forecast horizon and move back to a rate around the staff's current estimate of the growth of the economy's potential output. The period of subpar expansion was expected to foster an appreciable easing of pressures on resources and some moderation in core price inflation. Although substantial monetary easing had already been implemented and fiscal stimulus was in train, the forecast anticipated that the expansion of domestic final demand would continue to be held back by the effects on household net worth of recent and possible future declines in stock market prices and by damped consumer and business sentiment in a weaker job market. With long-term trends in innovation holding up reasonably well, business fixed investment, notably outlays for equipment and software, likely would return to relatively robust growth after a period of adjustment of capital stocks to more desirable levels, and a projected pickup in foreign economies was seen as providing some support for U.S. exports.

In the Committee's discussion of current and prospective economic developments, many of the members commented that the anticipated strengthening in economic expansion had not yet occurred and, indeed, that the economy and near-term economic prospects appeared to have deteriorated marginally further in the period since the previous meeting. Several members referred to a number of recently available economic indicators that in their view suggested the possibility that the string of disappointing readings on the economy might be about to end, but those indicators were insufficiently robust and too recent to provide conclusive evidence of emerging stabilization, much less that some overall strengthening might be under way. Among other things, the economy was still adjusting to downward revisions to expected earnings and to perceptions of greater risk and associated declines in wealth. In sum, the timing of the pickup in the growth of the economy had again been pushed back. Even so, the prospects for an upswing over coming quarters remained favorable against the backdrop of the lagged effects of substantial monetary policy easing already implemented this year, the recent passage and initial implementation of stimulative fiscal policy measures, the progress businesses had already achieved toward completing inventory adjustments, and the underlying support for business investments from continued technological innovations. Nonetheless, the members recognized that the recovery in business fixed investment, the major source of weakness in the economy, was likely to follow a more extended period of adjustment than had been anticipated in their earlier forecasts. With regard to the outlook for inflation, members reported on widespread indications of some slackening in what were still generally tight labor markets and also noted that capacity utilization rates had declined substantially in many industries. The reduced pressures on resources along with expectations of some further declines in energy prices were seen by many members as likely to foster a modest deceleration in many measures of wages and prices.

Statistical evidence of an ongoing, though gradual, worsening in overall business conditions was supported by anecdotal reports from around the nation. Weakness continued to be concentrated in manufacturing, notably in the high-tech sector and in high-tech service industries. Indications that the softening was spreading more generally were still fairly limited as suggested by employment data and anecdotal reports. At the same time, members cited some still quite tentative signs that declines in manufacturing had slowed or that activity had steadied in some depressed industries.

In their review of developments in key sectors of the economy, members again emphasized the ongoing strength in household spending and its vital role in moderating the weakness in overall economic activity. Tax rebates, declining energy prices, and widespread discounting of retail prices were cited as positive factors in support of consumer spending on a wide range of goods and services. In addition, increasingly persuasive evidence indicated that realized capital gains from the sale of homes were a source of fairly significant amounts of consumer purchasing power in the economy. Looking ahead, members expressed some concern about how long the household sector would continue to prop up the economy in the absence of an upturn in business expenditures. While accommodative financial conditions and reduced income tax rates should continue to undergird consumer spending and the data on retail sales for July displayed relatively impressive gains, negative wealth effects from falling stock market prices, declining payrolls, and sluggish income gains—should they persist—might well depress consumer expenditures over coming months. In this regard, some recent anecdotal reports pointed to weaker retail sales, importantly including motor vehicles. There also were some recent indications of declining consumer confidence, and many retailers had become less optimistic about the outlook for sales over the balance of the year.

Homebuilding generally had remained robust in recent months, as relatively low mortgage interest rates continued to offset weakness in employment and incomes and the negative effects of declining stock market wealth. Most regions continued to report strong housing markets, albeit with evidence of some weakening in sales of high-priced homes in a number of areas. For now, however, there were few signs that overall housing activity might be softening, though members noted that potentially bearish factors relating to the outlook for consumer spending might at some point also affect housing.

With household spending already elevated relative to income and its rate of increase unlikely to strengthen materially, if at all, under foreseeable near-term economic conditions, the anticipated upturn in overall economic expansion would depend critically on business investment spending and in turn on improved prospects for business profits and cash flows. Business capital expenditures appeared to be slowing sharply further after posting large declines earlier in the year in conjunction with the marking down of the expected growth of demand for and profitability of capital equipment, weak sales, the emergence of substantial excess capacity in many industries, notably in high-tech facilities, and the resulting decline in earnings. Market forecasts of business profits were progressively being reduced, and as a consequence members saw little likelihood of a marked turnaround in business capital investment over the months ahead despite some elements of strength such as sizable construction projects involving public utilities, energy, and, in some areas, public works. Indeed, history strongly suggested that capital spending might well fall below sustainable levels for a time as business firms over adjusted on the downside to previously excessive or misdirected buildups of capital resources. While the near-term outlook for business investment was not promising and considerable uncertainty surrounded the timing of the eventual upturn, members remained optimistic about the longer-term prospects for capital expenditures. In the context of a still favorable outlook for continued elevated rates of technological progress, business firms reportedly had not yet exploited many potentially profitable investment opportunities.

The persistence of substantial inventory liquidation was another negative factor in the current performance of the economy. While considerable progress reportedly had been made by numerous business firms in reducing their inventories to bring them into better alignment with sales, a rebound to inventory accumulation did not appear imminent for the economy as a whole. Unexpected weakness in final demands would, of course, lead to additional efforts to pare inventories, which would tend to damp and delay the rebound. Even so, leaner inventories had favorable implications for production going forward.

Fiscal policy developments were a supportive factor in the economy. The tax rebates currently being distributed undoubtedly were having a limited but positive effect on consumers, which likely would continue over coming months. The impetus could not be measured precisely, but it was reflected in available anecdotal reports. Moreover, the reductions in income tax rates would have an ongoing effect in boosting disposable household incomes. On the negative side, financial difficulties in a number of states were being met in part through higher taxes that implied at least some offset to the federal tax relief.

Many of the members expressed concern about what appeared to be cumulating weakness in numerous foreign economies that would feed back to the U.S. economy through reduced demand for U.S. exports and potentially through perceptions of greater risks in financial markets. A number of major industrial economies were growing more slowly than had been expected earlier in the summer. Moreover, severe economic and financial problems in a few developing nations could spill over to their trading partners and other similarly situated countries that could in turn have adverse repercussions more generally on the world economy.

The members generally viewed a modest decline in inflation as a reasonable prospect, at least for a while. Reports from around the nation indicated that labor market conditions had eased, though they remained generally tight and workers available to fill a variety of skilled job openings continued to be in short supply. On balance, however, upward pressures on labor compensation appeared to be easing somewhat despite large increases in the costs of medical care. Competitive pressures continued to make it very difficult for business firms to raise their prices, and there were no signs that widespread discounting might be coming to an end. An apparent downtrend in the costs of energy was another favorable factor in the outlook for inflation. Some members expressed a degree of concern, however, about the longer-term outlook for inflation. Pressures on resources would rise as the anticipated upturn and possible above-trend growth brought the economy closer to full capacity utilization. An important uncertainty in this regard was the outlook for productivity, whose growth might have moderated from the unusually high growth rates of 1999 and 2000, with possibly adverse implications for labor costs at very low levels of unemployment.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal calling for a slight further easing in reserve conditions consistent with a 25 basis point reduction in the federal funds rate to a level of 3½ percent. No member expressed a preference for leaving policy unchanged or easing by more than 25 basis points. The economy had continued to be weak—indeed, weaker than many had expected—and data and anecdotal reports from around the country had yet to point to persuasive signs of a turnaround. The monetary and fiscal policy stimulus already in train seemed adequate to promote and support an eventual appreciable rise in the growth of business activity to a pace near that of the economy's potential, but the strength and timing of the pickup remained uncertain and further weakness was a distinct threat in the nearer term. In particular, possible faltering in household expenditures at a time when business firms were still adjusting to inventory imbalances and to capital overinvestments would exacerbate the slowdown in the economy and delay its anticipated recovery. Growing concerns about foreign economies added to the current unease about potential near-term developments.

Against the considerable forces of restraint on aggregate demand, the federal funds rate had been lowered substantially and the monetary aggregates were growing rapidly, but some members noted that in a number of respects financial conditions did not indicate as much oncoming stimulus. Since the start of the year, long-term interest rates generally had not extended earlier declines, prices in equity markets had fallen substantially further, and the dollar had appreciated in foreign exchange markets. Accordingly, the inflation risks of some further monetary stimulus seemed limited and were outweighed by the need to lean against actual and potential shortfalls in demand and business activity.

The members recognized that in light of the lags in the effects of policy, the easing process probably would have to be terminated before available measures of economic activity provided clear evidence of a substantial strengthening trend. In the view of some members, this point might come relatively soon. Beyond the nearer term members also envisaged the desirability of moving preemptively to offset some of the extra monetary stimulus now in the economy in advance of inflation pressures beginning to build. The members were fully prepared to act on a timely basis, but several emphasized the recognition lags that would be involved in stopping and subsequently beginning to reverse the policy easing.

Given their views about the risks to the economy, notably over the nearer term, all the members supported the retention of the sentence in the press statement indicating that the risks continued to be weighted toward further weakness in the foreseeable future.

At the conclusion of this discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 3½ percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Messrs. Moskow and Poole. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, October 2, 2001.

The meeting adjourned at 12:40 p.m.

Reciprocal Currency Arrangements

Following the terrorist attacks on September 11, 2001, the Committee established or enlarged reciprocal currency (swap) arrangements with the European Central Bank, the Bank of Canada, and the Bank of England. The purpose of these arrangements was to facilitate the functioning of U.S. financial markets by providing as necessary through the foreign central banks the liquidity in dollars needed by European, Canadian, and British banks whose U.S. operations had been disrupted by the disturbances in the United States. These central bank arrangements would mature in thirty days unless extended by the Committee. Except for an initial drawing of up to $12 billion by the European Central Bank on September 12, individual drawings were subject to approval by the Foreign Currency Subcommittee of the Federal Open Market Committee. Under the agreements, dollars would be made available in the form of deposits at the Federal Reserve Bank of New York in exchange for deposits in the counterparty central banks of an equivalent amount of their currencies. The individual actions and votes were as follows:

> On September 12, 2001, available members of the Committee voted unanimously to establish a $50 billion swap line with the European Central Bank with a maturity of thirty days unless renewed.

Votes for this action: Messrs. Greenspan, Ferguson, Gramlich, Hoenig, Ms. Minehan, Messrs. Moskow, Poole, and Stewart. Absent and not voting: Messrs. Kelley and

Meyer. Mr. Stewart voted as alternate for Mr. McDonough.

On September 13, 2001, available members of the Committee voted unanimously to increase the System's swap line with the Bank of Canada from $2 billion to $10 billion, with the added facility to mature in thirty days unless renewed.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Ms. Minehan, Messrs. Moskow and Poole. Absent and not voting: Mr. Meyer.

On September 14, 2001, available members of the Committee voted unanimously to establish a $30 billion swap line with the Bank of England, with a maturity of thirty days unless renewed.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Hoenig, Kelley, Ms. Minehan, Messrs. Moskow and Poole. Absent and not voting: Messrs. Gramlich and Meyer.

Intermeeting Policy Action

On September 13, 2001, the Committee met by telephone conference to assess economic and financial developments stemming from the terrorist attacks on September 11 and the possible need for a monetary policy response. Banking and other financial market conditions, notably in New York City but also around the nation, were discussed in some detail as well as the outlook for reopening the stock exchanges. While the ongoing reactions to the recent tragedy were undoubtedly a negative factor in the economic outlook, the members agreed that financial markets were still too disrupted and the economic outlook too uncertain to provide an adequate basis for a policy move at this time. However, the members contemplated the need for some policy easing in the very near future. In the interim, the System would continue to stand ready to provide whatever liquidity might be needed to counter unusual strains and help assure the effective functioning of the banking system and restore more normal conditions in financial markets.

Subsequently, on September 17, 2001, the Committee members voted unanimously to ease reserve conditions appreciably further, consistent with a reduction in the federal funds rate of 50 basis points to a level of 3 percent. This policy action was associated with the approval by the Board of Governors of a reduction of equal size in the discount rate to a level of 2½ percent. These actions were taken against the backdrop of heightened concerns and uncertainty created by the recent terrorist attacks and their potentially adverse effects on asset prices and the performance of the economy. In conjunction with these policy moves, the Federal Reserve would continue to supply, as needed, an atypically large volume of liquidity to the financial system. As a consequence, the Committee recognized that the federal funds rate might fall below its target on occasion until more normal conditions were restored in the functioning of the financial system. The Committee's vote encompassed the retention of a statement in its press release indicating that the balance of risks remained weighted toward weakness for the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Messrs. Moskow and Poole. Votes against this action: None.

Donald L. Kohn
Secretary

Meeting Held on October 2, 2001

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, October 2, 2001, at 9:00 a.m.

Present:

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

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

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

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

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

Mr. Kos, Manager, System Open Market Account

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

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

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

Mr. Connors, Associate Director, Division of International Finance, Board of Governors

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

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

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

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

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

Messrs. Evans, Hilton, and Judd, Vice Presidents, Federal Reserve Banks of Chicago, New York, and San Francisco respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 21, 2001, and the conference calls held on September 13 and 17, 2001, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period August 21, 2001, through October 1, 2001. By unanimous vote, the

Committee ratified these transactions. The Committee expressed its appreciation of the outstanding manner in which the Federal Reserve Bank of New York had carried out its open market operations and other responsibilities under very difficult circumstances after the terrorist attacks on September 11, 2001.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below.

The information reviewed at this meeting suggested that the attacks of September 11 might well have induced a mild downturn in economic activity after several months of little movement in the level of economic activity. While few nonfinancial economic data were available on developments since the attacks, anecdotal and survey reports suggested that heightened uncertainty and sharply reduced confidence had curtailed consumer spending and had intensified the downward trajectory in business capital expenditures. Consumer price inflation had remained relatively subdued over the summer months.

Data for August portrayed some continued softening in overall labor market conditions. Private nonfarm payroll employment fell appreciably further, with the decline more than accounted for by additional job losses in manufacturing. Labor demand remained sluggish in most other sectors, though some pickup was reported in services. The unemployment rate rose to 4.9 percent in August, its highest level in four years. A sharp increase in initial claims for unemployment insurance in recent weeks was suggestive of additional deterioration in labor markets.

Industrial production fell substantially further in August after posting monthly losses starting in October of last year. Motor vehicle assemblies were down sharply, reversing a large advance in July, and production of high-tech equipment continued to register large declines. Outside of those two industries, production of business equipment, business supplies, consumer nondurables, and materials also moved appreciably lower. The rate of capacity utilization in manufacturing continued to fall, reaching its lowest level since mid-1983.

Growth in consumer spending picked up somewhat in July and August from a reduced pace in the second quarter despite a small drop in sales of new motor vehicles. However, anecdotal reports from around the nation pointed to a downturn in September, largely reflecting marked weakness after the terrorist attacks. Indicators of consumer confidence fell further in September.

Despite low mortgage interest rates, residential building activity softened somewhat in August and some indicators of housing demand, including mortgage applications for home purchases, had downshifted a bit further in recent weeks. However, builder backlogs appeared to be large enough to sustain homebuilding activity at a fairly elevated level for several months. Sales of new homes edged up in August but were little changed on balance since April.

Business capital spending contracted substantially further over the summer months, and anecdotal information after September 11 pointed to even deeper cutbacks by many firms. The added weakness evidently stemmed from increased concerns about future sales and earnings, which also was reflected in the sharp declines in stock market prices after the equity markets reopened on September 17. Available indicators suggested that expenditures for equipment and software had remained on a sharp downward trajectory into late summer, though the overall decline in such spending was moderated by sizable outlays for aircraft in July and August. New orders for nondefense capital goods edged up in August but were still well below their average for the second quarter. Nonresidential construction activity appeared to be falling appreciably further after a sharp downturn in the second quarter.

Business inventory liquidation remained substantial in July, extending the sizable declines since the start of the year. Large drawdowns were recorded in manufacturing and, excluding motor vehicles, in both wholesale and retail trade. The limited data available for August indicated some reduction in dealer stocks of motor vehicles and sizable further liquidation of durable goods by firms in the manufacturing sector. Nonetheless, the aggregate inventory–sales ratio for producers of durable goods edged up in August, led by a further rise in the ratio for computers and electronic products. In the days following the terrorist attacks, anecdotal reports indicated that disruptions in transportation facilities, including the temporary suspension of air cargo service and lengthy trucking delays at the nation's borders, caused some backups in inventories at some firms and shortages at others, but these problems generally seemed to ease within a few days.

The U.S. trade deficit in goods and services was about unchanged in July from its June level, but both exports and imports dropped sharply as weakness in worldwide economic activity continued to affect the nation's foreign trade. The reduced value of exports in July was spread among most trade categories but was especially pronounced in machinery, industrial supplies, and automotive products. The reduction in imports was led by declines in oil, semiconductors, other machinery, automotive products, and consumer goods. Data for foreign industrial economies confirmed earlier indications of little or no growth in those economies in the second quarter, and more recent information for the period prior to the terrorist attacks pointed to further weakness, including evidence of declining activity in Japan. Available information on conditions in major developing countries also suggested slowing or negative growth in recent months, in part as a consequence of weakness in their exports to the United States and, notably for some Asian economies, the poor performance of the global high-tech industry.

Consumer price inflation remained relatively limited in July and August, with core personal consumption expenditure (PCE) price inflation on an appreciably lower track than core consumer price index (CPI) inflation. For the twelve months ending in August, core PCE prices rose a bit less, and core CPI prices a bit more, than over the previous twelve-month period. Consumer energy prices fell sharply in July and August, but a sizable rebound was anticipated in September as prices of petroleum products moved higher after midsummer in response to refinery disruptions and tightening supplies. In electricity markets, upward price pressures dissipated over the summer, while the sharp run-up of natural gas prices continued to unwind as inventories rose further in the context of persisting high levels of production and sluggish demand. At the producer level, core prices declined in August, notably at the early stages of processing. With regard to labor costs, the rise in average hourly earnings of production or nonsupervisory workers diminished somewhat over July and

August, but the year-over-year advance was still appreciably above that for the previous twelve-month period. In addition, large increases in health insurance costs were continuing to add to overall employment costs.

At its meeting on August 21, 2001, the Committee adopted a directive that called for implementing conditions in reserve markets consistent with a reduction of 25 basis points in the intended level of the federal funds rate to a level of about 3½ percent. The Committee took this action in light of the absence of firm evidence that the deceleration in the economic expansion had run its course or that a recovery in output was imminent. With increasing slack in labor and product markets and with inflation expectations contained, the members agreed that the balance of risks continued to be weighted toward conditions that could generate economic weakness in the foreseeable future. Subsequently, on September 17, the Committee reduced its target for the federal funds rate by a further ½ percentage point. This action was taken against the backdrop of heightened concerns and uncertainty created by the recent terrorist attacks and their potentially adverse effects on asset prices and the performance of the economy. In conjunction with this easing move, the Federal Reserve indicated that it would continue to supply unusually large volumes of liquidity, and the Committee recognized that the federal funds rate might fall below its new target until the normal functioning of financial markets was restored.

In the period before the terrorist attacks, federal funds traded at rates near the reduced target level established at the August meeting. Most market interest rates edged lower over that period in response to generally downbeat news on the economy, and broad stock market indexes fell appreciably. For a few days after September 11, with federal funds brokerage disrupted, banks generally agreed to trade reserves at the 3½ percent federal funds target rate then prevailing. As more normal functioning resumed in the federal funds market, the rate fell well below the Committee's formal targets, including the reduced rate set on September 17. By the latter part of September and early October, however, the effective rate was fluctuating around the new target level. After the terrorist attacks, rates on short- and intermediate-term Treasury securities fell appreciably further, as did yields on highly rated obligations such as federal agency debt. However, the yield declines did not extend to long-term Treasury bonds, which changed little as investors apparently reacted to the deteriorating outlook for the federal budget surplus and prospectively larger Treasury bond supplies. Yields on investment-grade corporate bonds also were little changed, but rates on high-yield bonds, evidently reflecting increased investor aversion to holding risky securities, rose sharply in very thin markets. In the stock market, broad equity price measures fell considerably further in volatile trading after the markets reopened on September 17, but part of those losses had been recovered by the time of this meeting.

The trade-weighted value of the dollar against the other major foreign currencies was about unchanged on average over the period since the August meeting, as modest dollar appreciation early in the period was reversed after September 11. The dollar ended the period somewhat lower against the yen and the euro but registered an advance against the Canadian dollar. The dollar rose over the period against the currencies of other important trading partners.

Growth of M2 remained relatively robust in July and August, though below the average pace in the first half of the year, while the expansion of M3 weakened markedly over the two months. More recently, a record surge in M2 components in the week ending September 17, which was largely reversed in the following week, resulted in very rapid growth in both aggregates on a monthly average basis in September. In the immediate aftermath of the terrorist attacks, disruptions to the infrastructure of financial markets, including communications and transportation facilities, led to massive dislocations in the distribution of deposits and reserves. At the same time, greatly heightened demand for safe and liquid assets encouraged shifts from equity markets into deposit assets. These financial disturbances called for and were accommodated by record infusions of Federal Reserve credit through open market operations, the discount window, and other sources. In addition, the Federal Reserve eased its rules for lending securities to dealers and took a number of other steps to facilitate the operation of financial markets. To a considerable extent, more normal functioning was restored to those markets by the latter part of September, and the unusual demand for reserves abated.

In the presentation of its forecast to the Committee, the staff indicated that its downward revised outlook was subject to a very wide range of uncertainty regarding the ongoing effects of the tragic events of September 11. A mild downturn in overall economic activity probably was now under way and business conditions would continue to be depressed for some uncertain period by the sharp further deterioration in business and consumer confidence triggered by the terrorist attacks. However, a gradual recovery was anticipated during the first half of 2002, especially against the backdrop of a very accommodative monetary policy and an increasingly stimulative fiscal policy. The recovery would gather momentum during 2002 to a pace late in the year near the staff's current estimate of the growth in the economy's potential. With long-term trends in innovations and business opportunities expected to remain favorable, business fixed investment after the completion of ongoing adjustments likely would return to robust rates of growth, with favorable implications for employment, labor productivity, and consumer spending. The current and prospective slack in resource use over coming quarters, augmented by the pass-through effects of lower oil prices, would result in some modest deceleration in core PCE and CPI inflation.

In the Committee's discussion of current and prospective economic developments, the members focused on the shock to consumer and business confidence occasioned by the events of September 11 and the adverse repercussions on an already weak economy. The economy appeared to have been growing very little, if at all, prior to the terrorist attacks, and the dislocations arising from the latter seemed to have induced a downturn in overall economic activity against the backdrop of heightened anxiety and uncertainty about economic prospects and a sharp drop, at least initially, in stock prices after the equity markets reopened on September 17. Looking ahead, the members generally saw a relatively mild and short contraction followed by a gradual recovery next year as a plausible forecast but one that was subject to an unusually wide range of uncertainty, notably in the direction of a potentially much weaker outcome in the nearer term. In the short period since the attacks, anecdotal reports provided indications of a rebound from the sharp cutback in spending that characterized the immediate aftermath of those tragic events, but on balance business activity seemed to be in the process of moving lower. It was especially difficult to assess the outlook for consumer sentiment and spending in the period immediately ahead, which likely would depend to an important extent on the progress of the war against terrorism and reactions to any further terrorist activities. One risk bearing on that outlook was the possibility that prices in equity markets might continue to decline and perhaps even overadjust to lower earnings expectations. The confluence of worldwide economic weakness added to current uncertainties and concerns. In these circumstances a substantial further drop in consumer and business confidence and spending could not be ruled out.

The members nonetheless saw favorable prospects for an upturn in business activity next year, though the recovery clearly would be more delayed than they had anticipated before September 11. Major reasons for optimism about the outlook were the substantial easing in monetary policy, whose lagged effects would be felt increasingly in the year ahead, and the fiscal stimulus measures that already had been enacted and might well be supplemented over coming months. Other supportive elements included a likely rebound in business high-tech investment after its sharp retrenchment and a gradual turnaround in inventory investment as stocks became better aligned with expected sales. A sound banking system and low inflation were seen as sources of underlying strength in the economy that would contribute to the eventual pickup in economic activity. Even with a rebound in activity next year, however, consumer price inflation appeared likely to remain subdued or perhaps trend a bit lower in association with reduced pressures on labor and other resources and declining energy prices.

The Committee's review of recent and prospective developments in key sectors of the economy underscored the uncertainty that surrounded the overall economic outlook. The major question at this point was the extent to which the recent tragedies would continue to weigh on consumer spending and business investment. In the consumer sector, spending had with some exceptions held up well through late summer, but confidence had begun to deteriorate even before September 11. A factor that seemed to be exerting an increasingly depressing effect on consumer attitudes was the persisting stream of worker layoffs and rising unemployment. The adverse wealth effects stemming from the cumulative declines in stock market prices were a further negative, though one that had been cushioned by continued increases in the value of real estate. Retail sales along with expenditures associated with travel-related services had fallen dramatically in the immediate aftermath of the terrorist attacks. Very recent anecdotal reports suggested some improvement in consumer spending, though not a total recovery, with mixed indications ranging from a rebound to levels near pre-attack norms to still relatively depressed activity. Looking ahead, many retailer contacts anticipated sluggish sales over coming months. There were no historical precedents for judging the likely effects on consumer confidence and spending of the unique recent events, though it seemed likely that prospects for added job losses and the decline in equity wealth already experienced would hold down consumer expenditures over the months ahead. Even so, the members did not rule out a stronger-than-anticipated pickup later, depending in part on the size of additional fiscal policy actions.

Housing demand had remained at a relatively elevated level across much of the nation, though signs of some softening were apparent prior to September 11, especially in the high-priced segment of the housing market. The near-term outlook suggested some further waning in housing demand in association with the prospective weakness in employment and income. Some members noted in this regard that they sensed growing caution among homebuilders. However, the outlook for housing activity over the intermediate to longer term remained fairly promising against the backdrop of relatively low mortgage interest rates and a prospective recovery in overall economic activity that would foster rising employment and incomes.

The events of September 11 produced a marked increase in uncertainty and anxiety among contacts in the business sector. Spending for equipment and software and for commercial structures had been declining sharply through the summer, with only a few tentative signs that the pace of decline might be about to ebb. According to contacts, intensified concerns about prospects for sales and profits were depressing investment further by fostering an increasingly widespread wait-and-see attitude about undertaking new investment expenditures. While nationwide statistics on expenditures in the period since the terrorist attacks were not yet available, anecdotal reports pointed to especially large cutbacks in planned spending for commercial aircraft and rental cars stemming from the sudden and sharp deterioration of activity in the travel and tourist industries. Reports from banking contacts also indicated a substantial drop in demand for business loans that was attributed in part to the diminished willingness of small businesses in particular to undertake new investments in capital equipment and other production facilities. More generally, the increase in uncertainty and the decline in business confidence and corporate profits along with the currently high levels of excess capacity in many industries pointed to the persistence of poor prospects for capital spending over the short to intermediate term, with declines in outlays for high-tech products expected to remain especially pronounced. Looking further ahead, however, a robust upturn in business capital spending was still a probable outcome. Businesses likely would respond to profit opportunities stemming not only from rising demand resulting in part from fiscal and monetary stimulus but also from ongoing technological improvements and the need for new capital equipment as the process of retrenchment from earlier overinvestments was completed.

With a few short-lived exceptions, production on the whole had not been directly disrupted by the effects of the terrorist attacks. Consequently, some unintended accumulation of inventories probably had occurred as a result of sizable and unanticipated declines in the demand for many products. Even so, the pronounced downtrend in overall inventory spending appeared to be continuing, and with many business firms evidently still trying to liquidate what they viewed as excessive stocks, the inventory adjustment process was likely to persist for some time. Nonetheless, as progress was made in reducing unwanted stocks, the rate of inventory liquidation would diminish and an eventual turn toward accumulation would emerge, with positive implications for economic activity. Indeed, this buildup could be larger than previously anticipated if businesses now felt the need to hold larger stocks against the contingency of supply-chain slowdowns and disruptions.

The members saw the international sector as contributing to weakness in the domestic economy, especially over the nearer term. Downshifts in the U.S. economy were reinforcing more sluggish performance in many foreign economies, which in association with continued firmness in the dollar was in turn depressing the outlook for U.S. exports to those countries. In this regard, several members cited anecdotal evidence of flagging foreign markets for a variety of U.S. products. On the positive side, weakness in world demand for oil was fostering a significant downtrend in energy prices, albeit with adverse effects on energy producers in this country and abroad.

Members viewed the outlook for inflation as favorable. Expectations of greater and longer-lasting slack in labor and product markets than anticipated earlier had led to downward revisions to forecasts of wage and price inflation. This outlook was abetted by substantial declines in oil and other commodity prices. On the negative side, increases in spending on insurance and security and continued upward pressure on costs in the healthcare industry likely would impinge on business margins, limiting the downward adjustment of inflation.

In the discussion of policy for the intermeeting period ahead, all the members endorsed a proposal calling for some further easing of reserve conditions consistent with a 50 basis point reduction in the federal funds rate to a level of 2½ percent. While monetary policy had already been eased substantially this year, the increased evidence of a faltering economy and the decidedly downside risks in the outlook called for a further move at this meeting. Easing would help limit the extent of the downturn and later provide impetus to the eventual upturn in economic activity. Further vigorous easing action would tend to support business and household confidence, which a number of members saw as especially important in the current circumstances. Even after a 50 basis point reduction, the federal funds rate would not reflect an unusually accommodative policy stance in that, in real terms, it would still be positive by many measures and above its typical level in most earlier periods of economic weakness. Moreover, the decline in stock market prices and the widening of risk spreads had damped the stimulative financial effects of the Committee's earlier easing actions. The relatively low level of inflation and well-contained inflationary expectations allowed the Committee flexibility to focus on countering the downside risks to the economy without incurring a significant threat of fostering expectations of higher inflation. Monetary policy is a flexible instrument and, with inflation expectations likely to remain relatively benign, policy could be reversed in a timely manner later should stimulative policy measures and the inherent resiliency of the economy begin to foster an unsustainable pace of economic expansion.

In keeping with their views about the risks to the economy, all the members supported the retention of the sentence in the press statement indicating that the risks continued to be weighted toward further weakness in the foreseeable future.

At the conclusion of this discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 2½ percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting.

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Messrs. Moskow and Poole. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, November 6, 2001.

The meeting adjourned at 12:30 p.m.

Donald L. Kohn
Secretary

Meeting Held on November 6, 2001

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, November 6, 2001, at 9:00 a.m.

Present:

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

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

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

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

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

Mr. Kos, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

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

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

Messrs. Kamin and Whitesell, Assistant Directors, Divisions of International Finance and Monetary Affairs respectively, Board of Governors

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

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

Mr. Stewart, First Vice President, Federal Reserve Bank of New York

Messrs. Cox and Goodfriend, Mses. Mester and Perlmutter, Messrs. Rolnick and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Dallas, Richmond, Philadelphia, New York, Minneapolis, and Cleveland respectively

Mr. Thornton, Vice President, Federal Reserve Bank of St. Louis

Mr. Robertson, Assistant Vice President, Federal Reserve Bank of Atlanta

Mr. Rudebusch, Senior Research Advisor, Federal Reserve Bank of San Francisco

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on October 2, 2001, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period October 2, 2001, through November 5, 2001. By unanimous vote, the Committee ratified these transactions.

By notation vote circulated before this meeting, the Committee members unanimously approved the selection of Michelle A. Smith to serve as an assistant secretary of the Committee for the period until the first regularly scheduled meeting in 2002.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below.

The information reviewed at this meeting indicated that economic activity, already weak in late summer, had softened further after the terrorist attacks. Overall consumer spending faltered, though purchases of motor vehicles reached a near-record level, and the downward trajectory in business capital expenditures steepened. With sales contracting and inventory imbalances still substantial, the manufacturing sector continued its sharp slide, and aggregate employment plunged. Energy prices were moderating somewhat in response to lower worldwide demand, and core price inflation remained subdued.

Conditions in the labor market deteriorated sharply further in October, with private nonfarm payroll employment suffering its worst monthly decline since 1975. The largest drop was in manufacturing, but nearly every major sector experienced sizable job losses. Among other job market indicators, the average workweek edged down, initial claims for unemployment insurance remained very high, and the unemployment rate jumped to 5.4 percent, an increase of one-half percentage point.

Industrial production recorded another large decrease in September (latest data), and the weakness was spread across most market groups and industries. Motor vehicle assemblies registered a further sharp contraction, and output of high-technology goods plunged still lower. The additional decline in production in September brought the rate of utilization of overall manufacturing capacity to its lowest reading since May 1983.

Personal consumption expenditures fell sharply in September; purchases of goods plummeted and consumption of services, particularly transportation and recreation services, declined as well. In October, sales of light vehicles surged to near-record levels in response to special financing packages offered by many automakers, but available information suggested that non-auto spending was weak.

Residential building activity edged down during the August–September period, and signs of some further softness had emerged in recent weeks. Nonetheless, in an environment of very low mortgage rates, residential construction had been sustained at a comparatively high level despite a weakening labor market and sluggish growth in personal income. Sales of new and existing homes slipped in September but were not far below the near-record levels of last March.

Business capital spending on equipment and software fell sharply further in the third quarter. Moreover, the available information on orders and shipments of nondefense capital goods suggested another steep drop in such spending in the latter part of this year in the current environment of eroding corporate earnings and cash flows and a very uncertain outlook for future sales and earnings. The weakness in demand for durable equipment was spread across almost all categories of equipment but was particularly prominent for high-tech goods, aircraft, automobiles, and trucks. Nonresidential construction activity also declined in the spring and summer.

Total business inventories on a book-value basis decreased in July and August (latest data for wholesalers and retailers) at a rate close to that of the second quarter. At the manufacturing level, stocks continued to run off at a brisk pace through September; however, shipments weakened by more in the third quarter, and the aggregate inventory–shipments ratio for the sector reached its highest level in more than five years. Wholesalers also experienced a sizable decline in inventories over July and August that resulted in a slight reduction in their aggregate inventory–sales ratio, but that ratio was still in the upper end of its range for the past two years. Retail inventories climbed somewhat in July and August, but the sector's inventory–sales ratio was little changed in August and was in the lower end of its range for the past year.

The U.S. trade deficit in goods and services contracted slightly in August after having changed little in July, and the deficit for July and August combined was considerably smaller than that for the second quarter. The value of exports fell in the July–August period, with most of the drop occurring in capital goods, consumer goods, and industrial supplies. The value of imports was down appreciably more than that of exports, with decreases occurring in almost all major trade categories; automotive products, food, and aircraft were the only exceptions. Recent information indicated that foreign economic activity had changed little in the third quarter, and some forward indicators and anecdotal information pointed to reduced activity later in the year. Economic activity in the euro area and the United Kingdom appeared to be reviving in the summer months, but renewed softening stemming from a downturn in business and consumer confidence seemed to have emerged in September and October. Japan remained the weakest of the major foreign industrial economies; the sharp contraction in economic activity that began early in the year continued in the third quarter, and the unemployment rate reached a record high in September. Most major emerging-market economies, with the notable exception of China, also were continuing to experience an economic slowdown that was related at least in part to weakness in the industrialized world.

Core consumer price inflation remained at a relatively subdued pace in August and September; and with energy prices having moderated over the past year, total consumer price inflation had moved down, on a year-over-year basis, to the slower pace of its core component. Both the core consumer price (CPI) index and the personal consumption expenditure (PCE) chain-type index exhibited this general pattern. Core producer price inflation for finished goods also held at a low rate in the August–September period and on a year-over-year basis. With regard to labor costs, total hourly compensation of private industry workers decelerated further in the third quarter, despite a surge in benefit costs, and also slowed noticeably on a year-over-year basis. Average hourly earnings of production or nonsupervisory workers continued to rise in August and September at the relatively moderate rate that had prevailed in earlier months.

At its meeting on October 2, 2001, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with a decrease of 50 basis points in the intended level of the federal funds rate, to about 2½ percent. The members recognized that monetary policy already had been eased substantially this year, but they believed that the increased evidence of a faltering economy and the decidedly downside risks to the outlook called for a further move. The additional rate reduction would help limit the extent of the downturn and later would contribute to an upturn. Moreover, the recent declines in equity prices and widening of risk spreads tended to offset some of the stimulative effects of earlier easings, and the relatively low level of inflation and inflationary expectations provided room to counter downside forces without incurring significant risks of higher inflation. The members also believed that the balance of risks remained weighted toward conditions that could generate economic weakness in the foreseeable future.

Federal funds traded at rates near the Committee's target level over the intermeeting period. Most interest rates declined significantly during the period even though the reduction in the target level for the federal funds rate had been anticipated by market participants. They apparently saw the Committee's announcement and the subsequent release of weaker-than-expected data as portending further policy easing. With yields on private debt securities down sharply and investors perhaps becoming more confident about long-term business prospects, major indexes of equity prices moved higher over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies had increased slightly on balance since the October meeting. Incoming data for the foreign industrial economies were weaker than expected, and market interest rates abroad declined in response to reductions in policy interest rates in Canada and the United Kingdom and to market expectations that the European Central Bank would lower its policy rates by year-end. The dollar moved down slightly on balance in terms of an index of the currencies of other important trading partners. The Brazilian *real* was adversely affected by spillovers from Argentina's financial difficulties, while the Mexican peso rebounded from its decline against the dollar in the wake of the September terrorist attacks.

M2 changed little in October after a surge in September that was related in important measure to a temporary bulge in transaction deposits stemming largely from delayed settlements of security trades in the aftermath of the terrorist attacks. On balance, M2 grew rapidly over the September–October period, reflecting the sharp drop in market interest rates and perhaps the deposit of federal tax rebates. M3 also increased rapidly over September and October, largely in conjunction with the expansion of M2. The debt of domestic nonfinancial sectors grew at a moderate pace on balance through August.

The staff forecast prepared for this meeting emphasized the continuing wide range of uncertainty surrounding the outlook in the wake of the September attacks. The mild downturn in economic activity in the third quarter was seen as likely to deepen over the remainder of the year and to continue for a time next year. However, the cumulative easing that had occurred in the stance of monetary policy, coupled with the fiscal stimulus already in place and prospective additional measures, would provide support for economic activity. Moreover, the ongoing liquidation of inventories would eventually abate and give a sizable boost to production, while an expected pickup in foreign economies would provide some support for U.S. exports. As a result, economic expansion was projected to resume and gradually gain strength through 2003, reaching a rate around the staff's current estimate of the growth of the economy's potential output. The period of subpar expansion was expected to foster an appreciable easing of pressures on resources and some moderation in core price inflation.

In the Committee's discussion of current and prospective economic conditions, members commented that widespread anecdotal reports supported statistical indications that the economy was contracting, and they saw no significant evidence that overall business conditions were in the process of stabilizing prior to recovering. While the members continued to see a fairly brief and limited decrease in economic activity as the most likely outcome, they also agreed that the risks to such a forecast were strongly tilted to the downside. Business investment expenditures clearly seemed likely to continue to decline over coming months. On the other hand, consumer spending had held up reasonably well thus far, but further job losses could undermine consumer confidence and spending. Looking further ahead, the longer-term prospects for productivity and growth in the U.S. economy remained bright and an upturn during 2002 was a likely prospect. Such a recovery would be fostered by the lagged stimulus from both fiscal and monetary policies interacting with progress by business firms toward completing their adjustments to overhangs in capital resources and excess inventories. However, the strength and timing of the eventual recovery remained subject to question especially in light of the marked degree of uncertainty that surrounded the prospects for further fiscal policy legislation, developments in the war against terrorism, and weakness in foreign economies. In the context of diminished pressures on labor and other resources, the members expected underlying consumer price inflation to remain benign and possibly to drift lower over coming quarters, abetted by the indirect effects of generally weaker energy prices.

In their review of developments in key sectors of the economy, members noted that surveys and anecdotal commentary pointed to a considerable decline in consumer confidence, though in the view of some members the decline seemed less than might have been expected given prevailing circumstances. Retail sales, led by a surge in motor vehicles, had improved considerably following a downturn in the weeks after September 11. Even so, retail sales were still generally below their levels prior to the terrorist attacks, and overall spending on consumer services had decelerated considerably, notably reflecting continuing weakness in expenditures on airline travel and related travel activities. The extraordinary increase in sales of light motor vehicles in October clearly was propelled by exceptionally attractive financing incentives, but such inducements were temporary and many of the resulting sales undoubtedly borrowed from the future. Still, the jump in motor vehicle sales was a sign that underlying consumer confidence and willingness to spend had held up reasonably well in this period. Looking ahead, reports from retailer contacts were somewhat mixed; many anticipated relatively depressed holiday sales and where possible were making efforts to limit buildups of holiday merchandise, while other retailers were confident that sales would be reasonably well maintained, albeit generally somewhat below levels or growth rates experienced in previous holiday seasons. Beyond the months immediately ahead, members anticipated that, in addition to a drop in motor vehicle sales to more sustainable levels, consumer spending was likely to be held back by the persistence of widespread caution among households and by the decline in stock market wealth over the last year or so. Consumer confidence was vulnerable to renewed terrorism and to further weakness in labor markets.

Housing activity, though still at a relatively elevated level, had displayed signs of some slippage in recent months. There were anecdotal reports of excess inventories of unsold homes in some areas, and members again cited indications of particular softness in the high-price segment of the housing market. Weakness in employment and more generally the rise in uncertainty were having a depressing effect on homebuilding activity, which likely would persist over coming months. Nonetheless, low mortgage interest rates continued to provide important support to homebuilding, and in the absence of a much weaker economy than was currently anticipated or of a further sizable shock to consumer confidence, there appeared to be little basis in ongoing trends and housing finance conditions to expect substantial additional erosion in residential construction.

Business fixed investment currently seemed to be declining at an even faster rate than earlier in the year, and the sharp decrease in new orders of capital goods in September pointed to marked additional weakness over the months ahead. According to widespread anecdotal reports, business confidence appeared to have worsened considerably further since late summer in the context of a generally deteriorating outlook for sales and earnings. In these circumstances, business firms were likely to persist in their efforts to reduce what they viewed as excess capacity, notably in high-tech and travel-related industries. Some exceptions related to the expansion of healthcare and security-enhancing facilities. However, the longer-term attractiveness of efficiency-inducing capital investment would at some point promote a robust upturn in such expenditures. The timing remained uncertain, but a number of members saw a reasonable prospect that the decline in expenditures for capital equipment and software would abate early next year and that such spending probably would turn up during the second half of the year as businesses succeeded in better aligning actual and desired capital stocks. With regard to nonresidential construction, widespread increases in vacancy rates around the country suggested that the turnaround in overall activity might be more delayed despite some near-term stimulus from reconstruction activity in New York City. In general and given prevailing wait-and-see business attitudes, members believed that the risks over the forecast horizon remained in the direction of a shortfall in capital expenditures from what were already weak expectations.

A key uncertainty in the outlook for investment spending was the outcome of the ongoing Congressional debate relating to tax incentives for investment in equipment and software. Both the passage and the specific contents of such legislation remained in question. Moreover, several members stressed the difficulty of assessing the effectiveness of temporary fiscal policy measures directed at boosting investment expenditures. Though undoubtedly helpful in fostering greater capital spending while the tax incentives remained in place, members expressed reservations about the extent of the favorable effects in the nearer term when marked disincentives existed for many firms to make capital expenditures in the context of excess capacity, weak markets, and poor profit opportunities. More generally, forecasts of a reasonably vigorous rebound in the economy over 2002 depended in part on expectations of added fiscal stimulus, but prospects appeared to have diminished for prompt passage of fiscal policy initiatives that could significantly boost economic activity in the next several quarters.

Business firms were continuing to cut back production in efforts to adjust output to faltering demand and to pare excess inventories. Even so, with demand generally tending to be weaker than expected, inventory–sales ratios had remained on the high side for many firms and strong efforts to reduce inventories were persisting, including efforts by many retailers in light of their expectations that holiday sales would prove disappointing. The pace of inventory liquidation was thought likely to moderate in coming quarters and subsequently turn to accumulation as inventories came into better balance with sales, with increasingly positive implications for overall production and economic activity.

Weakness in foreign economies was continuing to foster declines in U.S. exports in what appeared to be an increasingly synchronous and mutually reinforcing pattern of economic activity among the world’s nations. With recent indications that on the whole foreign economic activity was deteriorating somewhat further and by more than previously anticipated, members viewed the risks for activity in foreign nations and their related demand for U.S. goods and services as tilted decidedly to the downside.

The considerable slack in labor markets, evidenced by both statistical and widespread anecdotal reports, was expected to exert appreciable downward pressure on wage increases over the forecast period. Concurrently, however, the favorable impact of wage disinflation on business costs would be offset in part by increasing costs of healthcare insurance, slower gains in structural productivity associated with reduced business capital investment, and by the necessity to divert some resources to enhance security. The passthrough effects of the substantial decline in energy prices over the past year were a favorable factor in the outlook for core inflation. On balance, core consumer price inflation was projected to remain subdued and quite possibly edge lower.

In the Committee's discussion of policy for the intermeeting period ahead, all the members indicated that they could support a proposal calling for further easing in reserve conditions consistent with a 50 basis point reduction in the federal funds rate to a level of 2 percent.

The heightened degree of uncertainty and risk aversion following the terrorist attacks seemed to be having a pronounced effect on business and household spending. The continued contraction in the economy and marking down of most forecasts of inflation and resource utilization going forward strongly suggested the desirability of further easing in the stance of policy. Although policy had been eased substantially in 2001, the forces restraining demand had been considerable, and a variety of factors had limited the passthrough of lower short-term interest rates into long-term rates, equity prices, bank lending rates, and the foreign exchange value of the dollar. In circumstances in which inflation was already reasonably low and pressures on resources and prices were likely to abate further in coming months, the risks were quite small that additional monetary stimulus aimed at bolstering the economy would foster a pickup in inflation.

A number of members noted that the choice between 25 and 50 basis points of easing was a close call. Three favored a smaller move on balance, although they could accept the larger decrease in the current environment of substantial uncertainty about the course of the economy and the appropriate stance of policy. These members noted that policy was already accommodative. Indeed, policy had been eased substantially further in September and October, and the effects of those actions and any added easing at this meeting would be felt mostly during the year ahead when fiscal stimulus and the inherent resilience of the economy should already be boosting growth substantially. Some also were concerned that the more sizable action in combination with an announcement of the Committee's continuing concern about further economic weakness would lead markets to build in inappropriate expectations of even more monetary stimulus.

Most members, however, favored a 50 basis point reduction in the Committee's target federal funds rate. These members stressed the absence of evidence that the economy was beginning to stabilize and some commented that indications of economic weakness had in fact intensified. Moreover, it was likely in the view of these members that core inflation, which was already modest, would decelerate further. In these circumstances insufficient monetary policy stimulus would risk a more extended contraction of the economy and possibly even downward pressures on prices that could be difficult to counter with the current federal funds rate already quite low. Should the economy display unanticipated strength in the near term, the emerging need for a tightening action would be a highly welcome development that could be readily accommodated in a timely manner to forestall any potential pickup in inflation.

All the members indicated that with the risks to the economy clearly tilted toward further weakness, they could vote in favor of retaining a statement to that effect in the press statement to be released shortly after today's meeting. Several stressed that such a statement did not constitute a commitment by the Committee to ease policy further at the next meeting. While the members agreed that significant further weakness in the economy might indeed warrant additional easing, a decision in that regard would depend entirely on the nature of future economic and financial developments.

At the conclusion of this discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 2 percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting.

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Messrs. Moskow and Poole. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 11, 2001.

The meeting adjourned at 1:20 p.m.

Donald L. Kohn
Secretary

Meeting Held on December 11, 2001

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 11, 2001, at 9:00 a.m.

Present:

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

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

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

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

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

Mr. Kos, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

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

Mr. Connors, Associate Director, Division of International Finance, Board of Governors

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

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

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

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

Mr. Rasdall, First Vice President, Federal Reserve Bank of Kansas City

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

Messrs. Bryan, Judd, and Krane, Vice Presidents, Federal Reserve Banks of Cleveland, San Francisco, and Chicago respectively

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

Prior to this meeting, Ms. Susan Schmidt Bies and Mr. Mark W. Olson had executed their oaths of office as members of the Board of Governors and the Federal Open Market Committee.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 6, 2001, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period November 6, 2001, through December 10, 2001. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below.

The information reviewed at this meeting indicated that economic activity had continued to decline into the fourth quarter, although some very recent data suggested that the rate of decline might be moderating. Labor market conditions had worsened further, especially in manufacturing and related industries, and industrial production had fallen in October and probably also in November. However, purchases of motor vehicles were very strong in both months, and other household and business spending seemed to have recovered somewhat from the sharp September decline. Energy prices were moderating noticeably in response to lower worldwide demand, and core price inflation remained subdued.

The labor market deteriorated substantially in October and November. Nonfarm payroll employment fell significantly in both months, with the largest job losses occurring in manufacturing, help supply services, and retail trade. Steep cuts in employment also occurred in industries directly affected by the September attacks, notably transportation, lodging, and tourism. Among the few industries that had not been adversely affected were health services, which continued to add workers, and finance, insurance, and real estate, which maintained stable employment on balance. The heavy job losses boosted the unemployment rate to 5.7 percent in November.

Industrial production fell sharply further in October, and the cuts continued to be spread widely across groups and industries, reflecting weak demand for business equipment, efforts by firms to pare inventories, and foreign competition. Motor vehicle assemblies slowed for a third straight month from the relatively high levels attained in the spring and early summer, and the output of high-technology goods remained on a steep downward trajectory, though a few positive signs had begun to emerge in the semiconductor and computer industries. The rate of utilization of total manufacturing capacity contracted further in October and was at a level substantially below the trough reached in the 1990–91 recession.

Personal consumption expenditures are estimated to have rebounded in October, following the large September decline, and were slightly above the third-quarter average. Purchases of motor vehicles surged in response to aggressive zero-rate financing packages offered by automakers, while spending on other goods made a partial recovery from the September drop. Outlays on consumer services strengthened in October, but they remained below their third-quarter average.

Residential building activity softened somewhat further in October, but in an environment of very low mortgage rates, homebuilding remained at a relatively high level despite the weak labor market and sluggish growth in personal income. Demand for single-family housing had held up relatively well. Sales of new single-family homes changed little in October and had been relatively steady since May, while sales of existing homes partially retraced the sharp drop-off that occurred in September.

Recent information suggested that the downward trend in business spending on durable equipment and software might be moderating somewhat. After plunging during the spring and summer, orders and shipments of nondefense capital goods turned up in October. Of particular note, both orders and shipments of office and computing equipment increased in October after having declined sharply for most of the year. For durable equipment in general, shipments had exceeded new orders since the first of the year, and as a result the backlog of unfilled orders was now below its level of a year ago. Nonresidential construction also had been weak during the spring and summer, reflecting an upward trend in vacancy rates and uncertainties regarding rents and property values. Although spending on industrial structures dropped further in October, outlays for office buildings and other commercial structures picked up noticeably.

The book value of business inventories fell steeply in the third quarter. The bulk of the reduction occurred in the manufacturing sector, but the sharp drop in stocks was matched by a contraction in shipments and the aggregate stock–shipments ratio for the sector remained at a very high level. In October, an additional sizable decline in manufacturing stocks resulted in a decrease in the sector's aggregate stock–shipments ratio, though it remained elevated. Wholesalers also experienced a sizable drop in inventories in the third quarter that produced a slight reduction in their aggregate inventory–sales ratio, but the latter was still in the upper portion of its range for the past two years. Retail inventories and the sector's inventory–sales ratio both edged up in the third quarter. Nonetheless, the sector's ratio remained in the lower end of its range for the past year.

The U.S. trade deficit in goods and services narrowed significantly in September and the third quarter, though most of those declines reflected estimated payments by foreign insurers related to the events of September 11. Abstracting from those payments, the trade deficit fell only a little in the third quarter as the value of exports fell by less than the value of imports. The softness in exports was widespread, with steep declines occurring in consumer goods, capital goods, and industrial supplies. Reductions in imports also were widespread, and as with exports, capital goods and industrial supplies were down sharply. The limited available information suggested a further weakening of economic activity in the foreign industrial countries in the current quarter, but there were some indications of a possible brightening of the economic outlook in the period ahead despite a sharp decline in business confidence in the aftermath of the September terrorist attacks. Additional monetary easing actions by the European Central Bank, the Bank of England, and the Bank of Canada contributed to that brighter outlook. Japan remained the weakest of the major foreign industrial economies, and the available information suggested further contraction in economic activity and worsened labor market conditions this quarter. Economic conditions in the major emerging-market countries remained weak, but there were signs that the worst might be over in some of the Asian economies most affected by the global downdraft in the high-tech sector. Economic growth in China seemed to have slowed a little. In Latin America, Argentina remained mired in recession, and the global slowdown continued to depress the economies of other nations in that region.

Core consumer price inflation remained at a relatively subdued pace in September and October, and a renewed decline in energy prices in October contributed to a sizable drop in total consumer price inflation during the twelve months ended in October when compared with the previous twelve-month period. The core personal consumption expenditure (PCE) chain-type price index also indicated that consumer inflation was significantly lower during the year ended in October, while the core consumer price index (CPI), with its narrower range of spending categories, had changed little over the past year. Core producer prices for finished goods edged up on balance during September and October, but inflation as measured by this index moderated slightly on a year-over-year basis. With regard to labor costs, growth of average hourly earnings of production or nonsupervisory workers slowed in September and October from the relatively moderate rate that had prevailed in earlier months.

At its meeting on November 6, 2001, the Committee adopted a directive that called for implementing conditions in reserve markets consistent with a decrease of 50 basis points in the intended level of the federal funds rate, to about 2 percent. The members referred to the heightened degree of uncertainty and risk aversion following the terrorist attacks that was having a significant effect on business and household spending, and they noted that the substantial easing of monetary policy that had been put in place this year had not shown through fully to long-term interest rates, equity prices, bank lending rates, and the foreign exchange value of the dollar. In these circumstances, with price inflation relatively low and pressures on prices and resources likely to ebb further, the members concluded that further monetary stimulus would provide some added insurance against a more extended contraction of the economy at little risk of a pickup in inflation. The members also believed that the balance of risks remained weighted toward conditions that could generate economic weakness in the foreseeable future.

Federal funds traded at rates close to the Committee's target level of 2 percent during the intermeeting period. Against the background of better-than-expected incoming economic data and of favorable news on military operations in Afghanistan, short-term interest rates declined a little over the intermeeting interval while intermediate- and long-term Treasury rates rose substantially. With market concerns about the economic outlook diminishing, yields on investment-grade corporate debt securities increased considerably less than those on comparable-maturity Treasuries, rates on speculative-grade bonds fell sharply, and major indexes of equity prices moved significantly higher.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies increased slightly on balance over the intermeeting period; the release of better-than-expected U.S. economic data lifted the dollar early in the intermeeting period, but subsequent data releases led to some erosion of that gain. Abroad, central bank policy rates were lowered in the euro area, England, and Canada in response to indications of flagging economic activity. In Japan, disappointing economic news and comments by Japanese officials about possible intervention to weaken the yen contributed to a decline in that currency. Meanwhile, the dollar was about unchanged on balance in terms of an index of the currencies of other important trading partners. The Mexican peso changed little on balance, the Brazilian *real* firmed despite the deepening problems of Argentina, and the Korean won rose against the background of incoming data that suggested the persistence of resilient domestic demand.

M2 growth in November was robust though well below the average pace of the two previous months. Liquid deposits continued to increase rapidly, reflecting the sharp drop in market interest rates this year, but inflows to retail money funds slowed as the economic outlook improved and the equity markets rallied. M3 expansion remained at a very high rate in November, bolstered by the growth of M2 and heavy bank acquisitions of nondeposit liabilities. The debt of domestic nonfinancial sectors grew at a moderate pace on balance through October.

The staff forecast prepared for this meeting suggested that economic activity would extend its decline for a time in 2002 but then would begin to turn upward. The recovery would be supported in part by the cumulative easing that had occurred in the stance of monetary policy, along with the fiscal stimulus already in place and some assumed additional measures not yet enacted. The turnaround in the economy and the gradual strengthening of the recovery would also be fostered by the completion of downward adjustments to inventories, a marked slowing in the contraction of business capital investments, and the added purchasing power arising from the recent declines in oil prices. Economic expansion was projected to strengthen appreciably by the second half of 2002 as the climate for business fixed investment improved and a strengthening of foreign economies led to somewhat greater demand for U.S. exports. Subpar expansion in the next few quarters was expected to foster an appreciable further easing of pressures on resources and some moderation in core price inflation.

In the Committee's discussion of current and prospective economic developments, members commented that the economy clearly was continuing to contract, led by further inventory liquidation and ongoing reductions in capital spending. The decline in inventories was likely to abate before long, boosting production, but the course of a recovery would depend on the behavior of final demand. The recent statistical and anecdotal information was more mixed than had been the case earlier and pointed on balance toward some moderation in the decline of overall final demand; for the first time in a long while the incoming data did not call for a downward revision to current forecasts. The members agreed, however, that the evidence of emerging stabilization in the economy remained quite tentative and the timing and strength of the eventual recovery continued to be surrounded by a high degree of uncertainty, with the risks to the economy still clearly tilted toward economic weakness. Among those risks, members cited the apparently reduced prospects for additional fiscal stimulus legislation, the vulnerability of current stock market valuations should forecasts of a robust rebound in earnings fail to materialize, the possibility of further terrorist incidents, and especially the potentially adverse effect on consumer confidence and spending of additional deterioration in labor market conditions. Nonetheless, with the critical consumer sector holding up relatively well thus far, members continued to anticipate an upturn in the economy during the year ahead in light of the progress already made by business firms in reducing excess inventories and unwinding capital overhangs, and the beneficial effects of the decline of energy prices. The lagged effects of the substantial easing in monetary policy this year and the fiscal stimulus measures already enacted into law were expected to buttress demand and economic recovery over the next year. The outlook for inflation was viewed as favorable, given the slack in labor and product markets, subdued inflationary expectations, and the prospect that aggregate demand would remain well below the economy's potential output over the next several quarters.

In the consumer sector, a major downside concern was the possibility that substantial further deterioration in labor market conditions, which was widely anticipated, could have a significant inhibiting effect on consumer confidence, incomes, and spending. Other potentially adverse economic factors cited by members included rising consumer debt burdens, the risk of a downturn in the stock market, and the recent rise in mortgage interest rates. That increase, among other things, would impinge on the extraction of capital gains from the turnover or refinancing of existing homes, which had provided important support for consumer spending. However, consumer expenditures appeared to have been relatively well sustained thus far, evidently in part the result of widespread price discounting and low interest rates, including zero rates on many motor vehicle loans, that were helping to overcome a currently high degree of caution and price consciousness among consumers. Moreover, recent survey evidence suggested that consumer confidence might be stabilizing after earlier declines. The significant decreases that had occurred in the prices of fuel oil and gasoline were a positive factor that would continue to bolster household spending for a while. Looking ahead, it was unclear how the various factors affecting consumers would interact, though apart from a likely downward adjustment in sales of motor vehicles to a more sustainable level following their recent surge, members generally anticipated that solid gains in consumer spending would underpin the economic recovery.

Like consumer spending, new home construction and sales had displayed considerable resilience in recent months, apparently in large part as a result of relatively attractive mortgage interest rates and perhaps to some extent as a consequence of favorable weather conditions in many parts of the country. Though overall housing activity remained at a high level, members reported softening activity in a few areas of the nation, notably in apartment units in some major cities. Sales of high-end houses also continued to be relatively depressed. With regard to the outlook, the recent rise in mortgage interest rates could be expected to have a retarding effect on housing activity. Even so, in the absence of seriously adverse shocks to confidence, housing activity seemed likely to hold near current levels over the quarters immediately ahead.

Business capital spending appeared to be continuing to decline at a rapid pace as business firms persisted in their efforts to bring production capacity into better alignment with forecasts for the growth of sales. With the near-term outlook for sales and profits remaining relatively depressed, the prospects for a significant pickup in spending for equipment and software did not seem favorable for the period immediately ahead. Businesses were reported to be very cautious, with many business executives awaiting concrete indications of improving markets before proceeding with planned investment expenditures. Even so, members referred to some tentative indications, such as an uptick in orders for durable goods and expectations of improving sales of some high-tech products, that might be signaling a turnaround in overall capital spending over coming quarters. Further progress in adjusting capacity and strengthening profit expectations would at some point lead to an upturn in spending for new equipment and software, but business contacts indicated that the timing for individual firms would vary considerably, with delays extending in some cases into 2003. New construction of nonresidential structures had declined sharply over the past several quarters, and with vacancy rates still rising in many key markets a further sizable decline was anticipated over the year ahead. Some members reported that higher insurance costs since the September 11 terrorist attacks were exerting an inhibiting effect on some nonresidential construction activity in their regions.

The liquidation of business inventories appeared to have accelerated in the current quarter, fostered to an important extent by very large declines in stocks of motor vehicles. Inventories now seemed to be approaching levels where firms would start to reduce their rate of liquidation early next year and perhaps turn to inventory accumulation as the year ahead progressed, giving a boost to production and incomes. Anecdotal reports provided some support for such an outlook, including widespread indications that retail inventories were already at quite lean levels, even outside the motor vehicle sector. At the same time, recent survey results pointed to less discomfort with current inventory levels though some further inventory correction was anticipated in manufacturing.

Further fiscal stimulus remained under active debate in the Congress, but with the rapid approach of the date for adjourning the current session, it was now questionable whether the legislation would be enacted this year. Although an expansionary fiscal policy was already in place as a result of earlier legislation and more stimulus might be legislated next year, especially if the economy continued to deteriorate, members saw an additional boost to near-term economic activity from new fiscal initiatives as increasingly unlikely. Some members also commented on mounting state and local government deficits, largely the result of diminishing income and sales tax receipts, and the adverse implications for governmental budgets and spending in various parts of the country.

Reflecting unusually synchronous global economic developments, foreign nations also were experiencing sluggish economic activity and in many instances actual recessions. The weakness was reflected in declining U.S. exports. Members saw little prospect that foreign economies would strengthen sufficiently on their own to provide significant independent impetus to U.S. exports, at least over the near term. Instead, an upturn in foreign economic activity would depend more on recovery in the United States.

Expectations that output would remain below the economy's potential for some time led many members to believe that underlying inflation might well edge lower from its currently modest levels. Reinforcing this outlook was recent evidence of somewhat faster than anticipated productivity growth, the prospect that world economic conditions would hold down energy prices, and a sharp drop in near-term inflation expectations of households as reported in recent surveys. Moreover, labor compensation appeared to be on a decelerating trend despite rapid increases in the cost of healthcare and other worker benefits. In these circumstances and given the persistence of highly competitive conditions in domestic and international markets, the ability of most businesses to raise prices was likely to remain quite limited or even nonexistent. While a number of members referred to the possibility of further disinflation, some also noted that the risks of a deflationary spiral seemed very limited, given the economy's self-correcting resilience and the ongoing effects of stimulative fiscal and monetary policies.

In the Committee's discussion of policy for the intermeeting period ahead, all but one member indicated their support of a proposal to ease reserve conditions slightly further, consistent with a 25 basis point reduction in the federal funds rate to a level of 1¾ percent. While there were signs that the weakness in aggregate demand might be abating, those signs were still quite limited and tentative. For now, contractionary forces continued to depress overall economic activity, and subpar economic performance seemed likely to persist, at least for a time. Moreover, a number of members saw substantial risks that economic activity could even fall short of a projection of stabilization in the near term and moderate recovery later next year. In these circumstances, the consequences of inactivity at this meeting could turn out to be considerable, and several members viewed an easing action as a measure of insurance against the potential for greater or more prolonged economic weakness than they currently anticipated. If a modest easing action taken today turned out to be unneeded, the Committee would have ample opportunity to reverse its action without incurring any real risk of allowing inflationary pressures to gather momentum, given the projected degree of slack in resource use and the current absence of significant inflationary pressures. The risk that a policy reversal, should it prove to be needed in the near term, would foster significant market unsettlement seemed limited in light of widespread expectations of some further easing at this meeting to be followed by a policy turnaround next year.

At the same time, members emphasized that the stance of policy was already quite accommodative, that much of the effects of recent easings had yet to be felt, and that tentative signs suggested the economy and the economic outlook were beginning to stabilize. In these circumstances several saw a decision to ease as a close call, but they favored it on balance given their weighting of the possible consequences should restraining forces in the economy persist to a greater extent than they currently expected. In the view of one member, policy was already sufficiently stimulative and the outlook improved enough to warrant a pause to assess further developments. In any event, members commented that the Committee's easing cycle was likely to be approaching its completion, and several suggested the desirability of signaling that view to the public.

Given their views about the risks to the economy, the members supported the retention of the sentence in the press statement to be released shortly after this meeting indicating that the risks continued to be weighted mainly toward conditions that could foster economic weakness in the foreseeable future. Such a statement was not intended to convey the impression that the Committee necessarily contemplated further easing actions. Members felt that the reduced size of today's action along with a reference in the statement to the emergence of signs that weakness in the economy could be moderating would tend to mitigate such an interpretation.

At the conclusion of this discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 1¾ percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Votes for this action: Messrs. Greenspan, and McDonough, Ms. Bies, Messrs. Ferguson, Gramlich, Meyer, Ms. Minehan, Messrs. Moskow, Olson, and Poole. Votes against this action: Mr. Hoenig. Absent and not voting: Mr. Kelley.

Mr. Hoenig dissented because he preferred to leave the federal funds rate unchanged. He judged that a 2 percent federal funds rate was already quite stimulative and that a more stimulative policy was not needed. Following the rapid and aggressive policy actions already taken, it would be prudent to give the current policy more time to work through the economy. It was also his position that reducing the federal funds rate at this meeting could increase interest rate volatility by creating an expectation of a faster or a more aggressive reversal of policy.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, January 29–30, 2002.

The meeting adjourned at 1:20 p.m.

Donald L. Kohn
Secretary

Litigation

During 2001 the Board of Governors was a party in seven lawsuits or appeals filed that year and was a party in thirteen other cases pending from previous years, for a total of twenty cases; in 2000, the Board had been a party in a total of twenty-seven cases. None of the lawsuits or appeals filed in 2001 raised questions under the Bank Holding Company Act. As of December 31, 2001, eight cases were pending.

Judicial Review of Board Orders under the Bank Holding Company Act

Dime Bancorp, Inc. v. Board of Governors, No. 00-4249 (2nd Circuit, filed December 11, 2000), was a petition for review of a Board order dated September 27, 2000, approving the applications of North Fork Bancorporation, Inc., Melville, New York, to acquire control of Dime Bancorp, Inc., and to thereby acquire its wholly owned subsidiary, The Dime Savings Bank of New York, FSB, both of New York, New York (86 *Federal Reserve Bulletin* 767). The petition was dismissed on the parties' stipulation on July 23, 2001.

Litigation under the Financial Institutions Supervisory Act

Board of Governors v. Pharaon, No. 91-CIV-6250 (S.D. New York, filed September 17, 1991), was an action brought to recover assets of an individual subject to a civil money penalty imposed by the Board. The case was remanded from the U.S. Court of Appeals for the Second Circuit for determination of the penalty amount following the court of appeals's determination requiring a 10 percent surcharge and prejudgment interest on the penalty imposed. On January 29, 2001, the court approved a settlement and terminated the action.

Litigation under the Gramm–Leach–Bliley Act

Trans Union LLC v. Federal Trade Commission, et al., No. 01-5202 (D.C. Circuit, filed June 4, 2001), is an appeal of a district court order upholding challenged provisions of an interagency rule regarding Privacy of Consumer Financial Information (145 F. Supp. 2d 6, April 30, 2001). The action was consolidated with *Individual Reference Services Group, Inc., v. Board of Governors,* No. 01-5175 (D.C. Circuit, filed May 25, 2001), *Reed Elsevier, Inc. v. Board of Governors,* No. 00-1289 (D.C. Circuit, filed June 30, 2000), and related petitions for review filed against other federal agencies challenging the same rules. On August 1, 2001, all appeals and petitions other than *Trans Union LLC* were dismissed on the motion of the appellants and petitioners.

Other Actions

Community Bank & Trust v. United States, No. 01-571C (Court of Federal Claims, filed October 3, 2001), is an action challenging on constitutional grounds the failure to pay interest on reserve accounts held at Federal Reserve Banks.

Emran v. Greenspan, No. 1:01CV1992 (D. District of Columbia, filed September 20, 2001), was an employment discrimination claim. On December 21, 2001, the case was dismissed by stipulation of the parties.

Laredo National Bancshares, Inc. v. Whalen v. Board of Governors, No. 01-CV-134 (S.D. Texas, removed on September 5, 2001, from Webb County, Texas, district court), is a third-party petition seeking indemnification or contribution from the Board in connection with a claim asserted against defendant Whalen alleging tortious interference with a contract.

Radfar v. United States, No. 1:01CV1292 (D. District of Columbia, filed June 11, 2001), is an action under the Federal Tort Claims Act for injury on Board premises.

Howe v. Bank for International Settlements, No. 00CV12485 RCL (D. Massachusetts, filed December 7, 2000), is an action seeking damages in connection with gold market activities and the repurchase by the Bank for International Settlements of its privately owned shares.

Barnes v. Reno, No. 1:00CV02900 (D. District of Columbia, filed December 4, 2000), was a civil rights action. On June 13, 2001, the district court dismissed the action.

Guerrero v. United States, No. 99-6771 (E.D. California, service effected November 21, 2000), was a suit brought by a prisoner. On October 30, 2001, the district court dismissed the action.

El Bey v. United States, No. 00-5293 (D.C. Circuit, filed August 31, 2000), was an appeal of a district court order dismissing a pro se action against the Federal Reserve and other defendants as lacking an arguable basis in law. On January 11, 2001, the court dismissed the appeal.

Sedgwick v. Board of Governors, No. 00-16525 (9th Circuit, filed August 16, 2000), was an appeal of the district court's dismissal of an action under the Federal Tort Claims Act alleging violation of bank supervision requirements. On May 31, 2001, the court of appeals affirmed the district court judgment. A petition for *certiorari* (No. 01-5654, filed August 6, 2001) was denied by the U.S. Supreme Court on October 1, 2001.

Bettersworth v. Board of Governors, No. 00-50262 (5th Circuit, filed April 14, 2000), was an appeal of the district court's dismissal of appellant's Privacy Act claims. On April 12, 2001, the court denied the petition for review. A petition for *certiorari* (No. 01-444, filed September 10, 2001) was denied by the U.S. Supreme Court on November 13, 2001.

Albrecht v. Board of Governors, No. 00-CV-317 (CKK) (D. District of Columbia, filed February 18, 2000), is an action challenging the method of funding of the retirement plan for certain Board employees.

Artis v. Greenspan, No. 1:99CV02073 (EGS) (D. District of Columbia, filed August 3, 1999), is an employment discrimination action. An identical action, No. 1:00CV0400 (filed February 22, 2001), was consolidated with this action.

Nelson v. Greenspan, No. 1:99CV00215 (EGS) (D. District of Columbia, filed January 28, 1999), was an employment discrimination complaint. On August 15, 2001, the court granted the Board's motion for summary judgment and dismissed the case.

In *Fraternal Order of Police v. Board of Governors,* No. 98-3116 (D. District of Columbia, filed December 22, 1998), plaintiff seeks a declaratory judgment regarding the Board's labor policy governing Federal Reserve Banks. ▪