

**Meeting of the Federal Open Market Committee  
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. Broadus, Guynn, and Parry, Presidents of the Federal Reserve  
Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist  
Mr. Bernard, Deputy Secretary  
Ms. Fox, Assistant Secretary  
Mr. 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

Transcript of Federal Open Market Committee Meeting of  
October 2, 2001

CHAIRMAN GREENSPAN. Good morning, everyone. Would somebody like to move approval of the minutes of August 21<sup>st</sup>?

VICE CHAIRMAN MCDONOUGH. So move, Mr. Chairman

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

MR. KOS. Thank you, Mr. Chairman. I'll be referring to the charts with the salmon cover that were distributed to you.<sup>1</sup> I will break up my remarks into two parts. First, I will talk about general market developments, especially since September 11<sup>th</sup>, and then I'll say a little about our operations in the aftermath of the attacks.

The first chart shows short-term deposit rates for the United States, the euro area, and Japan. U.S. short-term rates continued to decline during the intermeeting period. Both cash and forward rates had been declining even before September 11<sup>th</sup>, and the fall in those rates accelerated in the days following. Cash rates declined after the Committee's September 17<sup>th</sup> reduction in the target fed funds rate, though the 9-month forward rate barely moved, apparently reflecting the lingering expectation among some market participants that rates will be reversing course some time next year.

As shown in the middle panel, euro-area rates followed a similar pattern of heading downward gradually even before September 11<sup>th</sup>. And on September 17<sup>th</sup> the ECB reduced rates by 50 basis points several hours after the FOMC's policy announcement. The Bank of Canada, the Swiss National Bank, and several other central banks cut their rates as well.

As you can see in the bottom panel, Japanese rates continued to scrape along near zero. Late on September 17<sup>th</sup> our time, early on the 18<sup>th</sup> in Tokyo, the Bank of Japan (BOJ) announced another so-called easing of policy when it stated that its current account balances would be targeted at *above* 6 trillion yen as opposed to the 6 trillion target it had indicated previously. In the days that followed, that balance grew and by the last days of the quarter it rose to more than 12 trillion yen. By today, it had eased a bit to 10.3 trillion yen, still significantly above the earlier 6 trillion target. Interestingly, forward rates actually

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<sup>1</sup> Copies of the charts are reproduced in the Appendix.

ticked up a bit and the Japanese government bond (JGB) yield curve was little changed after the announcement, suggesting to some that the BOJ's tweaks in the past few months had ceased to have an impact on rates beyond the very short end of the coupon curve.

The top panel on page 2 graphs the 2-year, 10-year, and 30-year Treasury yields along with the target fed funds rate since August 1<sup>st</sup>. Two-year rates declined, beneficiaries of policy easing, a weak equity market, and general risk aversion. The curve steepened to 255 basis points from about 165 basis points at the time of the last meeting. The 10-year yield declined 32 basis points, while the 30-year fell a more modest 6 basis points. Some market participants explained the restrained move in 30-year yields as reflecting nascent inflationary risks, while others attributed the price action to the canceled September buybacks and the generally revised fiscal stance that would lead to far higher Treasury supplies than had been anticipated previously.

The steepening trend observed in the U. S. Treasury yield curve has also been seen in yields abroad, as reflected in the middle panel. The 2- to 10-year Bund spread moved almost in lockstep with movements in our curve. And even the Japanese 2- to 10-year spread steepened ever so slightly, primarily due to a shift in the 10-year JGB yield.

In the bottom panel we observe that in some segments of the bond markets the reaction has varied. Spreads in the investment grade sector--not seen here--have largely been stable. And in the case of agencies and swaps, the spreads have actually declined slightly. But spreads on riskier paper have widened. The EMBI+ spread and the Merrill Lynch high-yield spread both widened after the 11<sup>th</sup>. These high-yield spreads hit levels last seen on January 2<sup>nd</sup>, the day before the FOMC's first easing move in the cycle. Trading turnover in emerging markets and on high-yield paper decreased after the attacks. And liquidity conditions deteriorated and have not yet recovered to normal levels.

The three graphs on the next page depict the percentage change in various equity indices for the third quarter. The U.S. indices are shown in the top panel, major foreign indices in the middle panel, and a representative sample of emerging market equity indices in the bottom panel. Most indices declined between 15 and 30 percent and nearly all had fallen substantially even before September 11<sup>th</sup>, adjusting to downwardly revised growth and profit forecasts. Stocks of less established companies fared worse than more seasoned companies. In the United States the percentage decline in the

NASDAQ was almost double the fall of the Dow and the S&P. Internationally, emerging markets indices on balance fell somewhat more than markets in more developed countries.

Turning to page 4 and the major currencies in foreign exchange markets, the dollar actually was little changed as measured by most trade-weighted indices, but showed considerable variation in bilateral rates. In general, risk aversion was reflected in the appreciation of the Swiss franc and the yen, in part because of perceptions about their value as safe havens, and probably more importantly as yen- and Swiss franc-funded carry trades were unwound. On the other hand, currencies of countries with large commodity sectors, such as the Australian dollar, the Canadian dollar, and the New Zealand dollar, depreciated to near their all-time lows, as did the currencies of countries such as Brazil, which have large external financing requirements. While the downgrade in U.S. growth has probably reduced expected risk-adjusted returns on dollar assets, the contemporaneous downgrade of overseas prospects may have offset those adverse effects on the dollar.

Turning to the middle panel, the yen had been appreciating against the dollar since early August. With the retrenchment of risk appetites, yen-funded carry trades were unwound and Japanese investors were reportedly repatriating funds before their quarter-end. With the sustained upward pressure on the yen, the Japanese monetary authorities intervened on September 17<sup>th</sup> and continued to intervene in large amounts through this past Friday, the end of the Japanese fiscal half-year. In all, the Japanese monetary authorities purchased \$26.7 billion and 600 million euros, which the ECB acquired as agent of behalf of the Bank of Japan. The aggregate dollar purchases included \$200 million which the Desk acquired as agent for the Japanese on September 27<sup>th</sup>. Within the foreign exchange market, a major topic of discussion among traders is whether the Ministry of Finance's intervention was intended as a bridge to get Japanese financial institutions through the fiscal half-year-end on September 30<sup>th</sup> or whether the intervention will persist. If the latter, that would be taken as a signal of a renewed attempt to jump-start the export sector.

As the bottom panel shows, all of the euro's recent depreciation occurred in early August. Since mid-August, the euro has traded in a narrow range. The currency is perceived as neither a safe haven nor an asset associated with an economic area that has higher growth prospects than the United States. Therefore, asset returns are expected to be no better and no worse than what will be available in the United States.

Turning to the next page, the terrorist attacks triggered an increase in both observed and implied volatility in most markets, and these graphs show the volatility of a sample of major asset price relationships. The top panel depicts implied volatility on one-month euro-dollar and dollar-yen options. Both rose sharply on the 11<sup>th</sup> and hit highs of about 14-1/2 percent on September 17<sup>th</sup>, the day that the Committee and other central banks eased policy, but declined in subsequent days. These volatility levels, though sharply higher than the volatility levels of 10 percent or so in early July, are modest by historical standards. In 1998 the volatility of dollar-yen options reached a high of nearly 28 percent.

The middle panel graphs the implied volatility of the December Eurodollar contract and the bottom panel graphs the volatility of the S&P 100, also known as the VIX. Both volatility levels roughly doubled from their levels in late August and both reached highs that exceeded slightly the highs observed during the 1998 crisis. In the case of the December Eurodollar contract, the implied volatility exceeded the 1998 high by quite a bit. While the VIX index has declined somewhat from its recent highs, its implied volatility and that of the Eurodollar contract both remained at elevated levels.

Turning to the next page, the top panel depicts total Federal Reserve balances day by day since the last FOMC meeting. With the disruptions caused by the attacks, the combination of discount window loans, open market operations, plus autonomous factors sharply increased balances to as high as \$121 billion on September 13<sup>th</sup>. Despite the apparent flushness of markets, even allowing for higher demand for excess reserves, this was deceiving.

The inset in the top panel shows balances, both borrowed and nonborrowed, for the entire banking system for the five days starting on September 11<sup>th</sup>. The green bar in the inset shows the end-of-day balances of the Federal Reserve Bank of New York, which was having problems with its clearing and settlement system. On September 12<sup>th</sup>, the entire banking system held about \$63 billion of reserves before borrowing.

before discount window borrowing and overdrafts. Distribution of reserves continued to be a problem until the afternoon of the 14<sup>th</sup> when the Federal Reserve Bank of New York began to make progress in clearing its backlog of transactions. By early the following week, we began to work down balances as they started to be distributed more efficiently.

The bottom panel depicts the fed funds rate in the intermeeting period. The green line is the target fed funds rate. The red dots mark the effective fed funds rate on each day, and the vertical line shows the high-low range for each day. With four of the five major funds brokers incapacitated by the attacks, banks largely traded directly with each other rather than through brokers and they did so at the target of 3-1/2 percent in something of a “gentlemen’s agreement.” This pattern persisted until late Thursday, September 13<sup>th</sup>, when the weight of reserves in the system first began to show through and the funds rate traded below its target. This pattern of low rates, especially in later trading, continued in the period after the FOMC’s intermeeting easing action on September 17<sup>th</sup>, particularly in light of the Committee’s statement noting that the funds rate might occasionally trade below its target. By the 19<sup>th</sup> the Desk began to manage its operations with an eye toward restoring a sense of normalcy in the money market, which had begun to take rates below 2 percent and even 1 percent for granted. Thus we began to nudge the market back toward the target. In doing so the Desk continued to balance that objective against the desire to respond to the financing needs of dealers, but by that time dealers were not experiencing much trouble getting their funding done through their normal sources.

On page 7, the top panel shows three key autonomous factors that affected reserves during the period. The grounding of air traffic created an immediate spike in float to about \$47 billion on September 13<sup>th</sup>. The ECB’s three swap drawings added almost \$20 billion at their peak. Those two factors added more than \$60 billion of reserves on that day. Meanwhile, a near doubling of the repo pool drained reserves. On balance, these factors added reserves during the first few days of the crisis and thus reduced what might have been even more traffic at the discount window on several days. By the week of September 17<sup>th</sup> float declined and the foreign exchange swaps matured but the repo pool remained elevated, in part because of the large number of fails in the securities markets, and that was leaving central banks with extra cash at the end of the day. There was also an apparent desire for higher levels of liquidity, and in the case of Japan’s Ministry of Finance the need to invest large amounts of intervention proceeds.

The middle panel depicts the mix of overnight and term repurchase agreements used to manage reserves. We had no operations on September 11<sup>th</sup>. At first we relied on overnight RPs to add liquidity and allowed several long-term RPs to mature without replacement. When markets started working better, we increased the level of long-term RPs to help meet underlying needs.

The bottom panel shows for short-term RPs the level of accepted propositions in red and the level of rejected propositions in blue. Normally, dealers submit a large number of propositions of which we accept a relatively small amount. For four business days, from the 12<sup>th</sup> through the 17<sup>th</sup>, our operations were driven by the demand for financing rather than by reserve levels associated with a given funds rate. To better meet these demands, we operated later in the day than normal, after dealers had an opportunity to assess their financing needs. Then for a couple of days, on September 18<sup>th</sup> and 19<sup>th</sup>, we accepted virtually all dealer propositions on our overnight RPs. This was done not so much directly to meet their demands but to provide the level of reserves that was needed given that autonomous factors, especially the repo pool, were draining reserves. After we arranged several long-term RPs that settled on the 20<sup>th</sup>, the volume of our short-term RPs declined and the volume of accepted propositions was just a fraction of total propositions.

Turning to the last page, I want to give you a quick update on our securities lending operations during the intermeeting period. On a normal day, the Desk lends out a handful of securities from SOMA-- normally totaling less than \$2 billion and frequently less than \$500 million. With the disruptions caused by the attacks, not only to the Bank of New York but to several major inter-dealer brokers and some large dealers themselves, the number of fails rose dramatically. With the flow of securities from usual sources disrupted or scaled back, demand for SOMA securities rose despite our rather high pricing structure. We lent out about \$10 billion on September 11<sup>th</sup>, representing 70 different issues, and smaller though still high amounts in the days following. Volumes rose again last week in the run-up to the quarter-end and remained high yesterday. Fails began to rise last week for the 2-, 5-, and 10-year on-the-run securities for reasons that are not fully clear. The dollar volume of our lending increased beyond \$10 billion, although the number of issues was less than on the 11<sup>th</sup>, again because the number of fails was concentrated in the small numbers of on-the-run issues.

I want to make one final observation. On September 19<sup>th</sup>, the very small volume of lending did not imply tranquility on that day. With the funds rate trading soft, the rate for general collateral fell below 1 percent in the repo market. Since the Committee's authorization permits us to lend securities at a minimum of 1 percent, the formula implied a negative financing rate. Hence it was cheaper for dealers to fail and pay the near zero fails rate than to borrow from the Desk, pay our higher price, and complete settlement. In reviewing the securities lending facility in coming months, one aspect that we plan to study is the pricing structure. In a low interest rate

environment, the general collateral rate could be susceptible to occasional declines below 1 percent, thus making it difficult for our securities lending program to meet its objectives.

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

CHAIRMAN GREENSPAN. First, let me say that despite the tensions you were under, you make it sound very simple. And I applaud both what you did and making it simple. When will you get data on lending volume for October 1<sup>st</sup>?

MR. KOS. Securities lending volume?

CHAIRMAN GREENSPAN. Yes.

MR. KOS. We did a bit over \$10 billion yesterday.

CHAIRMAN GREENSPAN. In other words, the volume was essentially unchanged from September 28<sup>th</sup>?

MR. KOS. That's right. Apparently the volume of fails is still at a very high level.

CHAIRMAN GREENSPAN. But you still don't know fully why that is occurring?

MR. KOS. There are almost as many explanations as there are market participants. It is an issue that the market is struggling with, though. But they're still--

CHAIRMAN GREENSPAN. As a working hypothesis, assume they're all correct! [Laughter] Further questions for Dino?

MR. POOLE. I'd like to move the ratification of the operations. But I would also suggest that the Committee add to that a sense of gratitude to those at the Desk for the way they handled such a very, very complicated and difficult situation. And, of

course, the Desk itself was working in difficult circumstances with the relocation of its offices and all the upset that involved. So I think it was a fantastic performance and I believe the Committee should reflect that view in its vote to ratify the Desk operations.

CHAIRMAN GREENSPAN. I'm sure your suggestion will meet with no objection from your FOMC colleagues. Further questions? Yes, President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. I also thought that the Desk performed extraordinarily. No matter what kinds of contingency scenarios one might have envisioned, this was way beyond what anyone would have imagined. So the Desk's performance really was remarkable.

I was studying Charts 6, 7, and 8, especially in light of the FOMC's statement that the funds rate might trade below its target for a while, which you mentioned, Dino. It is clearly evident on Chart 6 that for four trading days you did let that happen. But I can interpret the chart as saying that after about four days you pretty much returned to operating in the way you normally do on a daily basis, letting the funds rate be both a floor and a ceiling. Part of my question is: Is that a fair characterization? Also, I'd like to ask you to say a little more about the way you conduct daily operations in terms of factors supplying and absorbing reserves. What led you to the conclusion that it would not continue to be appropriate to allow the funds rate to trade below its target? The reason I raise that is because in periods of heightened anxiety, liquidity preference, risk aversion, or other characterizations of these reactions we can't really observe, it would be very hard to know where an equilibrium is. The question really is: How comfortable were you in starting to view the target funds rate as a floor in that environment?

MR. KOS. In answering, let me try to package those questions together. I don't think we viewed the target funds rate as a floor. What we were trying to do was return to some sense of normalcy in the functioning of the market. The low rate itself was creating problems. There were problems for investors. For example, money market funds had trouble investing money; there were complaints from investors who could not get banks to take their money. These and other problems were being created by the very low funds rate and those issues had to be considered. What we also tried to do was to leave the market with enough liquidity, but there was a sense that if the rate remained too low for too long, some of these unintended adverse affects would continue.

If you look at the bottom of page 7, you can see that for several days beyond September 17<sup>th</sup> we were basically accepting all the propositions that the dealers were giving us. We were trying to respond to the financing demands from the dealers. And even in the subsequent period, once we got past the 19<sup>th</sup> and 20<sup>th</sup> or so, there were days when we tried to respond to the financing needs of the dealers even though it wasn't necessary for reserve purposes. One of the ways we did that was by having the Treasury increase its balance. That way we could respond by providing the dealers with more financing than might have been dictated by the numbers. So my message is that we really did not view the funds target as a floor. A lot of the trading was below the target rate but there were days, especially in the mornings, when the rate was firm. That often reflected efforts by European banks in particular to get their financing done early in the day. So we got a pattern with the rate firm in early-day activity and lower in reduced trading at the end of the day.

I don't know if I answered your questions.

MR. JORDAN. Well, that was helpful. The reason I'm raising the issue is that intuitively I think one thing that should not be allowed to happen is for the stock of central bank liquidity to decline inadvertently because of operational procedures. So I was judgmentally struggling with the data in the Board's H4.1 release for the week ending last Wednesday versus the week ending September 5<sup>th</sup>, the week before the crisis. I don't know what the seasonal factors were doing during that period--I can guess, though I don't know for sure--but to see the monetary base actually lower for the week ended last Wednesday than it was the week ended September 5<sup>th</sup> alarmed me a bit. I questioned whether that is something I would want to see happen. If heightened anxiety among other factors caused the natural equilibrium level to be very low--though I don't know where that level is--I don't think we would want to see our operating procedures result in the contraction of central bank liquidity.

MR. REINHART. Actually, I think a large part of the reason central bank liquidity contracted comes through in Dino's inset at the top of page 6, namely that intermediation wasn't functioning when four out of the five federal funds brokers were out of service. As the fed funds market became operational and those with insufficient positions could get their reserves from those with excess reserves, there wasn't a need for us to blow up our balance sheet to replace the unavailable intermediation. So I interpreted the reduction in nonborrowed reserves and the decline in the Desk's open market operations as evidence of a return of the federal funds market to more normal functioning.

MR. KOS. Yes, I think that's an important point. A large part of that market was in effect bottled up.

MR. JORDAN. Yes, and I can understand liquidity coming down from the elevated levels immediately after the attacks. But I was comparing the recent figures with those in the week before the attacks, the week ending September 5<sup>th</sup>. That week may have been atypical because it included the Labor Day weekend; I can't readily make a judgment on that. But I was looking at this in terms of wanting to be comfortable with our position going forward. We don't know what's going to happen or what the next terrorist event is going to be, but we can expect heightened anxieties, a preference for liquidity, and risk aversion. Those are all psychological factors that we really can't quantify. And we wouldn't want those things to cause us inadvertently to produce less central bank liquidity than we think is appropriate. Intuitively I think the demand for central bank liquidity has had to go up, so I am concerned to see this contraction in supply.

MR. HILTON. The other issue we were facing early in the week after the 17<sup>th</sup> was that, as a symptom that the financing markets were operating much more efficiently, the liquidity we had provided previously was beginning to have a very telling effect on financing rates and the funds rate. So when we were coming into the market in the morning, on some of those operations we were receiving propositions of below 1 percent. We continued to accept them for a while, but there was no sense of balance in the financing markets by the 18<sup>th</sup> or 19<sup>th</sup>--no sense that there was any upside risk to rates. And given the liquidity we had put in previously, market participants were really testing how low rates could go. There is no natural floor above zero. We did consciously reduce the amount we were supplying at the margin so that at least at the end of the day market participants would see that there was some risk of rates going up. We saw a little

evidence of that risk later in the week when in late trading rates reached as high as 6 or 7 percent. Since we restored that balance to market expectations, though, we have been supplying somewhat higher levels of central bank balances.

MR. JORDAN. Thank you.

MR. REINHART. I'd like to add just one other point. In establishing a reference point, President Jordan, you might want to go back one or two weeks from September 5<sup>th</sup>. Reserves are very erratic on a week-to-week basis and it looks as if from a weekly standpoint your base point is a little low relative to the previous two or three weeks.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. If I could make a comment, Mr. Chairman? President Jordan's concern, as I understand it, is that there not be some sort of central bank orthodoxy that says that the funds rate target has to be put back in place at a time when it would be inappropriate. Dino in both his presentation and in his answer to one of the questions indicated that he was being guided by the desire for a return to normalcy. That was our mantra at the Federal Reserve Bank of New York. We were dealing with a financial community in which there was an advanced degree of trauma on the part of people at trading desks and those managing firms. And there was a very strong conviction in the community that the Federal Reserve System and the New York Reserve Bank as its agent were going to do whatever was necessary to make the system function. Part of getting through a battle fatigue period is that it is necessary to return life to normal. So the Desk was under instructions that when it could conduct operations in the way it normally does, it should do so, because that gives a signal to the financial

community that life is okay again. And traumatized people need that signal. In my view it's a very important message that the Fed must continue to deliver because the trauma period is not over. Some of the firms are still operating out of temporary facilities and will do so for months. Some have suffered enormous human losses. In the case of Cantor Fitzgerald, two-thirds of the people in the firm lost their lives on September 11<sup>th</sup>. So this is not a situation where everybody will soon start to feel tranquil and okay; that won't happen for quite a long period of time. The more the Federal Reserve can say things are all right, we're functioning as we traditionally do, the better. That's a very important message to give.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Just to switch the subject a bit, Dino, you passed over the changes in the yield curve rather quickly. I'm interested in your perception of what the market is thinking about the shape of the yield curve these days and whether the outer end of the curve is a supply issue totally or if it is conveying other information.

MR. KOS. That's a good question and one that doesn't have an easy answer. In my own view, the shift is not so much an indication that people view inflationary risks as imminent or that they have very strong expectations of future inflation. I think it reflects more a concern about the fiscal side, given the talk of stimulus coming out of Congress, the cancellation of the Treasury's buyback program, and the prospect for lower federal revenues. In the New York Times or one of the major papers yesterday there was an article saying that perhaps we'll have a fiscal deficit. So the fiscal outlook has really changed. Now, the short end of the curve will tend to follow policy, or at least it has so far. But the long end is where the Treasury has been especially active with the buyback

program and that's where we might see concerns or a shift in expectations about the fiscal side.

CHAIRMAN GREENSPAN. But if it's wholly a matter of supply, can't you normalize that judgment against corporate issues? The yield spreads went up and it's very tough to make a judgment, when we see movements like that, as to whether it's a relative supply of Treasury securities vis-à-vis other securities or an aggregate supply effect. There's no way, I gather, that we can separate it out. I took a look at the TIPS data and they don't help either. The question sort of sits out there as a relatively important one because if we're looking at a supply phenomenon, the shift we've seen in the yield curve is what one would expect. There has to be some supply phenomenon involved. But whether, as President Minehan implies, an inflation premium is building up in the market is in my view an important issue for us to get a sense of.

MS. MINEHAN. Any thoughts on how to do that?

MR. KOS. I'll work on it! [Laughter]

CHAIRMAN GREENSPAN. Any further questions? I believe President Poole moved to ratify the transactions. Is there a second?

VICE CHAIRMAN MCDONOUGH. Second.

CHAIRMAN GREENSPAN. Without objection, they are approved. Thank you very much. Let's move on. We now go to the most important part of the meeting-- the most informative, illuminating, and provocative, right?

MR. STOCKTON. Well, that fits in perfectly with my introductory remarks.

CHAIRMAN GREENSPAN. I wasn't calling on you; I was calling on somebody else! [Laughter]

MR. STOCKTON. If I were to scale the length of my remarks this morning to be in proportion to my knowledge about the current state of the economy, then I think it would be fair to say that I have already spoken too long. The terrible events of September 11 have altered the political and economic landscape along so many dimensions that interpreting the data and putting together this forecast presented us with unusually daunting challenges. In particular, we were required to take strong stands on questions of psychology and politics-- considerations that are always present in constructing the forecast, but rarely with the prominence that they have achieved in the current circumstances. For that reason, I thought I could be helpful by laying out as clearly as possible how we handled some of these issues in addition to describing how we have reacted to the broader macroeconomic forces operating on the economy.

Our efforts were organized around four principal questions: How was information about economic developments prior to September 11 changing our view about the baseline forecast? How large were the economic disruptions directly associated with the attacks? To what extent and for how long would consumer and business confidence be damaged in the aftermath of these events? And, importantly, how were changes in the stock market, interest rates, and fiscal policy shaping the outlook for output and prices over the next two years?

With regard to the first question, the sharp drop in aggregate hours worked in August and the ongoing steep declines in manufacturing output suggested to us that real GDP was, at best, eking out a meager gain in the third quarter prior to the attacks. Moreover, the composition of activity was remarkably similar to that which we have observed since the spring: moderate advances in consumption and government spending offset by continued declines in equipment outlays and a further runoff of inventories. Based on developments prior to September 11, I suspect that we would have been coming back to the Committee this time with a forecast of essentially no change in real GDP, on net, in the second half of the year and a slow acceleration of activity next year.

That assessment forms the backdrop against which we had to evaluate the economic consequences of the terrorist attacks. In collecting information about the disruption of production and sales that occurred immediately following the attacks, we relied heavily on our business contacts as well as the extraordinary efforts made by research departments at the Reserve Banks to gather intelligence on activity in their Districts. Taken together, the evidence suggested that while the disruptions were pervasive and profound for business in New York, elsewhere the largest problems were concentrated in a few major sectors. Air travel was virtually shut down for several days, and many sporting

and entertainment events were cancelled or postponed. Auto production was disrupted by parts supply problems associated with the interruption of air cargo flights and by a backup of trucks on the Canadian and Mexican borders. Retailing also appears to have been seriously disrupted, though it is important to bear in mind that much of any shortfall in sales likely resulted in a buildup of retail inventories rather than an immediate curtailment of production.

Some of these effects likely were alleviated later in September, and others could well be reversed in the next couple of months. Our very rough stab at the magnitude of these effects suggests that direct disruptions are likely to have reduced growth in third-quarter GDP by about 1/2 percentage point at an annual rate, with those effects largely expected to be reversed this quarter.

As we enter the fourth quarter, the bigger question surrounds the extent to which recent events will weigh on consumer and business confidence. Readings on auto sales provided by the vehicle makers, news reports, and common sense suggest to us that consumers are likely to pull back on spending. With little to go on, we have assumed that consumer sentiment will drop considerably below levels implied by current macroeconomic circumstances--not quite so large over the next year as occurred in the aftermath of the Iraqi invasion of Kuwait, but still a significant drop by historical standards. Last Friday's report on consumer confidence from the Michigan survey points to a decline in sentiment in the final week of the month that is roughly consistent with our expected pattern.

We also examined how large shocks to sentiment play out over time and how they are correlated with other components of spending, and we adjusted our forecast accordingly. Going forward, we have the effects of this shock reducing the growth of real GDP by about 1-1/4 percentage points at an annual rate in the fourth quarter and by about 3/4 percentage point, on average, in 2002. Because there simply has been no other episode that closely matches the present one, it is very difficult for us to gauge the reasonableness of our assumption. Given that uncertainty, we considered a deeper shock to sentiment--one that roughly equals in size that which occurred after the invasion of Kuwait. A shock of that magnitude produces something resembling a more typical recession. But to be perfectly frank, there is no compelling reason to think that the shock couldn't be twice the size of the one associated with the invasion of Kuwait, or for that matter, something considerably smaller than we have assumed. Moreover, we can't predict how political, military, or terrorist actions could unfold in coming months or their potential influence on confidence and economic behavior. Obviously, we had to make some big assumptions on skimpy

evidence, and those assumptions have had important implications for the forecast.

Not all of the developments that have occurred since the last meeting are immune to more conventional economic analysis. With all of the understandable focus on the recent tragic events, one could be forgiven for overlooking some significant shifts that have occurred in monetary and fiscal policy. In our forecast, the federal funds rate is 125 basis points lower over the next year than was incorporated in our August projection. Taken by itself, a change in short-term rates of that dimension could be expected to generate considerable impetus to aggregate demand down the road. But, of course, this change cannot be taken by itself. The sharp drop in the stock market and the widening of risk spreads in the bond market to date have substantially blunted the stimulus from lower short-term rates. Indeed, as you know from reading the Bluebook, some estimates of the equilibrium funds rate have fallen almost as much as the actual funds rate. We still view the funds rate as having fallen below its equilibrium, and thus see the current setting of policy as capable of restoring a period of above-trend growth over time. But the near-term shock implies that the adjustment will take longer and start with a greater shortfall of activity from potential than we had previously projected.

I should hasten to add that it is important not to view these changes in financial developments in isolation. No doubt, some of the firmness in long-term rates in recent weeks reflects an expectation of a substantially more expansionary fiscal policy, which is poised to add more impetus to activity over the next year than we projected in August. We have incorporated in this forecast about \$52 billion of policy initiatives for fiscal 2002 and \$76 billion of initiatives in fiscal 2003, relative to a current services baseline. The figure for fiscal 2002 is roughly \$30 billion more than in our August forecast. In addition to the emergency supplemental and airline assistance packages already passed by Congress, we have assumed nearly \$20 billion more in spending on education and FEMA, an extension of unemployment insurance benefits that costs about \$10 billion, and a fiscal stimulus package that ramps up to about \$22 billion by fiscal 2003. To put the size of the total package in a cyclical context, the fiscal stimulus delivered over the next eight quarters is only exceeded, and just a bit, by the combination of tax cuts and increases in defense spending that occurred early in the Reagan administration.

Still, on our assumptions, the unified budget surplus is \$70 billion in fiscal 2002 and nearly \$40 billion in fiscal 2003. With money left on the table and an emerging bipartisan consensus for greater stimulus, we believe that the balance of risks to our fiscal assumptions is on the

upside. For that reason, we included in the Greenbook a simulation having enough additional stimulus to virtually eliminate the unified surplus over the next two years. Such actions would likely produce a faster turnaround in the growth of activity and trim the rise in the unemployment rate; an adverse reaction of the bond market would damp, but not eliminate, those effects.

While we view fiscal policy as an upside risk to our forecast, there also are some very prominent downside risks that are likely to be especially acute in the next couple of quarters. An event such as occurred on September 11 could act as a clear focal point that causes already skittish consumers and businesses to pull back simultaneously on spending plans. Those actions and their feedback on the economy would raise significantly the probability of a sharp reduction in aggregate activity. I would also note that even if we do not see immediate signs that such a contraction is under way, that risk will not have receded completely. Iraq invaded Kuwait in early August, but the steep cutbacks in aggregate output did not really commence until October.

If I had to net the various risks to real activity in this forecast, I would focus more on the downside risks in the near term and the upside risks farther out. The near-term forces of contraction could be substantial, but so too could be the medium-term stimulus from monetary and fiscal policy.

Let me conclude with a few words about inflation. In an environment of increasing slack in labor and product markets and declining energy prices, we expect measures of both total and core consumer price inflation to decline over the next two years. It might appear surprising that the disinflation in this forecast is as modest as it is, given the degree of slack expected to emerge in coming months. But in our view, there are a few reasons for being cautious in marking down the outlook for prices. We have built in a sharp deceleration in wages; our forecast of the increase in ECI wages drops from about 4 percent this year to 2-3/4 percent in 2003. However, because there are few signs of any slowing of health insurance costs, the deceleration in overall benefit costs is likely to be noticeably less than that of wages. Although benefit costs may well be offset by reduced wage gains in the long run, the frequency with which business people complain about health insurance costs suggests that this shifting is not likely to be immediate or painless.

The effects of the slowing in compensation costs also show through to a lesser extent on prices because of the slower pace of structural productivity growth that we are expecting over the next

couple of years. Moreover, with business margins having been eroded in recent years, there is less scope for firms to absorb cost pressures in margins. All in all, these considerations lead us to expect less disinflation over the next two years than might be inferred from our forecast of resource utilization alone.

Karen Johnson will now continue our presentation.

MS. JOHNSON. In trying to come to grips with the implications of recent events for the forecast, we were confident that we knew in which direction to revise foreign growth as a result of information learned since the August Greenbook: down. But it was much less clear to us how to assess the magnitude of that revision for individual foreign countries and for foreign growth on average.

Our downward revision to the forecast for foreign growth has three components: (1) incorporation of the news about economic activity in the second quarter and some indicators for July and August that have become available since the August forecast was completed; (2) assessment of the implications for foreign economies of the new outlook for the United States; and (3) consideration of the extent to which the events of September 11, through asset prices, confidence factors, and key global prices and industries, will influence real output growth abroad in addition to the direct impact transmitted by U.S. demand for imports from the rest of the world. The difficulties we confronted stemmed from our lack of information about real economic activity in the days since September 11 and the inherent uncertainty of prospective effects in the rest of the world as foreign consumers and business firms react to events that, at least so far, have occurred within the United States.

As we reported in the Greenbook, the economic data that had become available in recent weeks suggested a more depressed global economy than we had expected. This was particularly the case for the emerging Asian economies. There, the news was most negative for those whose exports of high-tech products were linked to investment spending in the United States and in other industrial countries. However, there were disappointing data for other countries, including such industrial countries as Canada and Japan. Incorporation of this information accounts for a significant share of our downward revision to foreign growth.

As has been evident in the global slowdown to date, a substantially weaker outlook for U.S. real GDP has clear implications, in the same direction, for real output growth abroad. Those effects are largest for our principal trading partners, such as Canada and Mexico.

However, for other regions of the globe, such as Europe, the consequences of second and third round effects through multilateral trading relationships are far from negligible. Should we be further surprised by developments in the U.S. economy, either positively or negatively, there would be a significant reinforcement of that surprise as output in foreign economies responded to the changed demand from the United States.

My third category of factors includes the host of reactions within the foreign countries and in global markets to the events of September 11. We have seen net declines in stock markets abroad as large as 18 percent. Our research and that of others suggest that the effect on consumption of such changes in wealth will not be as large abroad as in the United States, but the reaction will be significant. Similarly, we expect that confidence of consumers and businesses will be impaired by varying degrees across the rest of the world. We have a few bits of partial information from surveys that included responses after September 11 that confirm substantial drops in confidence. The latest Japanese Tankan survey, released on Monday, fell more than expected to its lowest level since June 1999 for the overall index. At this point, we can only guess how widespread the reaction of confidence abroad will be, how long it will persist, and how much it will contribute to lessening domestic demand in foreign countries.

We also have incorporated into this forecast available information from global markets. With respect to oil prices, the spot price of WTI has moved down, on balance, more than 15 percent since September 10, and futures prices call for it to move down slightly further. Market participants seem to be anticipating that reduced global demand for oil will be met by only limited supply cuts by OPEC. The recent international meeting of oil producers ended with no agreed reductions in production quotas despite the fact that spot prices were below the target range for OPEC's basket.

The global market for high-tech products in general, and semiconductors in particular, is an important element behind our projections for the emerging Asian economies. Weakness in this sector underlies the significantly greater-than-expected declines in output that were recorded in the second quarter in Malaysia, Singapore, and Taiwan. We have little hard information about inventories or production beyond August. Our projection that output in the region will recover next year depends upon some improvement in this sector.

We asked ourselves in which foreign countries scope might exist for additional policy response to the further downward pressure on demand. Among the industrial countries, monetary policy has been

broadly eased during the first half of this year, and eight major foreign central banks cut rates further following your action on September 17. Our forecast assumes that additional easing moves will be taken in Europe and Canada by year-end. Some emerging market central banks had been easing as well, as the global economy slowed and demand weakened within their economies. However, we expect that external financing pressures will likely intensify, in particular for Latin American countries with external deficits, making it less likely that monetary easing will be enacted there.

Within Europe and in Canada, fiscal policy should be somewhat supportive of growth in 2002 as tax revenues fall and deficits widen; we do not expect significant discretionary easing measures. In Japan, however, the long-standing problems within that economy and the agenda of the Koizumi government to implement fiscal reform are expected to result in moderate fiscal contraction during next year. Most emerging market economies have little scope to increase expenditures or cut taxes. One important exception is China, where continued government spending is expected to support growth during the second half of this year and next year. Other East Asian developing countries announced some fiscal stimulus measures earlier this year.

The downside risks to this forecast are distressingly clear. The hit to confidence from the terrorist attacks, coming at a time when output abroad was already decelerating, could set off a mutually reinforcing cycle of production and employment cuts, downward earnings revisions, lower asset prices, and additional drops in confidence. Our expectation of a rebound next year is based primarily on the projected turnaround in the United States, recognition that monetary stimulus has been implemented in the major countries, and our judgment that inventory adjustments abroad should be nearing completion by then. There is no evidence as yet on which to base resolution of the timing and pace of recovery.

That said, we may be too close to the events of September 11 to judge how countries more distant from those events will respond. We were aggressive in our reaction to the economic data and world news since the August Greenbook. It is possible that the effects of the attacks on growth abroad will be even more muted in comparison to that in the United States than we have projected. The possibility of such an outcome constitutes upside risk to our forecast.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. I wanted to ask you, David, about the psychology question, to use your term. One of the keys to the forecast obviously is consumer sentiment and consumer spending. I realize it's very hard to judge, but I would have thought that consumer sentiment now would be as bad if not worse than in the 1990-91 period following the Iraqi invasion of Kuwait. Then we had a fear of terrorism on our soil; now obviously it's a reality. Of course, you've dealt with a collapse in consumer and business sentiment in one of the alternative Greenbook scenarios, but I wondered why you didn't use that as the baseline. Do you have any other comments on how to compare these two periods in terms of consumer sentiment?

MR. STOCKTON. I hope I made clear that I didn't think the probabilities of our assumptions were significantly higher than the probabilities of a lot of others that could be made. Obviously, we thought long and hard about exactly how much of a sentiment effect to build in. I think the reason we ended up going with something less than what occurred after the Iraqi invasion of Kuwait was that that shock was also accompanied by a very distinct economic shock through much, much higher oil prices. And if one thinks back to that time, there were certainly enormous fears about how long and deep a military commitment we might be making in the Middle East. It's easy in retrospect to look back and recall that the military action went very well and was over so quickly. It's a little hard to put oneself back in the perspective at the time, when the initial thinking was that a lot of ground troops might be needed and that it might involve a very bloody and protracted military effort before the United States could disengage. So we decided not to put in as much sentiment effect at this point and to react to the evidence as it flows in, making adjustments up or down to what we have built into the

forecast. Obviously another characteristic that is different between this event and the Iraqi invasion episode is that there was a very distinct end to the latter. And we had a very sharp recovery in sentiment once it became quite clear in February that the military engagement was going to be a relatively short and victorious effort. We have the shock fading out more slowly this time. Even though it's not as deep, it fades out more slowly than what occurred after the Iraqi invasion of Kuwait. The pattern we have in our forecast is more typical of large negative shocks to sentiment. These shocks rarely have, as the Kuwait period did, such a clear ending and such a sharp recovery. So, as I said yesterday at the Board meeting, the forecast involves a very thin veneer of science applied to a whole lot of judgment. All I can say is that you as policymakers and we as forecasters are just going to have to roll with the information as it comes in and make appropriate adjustments from there.

MR. MOSKOW. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Karen, I want to ask you to say a little more about Japan. You mentioned that after the Committee's action on September 17<sup>th</sup> eight central banks eased policy. Well, that list wouldn't include Japan because in their case there was nothing to announce in terms of a rate cut. For at least some six months now they have been talking about quantitative easing and whether they have made that real or not certainly is questionable. Then you mentioned that fiscal policy in Japan could be contractionary. I might conclude that a contractionary Japanese fiscal policy would be stimulative because they've had 10 years of pushing on the fiscal strings with no effect, unless one thinks the economy would have been worse without that. One can look at the results of what has

been done over the last decade on the fiscal side and say that the Japanese people are all Ricardian. The more the government borrows and spends, the more its people don't spend; they save, and the government's effort comes to nothing. But as Dino mentioned, last week the government did more than double the amount of current account balances from 6 trillion to 12 trillion yen. So I would think the important question for Japan is: Are they going to unwind it or are they going to continue on what seems to be quantitatively a very stimulative monetary policy?

MS. JOHNSON. Well, to be honest I did include them in the eight because they cut what they call the overnight discount rate, which is a kind of Lombard rate. Technically it's an official lending rate of the Bank of Japan and they reduced it, so I said okay, they are one of my eight. And I think they intended, both from the timing of the announcement and the way they expressed it, to indicate that they were going to do what they could along with their brother central banks to weather the storm of this particular financial crisis. They wanted to be supportive, in the sense of aiding short-term liquidity and market functioning and so forth in the immediate aftermath of the attacks.

I think this period is somewhat of a crossroads for them. I interpret the intervention that they did and their decision to let the reserves stay in the system as an opening. Perhaps they are thinking of deliberately using transactions in the exchange markets--a concept they had resisted for some time--as opposed to operations in the domestic money markets as a way of getting more liquidity out there. The combination of circumstances created an appropriate meeting of the minds between the Ministry of Finance and the Bank of Japan with regard to undertaking these transactions. They responded in the way we've all urged them to respond. I took that to be a fairly positive

sign. It remains to be seen what they will do going forward, because at least today, for example, the yen has softened and has not moved up from its low. It's possible that a lot of the pressure on the yen has had to do with the end of their fiscal half-year on September 30<sup>th</sup>. When that is taken out of the picture, I think it remains a completely open question as to whether the Bank of Japan will revert to its previous practice and say, "Well, that approach was fine then but it's not appropriate right now." I am very pessimistic that this is a truly long-lasting change in their approach, but I think what they did in the weeks since September 11<sup>th</sup> was in the right direction and they could surprise us. They could be more aggressive than they've given signs of so far.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I had a question about Japan as well. When I look at the tables in Part I of the Greenbook it seems stunning--I don't know if that's the right word--to see with the addition of the forecast for 2003 what will be five years of deflation for Japan and a pickup in economic growth that is quite modest. And, of course, we've seen those projected pickups disappear in the past. This certainly says something, I think, about the effectiveness of their policy, not just in 2001 but over the next two-plus years. It surely has some major economic implications but possibly political implications as well. I wonder if you'd comment on that.

MS. JOHNSON. Prior to September 11<sup>th</sup>, I think the people in the International Division who closely watch Japan were trying to talk themselves into being slightly more optimistic about Japan than we had been for a while, and we've been rather pessimistic all along. We were trying to see some energy in the Koizumi reform, although what the government has done since the upper house election in July

disappointed us because instead of running with the reform and building on it they seemed to be backing off and hemming and hawing. But there were some shreds of signs of things possibly not getting worse at least. It's hard to say whether September 11<sup>th</sup> will really change that for them. There are no direct implications for Japan except for the loss in export potential from the rest of the world and certainly from the United States. I think they're so bound up in their own problems that I don't have a sense--or they weren't able to tell us is a better way to put it--of whether the Tankan survey was heavily influenced by the attacks or not. A significant portion of the survey responses were received by the agency after September 11<sup>th</sup>, but they made no effort and really had no way to tell how many had been filled out after September 11<sup>th</sup>. I think we are at risk of that economy remaining moribund--sitting there more or less doing nothing for quite some time--and largely for political reasons. Now, whether that would spark a real political overturn in Japan I am certainly not the person to say. Obviously, in most other countries it would have happened long ago. So it just defies my ability to judge. Personally, I had thought Koizumi might make a difference but I think circumstances are conspiring against that at the present time.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Dave, I was intrigued by the changes in your estimates of structural productivity--1.9 percent in 2001, slowing to 1.5 percent in 2002, and picking up to 1.8 percent in 2003. I know there are close relationships between productivity, capital deepening, and business fixed investment and so forth. We've been looking backward, but suppose we look forward and make the assumption that the impetus to be

more and more productive and more focused on the cost side is still very much present in U.S. industries. If we assume that this is not as much a function of capital deepening but increasingly a function of industrial reorganization or a sheer desire to do things better and cheaper all the time, what would a slightly higher and more stable level of productivity growth do to your projections? I know you have that feedback effect into demand. I'm interested in how that might look in the 2002-2003 time frame.

MR. STOCKTON. Basically, if we were to increase the multifactor productivity portion, which is the portion that would provide all the impetus that you were talking about, we would get stronger growth in activity brought about probably by a stronger stock market than we have in the baseline forecast. That stronger growth would probably be accompanied by very little additional inflation. In essence we'd see an unwinding or a backing off of exactly the kinds of revisions that we think have occurred over the past year, as productivity came in weaker than we and others had anticipated, the stock market weakened, and demand softened significantly. As I think you've noted on a number of occasions, one sometimes needs to look through the snapshots of structural productivity that we have in this forecast. Indeed, even with this 1 percent growth in multifactor productivity, we would expect, moving beyond this period of cyclical weakness in investment spending, to see some reacceleration of underlying productivity. But that occurs beyond the horizon that we currently are forecasting. Of course, we've made big mistakes in both directions in recent years, so it certainly could be the case that things will turn out even better in the near term. Businesses may be moving more aggressively on the cost-cutting side and may in essence get us back closer to the production possibilities frontier than we have assumed here. And that would produce a

stronger economy. But because of less cost pressures, it probably would be accompanied by less upward pressure on inflation as well.

MS. MINEHAN. And slightly lower unemployment?

MR. STOCKTON. Yes, working it the way that we have told the story and the way the model sees it, we would get stronger near-term demand effects than supply effects and that would produce somewhat lower unemployment.

CHAIRMAN GREENSPAN. Further questions? If not, who would like to start the Committee discussion? President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. The tragic events of September 11<sup>th</sup> have had a profound impact on the Seventh District's people, businesses, and economy. The response in terms of the giving of time, money, and blood has been inspiring.

As for our District economy, overall activity was sluggish before the terrorist attacks. Our weak manufacturing sector appeared to be nearing the bottom of its adjustment but contacts indicated that consumer spending had softened. The District economy has clearly deteriorated since the attacks. We've seen some improvement from the near standstill conditions experienced around September 11<sup>th</sup>, but overall activity is still significantly lower than it was in August and early September. The impact on travel and tourism has been particularly dramatic. Downturns are evident not only in airline travel but across a large number of related industries such as hotels, restaurants, car rental agencies, taxi cabs, and airport concessions. Contacts at Boeing told me that many airlines now expect double-digit declines in passenger traffic during the calendar year compared with a 2 percent decline in 1991 following the Iraqi invasion of Kuwait. As a

result, Boeing expects aircraft production cuts to be roughly four times as large as the cuts in the early 1990s.

Tighter security procedures are evident everywhere, not just at airports. They are affecting business activity and likely will continue to do so for some time. For example, we heard of 12- to 18-hour delays at the U.S./Canadian entry points, which effectively reduced cross border trucking capacity by a third in the week following the attacks. If such delays continue, obviously they would have a significant impact on many of our businesses, particularly the automobile industry. But as of late last week, waiting times were reported to be very close to normal. That was one of the few good pieces of news I've heard recently.

Consumer spending has definitely slowed. The sharp 50 to 70 percent sales declines retailers experienced on the 11<sup>th</sup> have narrowed significantly on average. But some retailers continue to report double-digit declines. Controlling inventories is a major concern and order cancellations are occurring more frequently, especially for apparel. Expectations for the upcoming holiday sales season have been lowered even further and are described as poor.

Sales of autos and light trucks have also slowed considerably and the weakness in car rentals is adversely affecting fleet sales. Automakers have responded by offering interest-free financing. Reports indicate that traffic in auto showrooms has been improving only slowly since September 11<sup>th</sup> and that automakers will need to cut production schedules substantially. One contact indicated a need to eliminate three to four weeks of production.

More generally, reports from our directors and other contacts from a broad range of industries have been decidedly gloomy. Many cite anxiety and wait-and-see attitudes as restraining factors. Most are planning for the worst and hoping for the better. As a result, firms are becoming even more cautious about capital spending, and many have taken or are seriously considering taking additional steps to reduce costs and trim their workforces.

Turning to the national outlook, at our August meeting it seemed possible that the economy could avoid a recession. Consumer spending seemed to be holding up relatively well in the face of the investment-led slowdown. But a major concern was that a further drop in consumer confidence would set off a second wave of economic slowing. In view of the layoff announcements and the stock market declines following the terrorist attacks, it seems certain now that consumer spending will decelerate further. Increasing unemployment will likely diminish confidence further. Reductions in household wealth will also be a restraining factor.

The outlook for business investment continues to be poor. Reductions in business confidence and declining corporate profits will be a drag on new capital investment decisions. This may lead businesses to believe they have an even larger capital overhang than they had previously perceived. The rest of the world will not be a stimulus for U.S. growth at this point, as we've discussed. Instead, our domestic slowing will continue to be a drag on the global economy. One positive note is the lack of inflationary pressures in today's economy.

Following the events of September 11<sup>th</sup>, the environment for formulating monetary policy is much more complex. There is a series of new unknowns on which we

must make judgments, including the impact on consumer confidence and spending, adverse disruptions to the physical and financial operations of businesses, prospective fiscal stimulus, and the reaction of the financial markets. In addition, military action by the United States and any further terrorist attacks will undoubtedly have significant impacts on the economy. It will take several months just to begin assessing these challenges. In the meantime, I believe there continues to be a substantial downside risk that the current economic slowdown will unravel further.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, economic activity in the Twelfth District was weak even before the terrorist attacks. Employment contracted in July and then was nearly flat in August. On net it fell about 1 percent at an annual rate in the two months. The main source of weakness was the high-tech sector. High-tech equipment manufacturers have been shedding jobs all year and the pace of decline accelerated substantially in July and August, with cuts at double-digit rates reported in California, Arizona, and Oregon. High-tech service providers also have been cutting jobs, including the loss of over 5 percent of employment in that sector in the State of Washington during July and August alone.

The slowdown was also evident in other sectors such as construction. Vacancy rates for office space have risen substantially in most metro areas, and home sales and price appreciation have come down as well. The slowdown in construction activity so far this year is most evident in the San Francisco Bay area, where the number of permits for new homes is running 13 percent below last year's numbers. Consumer spending and confidence in the District, which had been holding up well in the spring and early

summer, showed signs of weakening in early September. Of course, these weaknesses have been exacerbated in the aftermath of the attacks.

The immediate economic effects of the attacks included substantial reductions in consumer spending and some disruptions in business activity. Since then retail sales among large discount stores have recovered, though sales at department stores have remained depressed. As a result, for some apparel manufacturers clothing orders for spring reportedly are running well below pre-attack expectations. By contrast, construction activity in recent weeks has not been affected to any appreciable degree. However, the postponement or cancellation of some projects means that the pipeline is not filling up as fast as before.

The largest negative effects of the attacks have been on air travel and tourism, as was indicated by President Moskow. Due to the resulting bleak outlook, Boeing--and I think our numbers about Boeing are similar to those presented by President Moskow--immediately cut its estimated deliveries of commercial aircraft next year by 20 percent, with substantial additional cuts expected in 2003. In Seattle as many as 20,000 jobs could be lost at Boeing by the end of next year. District contacts have reported that airline bookings have been running 50 percent or more below normal. And in cities like San Francisco, where 85 percent of the hotel demand is derived from arrivals by air, hotel occupancies are very low. As a result, substantial layoffs are under way or planned by airports, airlines, and firms in other segments of the travel industry. Although this has been felt nationwide, the impact will be especially hard on some Twelfth District states that have unusually large tourism and travel sectors, notably Nevada and Hawaii, whose tourism sectors had already begun to struggle prior to the attacks.

Let me turn to the national picture. I certainly won't take exception to the widely held view that the terrorist attacks probably ended any chance of avoiding recession. In this regard, a member of our staff has taken a careful look at the monthly indicators and methods used by the NBER to date recessions. He concludes that if, as seems likely, activity falls enough in coming months for the NBER to declare a recession, the business cycle peak could well be backdated to the first half of this year and perhaps as early as March. This date would represent a compromise among the unusually diverse peaks in the various data series that the NBER relies upon.

In any event, our forecast for the second half of this year is similar to that of the Greenbook. It shows a small decline in real GDP in the third quarter and a drop of 1/2 to 1 percent in the fourth quarter. Assuming a funds rate of 2-1/2 percent, the most likely scenario for next year seems to be a gradual pickup in growth, especially in response to the easing of monetary policy as well as recent and expected fiscal actions. However, while growth should be more acceptable, it will likely remain well below the potential rate for some time. The exceptionally large risks surrounding the outlook are skewed to the weak side, especially in view of the potential hit to confidence that would go along with likely military action and possible additional terrorism. Another risk is the deepening stagnation of economies around the globe.

We have revised down our inflation forecast by about 1/2 percent since the August meeting, obviously in response to the greater expected slack in labor and product markets and a lower path for oil prices, but also due to negative speed effects. Our best estimate is for inflation of about 1-1/2 percent in the core PCE price index in 2002. Given the economic outlook as well as its downside risks, there is a strong argument for

implementing the additional cut in the funds rate that underlies our forecast and that in the Greenbook. Thank you.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. One of the minor casualties of September 11<sup>th</sup> was our educated and informed views and knowledge regarding the state of the economy. That knowledge, such as it was, is now obsolete and there's very little with which to replace it. I agree that our economy will probably be okay in the long run once we get past this unsettling. And I'm fairly confident that the consequences in the very short term will be seriously negative. The economy was already teetering on the brink of recession and this event has surely pushed it over that brink. What I don't know is how deep and how long the recession will be--that is, the outlook for the medium term. No one can know that now because it hasn't been determined yet. The length and depth of the recession will depend more on how everyone reacts to what happened on September 11<sup>th</sup> than on the event itself. It's hard to imagine that the great uncertainty on all fronts won't cause consumers and businesses alike to withdraw from new commitments and to hunker down.

We deal here in spending and income as measured by GDP and its components, but we should not forget that we are now poorer in ways beyond any estimates of GDP measures. We will be poorer at each level of GDP than we were before September 11<sup>th</sup>. To buy a level of security at or even below what we were already used to or thought we had will require more of our scarce resources to be devoted to security. More policemen, firemen, airport security, border security, and air marshals will be needed. They will generate measured income or GDP, but their opportunity costs will be large.

We will also be poorer as a result of longer lines and longer waits at airports, sporting events, concerts, and simply getting in and out of public buildings. We will miss out on a lot of good immigrants who won't get into our country as we try to screen out the undesirable ones. We will probably have to reintroduce some redundancies and inefficiencies that had been wrung out of the economy. As Ed Yardeni put it, "just-in-time inventories may become just-in-case inventories." Backup and relocation sites that will sit idle most of the time will become more important, even essential. Much of this will contribute to GDP but will represent a downgrading of living standards. Poorer will be the workers who will have to postpone retirement because their 401ks have tanked and the potential students who will have to enter the labor force rather than college. I don't know how to add all these factors, along with the decline in the stock market, into an estimate of the size of the negative wealth effect. But I believe they will be important factors.

As to the specific impact on the Eleventh District, I don't know much beyond the obvious. Most sectors and regions have weakened. American, Continental, and Southwest Airlines are headquartered in Texas, so we will feel the decline in air travel and related industries more than most areas. Our exports, especially to Mexico and Asia, are off. The decline in energy prices will remove a local positive, thank goodness. Natural gas is back down to \$2.50 per million BTUs, half of last year's price. We probably do have some firms that will benefit from beefed up defense spending, but we should not forget that that will represent a diversion of spending and not necessarily new spending. I'm told that Texas has about 500 manufacturing firms involved in the manufacture of instruments relating to research, detection, navigation, guidance,

aeronautical and nautical systems, as well as measuring and controlling systems. We also have a significant regional presence of high-tech defense companies, such as Northrop Grumman, Raytheon, Lockheed Martin, and Bell Textron. The stock prices of the first three have risen since the market reopened. Bell Textron's has not. It is still suffering from setbacks to the Osprey--the airplane that is supposed to land and take off like a helicopter and not require airports or flat terrain. If they could just get that plane to work, I know some places with bad terrain where they might be able to use it!

As for the national economy and the policy question, I had been thinking that this year's reduction in the funds rate from 6-1/2 to 3 percent plus all the extra liquidity that has been provided would probably be enough. But the psychology of the financial markets and their fragility might require a tad more easing. I'm somewhat surprised, however, by the near unanimity in the markets that we will reduce the funds rate by another 50 basis points today. The markets seem insatiable as well as fragile! I tend to think something less would be sufficient, but it is an awkward time to disappoint the markets in an effort to reclaim the Committee's authority over monetary policy. A fed funds rate of 3 percent was the low point of the nominal rate during the '90-'91 recession. But as the staff points out, the lower inflation rate today makes the current fed funds rate about a percentage point higher in real terms. Aside from the potential consequences of disappointing the market, I believe the amount of weight that we give to that distinction between the nominal and the real rate is probably the key to today's policy decision.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Thank you, Mr. Chairman. Let me talk first about conditions as described to me by my various contacts. Because of the obvious importance of consumer

confidence, I've had four conversations with my contact at Wal-Mart since September 11<sup>th</sup> --on the 14<sup>th</sup>, 17<sup>th</sup>, 19<sup>th</sup>, and again yesterday. His overall assessment is that sales are holding up pretty well. On the Tuesday of the terrorist attacks, of course, sales at Wal-Mart were down sharply, but for the week as a whole they were just slightly below plan. As I talked with my source several more times, that was the basic message--that sales were fairly close to what had been anticipated before the day of the attacks. Some changes in buying patterns have emerged that he doesn't know completely how to explain. Wal-Mart tracks the number of sales tickets and the average amount spent per sales ticket on a same-store basis to analyze data at comparable stores. He is seeing more of a split between the volume of traffic and that of tickets than usual; that is, there's a greater increase in the number of tickets and less growth in the amount spent per ticket. But as of yesterday, the total amount spent was coming in just slightly below what Wal-Mart had anticipated before September 11<sup>th</sup>.

My contact also said that the company has done a little research with some focus groups regarding Christmas spending plans. Of the consumer groups they've talked with, the percentage of respondents who say they're going to spend less for Christmas is about the same as the typical response in their focus groups at this time of year. The percentage saying that they will be spending more, however, is down significantly. The proportion planning to spend about the same is therefore up significantly. He said--and I pressed him somewhat on this--that he felt it was much too early to make any judgment about the longer-run outlook. People are still very much in shock in terms of adjusting to the event. In his view, drawing any conclusions is almost certainly premature at this point.

My contacts in the air cargo business, at both UPS and FedEx, say that their companies are maintaining their normal schedules. They have not cut back at all as yet. Volume is running somewhat below where it had been, but not dramatically so overall. However, the express business has been hard hit. The ground business and what they call the freight business--which is less than truckload quantities--is running about flat over last year.

emphasized that the outlook for domestic passenger airlines is truly dire. He said that as a consequence of the very stiff labor contracts that were settled in stages over last year and this year before September, labor costs have increased very significantly. would be the first of the airlines to fail. From looking at the financial reports, that airline already has negative net worth for the shareholders on its books. And, of course, they're all in junk bond status.

At current traffic levels all of them are literally within a few weeks of running out of cash and having to close down. So, the situation is very dire for the passenger airlines. And, of course, we heard this morning that Swiss Air has declared bankruptcy.

I also made a new contact with a person at a trucking firm called J.B. Hunt, which is headquartered in Arkansas and is one of the largest trucking companies in the United States. Hunt's business is very much at normal levels, with volume generally what they had expected. But the company is greatly concerned about the future, particularly the early part of next year. For the most part, buying plans for the fall are already completed, so the inventories are moving to the stores. But there's a very large amount of uncertainty about what will happen early next year.

Let me divide my comments on the total economy into two parts. First, I think it's fair to say that very little is known at the professional level about the sentiment question. I think back to my readings of the journal literature over a long period of studying macroeconomics and I don't remember ever seeing articles about consumer sentiment except in conjunction with the sentiment surveys. There's practically no analysis of sentiment at a professional level. I think we can say, though, that we have some basis for understanding the economic aspects of the current situation. It seems to me important to focus on the fact that some major fundamental strengths were in place at the time of the attacks. We had an environment of low inflation and very low expected inflation. Oil prices had been moving lower and, of course, have come down further since the attacks and that is an element of strength. We go into this situation with strong bank capital, unlike the situation in 1990-91 when bank capital was weak. Banks can make loans. And, of course, low short-term rates increase the margin for banks to compensate for the greater risk in this environment. We have a federal budget surplus, which means that the budget is not as big an issue as it might have been a dozen years ago in terms of the nature of a federal response. We had a very large amount of monetary stimulus already in place as of September 11<sup>th</sup>. Our economy operates with very flexible markets. We have a resilient people. We have a very strong set of fundamentals. The issue, I think, is how long it's going to take for businesses and consumers to get over it, so to speak, and to adjust to this circumstance. And we have very, very little by way of knowing the answer to that.

From looking at the effects on the stock market of past shock events--and I went back and examined as many as I could think of--the longest period of recovery from

a shock was after the stock market crash in 1987. It took quite a while for the market to get back to where it had been. After the invasion of Kuwait, the market was depressed until Desert Storm and that event tended to resolve that issue. In the current situation, we are likely to see more shocks to come. Almost certainly there are going to be some terrorist events abroad. Let's pray that no more come to our own land. But more shocks lie ahead that will possibly upset confidence.

I'm going to delay talking about our policy situation, but I think the issue there is that we need to focus much, much more than we usually do on the confidence issue. We need to focus on what we can do to help support confidence and stability rather than just on the setting of the federal funds rate itself.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. Let me start with a quick rundown of what's going on in the District economy. Much of this was in the written report we submitted earlier, although I do have some updates. Production was largely unaffected by the events of September 11<sup>th</sup>, and that is still the case today. On the other hand, consumer spending in the first few days following the attacks was essentially stopped in its tracks. But reports from large retailers in the District suggest that sales bounced back quite quickly. Now, I'm not talking about big-ticket items. This is exclusive of autos and homes and so forth. But activity at malls--at discount stores and even department stores--came back rather quickly to normal levels. I guess it's also fair to say that restaurants in the District have been surprisingly busy, at least in the last couple of weeks. Housing activity, which had been sound, remains sound. But as I reported at the last meeting, sales at the high end of the market certainly seemed to be slowing, and that

continues to be the case. My sense is that there is growing caution in that area and I would be surprised if next year's housing activity in the District came anywhere close to the pace of the last two or three years.

For the most part, nonresidential construction activity has continued unabated. There was, of course, a major expansion of the airport under way and that project has slowed if not been put on hold. I don't think that situation will go on for too long unless people are prepared just to let the project rust as it sits there. There have been a lot of cancellations of prospective conventions. September and October are very big convention months in Minneapolis, so that matters a good deal. The hotels are running with low occupancy rates and other travel-related businesses are similarly affected. The airports that I've been in at least have been very quiet, although Northwest Airlines has reported some improvement in future bookings. I'm not sure exactly what to make of that, but the airline people seem somewhat surprised about what's coming down the pike.

Obviously, the business community is of the opinion in general that aggressive action both on the fiscal side and on the monetary policy side is appropriate here. I don't have to go very far out the door to hear somebody in the business community offer that opinion. One other development is that in the wake of all this, we lost one medium-sized brokerage firm that was involved in an ill-advised securities lending transaction.

As far as the national economy is concerned, in thinking about the outlook and in listening to the staff discussion, the key word here is obviously uncertainty. I happen to think that the near-term outlook is for more weakness than projected in the Greenbook, but I wouldn't put too much stock in any forecast. As many people have already said, we're in an environment that we really don't know a lot about. Normally, when

uncertainty goes up, that implies to me the need for policy caution so as to avoid significant errors. But in the current situation we can be fairly certain--or at least I am of the opinion--that the downside risks have magnified and that the inflation risks have diminished. In any event though, I'm not sure that economic policy is going to be key to the relatively near-term future. I think what we need is tranquility at home and success abroad.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, the economy in the Tenth District, like that for the nation, remains sluggish. Some people might say it was mixed at best prior to the events of September 11<sup>th</sup>. Of course since then, as we've heard around this table, the anxiety and uncertainty that was already in the economy took an even greater hit and caused the outlook to worsen noticeably, as reflected in the Greenbook as well as in our staff and the Blue Chip forecasts.

Let me give you some data on the District. These developments are consistent with the national news because many of the reports are from firms operating nationally. First of all, the manufacturing survey we conducted in July was quite negative. Our dispersion index was minus 28. When we took a look at the August survey, we became somewhat hopeful because that negative had become much smaller, moving to minus 7. But in September--and part of the survey was clearly done after September 11<sup>th</sup>--that index went back to minus 16. So we saw a big switch in sentiment in terms of the prospects looking forward.

On the transportation side, I would make a couple of points. As for the airlines, our experience is the same as others have talked about. Boeing, which has

operations in Wichita, has announced significant layoffs. But as a side comment, Cessna, which also operates there, has a backlog on orders for corporate aircraft. And that backlog is growing, apparently reflecting increased demand for fractional ownership as the desire to find alternative air transportation is starting to take hold.

Let me talk for just a minute about the trucking industry. Bill Poole mentioned a firm in that sector. In Kansas City we also have a large nationally operating trucking company that does a lot of shipping for manufacturing firms. We recently had a conversation with their people, and they said the firm's business is down markedly. It was down noticeably prior to September 11<sup>th</sup> and since then it has only gotten worse, as their customers have pulled back. Their comment to me was that they are now operating at 1985 levels of business. So, they have had very significant reductions in volume and have just announced sizable layoffs. They have about 10,000 drivers and have laid off a significant number of them as well as staff in their corporate operations.

Looking at the railroad industry, we have a major railroad operating north-south from Kansas City and then into Mexico. Their volumes in and out of Mexico have dropped noticeably and their order books have dropped as well. Previous to September 11<sup>th</sup> they had initiated layoffs, and there are no signs of rehiring at this point.

As for the retail sector, like others we've talked to many retailers. They have reported a fairly persistent return to the pre-September 11<sup>th</sup> pattern in terms of sales. But the experience is very mixed as they look to the Christmas season. Some are saying they've pulled back dramatically. One, as was reported in the national press, followed through completely in their Christmas orders as their sales were up 25 percent. So we've heard very mixed reports on the retail side.

Energy, which for us is a two-edged sword, is also a mix. Because prices are down that's good in the general sense. But it also means that we've seen a real drop-off in activity in our region; it's down about 10 percent by our estimate.

Generally, activity in our region is slower. The change in psychology is noticeable, in terms of the effects.

Looking to the national situation and policy, I would say that we also see the economy recovering eventually. But given the psychology and the uncertainty, forecasting the timeline for the recovery is exceedingly difficult. I wouldn't pretend to have a better forecast than anyone else in this room; mine would be no better than Dave Stockton's, for sure.

Another factor mentioned here that I think is an important consideration is fiscal policy. We don't know how that's going to evolve. Trying to pull all this together, I would be supportive of an easing--pick the amount. I think an easing step would recognize that at least for the next several months the downside risks are probably going to weigh very heavily on our economy. Our experience in other instances, as people have pointed out, is that we tend to underestimate the downside. In my view that is a real possibility in this case as well. So I would be more inclined to err on the side of easing. We can reverse the easing should fiscal policy be overly stimulative or should the economy turn up, and I believe the market would understand that. I think we are in a good position in that regard. So overall a case for easing policy can be well supported, if that should be deemed necessary here. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. All of the available data on New England suggest that the regional economy slowed, possibly at an increasing rate, in the period since our last Open Market Committee meeting. Employment declined between July and August; each of the states in our District registered a higher unemployment rate. The value of manufactured exports declined, especially computers and electronics, and consumer and business confidence fell substantially. But these data almost entirely predate the tragic events of September 11<sup>th</sup>.

What feel we have for developments in the region since that time therefore relies more on anecdotal sources than science. I certainly understand Dave Stockton's comment about the desire to speak less when there is little science on one's side, but I feel compelled to explore the anecdotal reports that we have heard. At our Bank we had the benefit of hearing from those who attended two regularly scheduled advisory committee meetings--our small business and our academic advisory councils--and two regularly scheduled bankers' forums, all of which took place after September 11<sup>th</sup>. In addition, both before and after the tragedy, I spoke personally to several of the Bank's directors outside of regular meetings and to the CEOs of several large manufacturing and financial services companies. And, of course, we had the additional post-September 11<sup>th</sup> calls to Beige Book contacts. Several themes emerged from these interactions.

First, economic activity across a wide sample of firms and industries was slowing even in advance of September 11<sup>th</sup>, though not all the news was bad. The strong dollar and slowing demand had contributed to problems at many regional manufacturers, including one large worldwide manufacturer of consumer products. The U.S. forest product industry was reported by one contact to be on the verge of collapse, despite the

strong housing market, largely because of increased foreign competition related to the strong dollar and excess capacity put in place in the early to mid-1990s. The head of a regional software industry council reported on the demise of hundreds of firms in the wake of the drying up of demand, especially for Internet-related software. But she also reported that new start-ups were being formed as well, in fields such as wireless communication and teleconferencing. Similarly, regional businesses in the field of security saw the potential for some benefit in the near term, and a few had already seen a pickup in demand. Many contacts reported a very welcome softening in labor markets and the ability to attract technical staff easily for the first time in recent years. Housing markets reportedly had slowed, particularly at the high end, but the slowing reflected reductions from very high levels of activity earlier.

Second, the impact of the tragedy of September 11<sup>th</sup> was significant both culturally and economically but at least some aspects of the economic jolt will be short lived. A highly rated large manufacturer of airplane engines and consumer and industrial building products commented that access to commercial paper markets had been difficult during the week of the tragedy but that markets had more or less returned to normal, at least for very short maturity paper. Small manufacturers and suppliers of retail goods had experienced an immediate drop-off in demand. And bankers noted that traffic in branches came to a halt in the days following the tragedy. By the following weekend, however, shoppers had returned to malls. One specialty food and flower vendor, whose business had been disrupted by a lack of airplane shipments of imported goods, reported that sales for Rosh Hashanah broke all previous records. Families crowded his stores,

apparently in a desire both to be together and to enjoy the simple process of getting ready for the holiday.

There were, of course, important exceptions to this impression of short-term disruption. The airline engine manufacturer I mentioned noted that each engine is sold three times--once as a new product and twice in the form of parts in the after-market. With airline traffic down and likely to stay depressed, this executive thought that new orders would be curtailed sharply and that the number of parked aircraft would swell to perhaps twice the current number, which was already at the level of the last recession. He also expressed some concerns about the amount of supplier credit his firm had extended to airlines.

Another hard hit area is likely to be the New England tourism industry. The economic slowdown had already eaten into the "leaf peeping" season, but the dramatic decline in airline traffic, particularly from foreign countries, had brought the flow of large buses of tourists to a halt. Reportedly there has been an increase in Eastern seaboard tourists looking to relax a car drive away rather than an airplane flight away. But tourism in the region and particularly in Boston remains low. The fall tourist inflow is a mainstay to the region and its demise may involve more than short-run disruption.

Finally, all contacts saw prospects for the immediate future as more than unusually uncertain. Members of the academic advisory group noted the difficulty of finding a historical comparison on which to base forecasts and they debated both the possible size and impact of fiscal stimulus. Some felt that the potential for spending on homeland defense and on new military weapons, such as destroyers and planes, could be considerable. A few also saw the potential for an inflationary impact from a supply

shock related to moving substantial resources to fighting terrorism, if demand for more usual consumer products did not abate considerably. Most, however, did not see inflation as a current worry and focused more on the likelihood of negative rates of economic growth for two to three quarters.

In sum, shock, increased uncertainty, and turmoil, however short-lived, have been piled onto a regional economy that had been holding on to growth by its fingernails. It's not a pretty picture.

Turning to the national scene, the picture doesn't get much better. Whether one looks at the Greenbook or the forecasts of DRI, the Blue Chip, or our Bank, the outlook is the same--two or three quarters of mildly negative growth, a rebound over 2002 to rates of growth at about potential in 2003, and sharply rising unemployment. Even without the tragic events of September 11<sup>th</sup>, the prospects for this year and next would have been less positive today than they appeared in August. This was clear from the summer's industrial production data and employment and confidence indicators.

But sadly, the events of September 11<sup>th</sup> happened and the slowing economy received a serious negative shock. The obvious questions are how serious and how negative, but the answers are more than normally uncertain. We have very little data as yet to go on and not much in the way of history to guide us. The Greenbook expects the dip into negative territory to be relatively short and mild in nature, with consumption never actually turning negative. That's fairly unusual if in fact this is to be the first recession of the new millennium. I'm forced to wonder whether we are not engaged in a form of wishful thinking--the same process that has pushed the recovery out further in time in our forecast at every successive meeting this year. Corporate profits,

employment, asset markets, consumer spending, business investment, and confidence all present elements of increasing downside risk. Moreover, the confluence of weakness both here and abroad, while not unprecedented, is not comforting either. Thus, there are real risks that the baseline forecast has more than the normal amount of downside potential.

Offsetting this, of course, is the likelihood of additional fiscal stimulus. Again, questions abound. How much stimulus will be enacted, when will it affect the economy, and how will it be seen by financial markets? The Greenbook provides a reasoned estimate of the amount of such stimulus. But even the amount included in that forecast seems small relative to the rhetoric coming out of Washington. In that regard, I wish I understood better what the shape of the yield curve might be telling us about the risks over the medium term.

The other potential offset is the degree of monetary ease. We've reduced the federal funds target by 350 basis points since January. That's a much faster pace than in the early 1990s when it took a couple of years to implement about that same amount of change. Moreover, 75 basis points of that easing was done over the last few weeks and arguably has not worked its way into the economy. But with the decline in the stock market and the widening of risk spreads, financial conditions are not as accommodative as our degree of policy easing might imply. Earlier this year the consumer was the mainstay of the economy, bolstered by lower interest rates, and it was reasonable to be concerned about overdoing such low rates over the near term. Now, both consumption and investment face the headwinds of further diminished confidence, growing

uncertainty, and falling demand. Fiscal stimulus, if properly fashioned and temporary, can help. But at least in the near term, monetary policy should do more as well.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. The Atlanta District's economy continued to weaken during the third quarter even prior to September 11<sup>th</sup>. And like elsewhere, activity has weakened further in most sectors since that time. Auto sales are off and commercial real estate markets continue to soften. The most noticeable effects of the attacks are being felt in Florida, which had been our region's growth leader. As widely reported and as almost everyone has commented already this morning, uncertainty and perceived travel risk have hit tourism and the hospitality sector particularly hard. Tourism spending in Florida is reportedly down by about one-third, or \$20 million a day. Disney World in Orlando has shortened its operating hours, eliminated overtime, and reduced vending activities. Several large South Florida hotels have cut staffing by as much as 30 percent. And the excess cruise ship capacity I mentioned in my reports earlier this year is now sinking parts of that industry. Reflecting the decline in travel, our largest airlines, Delta and AirTran, have engaged in different mixes of very aggressive cost-cutting measures including job cuts, lower management bonuses, and reduced retirement contributions. And in some instances pilots have taken voluntary pay cuts.

Employment cuts will especially affect Georgia, which may actually see some decline in jobs in the fourth quarter for the first time since the 1990-91 recession. Reflecting the job situation, requests for consumer credit counseling in Georgia were at record levels in August. One of our Atlanta directors who runs a very large statewide consumer credit counseling organization reported that appointments for counseling were

up 5 percent in September from the month before and jumped another 15 percent after September 11<sup>th</sup>. There's also little change in the trajectory of the District's manufacturing sector, which continues to contract. Investment plans reportedly are still very much on hold until the signs of a pickup in new orders become apparent.

District auto producers reported that unit sales are around 15 to 20 percent below plan following September 11<sup>th</sup>, even with the introduction of new incentive programs and new models. Tennessee-based Nissan is revising down its sales and production projections for the remainder of the year and has eliminated all overtime for the foreseeable future. Auto parts delivery problems experienced by plants in our area immediately after the attacks have now been resolved.

State governments now face another round of budget difficulties because of declines in sales and income tax revenues. Reflecting the slowdown, bankers report slowing loan demand across all business lines, some tightening of credit standards, and some deterioration of credit quality. Finally, I'd note the unusual report from several sources that major corporations who had made previous charitable financial commitments have begun seeking ways to gracefully shift their gifts to next year or to pare them back significantly.

On the bright side, retail sales and residential real estate markets are our best performing sectors. While commercial markets continue to soften, single-family real estate remains reasonably strong. Few significant imbalances in either residential or commercial markets are appearing. Many companies are cutting hours for temporary help. Wage pressures are reported to be significant only for health-care workers.

Likewise, substantial price increases are generally limited to the health-care sector and to liability insurance premiums, which have risen sharply of late.

On the national front, as almost everyone has said, uncertainty is now the dominant consideration whether one focuses on financial markets or the real sector. It's now clear that significant slowing was evident in the third quarter even before September 11<sup>th</sup>. All things considered, I am a bit more optimistic than some that the shocks from the terrorist attacks will be relatively less pervasive and less long-lasting, aside from the obvious effects on areas such as travel and tourism. Having said that, uncertainty has clearly increased and markets are expecting a further drop in our target funds rate at this meeting. A further temporary drop in rates seems appropriate--but I emphasize the word "temporary"--as a short-term effort to provide liquidity and attempt to reduce uncertainty.

Unlike the economic situation preceding the Gulf War, we've already dropped rates eight times and significant stimulus is in the pipeline. Arguably the real funds rate is now very low and will be approaching zero according to some measures, if we make another large reduction today. I don't see a clear argument for pursuing such a low real rate policy at this time as an intermediate policy path, given the current best guesses about the likely course of the economy, except to temper further short-term uncertainty. Nevertheless, this does not seem a good time to add to uncertainty by not relaxing rates further as the markets expect.

My concern about the policy path is heightened by the belief that more fiscal stimulus than already enacted seems quite likely and will take hold about the time many forecasts indicate that the economy will begin to grow again. Current perceptions in some quarters seem to be that the White House, Congress, and even the Fed will do

almost anything to try to avoid a recession or a prolonged slowdown. Quite candidly, this worries me more than a modest recession itself. For these reasons, should we move again at this time--and I believe we should--we need to look for ways to explain that it's a temporary response that will likely be reversed when uncertainty declines and markets are more normal. Absent such an explanation, I'm concerned that the policy path will put the economy at significant longer-term inflation risk, with all the costs and difficulties that we understand will be associated with that. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. Prior to the attacks, the Third District economy had been flat. Employment continued to decline in the first two months of the third quarter. The manufacturing sector also continued to decline, albeit at a slower pace than earlier in the year. Retail sales remained flat. One sign of a rebound in activity was an upturn in the pace of residential construction from a weak first quarter. Our calls to business contacts since the September 11<sup>th</sup> attacks indicate that firms in all industries in the region have revised downward their forecasts of sales and revenues in light of continuing uncertainty about possible military action and a retrenchment in spending by consumers and businesses.

Retailers have noted a resumption of consumer spending since the initial days after the attacks but they say that store traffic and sales have not returned to the levels experienced prior to September 11<sup>th</sup>. Contacts among general merchandise retailers expect sales to rise only slowly in the weeks immediately ahead. Managers of local stores of national chains indicate that corporate marketing plans for the fall have been put on hold, at least temporarily, though fall and winter merchandise stocking levels have

already been set and are subject to only minor adjustment. But some retailers who need to place orders now for spring merchandise are contemplating reductions from their earlier plans.

Auto sales in the District had been slowing in the weeks before September 11<sup>th</sup>, and in the days after the attacks they fell to levels 20 to 40 percent below same-day sales last year. Auto dealers tell us that they will be reducing their orders to manufacturers for at least the next month or two. Obviously, the travel and tourism industries have been hard hit by recent events. In Philadelphia all the conventions scheduled for September after the attacks were canceled. The conventions scheduled for October have not yet been cancelled but attendance will be lower than normal since some companies have disallowed air travel for at least 30 days.

In terms of employment, while many firms in the region are anticipating slower sales only a few are considering layoffs, and most of these were contemplating layoffs before September 11<sup>th</sup>. Much more than the usual level of uncertainty surrounds the forecast for the regional economy. What is clear is that recent events have pushed the projected rebound further into the future than previously thought.

Our view of the national economy is somewhat the same. The incoming data suggest that prior to September 11<sup>th</sup> the economy had remained soft. The terrorist attacks on the United States have probably pushed the economy into recession. These unprecedented attacks have raised the specter of further shocks, such as U.S. military action and more terrorist strikes. While we've seen some rebound in consumer spending from the depressed levels in the days just after the attacks, there has not been a total recovery. Uncertainty about the future will cause consumers to delay some purchases

and to cancel others. While real estate and other assets certainly have cushioned the negative effects on household net worth, the significant fall in equity prices could result in a substantial decline in household spending. Uncertainty and a drop in consumer spending will cause businesses to delay capital outlays.

The economic situation abroad has also deteriorated since our last meeting, as we heard in the staff briefing. Data suggest that these economies were weaker prior to the attacks than we had anticipated. And though not on their soil, the terrorist attacks are a negative shock to economies outside the United States. Thus, this country cannot look to strong economies abroad to buoy our own economy.

Our near-term outlook is similar to that of the Greenbook. We agree that the attacks will have a significant negative impact in the short run. However, I believe there could be some upside risks associated with the Greenbook's forecast for 2002. The effects of the terrorist attacks on consumer and business confidence may fade more quickly than assumed. Expansionary fiscal policy in combination with easier monetary policy may have a stronger impact than assumed. Indeed, a Philadelphia staff analysis suggests that forecasters tend to under-predict the response of output growth to expansionary monetary policy. Thus, it is possible that the economic recovery could begin earlier in 2002 and end up stronger than projected in the Greenbook. This would imply that the Committee would have to be ready to raise interest rates sooner than assumed in the baseline forecast. That said, I find it difficult to argue with the basic outlines of the Board's staff forecast. Philadelphia staff analysis indicates that while forecasters significantly revised their forecasts downward in the aftermath of past crises, forecast errors were little different during crisis periods than in other periods. So, as

much as I would like to, I am unable to say that the Greenbook forecast surely errs on the downside. Thank you.

CHAIRMAN GREENSPAN. Let's take a break at this stage. Coffee is next door. Let's return in fifteen minutes, please. Thank you.

[Coffee break]

CHAIRMAN GREENSPAN. President Broaddus, will you continue for us?

MR. BROADDUS. Thank you, Mr. Chairman. Economic activity in our District seems to have advanced at a modest pace in August but it weakened sharply in September. Some of the anecdotal and survey information we've received indicates that activity would have slowed in September even in the absence of the attacks. Of course, we did have the attacks and they've had the same extremely negative impact on our region as they've had elsewhere in the country, as we've heard around the table this morning. Part of the drop in activity in our region might be temporary, if the terrorist threat can be reasonably well contained.

As several others have noted about their Districts, we too experienced a big drop in retail sales initially but in general they've come back to earlier levels since then. The exception is automobile sales, which have rebounded some but not to the levels we were seeing before the attacks occurred. In the manufacturing sector, early on there were some supply disruptions and some disruptions in shipments to customers, but at least for the time being those seem to have subsided. In our region as elsewhere the big hit, and probably the more permanent hit, is to the travel and tourist industries. Tourist activity here in Washington is usually very substantial at this time of the year and it is at a much lower level now than normally.

With respect to the airlines,

the airline headquartered in our District, just on the other side of the Potomac river. It was an airline in trouble--its condition was very shaky--even before the crisis. The company has announced 11,000 layoffs and a lot of those will be in our District. I think a good number of them will be right here in the Washington area. Also, beyond the layoffs, the US Airways hub in Charlotte has for a long time been a foundation for the growth and strength we've seen in that city over the last 15 years or so. So there is concern about that area.

With respect to the national economy, I think the data indicated pretty clearly that economic activity might be weakening even before the attacks. We had a run-up in the unemployment rate and, of course, manufacturing was still contracting despite the somewhat optimistic purchasing managers' report we got a month ago. With wages and home values rising, consumer spending was still holding up reasonably well going into the crisis. But the sharp increase in unemployment and evidence that housing demand and home prices might be beginning to soften have contributed to the deterioration in consumer confidence that I think was evident even before the terrorists struck.

Against this background, the September 11<sup>th</sup> attacks, of course, have added to the anxiety and uncertainty that households, business firms, and investors were to some extent already experiencing before the attacks occurred. Those concerns showed up initially in asset markets. The negative impact on asset markets appears at least for the moment to be reasonably well contained under the circumstances, but obviously the level of anxiety in those markets is still very high. With a recession increasingly likely, consumers feel exposed to the risk of losing their jobs as well as to other risks and,

therefore, are likely to spend less and save more out of current income in order to build their precautionary balances. And businesses, whose investment returns are now subject to a greater degree of risk than before the attacks, will probably cut back on their investment plans even further than they already have, at least for a time.

Barring any further attacks and resulting increase in anxiety, some of these effects may prove temporary. As households get their precautionary balances and asset positions back up to the higher level they may now desire, presumably they will again begin to spend a more normal fraction of their current income. And when business firms get to the point where they think they have sufficient liquidity to deal with the contingencies they're concerned about, presumably they will begin to redirect a greater portion of their earnings to investment.

Even so, it seems clear to me that the downside risk in the near-term outlook is significantly greater than the upside risk, at least for the time being. I don't really see much upside risk in this situation, and I think we need to recognize that a significant cumulative contraction can't be ruled out even in the absence of further terrorist activity.

In light of this risk, I think it's worth noting that the Greenbook is projecting a relatively mild and brief recession ending in the first quarter of next year. In my view it's a plausible point forecast. One reason it's plausible is that economic policy and other public policies at the moment are well positioned to cushion the downturn that we currently anticipate. Tax cuts are in place; rebates have been paid out; and there's a good likelihood that military spending will increase. We're likely to see more public spending on security here at home. Perhaps most importantly though, thanks to our actions over the last decade or more, the Fed generally as an institution--and Fed monetary policy

specifically--probably has as much credibility for low inflation as it has ever had. And inflation expectations have been declining so far this year. This to me is the big difference between the situation we face today and the one we faced in the early 1990s. Consequently, I think we can probably move interest rates still lower without triggering an inflation scare in bond markets. The question Cathy Minehan raised about what the bond markets are telling us with regard to inflation expectations is a very relevant one. But there are obviously other potential plausible explanations for what has been happening in bond markets.

The Greenbook projection assumes another 1/2 point cut in the funds rate before the end of this year. Frankly, I think there's a strong case to go ahead and make that move this morning. Having said that, I must say that I believe Jack Guynn made a very good point. We have been easing aggressively. I have favored this and I'm comfortable with it. And I would be comfortable with more easing this morning precisely because of our enhanced credibility. But once a recovery gets under way--and sooner or later that's going to happen--I think we're going to need to reverse course and move in the other direction just as aggressively as we've eased. That will be necessary in order to maintain our credibility, and in many ways I think that's the most important thing we have going for us in this situation. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. Let me begin with autos. Last week on an Executive Committee conference call one of our directors, a banker, reported on a conversation with one of his customers, an auto dealer. The dealer told the banker that over the prior weekend, September 22-23, only four customers even came into the

showroom and he had no sales at all. We, of course, were interested in following up on that, so people on our staff called auto dealers around the District yesterday to get information on their traffic and sales this past weekend. Comparing notes on what they heard, the staff's general consensus was that auto dealers were happily surprised not only by how much traffic they had but by how strong sales were for the weekend.

Nevertheless, when asked how sales were likely to come out for the month overall, the typical response was that sales were down about 20 to 25 percent versus a year ago.

However, and this is a point I'm going to come back to in a moment, it is very hard to discern a trend in anything at this stage and will be until the passage of a little more time.

Another of our directors runs a company that makes pastries both for retail use and for what they call institutional use--that is, sales to restaurants and airlines. Last week she said that all six of her airline customers had called and cancelled all orders for onboard service for the foreseeable future. Two of the company's other lines are corporate gift giving, which usually involves gifts to employees or suppliers, and individual gift giving by retail customers. They have had strong sales in individual gifts of pastries but a 50 percent drop in orders from corporations. So one can't draw conclusions about any overall trend from that.

We've been staying in weekly contact with representatives of Federated Department Stores. As you know, of course, Federated reported very sharp declines in sales immediately after September 11<sup>th</sup>. This last weekend, for the four-day selling period Thursday through Sunday, sales were back on plan except in New York City. Again, one cannot discern any trend from that because for the month overall sales will be down very considerably. Our contacts were very encouraged, however--we talked to

them yesterday--by the volume of traffic and sales over the weekend. Nevertheless, they now expect the fourth quarter to be weaker than previously anticipated. There's not much they can do about that. They are currently ordering for next year and they're going to order less for the spring than they previously thought they would.

Yesterday I received the raw data and a preliminary summary of the September survey of the National Federation of Independent Businesses. You know how they do that survey; through the course of the month they get responses to a lot of different questions and then they try to distill the information and summarize it. Those data, too, show the difficulty of drawing any conclusions about the trend. Almost half of the responses they received were dated prior to September 11<sup>th</sup> and a little over half were dated after September 11<sup>th</sup>. Based on the survey responses dated prior to the 11<sup>th</sup>, the analysts would have drawn the conclusion, given the firmness in the July and August data, that September would have marked the third month in a row of an improving trend. They would have been tempted to interpret that as indicating that activity had seen its low point. The data dropped off dramatically, of course, in the post-September 11<sup>th</sup> reports. If one tried to average together the two sub-samples the results would be nonsense. Neither period is going to characterize the month. And that's where we are stuck. We can't conclude anything about the August to September data per se. We really have to view this situation as a break in the series and try to find a new base, a new place to start and maybe see a trend forming. But that's going to take a little more time for any dataset.

Turning to the national economy, I have no idea what the national income accounts numbers are going to add up to for the foreseeable future, either from the product side or from the income side, let alone how they will break down for various

sectors and regions and so on. But I don't think that's really the biggest challenge we have. A number of people have mentioned in one way or another that uncertainty is an issue. Not long ago I thought most of the uncertainties we had to worry about involved developments that might occur outside the United States--perhaps involving Argentina or Japan or the launch of the euro or something else. Those concerns have not gone away entirely but obviously uncertainties within our country have suddenly jumped to the top of the list of things we're uncertain about. It may well be that we will escape some potential problems in the international arena. Maybe Argentine will not default and spark a crisis. Maybe Japan has turned a policy corner; maybe the mark-to-market of equity portfolios of their banks starting yesterday will not cause serious problems in their banking industry. Maybe the launch of the euro will go well. Nevertheless, it seems to me that we're going to face a protracted period of waxing and waning of anxieties, with good justification. I would not attach the term "irrational" to the anxiety. I think it is probably very rational. But it's difficult if not impossible to quantify, and certainly we can't observe it.

The Committee's press statement of September 17<sup>th</sup> said that we recognized that the actual federal funds rate might be below its target rate on occasion in these unusual circumstances. I was very pleased about the inclusion of that wording and I thought it might continue to be needed in our statements for some time. We've had decisionmaking periods in our history when the greatest uncertainties were about inflation and inflation psychology. And in those periods we found that it was especially difficult to draw any conclusion from movements in nominal magnitudes, so instead we resorted to paying more attention to--if not targeting outright--quantitative magnitudes.

For exactly the opposite reasons relating to the difficulty of observing inflation psychology, I think in this period of heightened anxiety we have to think along the same lines. If we don't go all the way to quantity targeting I'd at least like to think about a proviso clause as to what we're willing to see happen to nominal interest rates, especially the overnight interbank rate.

I don't expect that at this meeting we're going to change the statement that accompanies our announcement. But the statement that the risks are weighted mainly toward conditions that may generate economic weakness has become in effect a proviso clause. It says that if we get more weak data, the FOMC may cut the overnight interbank rate some more. If the stated funds rate target is not producing an expansion in central bank liquidity, the monetary base, I would prefer to think in terms of our being willing to let the rate drift lower. The one thing that we certainly would not want to see, as I was suggesting earlier in questioning Dino, is a contraction in the monetary base. In fact, not only should growth in the base not be negative, it should be adequate to assure that we accommodate the demand we believe exists for base money. Thank you.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. Dave Stockton got us off to a wonderful start in admitting just how uncertain we are. Now we are at least as uncertain but with an unbelievable amount of specificity about it!

What do we know about the Second District? It was weak going into the tragedy and it is weaker now. One of the results of that is going to be a stress on the fiscal situation of New York City. Even so, our analysis to date says that the City's fiscal

situation will hold up; that will have some effect on the fiscal situation of New York State as well.

We think the Greenbook forecast is as good a forecast as one could make. And we agree with the authors that the downside risk is very considerable, especially in coming quarters, and that we don't know what the longer term is going to look like. The likelihood is that the economy will snap back, as suggested in the forecast.

As regards monetary policy, I believe that we are being rewarded for the high degree of confidence in the Fed and the greater transparency we have achieved in recent years by the market forecasting what I at least think we clearly should do at this meeting. I believe we would be very ill-advised to test our credibility by saying this is what we're doing at this meeting but we're so certain about the future that we want to put everyone on notice that we may tighten monetary policy sometime soon. We don't know enough to say that. And nobody expects us to say it. If we say things that test our credibility in order to show our central banker virtues, I think we will lessen our central banker virtues and certainly lessen our credibility. Thank you.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. As others have said, in the short run we are facing potentially the start of a crisis of confidence both among businesses and households, which is likely to interact with the pre-existing weak macroeconomic environment to lead to a slide in economic activity. Both the length and the depth of that slide are uncertain but they could conceivably be longer and deeper than in the baseline forecast. Therefore, our challenge today is to take actions to attempt to avoid one of the more pessimistic consumer confidence scenarios.

Even before September 11<sup>th</sup> indicators of household behavior were somewhat troubling. Housing activity and particularly single-family starts, which had been a source of strength, had softened a bit. Consumer confidence was also sliding even before the attacks occurred, and that slide of confidence has certainly continued following September 11<sup>th</sup>. Last week's initial claims for unemployment insurance jumped, indicating further stress for households. With more layoff announcements, especially in the airline sector, and the likely multiplier effects for related industries, there is ample reason to believe that last week's increase in initial claims is likely to be the precursor to further increases in unemployment. Against this set of incoming data, the Greenbook's baseline forecast of unemployment reaching close to 6 percent does not seem out of the realm of possibility at all. In the context of such a rise in unemployment, it is unlikely that even the few retailers that saw a return to planned performance last week can be complacent that conditions in the household sector will support a return to a reasonable pace of growth.

Similarly, indicators on the business sector were also mixed and negative even before September 11<sup>th</sup>. Declines in business fixed investment, particularly in the high-tech categories, continued unabated. Informal contacts and surveys of banks and other businesses suggest that the uncertainty about the consumer response to the attacks is feeding through to uncertainty among businesses as well. Many banks report a sharp drop-off in demand for business loans after September 11<sup>th</sup>, suggesting that small businesses in particular are less willing to risk capital on expanding investment spending during this period of uncertainty.

While the auto industry is struggling to create demand by providing strong incentives, in a survey that straddled the September 11<sup>th</sup> date, the NAPM reported that manufacturing activity fell again in September, marking the fourteenth month of a factory slump.

The conditions leading to a downward trajectory in the real sector have been reinforced in financial markets. Over \$1 trillion of equity wealth has been lost since September 11<sup>th</sup>, which will almost certainly lead to a greater retrenchment by consumers. While equity indices have declined 10 to 20 percent over this intermeeting period, fixed income markets have not become more accommodative. As for the question Cathy Minehan raised, I think that at least in the government sector the bond market is driven by concerns about the budget outlook, since the TIPS market doesn't seem to indicate any increase in inflation concerns. In the below-investment-grade corporate bond sector, concerns about risks seem to be the predominant factor leading long-term rates to remain stubbornly high. Additionally, while large banks claim that they have not tightened terms and standards on business loans since the attacks, they do admit to watching closely for signs of deterioration. Bankers clearly understand that default risk has increased, and they will certainly act to protect their income and capital positions as much as possible.

Unfortunately, the international sector is unlikely to add any strength to the near-term outlook. Equity markets in almost all industrial economies have been hit by the same reevaluation of business prospects that has affected our equity markets. Similarly, safe haven flows from the dollar, the euro, and the pound sterling into the Swiss franc indicate that market participants may be rethinking the short-term prospects for a number of economies.

The most positive development from the international sector is that oil prices seem unlikely to spike higher, which is helpful on the inflation front but indicates that the supply and demand dynamics in that market are consistent with a future of slowing growth globally.

Against this background, I believe that policy must respond. A number of speakers have raised questions about the level of the real interest rate. It's important to note that since 1960 there have been six periods of slowdown. During five of those periods, the real interest rate touched zero and during two of those periods it was decidedly negative. So if we allow the real fed funds rate to drop to zero or close to it through the decisions that we make today, that will not in any sense be unprecedented. The markets are certainly expecting a response today. And I think to disappoint them risks setting off a global reaction that might be difficult to control. We are, as others have said, benefited by the fact that both inflation and inflation expectations are well contained. It is right to point out that in the longer run we may confront a potential interaction between a stimulative monetary policy and a stimulative fiscal policy as our monetary policy stimulus and more stimulus from the fiscal side are both called upon to counter the risk of further slowing in the economy. But even recognizing the challenge that might emerge from unpredictable long-term policy interactions, I believe that we need to set a priority today on the immediate macroeconomic challenge and the real downside risks confronting us in the near term. Thank you.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. First of all, my congratulations to the Greenbook staff for a fine job under impossible conditions. However, as the authors

themselves are at pains to point out, this and all other forecasts today can have only a limited credibility. This is evidenced by the quite appropriately wide spectrum of the alternative scenarios, several of which are virtually as plausible as the baseline forecast itself. Yet policy must be made. How are we to meet that necessity?

I felt earlier and feel today that monetary policy made its most important contribution to reversing this cycle over the first half of the year, and I'm proud of what was done by this Committee. Given what is already in the pipeline, together with the possibility of somewhat lower rates, policy seems very supportive. Changes from here on will likely play a relatively minor role compared to developments in fiscal policy, consumer confidence, and the progress of the war on terrorism. Monetary policy was, in my opinion, a key positive force earlier, but the focus today may be to ensure that it does not become a negative factor in the economic equation. How could that happen?

In the short run, this may be one of those very strange times when appearance could be the most important reality. The Fed is on the recovery team, of course. But we must be seen to be on that team by the man on the street, both on Main Street and Wall Street. To be so perceived will be a positive force for recovery, whereas to be seen otherwise could be a major negative. As our nation struggles to recover from a major trauma, surprising the markets could be an additional trauma we just do not need right now. This condition will hopefully change soon and the day will likely come when a policy surprise will be appropriate, but not today. Fortunately, Mr. Chairman, inflation is most likely going to trend downward over the forecast period, giving the Committee some further room to maneuver and time to reverse course in an orderly manner.

I believe the Committee will soon be facing two successive sets of challenges and the sooner the better in each case. The first will be when and how to terminate this easing cycle when the economy stabilizes. We obviously are not to that point yet. I hope the end of our easing process will be followed shortly by the second challenge, determining how and when it will be necessary to begin to damp the enormous amount of stimulation that has been and will be pumped into this economy first by monetary policy and soon by fiscal policy. I believe the Committee may be entitled to take some satisfaction in the role policy has played in recent years, but the future will probably prove to be at least equally as challenging as the past. What is needed today, however, seems pretty straightforward. Thank you.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. Thank you, Mr. Chairman. I found the alternative simulations provided by the staff in the latest Greenbook to be especially useful. Given the exceptional degree of uncertainty that we now face, the alternative scenarios help us to better appreciate the range of outcomes. But in addition, they allowed me to easily craft my own forecast by adding the alternative scenarios directly to the baseline subject to my personal assessment of the probabilities associated with each. When I began this exercise I thought that it would allow me to present to you an interesting, even compelling, alternative to the Greenbook forecast. To my surprise--and I must say disappointment--I found that when I completed this exercise, the alternative scenarios turned out to be remarkably offsetting. That left me, no doubt, with the same uncertainty as the staff had, and equally likely to be wrong, but with a forecast that turned out to be remarkably similar to the baseline. While we face enormous uncertainty as I indicated, I think this

sort of experience adds a little to the credibility of the baseline. I did wonder a bit if the staff might have been playing some games by offering us a series of alternatives that they knew were entirely offsetting just to reinforce the baseline. But David Stockton assured me that this was an accident of good fortune rather than a strategy!

I find that it's useful in my own thinking to separate the forecast horizon into two sub-periods. The near term covers the next two or three quarters and the remainder is the period through 2003. It seems to me that there are two key drivers of the near-term forecast. The first is the momentum in the economy prior to September 11<sup>th</sup>. The second is the effect of the events of September 11<sup>th</sup> through disruptions to key industries and via consumer and business sentiment. With respect to the momentum, some saw the data immediately preceding September 11<sup>th</sup> as very encouraging and signaling that the economy was poised for a rebound. Others interpreted the very same data as indicating that the economy had at most stabilized at a growth rate not much different from zero, and they were still revising down their forecasts.

I think there was ample scope in the data to support both of these differing interpretations, but I was in the latter camp. And the more pessimistic interpretation suggested that additional easing would have been justified in the absence of the events of September 11<sup>th</sup>. In part for that reason, my point of departure for the forecast was the alternative simulation with easier money policy.

But the events of September 11<sup>th</sup> clearly called for a downward revision to the near-term forecast--at least to the estimate of the third quarter and the forecast for the fourth quarter and likely into early 2002. Because a downward impetus to a considerable degree reflects an assessment of the psychological effects of the events of September

11<sup>th</sup>, the uncertainty about the forecast is an order of magnitude above normal. But my judgment is that over this time frame the risks are more likely asymmetric toward still weaker growth. So I give some considerable weight, 50 to 75 percent, to the alternative simulation of a collapse in consumer and business confidence. Having said that, the downside risk seems to be most acute in the fourth quarter because I'm also going to give very high weight to the alternative simulation of major fiscal stimulus. And by the first quarter, that also begins to weigh in importantly.

There is little that monetary policy can do through traditional channels to spur demand over this time frame. However, there might be and probably would be some salutary effect by bolstering confidence in the future. What we do and what we say should be designed to contribute to this end, and I think Governor Kelley made that point extremely well.

A second consideration concerns the implications for monetary policy of the evolution of overall financial conditions. Once again, we're confronted by a shock that has had direct effects both on financial conditions, specifically on equity prices, and on aggregate demand above and beyond the effect on equity prices. Monetary policy has to move aggressively enough to counter at least the adverse effects on overall financial conditions before it can hope to make a net contribution to offsetting the direct effect on aggregate demand.

Over the remainder of the forecast horizon it seems to me that the fiscal assumptions begin to dominate the forecast, complemented by the details of the internal dynamics of recovery as consumer sentiment and hopefully equity prices rebound. In addition, the latter development should be reinforced by the delayed contributions of the

forces we expected to support recovery before the events of September 11<sup>th</sup>, including a rebound in high-tech investment after a sharp and prolonged retrenchment and a return to inventory accumulation after liquidation runs its course.

Now, beyond the nearer-term period it seems to me that the risks turn to the upside, at least after mid-2002 and especially into 2003. My reading is that the fiscal stimulus will be an order of magnitude above that in the Greenbook baseline, something closer to the major fiscal stimulus simulation. Over this time frame, therefore, perhaps the key question is what monetary policy is a good fit with the assumed fiscal stimulus. There is a potential that an earlier and more aggressive reversal of recent and prospective monetary easing will ultimately be called for than may be contemplated at this point. Still, there's ample scope for additional monetary policy easing over the near term. In part this reflects the fact that, given the prospects of a rise in the unemployment rate to the 6 percent range, we should now be targeting a period of above trend growth. So, whereas before we might have thought that we needed stimulus to get economic growth back to trend as quickly as possible, now if we ended up with something that was less than a percentage point above trend I think we'd be disappointed. We could probably tolerate something even stronger than that for awhile. Nevertheless, as a number have already suggested, monetary policy will face the challenge at some point during the second period and beyond of a timely return toward neutrality.

I think the other issue relating to the strategy of monetary policy relates to the timing of any cumulative decline in the funds rate. Most of the bad macroeconomic news in particular relates to higher unemployment that lies ahead and likely will extend at least through the middle of next year. In evaluating what we do today, we should pay some

attention to how much more of a cumulative decline might be justified given the forecast we now hold. And then we need to consider how we should spread the change out over time so that we don't end up doing more than we would prefer to do. In addition, we might worry a bit about how we should signal markets about our future intentions so that we don't face market pressure again to move further than would be prudent. I must say, however, that I don't think that is really a story of today, but a story of what we do at subsequent meetings. Thank you.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. We've often spoken about the value of confidence in economic relationships. Confidence is a variable that is a direct term in no economic equation but is a key factor in almost all of them--consumption, investment, employment, stock markets, risk discounts, foreign trading, capital flows, and on down the list. The macroeconomic implications of a serious loss of confidence could be enormous. So what is the evidence? It has only been three weeks since the attacks and already there is a great deal of evidence that confidence is eroding. If you hadn't called a break, I was going to go through this list really quickly. I will still go through it quickly but a little less so now. [Laughter] One piece of evidence is travel demand, which is definitely down. Another is consumer confidence and Dave Stockton talked about that. Layoffs have risen. We see evidence in financial variables--the stock market, risk spreads on lesser-rated bonds, early signs of implied credit market volatility. There's some evidence that even housing demand and auto sales may be down in the period since September 11<sup>th</sup>.

There are two indicators on which I'm not quite sure about the timing. One, which Karen Johnson spoke about already, is the foreign sector. It's a little hard to tell what occurred before and after September 11<sup>th</sup>, but it's clear that the news there isn't good. Another is commodity prices, which have dropped sharply. I've often spoken about those before as a precursor of inflation. The staff has been persuading me that they may be an even better precursor of output demand, but whatever the case they are down sharply.

A last issue is the forecasts of others. The NABE took a survey of their forecasters since the event. Eighteen out of 21 of them had a significantly more pessimistic outlook. I'm not sure that they know any more than our forecasters, but all forecasters seem to be moving in one direction.

This all sets up what I see as a difficult policy problem. The attacks could be a major demand shock or a minor one, for a long period or a short period. Just how do we respond? On the fiscal side I think there are at least two things that fiscal policy should do. There should be expenditures for military and other security measures and compensation for the direct victims. Whether fiscal policy ought to do anything beyond that, I find a difficult question. But if more stimulus is required, I'd like to see it provided in a way that doesn't dissipate the long-term budget surplus, national saving, and the low long-term interest rates that have been a hallmark of the recent period.

On the monetary side, I also see the need for action. Monetary policy can be changed quickly. It can be used flexibly and it can be reversed just as quickly should circumstances change. As a number of you have said, this latter property is very important right now, given the massive uncertainty. The combination of short-term fiscal

easing and monetary easing I think is our best hope for keeping the economy as strong as possible in both the short run and the long run. Thanks.

CHAIRMAN GREENSPAN. Thank you. Let's move on to Don Kohn.

MR. KOHN. Thank you, Mr. Chairman. As noted in the Committee's announcement of two weeks ago, the terrorist attacks subjected an already weak economy to a further downward shock. Just before September 11<sup>th</sup> aggregate demand apparently was still being impeded by an ongoing downdraft in investment, as firms corrected a previous over-expansion of capital equipment, and the resulting decline in employment and equity prices threatened to sap consumer spending. As noted in the Greenbook, firm evidence that the downdraft was beginning to abate had not emerged and the economic forecast probably would again have been marked down and the anticipated strengthening pushed further into the future. The attacks themselves disrupted business transactions for a time and apparently have heightened concerns about the future, likely restraining spending even more and further delaying the resumption of solid growth.

A significant easing of financial conditions would seem to be called for to counter the effects of the unexpected weakness in demand from these various sources. While such an easing might have little effect on the near-term performance of the economy, it would appropriately give added impetus to an eventual return to full resource utilization. When the economy ultimately strengthens, it seems inevitable that it will resume growth from a base of an appreciably lower level of resource utilization than today or than you might have expected at your August meeting.

Yet financial conditions have not eased appreciably since late August. The pullback of investors in the face of perceptions of higher risk and weaker spending prospects apparently has offset the effects of the 50 basis points of easing you put in place two weeks ago and the further federal funds rate reductions now built into financial market prices. Broad measures of equity prices have fallen 10 to 20 percent since the August FOMC meeting and risk spreads have widened for all but the highest-rated businesses. Indeed, bond rates for many businesses are unchanged or even up considerably. In addition, the average value of the dollar on foreign exchange markets has appreciated slightly.

With markets strongly anticipating a further decrease in your federal funds rate target at this meeting, holding policy unchanged

likely would tighten financial conditions substantially. Thus, the question facing you today would seem to be not whether to ease further, but by how much. Market observers believe that your debate will be between 25 and 50 basis point reductions in the funds rate. The choice between these two would seem to depend not only on the most likely outcome for the economy under the two alternatives, but the risks around that modal outcome and the costs of missing to one side or the other.

The choice of a 25 basis point easing would be justified by concern that a larger action at this time could lead to policy becoming so accommodative over coming months that the rebound in demand beginning next year would be sharp enough to add to inflation pressures before a policy reversal could contain them effectively. A major uncertainty in the outlook is the stance of fiscal policy. Unless signs surface very quickly that near-term economic distress is abating, a process of political compromise by inclusion could well produce a substantially more expansive policy than is built into the staff forecast. When the resulting stimulus will hit the economy depends, of course, on the nature of the programs that are enacted. As next year goes on, however, aggregate demand could well be boosted by the effects of expansionary fiscal and monetary policies just as the internal dynamics of strengthening private demand take hold following the working down of inventory and investment goods overhangs.

Private demand also may be subject to upside as well as to the numerous downside risks. One possibility is that a good part of the cutback in spending in the last few weeks will turn out to be transitory. As the nature of the countermeasures against terrorism becomes clearer and more focused, as some successes are registered and security in the air and elsewhere is improved, uncertainty will narrow and some of the initial fears and perceptions of risk will decrease, fostering a return toward less distorted economic interactions and decisions. The rise in equity prices and decline in risk premiums over the last week may already have reflected some movement in this direction. Should activity rebound fairly strongly next year, upward pressures on wages and prices are likely to emerge at considerably lower levels of resource utilization than in the second half of the 1990s. The slower growth of structural productivity that seems to be in train would tend to boost unit labor costs at a time when profit margins have already been squeezed. Slimmer margins provide considerable inducement for businesses to pass labor costs through into prices and are likely to mute the competitive forces that make such a pass-through difficult, especially if, at the same time,

higher real interest rates induced by expansive fiscal policy militate against cost-saving capital deepening.

Although markets would be somewhat disappointed by a 25 basis point reduction in the federal funds rate target, the backup in other interest rates and the decline in equity prices likely would be limited by a sense that the FOMC was simply waiting for more definitive evidence of the dimensions of the response of demand to the attacks and was prepared to ease further, even within the intermeeting period, should the emerging information warrant. The total amount of additional ease built into the structure of market interest rates---now between 75 and 100 basis points--probably would be trimmed only a little. You may see these expectations as a reasonable assessment of the amount of ease needed to promote a satisfactory strengthening of the economy in 2002 and 2003. You may also see the resulting expectations as representing a highly likely policy outcome as well after a 25 basis point reduction at this meeting, given the possibility of further Committee actions as employment and production decline over the next several months.

But given the shocks to the economy and the absence of any apparent easing in financial conditions noted at the beginning of my discussion, the Committee may prefer a more aggressive policy action and want to lower the federal funds rate by 50 basis points at this meeting. The potential for inflation pressures to mount as the economy rebounds must be weighed against the likelihood of a prolonged period of weakness that opens up a sizable output gap. Indeed, the baseline forecast in the Greenbook describes the latter outcome. While that forecast assumes 50 basis points of easing over the fourth quarter, its assessment of likely demand and resource pressures would seem to suggest that an immediate reduction in the federal funds rate of 50 basis points would run minimal risk of higher inflation emerging before countervailing policy action had a chance to be felt. And, as shown in an alternative Greenbook simulation, stronger fiscal stimulus does not materially deflect the economy from the disinflationary track of the baseline projection.

If the headwinds facing the economy for a time are on the order of magnitude of those embodied in the staff forecast, a federal funds rate that is 50 basis points lower would not be all that accommodative. In real terms, such a rate would still be positive by many measures and above its level in previous periods of economic weakness--for example the early 1990s. With limited net financial stimulus in the pipeline even under this easier alternative, recovery importantly depends on the resiliency of the private economy as excesses are worked down and underlying investment incentives remain in place, with an extra push

from fiscal policy. Easier monetary policy itself can't address the underlying uncertainties and overhangs weighing on demand, but it can help to buoy asset prices and lower the cost of credit at least a little relative to a smaller easing move.

Moreover, in an uncertain environment, the larger action avoids the potential for especially adverse effects on confidence and risk-taking were the Committee seen to be less aggressive than anticipated. For this and other reasons, you may judge the probability that insufficiently accommodative policy would accentuate a process of progressive economic weakening that would be difficult to reverse as appreciably larger in the current circumstances than the probability that too stimulative a policy would intensify inflation pressures. Saving policy "ammunition" for later could create a situation in which much more easing is required before long to counter cumulating weakness. Of course, anticipatory and aggressive policy can lead to overshooting, but, by heading off worsening situations, it also is likely to require smaller total action than does policy that moves more gradually.

Market participants are likely to build in only a little, if any, more easing going forward should you lower the funds rate by 50 basis points at this meeting, given the high odds they have already put on this action. And their expectations of such a sizable move at this meeting have not led them to anticipate a number of further such declines in the future. The yield curve incorporates an additional 25 to 50 basis points of rate reductions by early next year followed by a subsequent rise in rates. Financial market participants evidently believe that you can ease aggressively and then stop and reverse in a timely fashion. Judging from the decline in TIPS spreads in recent weeks, the stickiness of long-term rates has been a response to more expansive fiscal policy rather than a reflection of rising inflation expectations as the path of the funds rate has been marked down.

Although a cut in the federal funds rate target at this meeting would bring the cumulative change in this rate to 100 or 125 basis points since late August, you may well see the risks to your objectives in the foreseeable future as still tilted toward economic weakness. Economic activity is almost certain to be quite soft in the near term, and the Committee would probably want evidence on the likely extent of the cutback in private demand and the impetus from fiscal policy before it could judge that this weakness was likely to be balanced by a strong rebound a few quarters hence.

CHAIRMAN GREENSPAN. Questions for Don? President Parry.

MR. PARRY. Don, I'd like to ask you and Dave a question about the chart and table in the Bluebook on Chart 4 following page 10. We've talked a bit about the equilibrium real rate as a way to measure the current stance of policy. If one believes that the equilibrium real rate is within the range of the shaded areas, the range has gotten so large that it leads one to believe, based on the Treasury inflation-indexed securities, that our policy is incredibly expansive. On the other hand, if one looks at some of the lower estimates, particularly the one based on historical data and the staff forecast, it appears as if we're providing an anemic amount of stimulus. I was thinking that perhaps you have some feelings or views about what rate within this historically wide range it might be reasonable for us to focus on.

MR. KOHN. I think the range is particularly wide because the staff forecast is dragging down the lower end of that range. The calculated equilibrium rates that tended to bring the range down are the ones that include the staff estimates of the restraining effects of both the pre-September 11<sup>th</sup> and post-September 11<sup>th</sup> shocks to demand. If you think the staff forecast is a reasonable estimate of where the economy will go--or at least a reasonable mode of that estimate--then something toward the lower end of that range probably is where you would think the rate is. Also, having the third-quarter inflation-indexed security at a 3.8 percent real rate doesn't reflect the most recent declines in that rate. That rate has declined some over the third quarter and I don't know what the forward rate derived from that would look like if we did it today. My guess is that it would be at least a number of tenths lower than shown in this chart. The TIPS rate reflects people's expectations about fiscal policy. That's a rate derived from going out on the yield curve, so it embodies the effects of the more expansionary fiscal policy as that

policy kicks in later next year and in future years. The elevated level is a reflection of that steep upward slope of the yield curve, partly supply induced and partly I think macroeconomically induced in the sense of the effects of fiscal policy over coming quarters. But probably somewhere out later next year and in following years the calculation would have interest rates being pushed up as a reflection of the expected turnaround in monetary policy.

MR. PARRY. So you think the degree of monetary ease is, pick one: huge, moderate, or meager?

MR. KOHN. I think right now it's moderate and I--well, I won't give a policy recommendation! [Laughter]

CHAIRMAN GREENSPAN. May I make a suggestion? Why don't you have Dave Stockton talk to you about this. He's got it down pat.

MR. STOCKTON. It's a little easier for me to answer this question because in some sense I would look at the line on Chart 4 labeled "FRB/US model, based on historical data and the staff forecast" as something that would approximate our best guess as to what the equilibrium rate is. Therefore, I'd have to say monetary policy provides a small to moderate amount of stimulus. I would hate to depress you further about this analysis, however, by pointing out that each one of these estimates has a significant confidence interval! The bottom edge of that shaded area is not the full confidence range that one could have.

CHAIRMAN GREENSPAN. I knew you wouldn't disappoint me! [Laughter]

MR. STOCKTON. I'm going to stop right there.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Actually, I was going to ask about what you just discussed, so I withdraw the question in the interest of moving things along.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. I wanted to follow up on that discussion of the equilibrium real rate because I think many of us have come to believe that information on this--if we had confidence in it--is very valuable to our setting of policy. I applaud the research that the staff has been doing on this subject; I think it already has provided a lot of insights and has been very useful. I have to say, however, that I have a high degree of skepticism about the amount of short-term variation in the staff measure of the equilibrium real rate. I think that at this point our methodology hasn't really allowed us to separate out very effectively cyclical from longer-term influences. So I think the issue needs some more thought. For one, the path of the equilibrium real rate has so much sensitivity to near-term data that I think any estimate that is not based upon a forecast that goes out at least five years for example--and returns to some sense of normality--has to be discounted considerably. But I think that's work for the future.

CHAIRMAN GREENSPAN. Anybody else? In keeping with the way Dave Stockton started off this discussion, I'll continue. I think the wide range of uncertainties regarding what has happened and what is about to happen has been fully explored here and I believe very effectively so. We learn a lot about the uncertainties that we face just by listening to those who are involved in evaluating recent developments--for example, what the individual presidents have said about what is going on in their Districts. And I think the degree of humility that the rest of us have expressed about our understanding is

a measure of the fact that we are indeed dealing with a situation that is extraordinarily uncertain.

The one area that has not been mentioned, which I believe requires a bit of discussion, is the very dramatic decline that we have had in equity asset prices. We are talking about losses in the last week or so of more than a trillion dollars in the value of stock market holdings. What we know about this sort of phenomenon is that it has a really significant impact. While it may be difficult to make a judgment as to the magnitude of that impact, we do have to have some sense of what the appropriate value of stocks ought to be or what equity premiums ought to be in the context of what we perceive to be the long-term equilibrium real federal funds rate. The work that has been done around here suggests, adjusted with all due humility, that the equity market is still slightly above where it ought to be. That is not an important issue in and of itself, but what is important is history. History suggests that markets do not go from over-valuation to normal valuation and stay there. It suggests that markets almost invariably over-adjust in the opposite direction. That in turn suggests to me that the notion that somehow we are beyond any further deflation from the asset side is at least open to serious question. I don't pretend to say that the adjustment process needs to occur very quickly. Indeed, one scenario could involve a very large adjustment in equity prices, a couple of years of hiatus, and then another adjustment. Clearly, that is not a noncredible scenario. We have seen it in the past.

All I want to indicate here is that the risks clearly are on the downside. And without getting into more discussion on the issue, I would merely say that what we ought to do--as I think most of the people around this table already have suggested--is to ease

by 50 basis points and retain the statement indicating that the risks are tilted toward economic weakness. The pluses and the minuses have been fully explored, and I think that would be the appropriate policy at this point. Vice Chair.

VICE CHAIRMAN MCDONOUGH. I fully support your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. I also support your recommendation.

CHAIRMAN GREENSPAN. Governor Meyer.

MR. MEYER. I support your recommendation.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. I support your recommendation. I would make just a couple of quick comments that relate to the chart we were talking about a minute ago. One way I looked at that was to ask the question: Going forward, which mistake do we most want to avoid? Given the fragility and the psychology of the market, I think we most want to avoid not appearing to be willing to take this action. So what you propose is exactly what I want. Second, I would like to say ditto to what the Vice Chairman said earlier. I expect--and maybe hope--that we will have to reverse this easing move. But I think the market is already thinking about that. We don't need to say it. And it is probably better if our statement is shorter rather than longer. Thank you.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I support your recommendation.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. I support it.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I support your recommendation, Mr. Chairman.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I support the 50 basis point reduction in the target rate today.

But for the period between now and the next meeting, I think the statement that was included in our announcement of the 17<sup>th</sup> is probably going to be needed again. As the President said, the terrorists decided when and how this started. The United States and its allies will decide when and how it ends. We don't know when that's going to be. If there is another occasion of greatly heightened anxiety, I would hope that the Desk would again be willing to let the funds rate trade as low as necessary to provide adequate liquidity.

VICE CHAIRMAN MCDONOUGH. The market will assume that.

CHAIRMAN GREENSPAN. Yes, I agree with the Vice Chair. Indeed, one of the things we haven't discussed relates to the implications of another episode. My impression is that in such an event we will do what we've done in the past. We would issue an FOMC statement at that time indicating in effect what you're suggesting. I prefer not to put that into the statement today. I think it complicates it and probably isn't necessary. President Santomero.

MR. SANTOMERO. I support your recommendation.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I support your recommendation.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, I support your recommendation, but I would like to add a comment. We've talked a lot about business and consumer confidence, and I think the state of confidence is not independent of our own visibility. Let me emphasize that point by assuming something contrary to fact because I think it will make the point clear. Suppose all of us who are commonly out on the road from time to time giving speeches and talking to the press were to withdraw from that activity? I think that would send a very bad message to the markets. It would say that we're terrified to fly and that we're terrified to talk because we might say something that would upset the markets. I think it's important that we be visible. We should work to resume a sense of normality. And the message that we all agree on around the table is the one that we should be stating publicly: The economy has excellent long-run prospects; our economy and society have strong fundamentals to deal with the short-run uncertainties, but there is no way to forecast what that short run is going to look like and, therefore, we're not going to offer such a forecast. For us to hunker down and disappear because we're afraid of saying something that might be wrong or misinterpreted is only going to tend to erode public confidence.

CHAIRMAN GREENSPAN. No, I think hunkering down was the appropriate thing to do right after the shock.

MR. POOLE. Right, but we're now three weeks beyond that shock.

CHAIRMAN GREENSPAN. Yes, I agree with you. There's certainly no need for us to change our normal practices. I do think our degree of uncertainty is higher, but that's the nature of the game.

MR. POOLE. Well, I just wanted to make that point clear because I feel very strongly that we must not disappear.

CHAIRMAN GREENSPAN. No, I agree with that.

MS. MINEHAN. Mr. Chairman, could I add a comment to that?

CHAIRMAN GREENSPAN. Yes.

MS. MINEHAN. It isn't always necessary to be speaking to the press in order to be seen as visible within the District. I've done more outreach than usual since September 11<sup>th</sup> to any number of groups without appearing in the press one time. And I feel comfortable, though I know the range of uncertainty is wide, that because of that activity I have some feel of what is going on--much more so than if I had made a dozen speeches. That's because these interactions give us more information and they involve less effort and worry than speaking to the press, with all the preparation that goes into that. So I think it's something that we all ought to think about carefully as we balance how to spend our time.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. I agree with your recommendation, Mr. Chairman. I don't think today is the time to take a risk of adversely affecting business confidence.

CHAIRMAN GREENSPAN. President Guynn.

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

CHAIRMAN GREENSPAN. Governor Kelley.

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

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. I support your recommendation.

CHAIRMAN GREENSPAN. And finally, President McTeer.

MR. MCTEER. I support your recommendation.

CHAIRMAN GREENSPAN. Thank you. Would you proceed to read the appropriate text?

MR. BERNARD. You'll find the wording on page 13 of Bluebook: "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 2-1/2 percent." For the balance of risks statement in the press statement: "Against the background of its long-run goals of price stability and sustainable economic growth, and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

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

CHAIRMAN GREENSPAN. I'd like to call a recess and request that the Board of Governors meet next door to discuss an appropriate action on the discount rate requests of the Reserve Banks.

[Meeting recessed]

CHAIRMAN GREENSPAN. As you can see in the draft press statement we've distributed, we've adopted the Hoenig principle on these types of press releases on the grounds that the more we try to say, the more complex the issue gets and the less clear our actual message. I think that has worked well and we thank you.

MR. HOENIG. Oh, you're very welcome! [Laughter]

CHAIRMAN GREENSPAN. In any event, this wording is very close to the previous statement made after our last meeting. I assume you've all had a chance to look at it. Does anybody have any strong objections to letting it go as it is? If not, I thank you all very much.

Our next meeting is scheduled for November 6<sup>th</sup>. This meeting is adjourned but we will have Don Winn as our guest at lunch to give us a review of the legislative agenda.

END OF MEETING