

**Meeting of the Federal Open Market Committee on  
August 13, 2002**

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 13, 2002, at 9:00 a.m. Those present were the following:

Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Mr. Bernanke  
Ms. Bies  
Mr. Ferguson  
Mr. Gramlich  
Mr. Jordan  
Mr. Kohn  
Mr. McTeer  
Mr. Olson  
Mr. Santomero  
Mr. Stern

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the  
Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal  
Reserve Banks of Kansas City, Boston, and St. Louis respectively

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

Mr. Connors, Ms. Cumming, Messrs. Howard and Lindsey, Ms. Mester,  
Messrs. Oliner, Rolnick, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

Messrs. Slifman and Struckmeyer, Associate Directors, Divisions of Research and Statistics, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

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

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

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

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

Messrs. Connolly and Stewart, First Vice Presidents, Federal Reserve Banks of Boston and New York respectively

Messrs. Goodfriend, Hakkio, Hunter, and Rasche, Senior Vice Presidents, Federal Reserve Banks of Richmond, Kansas City, Chicago, and St. Louis respectively

Messrs. Bryan, Cox, and Cunningham, Ms. Hargraves, Messrs. Rudebusch and Tootell, Vice Presidents, Federal Reserve Banks of Cleveland, Dallas, Atlanta, New York, San Francisco, and Boston respectively

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CHAIRMAN GREENSPAN. To start, I'd like to welcome Governors Bernanke and Kohn to their first meeting. This is the first time we've had a full contingent at an FOMC meeting in four years, I believe. Jack Gynn is back. How are you feeling, Jack?

MR. GYNN. It's nice to be back, thanks.

CHAIRMAN GREENSPAN. You can kick us around again. [Laughter]

MR. GYNN. I wouldn't dare do that.

CHAIRMAN GREENSPAN. Turning to our first agenda item, would somebody move to approve the minutes of June 25-26?

VICE CHAIRMAN MCDONOUGH. So move.

CHAIRMAN GREENSPAN. Without objection. We have in front of us a proposal to nominate Vincent Reinhart to replace Donald Kohn as Secretary and Economist of the FOMC to serve until the election of a successor at the first meeting of the Committee after December 31, 2002. Would somebody like to officially move that nomination?

MR. FERGUSON. I'll move that nomination.

CHAIRMAN GREENSPAN. Is there a second?

MR. JORDAN. Second.

CHAIRMAN GREENSPAN. All in favor say "aye."

SEVERAL. Aye.

CHAIRMAN GREENSPAN. I won't ask for the "no's."

VICE CHAIRMAN MCDONOUGH. Don Kohn isn't sure! [Laughter]

MR. KOHN. He's very sure!

CHAIRMAN GREENSPAN. I was more worried about Vince myself. Dino Kos, would you start us off, please?

MR. KOS.<sup>1</sup> Thank you, Mr. Chairman. Good morning. I'll be referring to the charts that were circulated a short time ago. On the first page, the top panel graphs U.S. and euro-area three-month interbank cash deposits rates as well as rates three months forward and nine months forward. The U.S. rates are in red, and those for the euro area are in green. The U.S. cash three-month deposit rates edged lower by a few basis points in the intermeeting period. But the three-month forward rate fell about 30 basis points and now trades slightly below the current three-month cash rate. The three-month rate nine months forward fell nearly 1 percentage point. All of these rates were influenced by lower equity prices, economic data that came in weaker than the market had hoped, and budding expectations of lower official rates at some point. The euro-area rates, shown by the green line, exhibit a similar if somewhat less pronounced pattern in recent months. Forward rates for the euro area are now at or below cash rates. The market's fling in early May with a possible tightening of policy has evaporated, as market participants downgraded their forecasts of the economic situation in the euro area and as the euro's appreciation came to be viewed as doing some of the ECB's work for it. In the bottom panel, Japanese short-term rates continued to stay low, and there's not very much to say there. U.S. Treasury yields moved lower in the intermeeting period, responding to the same economic and equity market news that affected U.S. forward rates. Liquidity in the U.S. Treasury market has been good, as is the case generally in the mortgage backed and swaps markets.

But one segment that has frayed a bit is the corporate sector, which is covered on page 2. The top panel on page 2 shows—with the dark bars—weekly issuance of investment-grade corporate debt for the year to date. March and early spring were active, as many corporations termed out commercial paper into longer-term liabilities. Issuance subsequently turned down and in the most recent weeks has slowed to a trickle. Perhaps there are seasonal effects, though that is only part of the story. As depicted by the red line, issuance held up during this period in 2001 with the exception of the July 4 week, which is always a week when there's little or no activity. On the demand side, investors who have taken losses in their portfolios in recent months have been reluctant to expand the amount of credit risk in their holdings. And on the supply side, companies appear to be a bit more restrained about raising funds in the current atmosphere.

The middle panel depicts the spread over Treasuries of investment-grade debt since April 1. This is a Lehman Brothers index, which indicated a spread that was hovering mostly between 175 and 200 basis points for much of the spring. That was an already elevated spread, but perhaps understandable given the accounting and corporate governance issues that investors have had to factor into their pricing. From late June until early August, spreads widened another 50 basis points, to more than

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

250 basis points. Liquidity in the corporate sector decreased during this period, with dealers widening out spreads and reducing the amount for which a quote would be good down to about \$5 million in many cases. This has made it very difficult for investors to transfer larger positions.

While telecom names have been problematic for some time, new sectors have become tainted. Energy trading and power companies are one example. And in the past few weeks, the bonds of the auto companies have also been repriced downward. Representative of that, I've shown in the bottom left panel the spreads over Treasuries of Ford Motor Credit and GMAC bonds since July 23. The spreads for both have widened sharply in the two weeks, particularly for Ford, which was hit by rumors of a possible downgrade. The 7¼ percent bond of 2011 widened from 350 to 450 basis points, and other Ford bonds rose to as high as 500 basis points over Treasuries in the past few trading days. The bottom right-hand panel depicts the bid-asked spread, expressed in basis points, for the same two bonds shown at left. This spread in a normal environment might be 2 or 3 basis points. By late July it had already widened out to 5 basis points for GMAC and 10 basis points for Ford Motor Credit. The spreads then ballooned to 20 and 30 basis points, respectively, in the first seven or eight trading sessions in August.

As the equity markets declined and fixed income markets turned volatile, the price of insurance expressed by implied volatilities rose. The top panel on page 3 graphs the implied volatility on the S&P 100 equity index, which had been rising steadily since late May but spiked higher in July and peaked at about 50 percent in late July and again in early August. This is slightly higher than the peaks reached in 1998 and higher than the peak in September 2001 after the terrorist attacks. The middle panel shows the volatility index for short and intermediate swaptions. These are implied volatilities on options that give the holder the right but not the obligation to exercise and roll into an interest rate swap. These instruments are used extensively in hedging operations, especially by mortgage investors. Both indexes have hit very high levels recently. The short-term swaption index has nearly doubled to almost 45 percent. By way of comparison, that index peaked at about 20 percent in 1998 and at 36 percent in the aftermath of September 11. The intermediate-term index is also at elevated levels and is currently near levels observed in October 1998. In contrast, implied volatilities on currency options rose in late June but quickly began to trend lower again. None of the three major currency pairs is now near the peak levels observed in either 1998 or 2001. Part of the reason currency volatilities have been restrained is perhaps that speculative positions appear to be relatively small; hence there is less demand by that segment for hedging purposes. It may also reflect the market's lack of conviction about the future course of volatility in exchange rates, as the major economies are expected to move broadly in sync.

Turning to page 4, the top panel graphs the dollar's exchange rate against the euro, the yen, the Swiss franc, the Canadian dollar, and the Australian dollar re-indexed to April 1. The dollar had been falling against all major currencies through mid-June, and it continued to depreciate against the euro, the yen, and the Swiss

franc. But the U.S. dollar actually began to appreciate against the Australian and Canadian dollars, as investors came to view a slowdown in the United States as adverse for major commodity currencies. More recently, the reassessment of growth prospects in Europe has resulted at least in a pause in the dollar's trend to the downside against other currencies. The reduced growth prospects overseas can also be seen in equity markets. The middle panel depicts changes in the S&P 500 and major global equity indexes since April 1. All major indexes are lower, though those for France and Germany, with heavy representations of telecom and media firms, have performed worse than the others. Finally, in the bottom panel is the spread on ten-year minus two-year government yields for the United States, Canada, Japan, the United Kingdom, and Germany. As growth expectations have come down, the curves have steepened, primarily by virtue of the two-year note declining faster than the ten-year note in each of these countries. The exception, of course, is Japan, where yields at the short end can't go any lower than they are now.

Mr. Chairman, there were no foreign operations for the System account in this period, and I will need a vote to ratify our domestic operations. I would be happy to take any questions. Thank you.

CHAIRMAN GREENSPAN. Refresh my memory. What was it that occurred on August 1 that abruptly opened the bid-asked spreads on Ford Motor Credit Company and GMAC debt? Obviously, as shown in the graph, the spread was flat prior to that time, and then it suddenly bounced.

MR. KOS. I don't know that there was any single event. There were rumors at about that time that Ford Motor might be downgraded. Since then those rumors have taken on even more steam.

CHAIRMAN GREENSPAN. But General Motors did not have the same problems, as I recall.

MR. KOS. Yes, I agree with that. Again, what seemed to be involved was a liquidity shift and not really a single event. Now, corporate governance and accounting stories were circulating, but these companies were not tied to those. I think that's one of the more interesting aspects about these bonds. The issuers are not in industries that have been tainted by those problems, which does point to some interesting questions.

CHAIRMAN GREENSPAN. What would happen if you were to choose a number of other similarly situated so-called “untainted” companies? Well, today nobody is untainted, unfortunately. Would you get the same sort of pattern? What is very interesting about this is that the widening in the spreads starts on the first of the month. While I vaguely recall that that’s not the same period in which BBB and high-yield bonds really began to take off against Treasuries, it’s not that far off, is it?

MR. KOS. This is a very short period; it’s only about two weeks. Again, these spreads had already begun to rise earlier. They were then stable for a few days and subsequently began rising again. If I could approach your question in a slightly different way—I think if we looked at a number of companies, the patterns in their spreads might depend in part not only on perceived creditworthiness but on how much debt they have outstanding. Ford Motor Credit is, I believe, the largest issuer in the bond market. It’s a very, very large issuer, and of course, GMAC is as well. A year or two ago investors wanted to hold these jumbo issues. They were considered desirable because investors perceived them as having a lot of liquidity. Now, we know what has happened to some of the jumbo issues like those of WorldCom. Suddenly investors don’t want to have these big positions on their books. They actually prefer to have debt of issuers that don’t come to market that much, which will help to diversify their portfolios. So to some degree a firm’s having lots of paper out there was perceived to be an advantage from the investor’s perspective two years ago, and it is not viewed as advantageous today.

CHAIRMAN GREENSPAN. So it’s not the corporation; it’s the investor. It’s the demand not the supply, so to speak.

MR. KOS. Well, it’s a mix. To some extent it may be that investors have some questions about the auto companies specifically. They’re selling a lot of cars—auto sales have

been strong—and yet they don't seem to be making any money. So there may be a repricing of their creditworthiness as well.

CHAIRMAN GREENSPAN. They need the debt, but the debt service capability is not there.

MR. KOS. Exactly.

CHAIRMAN GREENSPAN. What does GE Capital look like in that regard?

MR. KOS. I don't have the exact numbers in mind, but if I remember correctly, they haven't had quite this kind of deleterious performance.

MR. REINHART. Mr. Chairman, one way to look at it would be the credit defaults swap spread for GE Capital—this is for five-year protection against default—which is 75 basis points versus 290 for GMAC and 455 for Ford Motor Credit. It did rise, however, about 15 basis points over the intermeeting period. But in comparison, the Ford Motor Credit spread rose 265 basis points over that period.

CHAIRMAN GREENSPAN. Yes. What I find interesting about the profitless sales argument is that the markets knew that July was going to be a really big month for auto sales. Indeed, they caught on to it very early, and the estimates in the marketplace didn't change much throughout the month. Yet there is no evidence of this move until the end of that month. So, the system doesn't square in a number of respects.

MR. REINHART. Mr. Chairman, one other aspect that was talked about at that time was the financial strength of the parent. There were a number of stories about GM particularly and the unfunded pension liabilities associated with the declines in equity prices. So it's also possible that that could have affected investor sentiment toward those companies, independently of what they sell.

CHAIRMAN GREENSPAN. That's true, a pension fund problem would clearly be reflected in these types of numbers. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I think another factor that increasingly has crept into the market, and for some reason it seems to have increased a lot on or about August 1, is the risk aversion on the part of marketmakers. One can see it in the bid-asked spreads and investors' willingness to hold in portfolio amounts that would have been considered quite manageable a year ago. One can see it in the international markets and the domestic markets. Market participants are just running scared; and when they're running scared, they tend to manage much lower positions, and we get much greater volatility in markets.

CHAIRMAN GREENSPAN. Yes, I think that's clearly what the data show. But that's like taking somebody's temperature and then saying it's high. It doesn't tell us why it's high.

VICE CHAIRMAN MCDONOUGH. Well, I think one is looking for a rational explanation of fear, and fear is not entirely rational.

CHAIRMAN GREENSPAN. Well, that's a good point. But sometimes, regrettably, it tends to be.

VICE CHAIRMAN MCDONOUGH. I think they have reasons to be frightened, but they're a little more frightened than one would wish they were.

CHAIRMAN GREENSPAN. Incidentally, I've been impressed with the tightness of the Australian and Canadian dollars for the obvious reasons of the nature of their international positions. But that relationship looks peculiarly tight over the intermeeting period. Has it always been that tight going back?

MR. KOS. Broadly, they do tend to move together, but we can have periods when the correlation is fairly low. It seems that at times—such as now, when the perception about the

outlook for the economy is changing—they tend to move together. At other times, they'll move on local factors and not as much on international ones.

CHAIRMAN GREENSPAN. The composition of their internationally traded goods is really quite similar. They are very heavy in wheat, minerals, and metals.

MR. KOS. I think the answer to your question is “yes, often.” But at times the correlation will break down.

CHAIRMAN GREENSPAN. Further questions for Dino?

MS. BIES. I have a question. Can you comment just a little on what you see happening in the commercial paper markets at this time?

MR. KOS. Well, the amounts of outstanding commercial paper have come down. I would note two developments in particular in that market. One is that commercial paper for a long time was a very low cost way of raising money. But having seen the commercial paper market shut down to so many issuers, other corporations now are thinking twice about how to structure their liabilities. They're being a little more cautious about how much they want to rely on commercial paper. There is also an interesting effect between commercial paper backup lines and credit default swaps. That is, a firm wants to issue commercial paper and needs to have backup lines of credit. The firm gets these cheap backup lines, and the people who provide the backup lines then run out and hedge through the credit default swaps. We then have this effect that Vince mentioned that the credit default swap rates go up and that makes it appear as if the market has less confidence in the creditworthiness of those specific issuers. It has this unintended consequence for the issuer. And I think people are finally beginning to figure that out. To some degree I think issuers are having some second thoughts about how much paper

they want to issue, given that there's this avenue through which other people might view them as being less creditworthy.

MR. REINHART. Also, Governor Bies, July was the first month in which commercial paper outstanding increased this year. One important reason was that there have been large inflows to money market mutual funds and the fund managers had to invest those dollars somewhere. So probably on the margin that made commercial paper a little more attractive.

MR. PARRY. But didn't the turnaround occur in nonfinancial commercial paper?

MR. REINHART. Yes, July was the first monthly increase in nonfinancial commercial paper this year.

VICE CHAIRMAN MCDONOUGH. I move approval of the domestic operations.

CHAIRMAN GREENSPAN. Without objection. Thank you, very much. We'll now go to David Wilcox and Karen Johnson.

MR. WILCOX. Thank you, Mr. Chairman. I suspect that the typical reader of the recent business press would find the outlook described in the August Greenbook surprisingly bright. After all, the drumbeat of negative news during the last few weeks has been nearly unrelenting, with news of corporate accounting scandals, somber warnings about future earnings, stock prices that have been headed more south than north, negative results on hiring and especially hours in July, sour reports from various associations of purchasing managers around the country, a disheartening reading on consumer sentiment, and the spectacle of the nation's top CEOs and CFOs having to swear that they are telling the truth in the documents they submit to the Securities and Exchange Commission. One of the few upbeat counterpoints has been the persistent strength of consumer spending, most strikingly for new motor vehicles but also, according to this morning's advance report, for other goods as well. But the brisk pace of traffic in auto showrooms hasn't dissuaded many observers from focusing on the possibility of a second bout of contraction. In that context, how do we explain a projection featuring 2½ percent growth in real GDP on average this quarter and next, with the unemployment rate edging up only a little and private-sector payrolls starting to show some life?

Unfortunately, of course, it is all too possible that the pundits have it right. But I want to begin by outlining a few of the reasons why, based on the information currently in hand, we think the more likely path forward involves continued recovery, even if at a sluggish pace by historical standards. First, by far the bulk of the earlier

inventory problem now seems to have been worked off. There are still a few entries on the “watch” list—most notably communications equipment—but for most goods, inventory holdings are in much better alignment with sales, and if anything, even a bit lean. While the *timing* of the lift from inventory investment is highly uncertain, we are reasonably confident that the lift will come and probably not too long from now. Second, monetary policy remains accommodative. Measured in real terms, the funds rate is in the neighborhood of zero, a very low level by historical standards. If you prefer to measure the stance of policy in terms of the deviation of  $r$  from  $r^*$ , you could take comfort in the fact that the actual real funds rate still appears to be well below the equilibrium rate, even if by a somewhat smaller margin according to our latest estimates. And one important lesson of the recent experience is that the policy channels are working fine: Low prevailing market rates allowed the automakers to offer the cut-rate financing deals that attracted so many customers, and historically low mortgage rates have helped sustain residential investment in the face of steeply declining wealth and uncertain prospects for the labor market.

On the fiscal policy side, the marginal-rate cut implemented at the beginning of this year still should be feeding through into household spending. And we continue to believe that businesses will be encouraged by the temporary partial-expensing provision to boost their spending on new equipment and software. Part of the impetus from the federal level will be offset on the state and local side, but the government sector as a whole should be a net plus for the growth of GDP. At the margin, the downturn in the dollar during the last few months will also be a plus, especially in comparison with the run-up during the preceding two years.

Taken together, these factors are enough to support sustained growth in GDP in our baseline projection. We had projected that consumers would not flag in their actual spending—even if they continue to share their apprehensions with the University of Michigan and the Conference Board—and this morning’s retail sales report provides reassuring evidence on that point. And in the business sector, while we have become much gloomier about the outlook for nonresidential structures, we still see spending on equipment and software as being on a slow but steady path to recovery.

We also updated our views about a number of important parameters on the supply side of the economy. First, the annual revisions to the national income and product accounts told us that the average pace of growth during the last few years was several tenths lower than previously estimated. From this information, we inferred that the pace of structural productivity growth probably had been slower—and likely would remain slower—than we had previously estimated, so we revised down our estimate of the rate of growth of potential GDP. But with the slower rate of growth of structural productivity, we were left with an incipient puzzle: The favorable inflation performance of the last few years stood essentially as before, but now it appeared that structural productivity growth was a less powerful explanation. To fill the gap, we marked down our assumption for the NAIRU, from  $5\frac{1}{4}$  percent to 5 percent, thereby

generating enough additional labor market slack to make the inflation picture fit together.

Over the intermeeting period, the volatility in the stock market left major indexes down substantially on net. Two items in this regard are worth noting. First, if the long-term earnings growth projections of the equity analysts are to be given any credence—and that is a mighty big “if”—then a real possibility has emerged that stocks are currently *undervalued*. This points to one of the upside risks that we highlighted in the Alternative Simulations section of the Greenbook. Second, perhaps on cue from our Alternative Simulations section, stock prices have rebounded some since we put the Greenbook to bed last week. If we had had the foresight to anticipate that mini-recovery, we wouldn’t have altered our projection for the remainder of this year materially but would have shown another tenth or two of growth next year.

All in all, we see the incoming information as telling us that the economy is moving along a growth track that is slower than previously projected but moving forward nonetheless and with a slightly wider gap in resource utilization. In that context, the prospects for future inflation remain extremely favorable. In the near term, the greater margin of slack and its implication of even less inflationary pressure are essentially offset by the reduced contribution from structural productivity growth and by the acceleration we anticipate in import prices. Although the net effect of these factors is essentially nil in 2003, if we had shown you a projection this time around for 2004, as we will in the next Greenbook, you would have seen core PCE inflation edging down another tenth or two from its already very low level.

Having highlighted the upside risk from the possible undervaluation of the stock market, let me close by underscoring the possibility of a shortfall in aggregate demand. As you know from reading the Greenbook, one of the downside risks we featured was a further disappointment in business spending for equipment and software. In particular, we simulated the effects for the rest of the economy of assuming that outlays for E&S are flat for the remainder of this year and increase only half as fast next year as in our baseline projection. According to our model, the probability of an investment surprise of this magnitude is in the neighborhood of 10 to 15 percent. In the simulation we reported in the Greenbook, the funds rate was assumed to be held fixed in nominal terms, and in that case, the output gap was estimated to widen by nearly 1 percentage point relative to the baseline. However, a policymaker following an aggressive version of the Taylor rule could limit the increase in the GDP gap to a little more than  $\frac{1}{2}$  percentage point by moving the funds rate down by about  $\frac{3}{4}$  percentage point by the fourth quarter of next year.

A second downside possibility we examined is that households adopt the same type of caution that seems to have characterized recent business behavior and so push up the personal saving rate 1 percentage point higher than in our baseline. The model suggests that the probability of such a large ongoing shift in the personal saving rate, quarter after quarter, is very remote. But one can alternatively view this shock as a

stand-in for the full range of shocks on the demand side of the model; and under that interpretation, a shortfall of this magnitude has about a 10 percent probability of occurring, according to our model. In the results that we showed in the Greenbook, the GDP gap finishes 2003 about 1½ percentage points wider than in the baseline. However, a policymaker whose behavior is described by an aggressive Taylor rule once again can limit the damage, in this case holding the increase in the GDP gap to about ¾ percentage point by dropping the funds rate about 1 percentage point by the first half of next year. Karen Johnson will now continue our presentation.

MS. JOHNSON. As we tried to convey in the Greenbook, the staff outlook for the global economy over the remainder of this year and next is a bit weaker than last time and less certain. The factors behind this change in tone with respect to global prospects can be grouped into three categories: (1) recent developments that are broadly global in nature, in particular global financial market developments; (2) consequences for key foreign economies of the downward revision to our forecast for U.S. real growth; and (3) developments that essentially are external to the U.S. economy and are being driven by economic and political shocks abroad.

The sharp decline and heightened volatility in equity prices over the intermeeting period was a common feature across most global stock markets. European equity prices were particularly hard hit. As in the United States, the effects of the resulting loss of wealth on total spending are partially offset by the declines that have occurred in many long-term interest rates. But long rates in the other major industrial countries generally moved down less than did those in U.S. markets. Although foreign stock markets seemed to take their cue primarily from movements in U.S. markets, issues of corporate governance and accounting accuracy have also arisen with respect to some large foreign firms. And a general reduction in the willingness on the part of investors to bear risk seems to be widespread. Certain sectors, such as European insurance firms, have been particularly penalized in the current market environment.

We expect that these less favorable financial conditions will weigh on confidence and spending abroad. Indeed, we have some early readings on confidence that indicate such a reaction. Negative wealth effects are to be expected particularly in the United Kingdom and Canada, where our research tells us that consumers are quite sensitive to wealth changes. The contractionary effects of these financial market developments should be cushioned, however, by the absence of monetary tightening on the part of most major foreign central banks in the near term. Although in June we had incorporated such tightening into the forecast, we share the view currently reflected in short-term interest rate futures that monetary policy will remain generally accommodative into next year in the major foreign industrial countries.

As we noted in the Greenbook, several of the regions that evidenced strength in the first half of the year, in some cases more than we were expecting, depended for that strength on their export sectors. This was the case in Japan, in emerging Asia, and to some extent in Europe. For Japan and emerging Asia, a significant part of the rebound in exports was in the high-tech sector. Continued recovery in that sector

depends broadly on global developments. But a key risk to ongoing expansion in these export-dependent economies is a negative surprise in U.S. output growth.

The downward revision made to the outlook for the U.S. economy fed directly into our less optimistic outlooks for Canada and Mexico. Canada has been something of an outlier among the industrial countries during the first half of this year, recording rapid output growth in both quarters and strength in final domestic demand. In response, the Bank of Canada has raised its policy rate a total of 75 basis points since April. We expect Canadian growth to slow to a more sustainable rate, and we have edged projected growth down a bit more to reflect the somewhat weaker path for U.S. real GDP this time than in the June Greenbook. Similarly, we are looking for recovery to become established in Mexico, the one bright spot in our outlook for Latin America. However, we have shaded our projection for Mexico in light of the less favorable U.S. projection.

Finally, a series of developments in the past several weeks in a few foreign countries, importantly several in South America, have cast significant gloom over the foreign outlook. To some degree, problems in these countries have interacted to reinforce the negative effects being felt in each and to raise the risk of a serious collapse in economic activity and stability in the region. Because of the size of its economy and the extent of its participation in global financial markets, Brazil is arguably the most important of the potential crises brewing in South America.

The proximate cause of Brazil's current financial distress is concern on the part of investors, both domestic and foreign, about the future course of economic policy in Brazil as a result of the election to be held in October. The current government has generally followed policies since the January 1999 crisis that have met with market approval. But there is nothing that this government can do to ensure the continuation of such policies. And statements alone by the candidates have not been reassuring to markets, especially in light of the long-standing differences in political positions and sources of support of the three principal candidates. Spreads on Brazilian dollar-denominated debt rose from 1,500 basis points to around 2,400 basis points over less than two weeks, as political news swayed markets. Reports circulated that international banks were withdrawing trade credits and similar short-term lines.

After the Greenbook was finalized, the IMF announced an extension and enlargement of Brazil's existing IMF program that will total about \$30 billion. One important feature of this new program is that only \$6 billion is to be disbursed this year, with the remainder slated for 2003, after the new government is in place. Thus the program should create strong incentives for the new government, regardless of who wins, to follow policies consistent with the program in order to obtain those funds. Market participants now understand that those incentives are in place and that, because of the IMF commitment, the Brazilian government could have sufficient resources to manage its sovereign debt in 2003.

To be successful the program has to result in lower spreads and improved exchange rate stability for Brazil following the election and perhaps much sooner. To help in that regard, the program gives Brazilian officials more scope to use their existing reserves to provide liquidity to bond markets and to intervene in the foreign exchange market. Although the program is large and designed to reassure markets, it is something of a gamble. Enough capital needs to remain in Brazil for the private economy to function reasonably between now and the election. After the election, market-compatible policies need to be followed—either because of the incentives created by the IMF program or because, once elected, the new president will have to weigh election rhetoric against the cold light of reality in making his choices. Following the announcement, spreads first narrowed sharply and the *real* appreciated. However, investor enthusiasm for the loan package is already waning. The *real* has subsequently more than reversed its post-announcement gains, despite intervention support for the currency, and spreads have backed up to more than 2,300 basis points.

The Greenbook baseline forecast is for Brazil to weather this storm. Output is expected to stagnate during the rest of this year, as turbulent financial conditions and heightened uncertainty disrupt economic activity. But low growth is projected to resume next year as financial conditions improve. However, the risk that financial conditions will instead deteriorate further and force some kind of debt standstill and/or capital controls before the election even takes place is certainly present. In that situation, the incentives for the new government, once elected, to follow market-compatible policies would be greatly reduced. If that is the course followed by Brazil, the pressures on other South American countries and their financial systems will intensify and prospects for even low growth of economic activity in the region will be sharply reduced. That concludes our report. We'd be happy to take any questions.

CHAIRMAN GREENSPAN. I've been meaning to ask you this recently. I notice that the export data on high-tech equipment from Singapore, Taiwan, and other East Asian countries tend to be quite current. I always have the impression that I somehow seem to be getting insights into the American high-tech order pattern in advance from those data. Is that an illusion, or is there something systematic in that relationship?

MS. JOHNSON. Well, first of all, they are industry data. There is a good apparatus for monitoring developments that is generally industry based.

CHAIRMAN GREENSPAN. Especially in Singapore.

MS. JOHNSON. Yes. In those economies, high-tech exports are such a large part of what is going on that it is a focus. So I think in some sense, yes, it might be an early reflection of the orders of their principal purchaser, the United States.

CHAIRMAN GREESPAN. What I'm trying to get at is that we order, for example, from Singapore. But it seems to me that before data are available on our orders, exports coming out of Singapore are reported. I don't know whether that's factually accurate though.

MS. JOHNSON. I think it is close.

MR. STOCKTON. Actually we now get fairly timely data that we purchase from the semiconductor industry on global production, which I think are probably as timely as the export data. But there's a very high degree of correlation because of the global integration of this industry across all these data sources. I think in some sense we've seen that show up fairly reliably in the export data and on the import side as well, and in the global production data that we're using to construct industrial production.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. I had a question for David on the very large drop in the workweek in July. In the Greenbook you said that you expect that to be reversed. We looked at the historical data and over the last fifteen years there has only been one time that we've seen a drop this significant where it wasn't associated with a strike or bad weather or something of that sort. So I'm just wondering if you had any further insights on that from your deep background contacts at BLS. Or was it just a question of probabilities that you're expecting this reversal?

MR. WILCOX. It's a risk. We brought the workweek back from 34.0 to 34.2 hours in our assumptions for August and September partly on the judgment that this year July 4 fell on a Thursday so it was particularly easy for employers to grant a four-day weekend. That's relevant

for those employers who are on a biweekly reporting basis because that period would be included in the time frame of the reports that they submitted to the BLS. In addition, we saw the weekly claims data coming down over the month. So our guess was, partly on the basis of statistical considerations and what we read as the trajectory of the labor market over the month, that the survey results were not representative of the month as a whole.

MR. MOSKOW. The BLS people didn't have any further insights into this?

MR. WILCOX. I think they concur in the judgment regarding July 4, and I don't believe they offered an opinion on the remainder of our logic.

MR. MOSKOW. Thank you.

CHAIRMAN GREENSPAN. President Parry?

MR. PARRY. David, in the Greenbook forecast the growth rate has been revised down a full percentage point, roughly, for the second half and about 0.6 percentage point for next year. It seemed to me in looking at the Greenbook that a very large portion of that change was a result of the annual revisions and the effects of those revisions on productivity and potential. Not much of the change appeared to be due to what I guess was referred to in yesterday's Board briefing as the "headwinds" and some of the negatives you've been talking about that have affected the economy very recently. Would you agree with that assessment, or do I have those proportions differently parsed?

MR. WILCOX. I have a different take on it. We took potential GDP growth down 0.3 this year and 0.4 next year, and our model simulations suggest that that should feed through essentially one for one into the growth of aggregate demand. So the way I'd parse it out is that I'd say about 0.3 of the roughly 1 percentage point revision for the second half reflects the adjustment to our trend rate of growth of potential GDP. For next year, I'd attribute a larger

fraction of our revision, perhaps 0.4 of our total revision of 0.6, to the adjustment to the growth of potential GDP. In growth rate terms, the negative news from the stock market is very important for this year as are the adverse signals that we think we're getting about production in the near term from the labor market report and from the negative purchasing managers' surveys. We also gave a nod to the adverse results from consumer sentiment surveys, as modulated by strong auto sales. So the larger fraction of the revision this year is due to other indicators that we think tell us that the gap is going to be widening.

MR. PARRY. Thank you.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I'd like to compliment Karen on what I thought was an extremely sensitive and unfortunately highly accurate picture of the dangers in Brazil. Her report was very well done. Aggravating the Brazilian situation is the fact that the major international banks dealing there are, as I mentioned earlier, part of the "running scared" group. The two big Spanish banks are very active in Brazil. They've taken severe losses in Argentina and are very concerned about what could happen to them in Brazil. The major American banks are seeing their names in the paper in a rather unflattering way and are also quite risk averse. So, unfortunately, what seems to have happened in the last few days is that the international banking community is taking advantage of the IMF package to reduce their exposure. That in any long-term sense is very much against their interest and is not very smart, but that seems to be what they're doing.

Another effect of their conduct, if it continues—which I sincerely hope it will not—is that it will almost certainly bring about a much higher likelihood that any future IMF program will have as a conditioned precedent a quite formal agreement between the country and its

international creditors. The reason that the IMF didn't do so in the case of Brazil, I think wisely, is that the situation was sufficiently precarious that, if they sat around negotiating some sort of "stand still" agreement with Brazil's creditors, the country certainly would have tanked. So it was a risk that the Fund had to take. But if the international banking community continues to behave as it has in the last few days, I think it will be very difficult in the future for the Fund to organize a major package like this and take the risk of the same thing happening. So, in addition to the very accurate picture that Karen gave, there is this potential aggravating factor. Thank you.

CHAIRMAN GREENSPAN. Further questions for our colleagues? If not, would somebody like to begin the Committee discussion? President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. On balance, the general tone of the reports on business conditions in the Seventh District continues mixed. Most of our contacts are still waiting to see the light at the end of the tunnel. However, for the first time in a long while, I started to receive some upbeat reports from several of my regular contacts who are directors, CEOs, or other senior leaders of businesses with large national operations. It's still too early to tell whether these reflect a turning point, but I was encouraged by the unexpected good news.

Reports on consumer spending remain mixed both within the District and at the national level. Discount chains still appear to be doing all right. However, a large developer and operator of retail malls said that traffic slowed in June and weakened further in July and early August. Air travel had been trending back toward pre-September 11 levels but has flattened out since June. For manufacturing, our regional purchasing managers' indexes in Chicago, Detroit, and Milwaukee present a picture of anemic growth in the District. But the motor vehicle sector is relatively strong. The return of zero percent financing programs has boosted sales, and we've

heard that light vehicle production plans for the third and fourth quarters are likely to be raised again. Heavy-duty truck production and shipments will be strong through October but are expected to drop off markedly after that, as the new EPA regulations on engines take effect. Some of the positive news that I heard was from our contacts in the railroad and packaging industries who indicated that shipping volumes were up in June and July. Trucking contacts also were upbeat, but this may reflect the shakeout of excess trucking capacity during the last year instead of a pickup in overall demand.

Turning to capital spending, we still are not hearing any reports of plans to increase outlays. We asked our directors and our Beige Book contacts whether the recent special tax depreciation allowances had affected capital spending decisions, and only a very few indicated that they had moved up the timing of some investments. Of course, it's still early, and there was a sense that spending might pick up closer to the time when the provisions are set to expire.

The vast majority of our contacts continue to say that they have little pricing power. There were, however, a few reports of price increases—for example, in steel, plastic resins, and tuition costs. Within the District, employers remain reluctant to take on new permanent hires. At the national level, Manpower's latest survey, which will be publicly released on August 26, shows hiring plans for the fourth quarter remaining at the improved third-quarter level. Our Manpower contact also said that he did not think that the decline in temporary employment in the July payroll numbers was indicative of conditions in the help-supply industry, which he continues to view as being better than in previous recoveries. Our Kelly Services contact was less optimistic.

Turning to the national outlook, we appear to have hit quite a rough patch in the recovery. The incoming data have been disappointing though not uniformly so. We must make a judgment

on whether the economy is currently experiencing a temporary slowdown in activity, a prolonged period of subpar growth that is being generated by special circumstances in this expansion, or the beginnings of another downturn. In doing so we must think about the consequences of the latest shock to the financial sector, the recent revelations suggesting that failures in corporate governance extend beyond a handful of black sheep firms. These revelations have added a great deal of skittishness to an already uncertain business climate. They also have broadened the perception that during the late 1990s markets had been overestimating the returns and underestimating the risks associated with many investment projects. So, what is the fallout of this on economic activity? One impact may be the recent disappointing readings on orders. Indeed, when I combine all of this with what I'm hearing from my contacts I'm concerned that we may be in for further weakness in business spending.

There are negatives for the household sector as well. Confidence is down, and the drop in equity prices since our May meeting has made a substantial dent in households' balance sheets. However, the strong response to the latest set of auto incentives reminds us not to give up on the consumer. Furthermore, even after the NIPA revisions, the underlying trend in productivity still appears to be positive. This suggests that some of the recent disappointing news regarding real activity reflects transitory movements in volatile data as opposed to a more persistent weakening in activity. And we have to remind ourselves that, given the typical lags, we are now entering the period when last fall's rate cuts should have their strongest effects.

So balancing these factors we, too, have marked down our forecast for growth, but our best guess is that the softness we're currently seeing will not cascade further either into an actual double-dip or a prolonged period of growth well below potential. Similar to the Greenbook, we now are thinking that real GDP growth will average closer to 3 percent in 2002 and 3½ percent

in 2003, down from the projected rate of 3¾ percent for both years in our previous forecast. This outlook is conditioned on our prolonging a period of accommodative monetary policy. So, I think maintaining our current stance is appropriate. But it will be important for us to acknowledge in our statement the current rough patch in the expansion.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, economic activity in the West continues to expand but at a modest pace. Lackluster job growth, stock market volatility, and the daily announcements of corporate scandals have worked to damp consumer confidence in the West in recent weeks. More-uncertain consumers appear to have reined in spending somewhat, especially on nondiscounted products. Consumers also have pulled back on investment activity, prompting another round of layoffs at local brokerage firms. Charles Schwab, for example, recently announced that it will lay off 1,000 more people in coming quarters, about 5 percent of its current staff. On the bright side, aggressive pricing practices have kept car sales robust, and home sales continue to increase, although there are some signs that real estate markets are cooling. Visitor counts and travel spending also improved in the District, driven by solid increases in domestic demand. Although job growth remained subdued in most District states, productivity growth likely has kept output expanding. However, District growth probably is not outpacing the rest of the nation, as we appear to have lost most of our productivity growth advantage over the last year.

The District's high-tech sector has continued to expand recently but at a more subdued pace than many had expected. Demand for personal computers, consumer electronics, and telecommunications equipment has fallen in recent months, moderating the outlook among District semiconductor makers. Intel, the District's largest chip producer, announced plans to lay

off 4,000 workers, and about half of Intel's 83,000 employees actually reside in the Twelfth District. Conditions among software makers were mixed, with Microsoft announcing plans to expand payrolls but firms like Oracle cutting costs to maintain profitability. Overall, District technology contacts have pushed back their time frame for full recovery in the sector. Moreover, a number of firms are saying that things may get slightly worse before they get better. The long downturn in the tech sector is taking a toll on a number of District investment companies. The technology-oriented investment bank, Robertson Stevens, closed its doors last month, as you all know, letting go more than 800 employees. Venture capital firms also are feeling the strain. We now expect a number of these firms to merge or to go out of business by the end of this year.

I'd like to comment on the West Coast port situation. There's no doubt that any work disruption at West Coast ports would be extremely costly. However, the threat of such an action either by labor or by management has diminished significantly over the last several weeks. Contract negotiations resume today, and our contacts believe that both sides are eager for a settlement. As the probability of a strike has decreased, reports we've received of precautionary importing on the part of firms have subsided.

Turning to the national economy, while some recent news on real activity has been on the weak side, we have lowered our forecast for GDP growth in the second half of this year only about ½ percentage point, not nearly as much as the reduction in the Greenbook forecast. After the surge in the first quarter, domestic demand has held up fairly well. We believe the 1.1 percent increase in real GDP in the second quarter gives an overly pessimistic impression, as several temporary factors such as a spike in imports and mild winter weather probably restrained second-quarter growth and boosted growth in the first quarter. Furthermore, real consumer spending and disposable income turned up strongly in June, and auto sales, of course, jumped in

July. Both of these developments bode well for third-quarter growth. I would add that I think the retail sales data that we have just received are certainly supportive of that as well.

In addition, I'm encouraged that real capital spending on equipment and software posted a long-awaited increase last quarter. Of course, some other recent indicators of economic activity have fallen short of expectations, especially payroll employment, aggregate hours, and orders for capital goods. Also, the roller coaster that financial markets have been riding should sap some strength from the economy, particularly next year, although interest rates often have tended to follow equity prices up and down and may have partially offset the damage.

On balance, we continue to see a moderate expansion as the most likely outcome. In particular, a double-dip still seems to be only a remote possibility. We anticipate growth in the second half of this year of almost 3½ percent. Assuming a steady funds rate, we project real GDP growth of about 4 percent in 2003, and we continue to expect inflation to remain well contained, with the core PCE price index increasing about 1½ percent next year. I'd also say that significant slack in resource utilization certainly remains, especially in manufacturing. However, the current easy stance of monetary policy appears well calibrated to provide sufficient stimulus to ensure economic recovery. Thank you.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, the Tenth District economy for the most part has followed the national economy. After rebounding in the first half of the year, it has slowed appreciably. Layoff announcements rose noticeably in July and early August. Let me talk about the manufacturing sector in our District, which appears for the most part to have improved since last fall and winter. But it also, in a sense, has topped off. Our July survey shows about the same level of manufacturing activity as in June and, while firms are still optimistic about the

future, they also indicate that they're cautiously optimistic. And that's a bit of a change since the spring. Labor markets remain slack, with firms having no difficulty filling almost any position at this point. Retail spending and housing activity continue to hold up well. Retailers are generally optimistic about future sales and are showing some willingness to build inventories. Auto sales, as in the rest of the country, have responded to the financing incentives. And home sales and construction remain solid on the retail side though, of course, office space is pretty much dead. Energy activity in the District actually remained strong, with the rig count holding on to earlier gains. However, there are some issues in Wyoming because energy firms have produced a lot of natural gas but have no way of getting it out of the area. So that's causing some pressures there. Price pressures remained subdued across the District. District manufacturers expect further increases in materials costs, but they have no intimation that they can pass them on at this time.

I want to talk briefly about the drought. I know there is a drought generally in this country, but it has been particularly severe in our part of the country. If you draw a line north-south through the middle of Kansas and Nebraska, the area surrounding that line has been enormously dry. In some parts of Kansas the residents consider themselves lucky to have had almost three inches of rain since January 1 of this year. It shows in the soil. I recently drove through a good part of these areas in the District, and the picture is quite dramatic. Reservoirs in Colorado are at anywhere between 20 and 60 percent of capacity in terms of their water levels. Dillon Lake, which some of you may know because the Interstate and the Eisenhower Tunnel are near there, is reported to be between 50 percent and 60 percent of capacity. It looks like a wheat bed in much of that extremely dry area. I talked with some of the agricultural people in Colorado about the cattle situation. Hay production, which is very important to them, is somewhere in the range of 15 to 20 percent of normal. That puts them in a dilemma because

they need a lot of snow this winter and, if it materializes, then they can't afford to feed the livestock. That's why we have the liquidation of cattle inventory going on. In fact, cattle auctions in some areas are being held seven days a week and there is no market. So the situation is particularly dire there. As for land sales in the ranch area, as one major real estate dealer said to me, the market is virtually dead. In sum, the drought is very severe. It's as bad as in the 1950s and actually as bad as it was in the 1930s in much of this region. One likely impact of this may be on fiscal policy, because as I understand it there is a fairly strong effort under way to enact some type of bailout or support for stockmen in the western part of the United States. We'll watch and see how that goes.

Turning to the national economy, I'll be relatively brief. We have no major disagreements with the Greenbook. We also have revised down our forecast to below 3 percent, for the reasons that others have delineated here. One point I do want to note, though, is that in talking with contacts at major companies that are not investment grade but one level below that, I am being told that credit standards have become tighter. One man in particular said that his firm's financial numbers—and they're standing by their numbers—show pretty good improvement in the past year. But even with that, when they've gone to their bank lenders to discuss rolling over debt, they have been asked to show improved ratios before the banks will renew those lines. So in that sense credit standards have tightened quite noticeably.

As for the outlook, I think growth will be slower but still positive. The reason for that is the stimulus that continues to exist in this economy. We will watch that carefully, obviously. But we do look for somewhat less than 3 percent growth this year and into 2003. Thank you.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. Economic conditions in the Southeast have deteriorated somewhat further across almost all sectors since our June meeting. I keep looking for positive signs of a pickup in growth, but evidence seems sparse at this point. One consolation is that activity remains at a relatively high level.

Turning to individual sectors, regional retailers report that sales weakened overall despite an improvement in auto sales. Manufacturing activity in the Southeast continued lackluster, but executives remain relatively optimistic, and inventories are reportedly balanced in most cases. Our contacts report that technology spending in the District has generally been restricted to software upgrades, with substantial new investment remaining on hold. Our growing regional auto industry is one area that continues to invest and expand. One announcement was unique. One of our Tennessee directors is a top North American executive for Nissan, and he told us that Nissan plans to increase capacity at their yet-to-be-completed Canton, Mississippi, plant by adding some 1,300 additional jobs even before producing the very first car. I believe that may be the first time that kind of thing has happened in the United States. The rest of our regional auto industry also continues to expand, reflecting the strong auto sales nationwide. Honda is expanding its Lincoln, Alabama, plant and plans to add 2,000 jobs in 2004. And a number of other such announcements have been made in recent months.

Reflecting the slow pace of manufacturing, employment growth in that sector remained modest at best. However, overall District employment shrank about 0.7 percent, slightly less than in the nation as a whole. Florida and Georgia did register modest job gains in June, but the other four states in our District posted job losses. Despite the lower payroll numbers, the District unemployment rate actually declined 0.2 percent, to 5.2 percent, in June because the labor force shrank for the second consecutive month.

The other positive sector continues to be housing. Residential markets posted more-moderate growth in recent months, but activity remained at very high levels. New home construction was essentially flat, and inventories were balanced in most markets. Home sales rose modestly in June compared with a year ago, and realtors generally anticipate that sales in the third and fourth quarters will exceed year-ago levels. The chairman of our Bank's board is a large custom homebuilder, operating in several states, and he reports that the high-end market clearly has softened in a number of cities. Multifamily housing and commercial real estate remain weak, although some improvement in industrial leasing is showing up in a few markets. In contrast, as elsewhere, the office market shows no sign of improvement yet, and my inquiries among leading architectural firms have picked up few signs of new activity in the pipeline.

Meanwhile reports from the tourism and hospitality sector were not as upbeat as earlier this year. Disney says it is operating at 90 percent of normal capacity for this time of year, and visitors appear to be staying for shorter periods and spending less this year compared with last year. Business travel is still quite weak.

There have been some concerns expressed recently about a possible credit crunch, but that isn't consistent with the information provided by my examiners or what we are hearing anecdotally. Consumer lending continues to increase moderately, and the share of problem assets remains relatively low. In most areas, banks continue to report little growth in commercial loan demand. And mortgage lenders, not surprisingly, say that they expect continued strong demand from borrowers in the second half of the year.

Finally at the regional level, I would note that the only current price pressures showing up are for health care, insurance, and steel. The impact of the 30 percent tariff on imported steel is particularly pronounced and is being felt in steel prices across the District. Some car

manufacturers and others tell us that they are now facing double-digit increases in prices of imported steel goods.

On the national front, the high-frequency data combined with recent revisions to both the GDP and the productivity statistics are not as encouraging as we might have hoped following our last meeting. Virtually all forecasts have been revised downward, reflecting lower growth rates for key components such as investment, weaker data on consumer expectations, construction, manufacturing, core capital goods, and all the other things that people have already listed. My own expectations going into the year were perhaps a bit more modest than some. But I've been disappointed that we are not yet seeing some early signs of building momentum. As a great believer in technology, I had expected to see more investment spending of that type by now, both to reduce costs and to exploit new product opportunities. But even that has been slow to get restarted.

Putting all the data and the stories together, the picture that emerges for me is one of businesses still very much hunkered down, putting off both investment spending and additions to staff. Despite that, unemployment, if it does not rise appreciably further, is still at a relatively modest level compared with some other cycles. One of my economists half jokingly reminded me that current unemployment is actually below some earlier estimates of NAIRU. The current level of employment is still providing income at levels to support some growth in consumer spending despite the adjustments taking place there. And it's hard to see any big kick from government spending over the period ahead, as growing pressures on revenues and spending at the state and local level are offsetting some of the federal spending that we're getting.

All things considered, I share the Greenbook's view that the most likely path over the near term is slow, unexceptional, growth that only gradually moves back toward potential next

year. While it is easy to get impatient, as many people are now doing, it's important as we move into the policy discussion later to remind ourselves and others once again just how accommodative policy already is. And we need to avoid the unintended consequences of possibly doing something at this point that would thwart the generally orderly adjustment process that is still taking place in a number of areas. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Thank you, Mr. Chairman. Over and over again from people who come through the Bank and from those I meet in traveling around the District, the very common refrain I hear on the cost side is that health insurance and other insurance costs are causing a lot of problems. Labor turnover is down, and labor is readily available. I hear that repeatedly. I'd say that the pessimists are only mildly pessimistic and that the optimists are only mildly optimistic. The overall view is sort of blah. But I think it's important that it's blah and not yuck! [Laughter] Slow growth seems to be the expectation.

Based on the comments I hear from contacts at some of the big firms that I call, inventories are reported to be slim. My contact at Wal-Mart said that the company has sold out essentially all its summer merchandise. My FedEx contact reported that all of his customers indicate that inventories are slim. Probably the most interesting thing I learned from my recent phone calls had to do with developments abroad. Obviously, South America has severe problems. But a number of people I spoke with pointed to good performance in Asia. My J.B. Hunt trucking contact said that their domestic business is very slow but they see a lot of demand for capacity to move goods out of the West Coast ports. So the goods are coming in for the fall and the holiday shopping season. My FedEx contact indicated that his firm's volume from Asia to the rest of the world was up 25 percent in a recent month compared with the same

month last year. For goods of European origin, business is up 15 percent on a year-over-year basis. And my UPS contact has the same judgment on that. So I reason from that information that a lot of goods are flowing into this country from abroad. That would, of course, also fit with the import numbers that we got for the second quarter. And the expectation seems to be that that will continue. Thank you.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Economic growth appears to be slow right now, whether we look at it regionally, nationally, or internationally. The latest data from the Eleventh District point to widespread weakness across the region and across industries. A modest recovery appears to be under way, but it lacks the economic drivers—energy, high-tech, and trade—that usually provide boosts to economic activity in our region. Sluggish growth and continued productivity gains place the District in pretty much the same position as the United States, with a jobless recovery similar to the one following the 1990-91 recession.

After losing hourly wage and salary jobs nearly every month from April to December 2001, Texas seemed to turn the corner in January with a solid gain in employment. However, the advances of early this year have slowly evaporated, and private employment levels for the second quarter of 2002 have fallen back to those of the fourth quarter of 2001. The three-month rate of job loss has been greatest in mining, manufacturing, transportation, communications, and trade, all of which saw job losses accelerate in June. Some offsets came in government employment and in services to consumers and businesses but not enough to stop the overall decline.

Whether we look along the border, in the oil patch, at the farm belt, at the high-tech electronics-based economies of Austin and Dallas, or in the District's largest economy, Houston,

we see few encouraging signs of strength. Our leading indicators index for Texas has been flat since January and continues to point toward sluggish growth ahead. There is little reason to expect any of the key drivers of regional growth in the 1990s to return soon. We still have a substantial overhang of regional high-tech capacity, and Mexico is yet to pull decisively out of recession. And travel reductions and war rumors plus the slow pace of industrial recovery have kept oil and gas reserves relatively high. In sum, District economic activity is still weak and is expected to remain so for some time. We likely won't be helping to lead the national economy into expansion. We'll probably be following this time, as we've become more reliant on the nation for good news.

Turning to the nation, I find it difficult to be sure that a solid recovery has taken hold when so much of the growth we thought we had achieved vanished with the GDP revisions. Moreover, as in the Eleventh District economy, the drivers for growth in the national economy appear to have weakened as well. The recent recession was marked by two distinctive elements: a dramatic decline in investment with a hard hit high-tech sector yet consumers who kept on spending. Recent data suggest that investment has hit bottom and has begun to rebound. But this rebound can't continue apart from consumer uptake of the products firms are offering. In the last expansion, my sense is that firms got a little ahead of consumers in terms of their vision for the future. Firms were able to offer tons of new and better products, from faster computers to videophones, at a rate beyond what consumers could absorb. So they inevitably had to pull back, and investors' cash got burned. With such a recent experience, I don't expect investment to return to anywhere near the levels of the late 1990s—nor should it. Consumer spending is not as strong as it was in the mid-to-late 1990s, and it is not likely to return to that pace in view of a more cautious consumer. Stock market declines, extremely volatile financial markets, recent

accounting scandals, and corporate ethics problems plus continued concerns over war and terrorism have made consumers more reticent, and that is likely to continue for some time.

I'd also feel better about the national economy if I saw a brighter international one. But I don't. Across Europe the pace of recovery seems to have slowed in recent months. Argentina is stuck in a crisis. Brazil may be headed for a double-dip recession or worse. And the strength of Mexico's recovery is in question as is the condition of most Latin American economies. The economies of Japan and Taiwan have stabilized but remain sluggish. About the only robust economies internationally are those of China and Korea.

Overall, coming back to my opening statement, growth appears to be slow now and for the foreseeable future almost no matter where we look. The currently slow expansion needs something new to drive it forward. And the risks have clearly shifted downward toward economic weakness.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. If at our last meeting the recovery in New England seemed to be bubbling along, albeit unevenly, it now seems that the heat really has been turned down. Activity hasn't ground to a complete halt, but areas that seemed poised to improve in May now seem to be pausing or perhaps even stalling out as the effect of weaker national economic growth and the overhang of financial market uncertainty and risk aversion have cast a considerable pall.

New England lost jobs in June relative to a year earlier, and on a month-to-month basis the region registered its sharpest employment declines since last October. In May it seemed that regional job levels were poised to grow, and two states actually had employment levels above their pre-recession peaks. Now only one state—the smallest, Rhode Island—is above its earlier

high, and the largest states in the region are both below their peaks and below year-earlier job totals. The District's steepest job losses continue to be in manufacturing, especially in the high-tech arena. These employment losses reflect not only weak domestic demand for manufactured goods but also falling exports. Data available for the first quarter show merchandise exports for the region down 21 percent versus 15 percent for the nation as a whole, with all six New England states and virtually all major industries and export destinations registering declines. Contacts in manufacturing expressed considerable uncertainty and see cost cutting, not revenue growth, as key to their near-term survival. They see the stock market affecting both capital goods demand and consumer willingness to spend. Some view this as a race between a collapse in consumer sentiment that could undermine growth and an improvement in employment that could buoy confidence.

Residential real estate markets are vibrant. Indeed, some contacts fear a bubble is growing there and report price increases in some areas that border on those of the late 1980s. Commercial real estate markets remain weak, however, especially in Boston. Data from three sources all point in the same direction. Vacancy rates have multiplied and are likely to get worse before they get better. This is not a real estate problem affecting the major banks as it was in the 1980s since overbuilding using bank credit is not the issue. Over-committing on the part of tenants is the problem. Rental rates are falling. Considerable amounts of unused space have been sublet or currently remain unused, and new tenants could be hard to find as lease terms expire.

Both consumer and business confidence dropped in July after a modest decline in June. Consumers registered pessimism about current as well as future conditions, and perhaps reflecting this pessimism, retail sales were reported to be flat or down in June and July. Business

confidence, as measured by a local index, fell below 50 into negative territory. The drop was said to be related to the fact that the expected third-quarter upturn was not materializing and that prospects for sustained growth seem to be receding into the future. An index of leading indicators from Massachusetts moved down in tandem with the confidence index. Both point to the delayed turnaround in technology industries as a key source of the region's economic softness. While the pace of job layoffs nationwide seems to have abated, industries that are key in our region such as telecommunications, computers, and electronics continue to register large layoffs. A review of job postings on Monster.com and a quarterly confidence survey of technology executives conducted by the Massachusetts high-tech council pointed to a continuing employment drought within the region's technology sectors.

The gloom, doom, and volatility in the financial markets have taken a toll as well. Equity mutual funds in the region experienced large outflows in July, though much of this flow found its way to bond or money market funds in the same family. One contact reported a marked change in the attitudes and even voices of individuals as they called customer service centers in July. In this person's words, fear seemed to predominate. An executive at a major insurance company reported the worst losses in the company's corporate bond portfolio in its long history. Finally, the perfect storm of Latin American turmoil, the demise of the dot-com world, and continuing negative credit surprises have taken a toll on one major regional banking organization. In sum, it's not a pretty picture in New England.

Incoming data for the nation as a whole haven't been that pretty either, with booming auto sales—albeit at discounts—and residential investment the major exceptions. Whether it was slow or nonexistent employment growth, downward projections for corporate profits, falling nondefense capital orders, dropping confidence and sentiment indicators, or the cooling off in

foreign markets and economies, the data have been downbeat on the state of the real economy. But the 300-pound gorilla is clearly the volatility and negative direction of U.S. capital and equity markets. Reflecting the data and the overhang of market sentiment, the Greenbook authors have written down their forecast, and we have, too, in Boston. Since we both use many of the same frameworks, it's not surprising that our forecasts for 2002 and 2003 look very similar, with below-potential growth for much of the period. But we show somewhat lower inflation and higher unemployment in 2003 than does the Greenbook.

More important than a particular forecast, however, is where the risks are and whether we are adequately poised to address them. It's hard to see how the consumer can continue to be the mainstay of economic growth without better news on the job front. And without that, I think the confidence indicators are telling us that spending on residential investment will slow. Businesses seem so preoccupied with market volatility and cost cutting in order to maintain some profit margin that new hiring and new investment seem further off in time. And as we've seen, if the U.S. economy does not bounce back, foreign economies won't either. Real economic data no longer seem at variance with the markets. Together they both paint a darker picture of the future.

So I see the risks largely on the downside to a forecast that, given usual post-recession patterns, is pretty downbeat already. Is monetary policy poised to address a slowly growing economy with downside risks? I wonder. Until recently I thought the current historically low level of the federal funds rate was more than accommodative and not consistent with price stability over time. I thought that our next move had to be up as conditions in labor and other resource markets began to tighten. Now, however, the financial market headwinds of equity downturns and widening credit market spreads combined with the sense that the real economy has stalled call into question how accommodative policy is. The Bluebook assessment of

equilibrium rates seems to indicate that current real rates are less accommodative than earlier. The perfect foresight modeling indicates that further reductions in rates would be consistent with maintaining and even lowering inflation over the next couple of years. Now, models need to be taken with a grain of salt. But the direction of this analysis and what we're seeing in the economy and the markets seem to me to point to the possibility that further policy support, a bit of insurance perhaps, might spur growth without inflation risk. When and how to ease policy further and what to say about it—even if we don't do it right away—without causing further market uncertainty are obvious questions.

CHAIRMAN GREENSPAN. Thank you. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. Incoming data point to continued moderate recovery in economic activity in the Third District, but the pace has slowed from earlier this year. Retail sales in the region were mainly flat in July but were up from year-ago levels in most product lines. Local auto dealers report that the new rounds of incentives supported increased sales in July. Many of the area retailers we contacted did express some concern that the recent turmoil in financial markets and lower consumer confidence could lead to a pullback in consumer spending. As a result, retailers have become a bit more cautious in placing orders for goods. Regional real estate markets are consistent with national trends: Residential markets remain strong while commercial markets remain weak. Residential construction contracts, housing permits, and home sales have all been increasing this year compared with the same period last year. Housing markets have shown somewhat more strength in our region than in the nation as a whole. In the first quarter, house-price appreciation was above the national average in New Jersey and about at the national average in Pennsylvania and Delaware. In contrast, commercial real estate markets remained soft. Office vacancy rates are

around 12 or 13 percent in the city of Philadelphia and even higher in the suburban markets where construction of some new office space has been completed. New buildings coming on line in the first quarter were only half leased.

Labor markets in the District remain stable. Employment in our region increased slightly in June for the first time in eighteen months. The unemployment rate in Delaware, New Jersey, and Pennsylvania remained below that of the nation. The tri-state unemployment rate stood at 5.4 percent in the second quarter compared with 5.9 percent for the nation. Activity in the region's manufacturing sector is mixed. In July our business outlook survey index of general activity posted its seventh positive reading in a row. Although manufacturing activity in the region expanded in July, it did so at a slower pace than earlier this year. Based on our August survey, which will be released this Thursday, that trend continued in August. The new data suggested some contraction in regional manufacturing this month; the August number is minus 3.1. To me this is not good news. However, I caution you that it is only a single month and that recoveries are not always linear.

Inflation remains modest in the region. Wages and house prices are rising at a somewhat faster pace in the Philadelphia region than in the nation, but industrial prices are mostly holding steady. The sluggishness of the recovery has taken its toll on the budgets of the three states in our District. All three cut spending to below plan during the fiscal year ending June 30, 2002. Pennsylvania and New Jersey have also used their rainy day funds to replace a large portion of the revenue shortfall. The increase in New Jersey's fiscal year 2003 budget over its 2002 budget is based upon very optimistic assumptions about income and sales tax revenues. Because state revenue growth generally lags the end of a recession, state fiscal problems are expected to continue at least through fiscal year 2003.

Nevertheless, the incoming data suggest that the Third District has continued to experience a gradual recovery. It is more gradual than I would like, but perhaps I should be content. In the past our District has felt recessions more deeply than the nation and has lagged the nation in its recoveries. This time we have kept pace.

Turning to the national outlook, incoming data on the national economy have been weaker than expected. This is undeniable. And the stock market retreat is likely to further damp both business investment and consumer expenditures. As a result, my outlook for the economy has been tempered from my earlier view, which was not overly optimistic. Nevertheless, in my view the data taken as a whole continue to tell us that a moderate recovery is under way, albeit a more gradual one than we would like. Consequently, monetary policy will probably have to remain accommodative for longer than we had previously thought. However, we should keep in mind that the weak second-quarter GDP growth reflected a surprising surge in imports rather than unexpectedly weak domestic demand. Inventory decumulations slowed substantially in the first quarter, and inventories were essentially unchanged in the second quarter. In addition, we saw a moderate increase in business investment in equipment and software in the second quarter. Labor markets have stabilized, although they have not yet bounced back. All this is consistent with a recovery.

Going forward, the recent declines in the stock market, if sustained, will temper consumer spending and business investment. But it is still too soon to know by how much and, for that matter, the market's future course. In my opinion the sluggishness in labor markets is potentially a larger downside risk to consumer spending than the stock market declines. Could the recovery derail? Yes. But by and large the weaker economic data we have seen pertain to a single month. We should remember that recoveries usually proceed in fits and starts and that our

data are subject to revision. For example, the data available to the Committee in October 1992 showed that economic growth was weakening. GDP growth had come in at 2.9 percent in the first quarter and 1.5 percent in the second. Employment reportedly had fallen in three of the four previous months for a cumulative loss of 87,000 jobs. But subsequent data revisions showed that GDP growth was 3.8 percent for the first half of 1992 and that employment, in fact, grew by 312,000 jobs for the four-month period between June and September of that year.

In short, I don't think we have sufficient evidence today to make a case that the recovery has stalled. Responding at this point would appear to be an overreaction. Such fine-tuning is dangerous in my opinion. We are just as likely to generate instability as we are to improve economic outcomes. At a time like this, when there is increased uncertainty in the markets, it is tempting to respond. However, we must keep in mind that the monetary policy we already have in place is quite accommodative. It seems prudent to stay the course and keep watching the data. Should the data suggest that the economic recovery is faltering, then we should take decisive action. Nevertheless, I would have to say that, in my view, the risks have tilted toward weaker economic activity in the short term and a key question is whether we should say so. I think some recognition of the weakness of economic conditions is probably in order, but that is not necessarily the same as shifting the bias. We all know that such a shift in the statement at this time is likely to be interpreted as a signal that we plan to or think it is likely that we will cut rates at our next meeting in September. At this point I'm not convinced that such action will be needed in September. So, to avoid sending the wrong signal, I have a slight preference for leaving the statement unchanged at this meeting. Thank you.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Thank you, Mr. Chairman. First on the region, our District economy clearly lost momentum in recent weeks. Both factory shipments and auto sales were flat in July after rising significantly earlier this year. More broadly, our business contacts from the furniture industry and other principal regional industries tell us that demand is weak and hence factories are reducing output and hiring. All of this, not surprisingly, is affecting capital spending plans. I probably had twenty or more people in various manufacturing companies tell me that whatever little capital spending is going on now is aimed almost entirely at increasing productivity rather than enlarging capacity. So the manufacturing sector, which of course is a big part of our District economy, clearly is showing signs of weakness, at least for the moment.

Not all of the news in the region is gloomy, though. Housing activity in our District, as elsewhere, is still strong pretty much across the board. But business expectations overall in our area are clearly more downbeat and pessimistic than they were at the time of the last FOMC meeting. These expectations were summed up rather well, I think, by a comment I heard recently from a guy in the furniture industry. He said the good news was that a recent survey they had done showed that 67 percent of American households had definite plans to buy furniture. The bad news was that they didn't know when. [Laughter]

Turning to the national economy, the period since our June meeting was a remarkably unsettled and, in my view, unsettling period. Financial markets were obviously nervous and pessimistic, and much of the latest economic data—such as the 10 point drop in the new orders component of the ISM index and the decline in weekly hours in July—rather dramatically confirmed the reluctance of both businesses and households to make future spending commitments. Taking all of the quantifiable negatives into account, the staff has revised its forecast for the second half down a full percentage point, to 2½ percent. I think that's reasonable

under the circumstances. But the softening in the economy in the projection is expected only to delay the recovery not to derail it. The problem, of course—and I know the staff is well aware of this—is that there are currently an unusually large number of significant downside risks in the outlook that are very difficult to quantify and to incorporate in a forecast. Those risks include, for example, the possibility of a renewed and perhaps sharper drop in stock prices than we've already seen, a war in the Middle East, financial collapse in Brazil, or another terrorist attack in the United States. There are positives in the picture. Structural productivity growth still appears to be running above 2 percent. The Fed has now achieved price stability, and we have in place, I would argue, a highly stimulative monetary policy as indexed by the zero real funds rate. But these positives may be insufficient to shield the recovery if one of the downside possibilities were actually to materialize.

Broadly, the challenge for policy in this situation is that the tentative character of the current recovery—and “tentative” is the word I would use to describe it—makes it very vulnerable to negative shocks, especially with the nominal funds rate near the zero bound. Since we've achieved credible price stability, I think it's reasonable and natural for us to ask whether we might ease policy today to speed the economy up just a bit and reduce that vulnerability to an unanticipated negative shock.

Last November I strongly favored a preemptive policy easing in the situation we faced at the time. But I would not favor such a move today. I think there are significant differences in the two situations. Back in November we were still responding to the immediate fallout from September 11. We had seen the fastest increase in the unemployment rate since the 1981-82 recession and a substantial widening in the output gap that threatened a big acceleration in disinflation and, with the proximity to the zero bound, actually posed the risk of deflation. We

haven't experienced another shock like September 11 at this point, and both the unemployment rate and the output gap, at least for now, are relatively stable. Again, the real funds rate is already at or near the zero level. Our experience with go-stop monetary policy in the past—and this goes to a point that Tony made a minute ago—teaches us that the Fed isn't likely to be able to speed up the recovery by making the real funds rate negative without sowing the seeds of future inflation. We haven't talked about that much lately, but that can happen. Too much monetary stimulus could sow the seeds of inflation that over time could destabilize the economy—maybe not in the near future but at some point down the road.

I can think of circumstances where we might want to ease. If inflation drifts down, we obviously should reduce the nominal funds rate to prevent the real funds rate from rising. If the disinflation were sharp enough, I think we should consider reducing the real funds rate below zero temporarily to preempt deflation. And if we experience another substantial negative shock that disrupts financial markets, then too we should consider making the real rate negative to preempt the widening of the output gap that again would pose a risk of deflation. But we're not faced with any of these conditions yet, as I see it. Thank you.

CHAIRMAN GREENSPAN. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. I'm used to speaking at these meetings after a jolt of caffeine for me and for you! The economy certainly has been working through a difficult adjustment to previous overbuilding and overvaluation of the capital stock. This type of cycle is highly unusual in post-World War II economic experience, and the Committee has been uncertain as to how it would play out. I certainly saw this uncertainty at recent meetings as a bit one-sided. That is, my suspicion was that the rebound in aggregate demand could be a bit weaker than the modal forecast and considerably weaker than the market seemed to expect. This

suspicion was balanced against a belief that the current stance of policy was unsustainably accommodative over the long run. And that view about short-run shortfalls and long-run accommodation produced a balanced risk assessment in our statements.

In my opinion there were already hints before the last meeting that the process of recovery might be encountering impediments. Those indications were largely in financial markets where equity prices had declined. Risk spreads were starting to open up, importantly under the influence of the uncertainty-heightening effects of accounting irregularities. The economic data were better, but there was a question as to whether the uncertainties and doubts manifest in financial markets would also show up in spending. The information becoming available since the last meeting suggests that in fact they have—that demand is not strengthening as much as expected. Businesses probably were always going to be responding cautiously to the good fundamentals, given their experience with overbuilding. But the recent data suggest that they are being even more cautious than we anticipated. We can see this in the hiring and new orders data, which didn't pick up to the degree expected at the end of the second quarter and the beginning of the third. Judging from earnings forecasts, businesses have reduced their expectations about sales. And I think every Federal Reserve Bank president around the table today has noted that business people in their Districts are less optimistic and are revising down their expectations.

Recent declines in commodity prices tend to confirm an easing in demand in the industrial sector. And as a number of you have pointed out, financial market conditions have tightened in some respects, which could damp the growth of demand going forward. Markets are reflecting this less optimistic outlook for sales and are carrying the added burden of working through the uncertainty of how firms will be affected as financial results are restated. This is

affecting not only savers but also, as Dino noted, intermediaries. They are shying away from making markets and taking positions. The resulting rise in risk premiums has lowered prices of shares and lowered bond ratings. Markets are much more volatile and brittle, reflecting uncertainty and the lack of marketmaking. Indeed, the corporate bond market has virtually dried up in the last month or so.

Banks also are tightening terms, and accounting concerns have prompted them to be much more cautious, demand more information, and enforce covenants more closely. As a consequence, although the market response to weaker data has been to take out a good deal of the expected policy tightening, this marking down of intermediate- and longer-term rates has not flowed through to many business borrowers. Now, households are seeing lower rates in mortgages, and that is bolstering housing prices and facilitating the unlocking of housing equity. But household wealth levels have fallen in recent months, and the greater risk aversion is reflected in shifts from longer-term securities into money. Undoubtedly, skittish markets are reinforcing business tendencies toward caution in spending and hiring, not only owing to the adverse financing conditions but also to concerns about conserving cash in case their particular firm is affected by future volatility in markets.

This disappointing performance is not only a U.S. phenomenon. Foreign industrial economies now seem to be on a slower growth track, prices in their equity markets have been marked down, and the perception that they're facing a weaker outlook has kept the dollar from falling. All this implies that the United States will receive little help from the foreign sector in terms of boosting demand. And Karen Johnson and Bill McDonough have pointed to the downside risks in South America.

I want to emphasize that these recent weaker indications do not in my mind undermine the basic expectation that the expansion will proceed at least at a moderate clip. The growth in household and government spending will bolster increases in demand and income. By and large, excess stocks of capital inventories have been worked down. Weakness in investment spending has abated, and investment fundamentals do look good. The earlier pickup in sales has activated the accelerator. Cash flow is improving, as gains in productivity and softness in labor markets hold down labor costs. And prices of high-tech capital equipment continue to plummet, giving an inducement to purchase them. But I do have greater concern that it could be some time before the rate of expansion is fast enough to begin to reduce margins of underutilized resources. Indeed, such margins could widen before they begin to narrow. As a consequence, inflation could fall further before it stabilizes. A limited shortfall or delay in the economic pickup wouldn't be much of a concern if we weren't already at 1½ percent inflation, 6 percent unemployment, and a 1¾ percent funds rate. But my thoughts on the implications for the Committee's posture policy going forward should wait for the next round of our discussion if I'm to practice—at least in my first meeting as a Governor—what I've been preaching to the Committee over the last fifteen years about separating the two discussions. [Laughter]

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. Most, but not all, of the anecdotes and readings on the District economy have been positive. Retail sales and consumer spending continue to advance. That's true of autos, but it's also true outside the auto sector as well, according to the reports we get. Spring and summer tourism has been pretty good in most parts of the District. The agricultural situation actually has improved. To the extent that there were drought conditions in our District, for the most part that has been relieved. The energy sector in

western North Dakota and eastern Montana is operating at a relatively high rate. The employment situation is mixed, with no change in white-collar employment but some improvement in hiring of production and temporary workers. And while there certainly are no broad-based signs of inflation, some materials prices are reportedly moving up.

Nonresidential construction activity is slow, and vacancy rates, especially for Class B and lower-rated buildings, are high and rising. Residential construction activity and all that surrounds it, including sales and permits and so forth, remain very favorable. Reportedly, for example, home prices in the Twin Cities are up 15 percent over the past year. Meanwhile, though, apartment vacancy rates have increased, and I think rents are stabilizing and perhaps even weakening a bit. And at some point the relative price shift will feed back into relative changes in activity. But I think that's probably some time off.

Let me offer a few thoughts about the national economy and outlook. We've already talked a lot about that. Obviously, I don't want to dismiss the disappointing nature of the incoming aggregate data we've seen, the revisions, and the weakness in equity values. But I don't want to exaggerate it or overreact to it either. I haven't changed my forecast of the economy over the next six quarters or so. My forecast was a little lower than the Greenbook's as of the last meeting, and now we're closer together. We really don't know whether the economy is going to grow at a rate of 2½ percent or 3½ percent, just to throw out a couple of numbers, over the second half of this year. But it seems to me that the outlook remains basically satisfactory. As many people have commented already, policies, both fiscal and monetary, seem to be expansionary. I do think that we will see some material improvement in spending on equipment and software next year, and I believe consumer spending will continue to advance. And as I've noted before, when we see the activity we're seeing in housing and homebuilding

and people's willingness to make fifteen- to thirty-year commitments, which is inherent in most purchases, it seems to me that consumers remain relatively positive about their circumstances and about the outlook. Finally, history is on our side in the sense that the economy has proven to be resilient in the past and I think it's proving to be resilient again. After all, we've had three consecutive quarters of growth, albeit modest growth, following September 11. And if you had told me back in September or October that that was the performance we were going to get, I certainly would have been pleasantly surprised.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. As others have already noted, during the intermeeting period we've seen a number of indicators, all of which have been a little weaker than expected. Labor market indicators, consumer confidence, manufacturing activity, and business investment all have led forecasters to shade down their outlooks to one degree or another. That has been true of those who have done our Greenbook, and I have no basic quibble with their baseline forecast. Having said that, I think at this meeting the most important issue about the economy in some sense is not the forecast per se but rather the risks to the forecast. While the usual etiquette is to leave the answer to that question about the balance of risks until the end of one's opening statement, I will actually be more transparent and tell you up front that I think the risks to the forecast have shifted notably downward.

I say that for two or three reasons. First, the incoming data as weak as they have been, while not signaling a so-called double dip, obviously do put into question—more so than I at least am comfortable with—the basic baseline forecast. Second, the markets—which should be and most people think are more forward-looking—also suggest that the outlook is less certain now than just a few months ago. Investors appear to have serious concerns about the continued

deterioration in business conditions and subsequently, or consequently, credit conditions. This is doubly worrisome because obviously a general decline in equity wealth such as the one we've experienced even in the intermeeting period will continue to weigh on households and put into question to some degree the ongoing strength of consumer spending. It is also worrisome because the capital required to finance business investment depends on hospitable financial markets. However, equity issuance has been extremely light. The data I have show that in July, in fact, the net equity issuance was negative. In addition, we've seen with respect to bond issuance and bank loans as well that conditions are far less accommodative than they were even a short time ago. So the basic building blocks for investment strike me as much less certain than they were a little while ago.

Consequently, on the side of our mission that deals with sustainable growth, I think the odds of a large shortfall have increased. This is summarized in the changed levels of output gap that at least the Board's staff has estimated. At the time of the June Greenbook, the staff thought that an output gap of 2 percent of potential GDP growth in 2001 would come down to 1.3 percent in 2002 and to 0.6 percent in 2003. Now the staff estimates that the output gap started at 1.7 percent in 2001, a slight improvement, but unfortunately stays stubbornly high at 1.7 in 2002 and 1.3 in 2003. So in terms of the sustainable growth side of our mission, I would say that the risks are clearly that we are moving further and further away from achieving sustainable growth.

The other side of the mission obviously looks to the question of inflation. I'd say that the risks of inflation, if anything, have receded during the intermeeting period. That's due in part to the limitation of pricing power that a number of you have already referred to plus still strong increases in productivity growth as well as slack in labor markets and capacity utilization, which

look as though they will linger on longer than we had thought originally. With those developments plus sluggish growth abroad and the associated risks that Karen has already indicated as well as tame commodity prices, it is hard to see that inflation pressures are likely to emerge during the forecast period. By almost any measure, inflation expectations appear relatively unchanged.

Taken together, it seems to me that the balance of risks has moved from what I described at the last meeting as uncomfortably balanced to at this stage being much more negative. Now, this is the part where I will do what Governor Kohn has pleaded with us not to do. [Laughter] From the question of the outlook I'll touch on what might be thought of as policy. But since I believe that the balance of risks statement has very little to do with policy and has everything to do with the outlook, I will move forth.

President Santomero has put on the table some concerns about having the Committee signal that we think that the risks have changed distinctly to the downside. I'd like to recognize in all honesty that there are three concerns that one might have in making that shift in language but, if you will let me do this, I will go through them and reject each one of those concerns.

The first is a concern that we might surprise the market. But indeed all the incoming survey data that I have seen, including some from this morning, suggest that almost all government securities dealers think that we will probably change the language that we use and describe the risks as being tilted toward weakness. So I don't think we would surprise the market if we were to make that change.

The second concern that I think President Santomero raised quite explicitly relates to the implications of this change in language for real policy, which is the setting of the funds rate—a topic I will not discuss at this point. I would say that I, as do many of you, get copies of some of

these very expensive Fed-watching materials. The one I found most interesting was one I read this morning that said, and I quote, “Indeed, the Fed has emphasized that the economic risk statement should not be interpreted as a signal of what will happen at the next meeting but rather is more an assessment of how it sees the future.” If we in fact have emphasized that and we believe it to be true, then I wouldn’t let a concern about a misinterpretation filter in since indeed the real meaning of that language is becoming much better understood by the public.

The third issue is one that President Minehan alluded to already to some degree. And that is, if we should deem it necessary—following, let’s say, the perfect foresight model in the Bluebook or one version of the forward-looking Taylor rule—to reduce rates over time, then by definition having suggested that there’s some weakness in the economy would provide some explanation of why such a move is needed.

So I see very few downsides, but I do see a couple of upsides to being clearer about our outlook. One of the upsides is that it would reinforce our view of transparency, which I think is obviously helpful. Second, I think it would allow the markets to focus more fully on incoming data and not perceive that we are hamstrung in one way or the other with respect to the future. So, Mr. Chairman, I do believe that the risks are mainly to the downside. And I think the Committee ought to have the courage of its conviction and indicate that that is the case. Thank you.

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. In preparation for the meeting today, I surveyed a number of bankers, and in many respects my findings basically are consistent with what we’ve heard around the table today. Consumer lending has remained strong. The growth is starting to level in nonmortgage consumer products, but loan quality remains strong. Home equity lines continue to grow and

perform well. Mortgage lending both for refinancing and purchase are not simply strong but in some cases will continue to set records. On the commercial lending side, the medium and regional-sized banks are reporting flat loan growth—in fact, almost no loan growth—but steady loan performance, which suggests that loan quality is still good. The most notable observation came from two CEOs of large commercial bank lenders who both reported a significant change in what one might call the temperament of their largest borrowers. The resulting combination of risk aversion on the bank's side and hesitancy on the borrower's side is quite consistent with what we've seen in the commercial paper markets and the commercial bond markets.

With respect to agriculture, there was an acknowledgement of the drought around the country, although some of the areas where the drought is the worst are also areas where the irrigation systems are the best. So the farm economy is expected to be fairly strong, on balance, in part because yields are high. And the lenders say with some chagrin that the agricultural bill also will add price improvement on top of the high yields. So the farm sector will be in relatively good shape.

The other point I want to mention is the fiscal discipline issue that the Congress will face when it comes back after Labor Day. This Congress, as we've discussed before, will adjourn without having passed a budget resolution—for only the second time in history and for the first time since 1997. On the House side they've passed a budget, and that is their focal point now as they go through the appropriations process. In the Senate, the lack of a budget resolution means that there is no spending discipline in the Senate because with a budget resolution there is a requirement of sixty votes in order to exceed the budget. So the prospect for legislation of the type that President Hoenig mentioned is very much alive. Moreover, the expectation is that this Congress will adjourn having passed perhaps only half of the thirteen appropriation bills required

and that the government will be funded on a continuing resolution basis from September until probably February.

All in all, the reports still suggest underlying strength on the consumer side of the economy, a very strong wariness with respect to business investment, and a lack of fiscal discipline on the part of the Congress. That certainly reinforces the view that there is some uncertainty in the marketplace. Incidentally, the President's economic forum in Texas today is expected to focus significantly on the fiscal issues, anticipating what is going to happen in the fall.

CHAIRMAN GREENSPAN. Thank you. I suggest we take a ten-minute break for coffee.

[Coffee break]

CHAIRMAN GREENSPAN. Governor Bernanke, would you start us off?

MR. BERNANKE. Thank you, Mr. Chairman. As we search for the signal of an incipient recovery, we have heavy noise coming from two sides. The first source of noise is the financial markets. Our financial markets usually exhibit controlled hysteria, but lately we probably could drop the adjective "controlled." The stock market in particular seems to be searching for a consensus valuation without too much luck so far. The other source of noise is the data. Of course, revisions in the data show that the recession was worse than we thought. We were always pessimistic about forecasting, and now backcasting seems to be a problem as well! I have a modest proposal, which is that if the BEA can restate GDP figures and firms can restate their earnings, the Fed should have the option to go back and restate interest rates from last time. [Laughter]

How should we respond to these noisy conditions? First, regarding financial markets, I think the best thing to do is to keep our heads while all about us are losing theirs. Monetary policy should be directed at the underlying economy and should respond to financial markets only insofar as they contain information about or affect the underlying economy. I think on net the effects of financial markets on the current economy are not very large. The direct effects of the stock market are being partly offset by strong house prices, lower interest rates, and a falling dollar. It's true that the volatility that we're currently observing at record levels is feeding anxiety and caution, but volatility by its nature tends to be temporary. So on net the current market volatility in my view is an argument for waiting to see where things settle down before taking action.

Second, regarding the other source of noise, the data revisions, we can no longer blame the shallow recession for the weak recovery. [Laughter] The economy is not booming obviously; but looking again beyond the financial markets, it seems to be reasonably sound. In particular, the revision has largely left intact the growth in productivity, which I believe in some sense is the most crucial element of the recovery and bodes well for both profits and economic growth. I note the comments that Governor Kohn made about financial conditions, but overall I think the financial headwinds are not very strong. Banks are healthy, consumer and firm balance sheets are reasonably strong for this stage of the cycle, and a lot of what is happening in the markets with respect to risk spreads and the like has more to do with volatility and financial market uncertainty than with fundamental conditions.

Third, the policy stances, both monetary and fiscal, remain expansionary. It's true that there are some uncertainties as we look forward. Consumers and the government are doing their

part, but firms in particular seem relatively hesitant both on the investment side and on the hiring side.

I think it's worth noting that there's an awful lot of heterogeneity among industries in terms of growth potential. Certain industries—telecommunications, aircraft, commercial real estate, and others—are doing very poorly. They are suffering from overhangs, and it's questionable whether small changes in interest rates, for example, would substantially affect their activity. On the other hand, residential housing, autos, and consumer goods look very strong, and other areas like equipment and software seem to be improving.

My bottom line here is that there's a lot of uncertainty and that any of the three responses suggested in the Bluebook would not be unreasonable. But given the uncertainty that we have now, my inclination is to wait and see and to get more information. At the same time, I don't think we want to appear tone deaf to legitimate concerns among the public about the state of the economy. And I think we ought to set the stage to respond in case conditions worsen. So I would indicate my preference to communicate either in the statement or in the balance of risks sentence that the Fed is vigilant and is willing and able to cut rates in the future if conditions worsen. Thank you.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. As many of us have already noted, the economy is continuing to expand but at a slower pace than earlier in the year. As we have noted in our prior meetings, we have been revising downward our forecast since spring. At this stage it is hard to identify major risks of inflation over the intermediate term. Thus the focus now should be on the strength of economic activity. While real GDP growth is now reported to have slowed from 5 percent in the first quarter to 1.2 percent in the second, the Greenbook forecast is for growth to move toward its

long-term potential growth rate in 2003. The unusual growth of imports in the second quarter significantly reduced real GDP growth while the conclusion of inventory liquidation should provide the basis for continued expansion of industrial production as final sales advance.

Survey measures of consumer confidence have fallen, with recent reports of corporate fraud and the fall in equity values. But real consumer activity, not the surveys, continues to be resilient in this cycle. Both housing and auto sales remain near record highs. This is due partly to thirty-two-year lows on mortgage rates and incentives by auto manufacturers that make cars more affordable today than they have been in thirty-four years. Consumers do not usually make such major purchases if their outlook for the future is really dim. Rather, the persistent growth of real disposable income and slowing new claims for unemployment insurance serve to provide a foundation for continued, though perhaps uneven, increases in consumer spending. And today's retail sales numbers support that view.

To me the real focus should be on the pessimism of corporate CEOs. The drop in business investment led this recession, and the lack of conviction about future revenue growth has continued to slow the recovery of new investment commitments. We did see growth in equipment and software sales in the last quarter for the first time in six quarters, and industrial production has grown every month this year. But the July drop in the ISM index and the decline in hours worked raise questions about the strength of the recovery. And because of my concern about the pace of business investment, I am becoming more concerned about the overall outlook for the pace of economic growth.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. The economy seems pretty clearly to have suffered a relapse since our last meeting. Equity prices have dropped sharply, and various

spending, employment, and confidence measures have been weaker than expected. Even the GDP revisions have lowered the recent growth numbers. There are some bright spots, notably autos and housing. But even these bright spots could be tainted if they imply lower future spending. The staff, for example, has auto production dropping in the fourth quarter after a robust third quarter. Housing is less likely to follow this pattern, but there are uncertainties about housing. Since homeowners are both consumers of housing services and wealth holders, there has always been a question of why increases in housing wealth should stimulate other types of spending. The answer to this puzzle seems to be cash-out refinancing. But this cash-out refinancing may not last if either mortgage rates or house prices stabilize, and in any case it's a very weak reed to support the whole recovery.

One way to measure this weakened sentiment is to follow the changes made by the Blue Chip forecasters. As I've said before, the Blue Chip forecasters as forecasters do not particularly impress me. What they seem to do is to react to the recent economic data and give an aggregated measure of what these data are saying. Last fall these observers dropped the consensus forecast for 2002 very sharply as the economy weakened. This spring they brought the consensus forecast for 2002 up fairly sharply as they found signs of strength. But now they are lowering it again. In the August poll their consensus forecast for 2002 was reduced a full  $\frac{1}{2}$  percentage point, a huge change for people forecasting a year that is almost over. Clearly, these forecaster observers are seeing plenty of negative signs.

Another relevant indicator is the perfect foresight simulation exercise in the Bluebook. As the Bluebook explains, this is not really a perfect foresight simulation because the model is used as it stands now. But again, it does aggregate all the latest information on equation variables and residuals to show the path of monetary policy consistent with NAIRU and with

various suggested inflation targets. This perfect foresight simulation suggests that the economy could use additional doses of monetary expansion even if our long-run inflation target were as low as 1 percent.

Turning to policy, I'm sitting between Roger and Don, so let me go about halfway between them in terms of what I say about policy. At our last meeting the signs of weakness were still incipient. The Blue Chip forecasters, for example, had not written down their forecast at all. And it was argued that if the Fed recognized these signs of weakness by changing the stance of monetary policy, it would in effect enshrine those signs and spook markets. Apparently the signs of weakness are so pervasive now that they are already enshrined. Now the argument is that if the Fed does not recognize those signs, it will look as though the FOMC is out to lunch and that will spook markets. What a difference a month makes! [Laughter] But whether all this market talk makes any sense at all—and I don't know if it does—in the last month we probably have crossed an important recognition threshold. Therefore, it probably does make sense in developing our policy stance to show at least some cognizance of the spreading signs of weakness. Thank you.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. Developments in the Second District's economy have been mixed since the last report, though housing has continued to be robust. On the price side, despite continued escalation in nonwage benefit costs, prices of finished goods and services have remained remarkably stable. Retail sales, which were weak in April and May, seem to have improved and gone up with the temperature gauge in June and July. Consumer confidence slipped in June and July, but labor markets, although sluggish, were quite stable. Housing markets and home construction activity were robust in the second quarter.

Office markets weakened a little more. Surveys of manufacturers and purchasing managers in the District suggested some rebound in activity in the last few weeks, following a pause in July. And our bankers reported some softening in consumer loan demand but improved commercial lending. They also noted tighter lending standards, which are appropriate, and steady delinquency rates.

I would like to talk a bit more about what I see as the fragility in the financial sector both in the United States and in other industrialized countries. I think that fragility is a result of both real developments and, perhaps even more, a high degree of risk aversion, especially in the commercial banking sector. The banks have been quite profitable. Their capital ratios are good, and therefore, in my view their degree of risk aversion is considerably overdone. If we look at Europe, their insurance companies are very heavy investors in equities both in Europe and the United States. And many of those companies would be of questionable positive net worth if they were marked to market. Banks in Europe are very heavily involved in the telecom sector, much more than those in the United States, and their risk-taking ability is quite severely affected as a result. As for Japan, the Japanese bank institutional situation has not improved any. An indication of where some of the big banks in the United States stand is that the spread between Treasuries and credits of Citigroup, the holding company, is considerably wider than that of its much lower rated customer, Gillette. And even though I hope lots of us are shaving with Mach-III's, one would think that Citigroup is a little better credit.

The syndicated loan market is very, very quiet. Now to a large degree, that's because of lack of demand. But when we have more demand for credit in the economy, I think the availability of the syndicated loan market is going to be quite questionable. The reason is that there are three strong managers of syndicated loans: Citigroup, J.P. Morgan Chase, and Bank of

America. All of them have lost a great deal of credibility with the banks that make up their syndicates, much more than would be the case with proper banking. The syndicate leader had done the due diligence, and most of the members of the syndicate took the word of the syndicate leader on that score. There has been a question in recent times on whether the syndicate leader was quite as loyal to the syndicate as it was to its own shareholders and in addition on whether the due diligence of the lead bank had been what it should have been. Therefore, I think it will be difficult for syndicated credits to be put together for quite some period of time until that faith is restored.

We, like all the other people who have commented here today, believe that the economy is clearly weaker than we thought it was at the last meeting. And I think it's important that the central bank of the United States show that it lives in the real world by reflecting that in our statement. On the other hand, given the vast importance of this institution to the stability of the United States and the world, it is imperative that we act with prudence. When we have to ease monetary policy, if we do—and I certainly believe the time is not today—I think we should do so with some degree of boldness in order to show the leadership that will be required of us. In the meantime, it seems to me crucial that we remain prudent and appear to be prudent. Not even St. Jude himself, the patron saint of lost causes, would hope that this entire group would remain silent. But in our public statements I think it would be unwise and even dangerous if we shared some of the discussion of the downside risks that we have traded among ourselves today. Thank you.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. I had absolutely no desire to speak last this morning. In fact I thought I had indicated the desire to speak early, but it seems that my

presence at the table has already begun to fade! [Laughter] Had I spoken earlier about the region, right after Mike Moskow, my remarks not surprisingly would have sounded very similar to his. So at least on that score maybe it was good that I wasn't next to speak. As for the rest of what I heard this morning, to a remarkable degree common themes ran through the commentary. Mainly, as far as I could tell by listening to all of you and based on the notes I made for myself, the go-around has really been a way for everyone to express some of the same concerns and ideas somewhat differently.

The contrast between what I've been hearing in the District versus reading about the national economy suggests that our region is continuing to do somewhat better than the rest of the country. Certainly, the rather panicky tone of Wall Street letters is not mirrored in the comments that I hear in the region. An article in the *Wall Street Journal* a few weeks ago regarding the effects of the decline in the dollar on manufacturing mentioned a couple of small Ohio companies. That prompted our research analysts to get a list of over 100 companies and their phone numbers to call. Most firms reported no increase in export orders. But the reason turned out to be that over half of all the exports coming from Ohio alone are to Canada, and another significant chunk goes to Mexico. And, of course, the Canadian dollar was only briefly higher than the U.S. dollar, and the Mexican peso has been fairly steady. For those companies that did see a pickup in orders, it reflected exports to Asia and not at all to Latin America or to Europe. A few contacts, however, said that, though their orders for exports have been steady, the profitability of their export business has been improving.

We did a roundup regarding capital spending by companies located in the District, and that produced mixed results, of course. Those increasing spending supply mainly the auto, housing, and health care sectors. Only one company cited the new tax incentives for investment

as the reason for undertaking some capital investment that they had not previously planned to do. We asked them why they did it now rather than wait since the incentives will be in effect for a while. Our contact said he was quite sure that the Congress was going to remove that tax incentive after the November election.

Another topic of discussion in the District this summer has been the effects of weather. The farming region tells us that, even if normal rain were to resume now, the corn crops are wiped out. We don't have irrigation of our corn crops in our District. And the yields of soybeans would be cut in half even if normal amounts of rainfall were to resume. That, of course, means that the ag sector lenders have big credit quality problems and are voicing a lot of concerns. We've heard concerns registered not only about the smaller banking companies but also about the Farm Credit Banks. It's still too early to know who really holds the worst of these problem loans. The flip side of the effects of the dry weather is that both highway construction and theme park destinations have lost fewer days due to bad weather. Revenues at these parks so far this year have considerably exceeded expectations. We also were told that roadside restaurants and motels are operating at very high capacity levels, while central city hotels, especially in large metro areas, have very high vacancy rates. Some of that has nothing to do with recent developments in the economy. In Cincinnati, for example, a lot of conventions have been cancelled, but that has nothing to do with anything going on elsewhere. Electric power generation companies, not surprisingly, are also operating at flat-out capacity. So demand for coal has been strong, and the price of coal has been high.

Reports from the residential housing market continue to indicate a very tight market at the lower and moderate price ranges, while upper-end houses are staying on the market for ever longer periods of time. The income generated from building houses is being spent. People are

buying vehicles to park in front of their houses, and the housing-related sectors, such as furniture and appliances and other items that homeowners put inside their houses, are all doing quite well. All are generating income, and that income is being spent. Meanwhile the telecom sector continues to contract. Metals companies produce more tonnage with fewer people. And the commercial and industrial construction sector continues to decline. Nevertheless, in spite of what we also are hearing—as Tom Hoenig and others reported—regarding state and local financing problems, public sector construction for schools and that sort of thing is very strong, based on bond financing.

One large employer in the region said that turnover in employment is declining because of what he described as “the fear of joining the already unemployed.” He said this is reducing employees’ resistance to the shifting of some of the sharp increases in health care costs to them. Not a very nice thing to do! At a recent small business advisory council meeting I learned that those manufacturing companies that are getting strong orders are not only using temps but also mandatory overtime rather than add permanent workers. This, of course, is contrary to the monthly report indicating reduced hours. Union contract negotiations have been reported to be settling for pay increases in the 3½ to 4 percent range.

Regarding the national economy, as always it’s a contest between the strength of forces generated by the inherent resiliency of market mechanisms versus the frequency and the strength of various adverse impulses. When asked what is causing so much caution in the business sector as well as the declared nervousness of households—an attitude not necessarily reflected in their spending—people point to three major uncertainties. And here “uncertainties” is the right word, not “risks.” Somebody else mentioned—I think it may have been Cathy—the word “fear.” I heard the word “fear” much more than the word “risk” during this recent period. There are

uncertainties about where, when, and how bad the next terror attack will be, about the startling loss of confidence in the quality of balance sheet and income statements of businesses, and about when and how the violence of the Middle East can be brought to an end. None of these sources of uncertainty has a clear, easy, or near-term solution. There will not be a VT day—victory over terrorism day—that we will mark on our calendars to celebrate in the future. The credibility of financial statements will be restored only very gradually. It may be comparable to when a central bank loses the credibility of its commitment to price stability; it takes a long time to get that credibility back. And I think the business sector is going to have to wait a very long period of time before it deserves the public's faith in the credibility of companies' reports. Our ultimate occupation of the Middle East will last decades. People not yet born will serve in our armed forces in the Middle East.

It's significant that neither business contacts nor economists identify monetary or fiscal policies as among the negative impulses. If there is a second downward leg of this cycle, it will be caused by new or strengthened negative impulses that are already present. The staff produces what I consider to be very useful alternative simulations of various types of risks, but these are not the things that people talk about when they are asked about their concerns and sources of uncertainty. I look forward to the staff's forecast every September when they add that extra year and look further out into the future. Of course I don't know what that projection is going to say, but I'll forecast what it's going to say. It's going to say that on average over the subsequent eight-quarter period the economy will have growth of about 3 percent. That's because for the last half-century, the last time I looked at the data, it has experienced about 3 percent growth. The last time I did look at the figures—and this was before the most recent revisions of the data—some 70 percent of the quarter-to-quarter changes in real GDP growth, almost three-

quarters of the observations, were below 2 percent or above 4 percent. My guess is that six out the next eight quarters of the staff forecast will not show growth below 2 percent or above 4 percent, but I bet they will average close to 3 percent.

CHAIRMAN GREENSPAN. A splendid way to end—with a very large question mark.

I think we can now move on to Vince Reinhart.

MR. REINHART. Thank you, Mr. Chairman. Talk about the dog days of summer: Over the intermeeting period, share prices rode a roller coaster that left equity investors  $7\frac{3}{4}$  percent less wealthy, key emerging financial markets flared, rumors of funding difficulties at several large intermediaries surfaced, and incoming indicators suggested that employment and spending growth had softened. It is beyond my ability to explain why financial markets were so volatile over the intermeeting period. However, I believe that three threads of the complete story bear upon your policy deliberations today.

First, as David related at the beginning and virtually every other speaker around the table reinforced, the economic news, especially of recent vintage, proved disappointing. But, second, those economic data were more of a surprise to market participants than they were to us. At the time of your first meeting in 2002, market forecasts of aggregate demand and its implicit balance with aggregate supply were such that the federal funds rate was expected to be 2 percent by now and to move up to  $4\frac{1}{2}$  percent by the end of next year. In the time since, the structure of expected policy rates up to the end of next year has shifted down as much as  $2\frac{1}{4}$  percentage points. One question is whether, in the process of adjusting their outsized forecasts of economic activity and the attendant policy response, market participants have undershot the mark as much as they overshot it in January.

What was a surprise to us—and to virtually all other observers—was the amplitude of the swings in financial markets. On six out of ten days during the intermeeting period, the Dow Jones Industrial Average moved more than 100 points. At their nadir, broad share indexes were 20 percent below their June 25 levels but now have rolled back almost two-thirds of those losses in a couple of weeks. This leads to my third observation: To some extent, market dynamics feed upon themselves. One mechanism in that process is the unfortunate tendency for large swings in prices to expose weaknesses on some balance sheets. In the 1994-95 episode of a substantial runup in long-term yields, a few mortgage-backed hedge funds and a county treasury of note were found to have feet of clay. In 1998, the losses came from a hedge fund that was even more noteworthy. This time around, a less receptive capital market showed that some firms in the energy trading and telecom industries were not much more than Potemkin villages, hiding hollowed balance sheets behind the glitz. History suggests that there is a natural cycle of recoil, recrimination, regulatory response with a lag, and relapse over the long run. With

investors apparently still in the recoiling stage, the staff projects in the Greenbook considerably lower equity wealth over the next year and a half than in the last forecast.

The disappointing economic data, the loss in equity wealth, and a tightening of credit markets imply that the expansion has lost some traction in the second half of this year. But as these effects on the level of demand dissipate, the economy should recover to a growth rate just a bit above that of potential output. As a result, the staff is forecasting that more resources go unused for some time but that the extra slack helps to hold inflation around its current level.

Compared with the forecast in the June Greenbook, these outcomes are likely to be less appealing to you in furthering the Federal Reserve's dual mandate. But you might still elect to keep the federal funds rate at 1¾ percent even if you thought the staff outlook was the most likely to materialize. In particular, your perception of the lags of monetary policy may be such that action at this meeting would not materially influence economic growth over the balance of this year. That is, today's setting of the policy rate would mostly shape economic performance in 2003 and beyond. And while there is a weaker demand component to the staff's revision to next year's outlook, a significant portion reflects a reassessment of the growth of aggregate supply that you might view as outside the scope of your influence.

Moreover, you might have reason to believe spending will revive more forcefully than in the staff forecast. Households have proven remarkably resilient over the past two years and may do so again, a notion supported by continued strong auto sales. With a real federal funds rate close to zero, policy has provided forward thrust to the real estate sector and has facilitated the ongoing extraction of owners' equity, evidenced in part by another wave of refinancing that seems not yet to have crested. The hesitancy of firms to hire and to invest may be due, in part, to elevated uncertainty in financial markets. But if the deadline for executives to certify their corporate reports passes without any major fireworks, perhaps that sense of uncertainty will ebb and the advance of employment and capital spending will regain vigor. Indeed, the nearness of that date when uncertainty might be considerably reduced may further recommend a policy of watchful waiting to the Committee for its meeting today.

The case for policy ease at this meeting would seem to rest on the sense either that the staff's outlook has it about right but the slow pace at which slack is whittled down is unacceptable, given inflation holding steady, or that there are significant prospects that outcomes could lean toward weaker aggregate demand and lower inflation than in the Greenbook. As to the former, the perfect foresight simulations reported in the Bluebook accept the staff's assessment of near-term developments and the FRB/US model's specification of behavior with complete conviction. Within that framework, policymakers desirous of smoothing employment and output gaps would ease policy soon—even if the inflation goal were as low as 1 percent. In that exercise, a little more than ¼ percentage point ease would trim a few tenths off the unemployment

rate while still putting inflation on a course that drifts lower. An inflation goal of 1½ percent could accommodate more-substantial easing now while moving the unemployment rate down to 4¾ percent in the transition to its long-run equilibrium. These exercises, of course, convey a false precision about our understanding of the workings of the economy or your ability to use policy to shape outcomes. But the general message is also conveyed by the decline in most measures of the equilibrium real federal funds rate reported in the Bluebook.

Also arguing for easing policy at this meeting, the Committee might believe that the staff was too tentative in reassessing the forces determining inflation. The sense of heightened uncertainty, lessened earnings prospects, and withdrawal from risk-taking evident in the substantial declines in equity prices could also surface as unusual restraint on the spending decisions of households and businesses in coming quarters. As Karen noted, the ongoing travails of key emerging markets also have the potential for reducing demands for U.S. goods. And the revisions to the path of productivity now seem to accord a greater role to a reduced natural rate of unemployment in explaining the good performance of inflation. If the natural rate of unemployment is, in fact, south of the staff's new estimate of 5 percent, even more disinflation may be in store than along the Greenbook baseline. Such further disinflation would erode the inflation cushion the Committee has to put real interest rates sufficiently into negative territory at some later date if events warrant

As gauged by money market futures rates, the federal funds rate is now expected to drop below 1½ percent later this year. Thus, viewed from financial markets, the question is not if the Committee will ease but when. And the answer from those markets apparently is not now but soon, in that recent surveys indicate that the modal outcome for this meeting is that you'll keep the funds rate at 1¾ percent. So as long as you do not disabuse market participants of your willingness to ease policy if the situation warrants in coming months, the economy will benefit from the expectation of imminent ease—that is, from lower capital market yields. If events over the coming intermeeting period call for an easing move, the Committee can confirm those policy expectations at the next meeting—or sometime sooner if necessary—to preserve prevailing financial conditions. If the current run of subdued economic reports gives way to a pattern more consistent with sustainable economic expansion and markets settle down, investors will roll back that putative easing in coming weeks of their own accord.

From this perspective, if you keep the federal funds rate unchanged, your decision on the balance of risks depends on whether you share the assessment of risks apparent in the markets. The retention of balanced risks to the Committee's dual objectives would work to send the message that it believes that market participants had swung too much from their over-optimistic mood of the spring. Recent surveys and the configuration of futures rates is consistent with significant probability weight massed on a more accommodative message, so short- and long-term rates would back up some if that proved not to be the case. If so, equity prices would soften.

If the Committee's assessment is that the tail of adverse outcomes has fattened sufficiently, switching to a balance of risks weighted toward economic weakness would both more accurately convey that sense and likely encourage asset markets to continue to support economic growth. Short- and long-term interest rates would probably edge lower, and a bounce-up in equity prices would probably be in store. While there is a risk that market participants would interpret the switch to unbalanced risks as evidence of the Committee's doubts about economic growth going forward, that could be mitigated by emphasizing in the press release that the economy is expected to continue to expand.

CHAIRMAN GREENSPAN. Questions for Vince?

MR. PARRY. I have a question. In the Bluebook, the Taylor rule recommendation and the recommendation of the perfect foresight simulations are quite different. Which of those two approaches would best really model or characterize past policy?

MR. REINHART. Well, the Taylor rule is supposed to be in part descriptive of policy decisions. That is, the parameters were fit to explain a good part of the 1990s. So in that sense the Taylor rule is consistent with what the Committee has done in the past. The important piece of information that the Taylor rule doesn't have but the perfect foresight simulations do have is the intercept—that is,  $r^*$ . This particular picture has a real interest rate of  $2\frac{1}{2}$  percent. Well, if you turn to chart 5 in the Bluebook, you see that just about all the model-based estimates of the equilibrium funds rate are below that. So it wouldn't take much shifting down of that intercept in the Taylor rule to make them consistent.

MR. PARRY. Okay, thank you.

CHAIRMAN GREENSPAN. Any further questions? If not, let me get started. All of you have directly or indirectly emphasized the issues of the overvaluation of the stock market and the irregularities of corporate governance that have led to a very significant contraction in stock prices and a major widening of spreads in a number of financial markets. We were made particularly aware after a congressional hearing a week or so ago how sensitive interest rate

spreads and indeed stock prices have become to the corporate governance issue. Both Citicorp and J.P. Morgan Chase were accused of what three or four years ago would scarcely have raised an eyebrow, namely their efforts to structure various forms of credit in ways that would be useful to their customers without significantly undercutting the safety and soundness of their banking institutions. But that kind of activity has turned into a major concern, and indeed its revelation has resulted in a very large drop in the stock prices of both banking firms and has widened spreads on their debt issues quite considerably.

That, of course, is not the only example of such a development. We see it throughout the financial markets. We are now looking at equity premiums that have risen in the latest period above their 1994 averages, after having declined to virtually record lows. This suggests, as David Wilcox indicated, that stock prices by some measures may be undervalued or below their “fair” value, as some people like to say. The trouble with that assessment, unfortunately, is that stock prices historically have always moved above and below fair value in the sense that they never seem to stop at fair value. This raises an obvious question: What in the world does fair value mean? In any event, the very significant contraction on balance in stock market prices over recent weeks has raised the possibility that such prices may finally be reaching some form of bottom. I trust that when I reread these remarks when they are released to the public five years from now they will not look anything less than thoughtful!

The problem is one that we have not had to confront in this way before. One interesting aspect of the problem relates to the risk spreads in the stock market and the weakness in capital expenditures. But another very interesting aspect is that, despite the extraordinary weakness in capital spending, profit margins rose significantly in the fourth quarter of last year and essentially stayed at the higher level in the first and second quarters of this year. This has

occurred in the context of quite small increases in unit labor costs, at least as judged by the deceleration in the implicit price deflator for nonfinancial corporations, that in turn reflect very strong growth in output per manhour. As I recall, the estimated four-quarter average growth in productivity for nonfinancial corporations shows an increase of 5.7 percent. The staff estimates that the second-quarter number by itself is 4.0 percent.

Most interesting in this very odd pattern of data is the fact that the evidently significant flight to quality, which is implicit in the number of widening credit spreads, has been accompanied by a very marked decline in the ten-year Treasury yield. At the last reading it was about 4.2 percent. That decline, of course, has had a major impact on thirty-year fixed mortgage rates. Indeed, those rates have fallen below 6½ percent, and I believe they are now close to 6¼ percent. At that level we are seeing very significant churning in the mortgage markets, and as I have indicated previously, the increase in home equity is cumulative over a period of years because the prices of homes very rarely turn negative. What we are observing at this point is a very high rate of house turnover. Existing home sales are very high, and I'd say parenthetically that the drop in July in the seasonally adjusted data coming from the National Association of Realtors appears to involve a deficient seasonal adjustment factor. There is no evidence of any contraction of any moment in existing home sales except, as a couple of members mentioned previously, in sales of high-priced homes, which have been pretty soggy. The housing market has been tight across much of the country, and it has been tight in part because of the strong influence that immigration is having on the demand for housing.

The turnover of homes of necessity engenders realized capital gains, and those gains tend to be the element in the housing market that extracts the most home equity. Indeed, what we always observe is that the mortgage loan taken out by the buyer is significantly larger than the

mortgage cancelled by the seller. And the spread between the two, which is the net increase in mortgage debt on that existing home, is very close in general to the realized capital gain. To be sure, a very significant amount of equity extraction occurs without realized gains, and it occurs largely because of the cash-outs from refinancings. Those cash-outs are becoming quite large. An internal estimate by Freddie Mac for last year indicates that it was a little over \$100 billion. The total is down somewhat this year because the refinancings are not as large, and I believe the ratio of cash-outs to refinancings usually comes down a bit when refinancings to total originations go up.

All in all, there have been very large extractions from home equity. They do not seem to be impaired or enhanced by fluctuations in stock prices. The result has been a very major addition to personal consumption expenditures and to home modernization outlays, which, of course, are part of GDP. What we have observed here is a major offset to the quite extensive decline in wealth from equities. And what is also interesting is that we are looking at two different segments of household incomes. A very substantial part of the wealth creation and destruction through equity stock prices occurs in the upper-income quintile, while a very substantial part of the home equity extraction occurs in the lower four quintiles. And the evidence is that on average the impact on personal consumption expenditures from changes in equity wealth according to the FRB/US model is about the same overall as the extraction of equity from housing. In my view, however, the available evidence suggests that that may be in error in the sense that we may find after the fact that the marginal propensity to consume out of capital gains in homes, especially those that are realized, is very significantly above the marginal propensity to consume out of either realized or unrealized gains in equities. Only in recent years

have unrealized gains in equities become a very prominent factor in both personal consumption expenditures and home modernization outlays.

This process seems to be continuing. We are finding that the wealth effect is probably negligible for the non-equity, nonhousing types of wealth. Consumer durable stocks constitute a big portion of household wealth, and there is no evidence that the level of such wealth has any effect whatsoever on consumer spending. But the point I want to emphasize here is that there is very little evidence of which I'm aware that the continued rise in home prices and the related expansion of home equity is going to cease. The basic reason is that home equity has almost always increased. In fact, the average value of homes deflated by a GDP deflator has been going up about 1½ percent per year for a very long period.

The explanation as best I can judge relates in part to the fact that the growth of productivity in home construction is negligible. People essentially buy custom housing, which does not lend itself to improvements in homebuilding productivity. Indeed, the manufacturing component of home construction, even though it is rising, is held back to a remarkable extent by the idiosyncratic desire of homeowners not to have a house that looks like the next-door neighbor's. The result is very low productivity in construction. In fact, the published figures on gross product originating in construction show declining productivity on a per hour basis in the last twenty or thirty years. In itself, that is not credible. But if we assume that average hourly compensation equates across all segments of the economy, we would expect that the differential in unit labor costs between the home construction sector and the economy overall would reflect the differential productivity changes. And indeed, if we take nonfarm business productivity and subtract home construction productivity, which is essentially zero, what we get is the long-term 1½ percent increase in prices. So in effect what we get in equilibrium is a constant net increment

to purchasing power from capital gains in homes over and above the increase in personal income. When we factor these capital gains into the regular models, we do not get any reversal in this increment at any time.

There clearly is concern at this stage about a housing value bubble that is going to burst. But I think that most of those who look at this in some detail question whether that's a valid notion. And while the second-quarter increase in home values is now significantly below the big rise of last year, I believe a 3 percent annual rate is the current estimate that's being used for existing home sales. So overall the notion that we're going to lose the home equity part of the current support for consumer expenditures does not seem reasonable at this stage. This does not mean, of course, that we could not get a decline in home prices. It's the notion that there is an equivalency between equity bubbles and housing bubbles that I think is an illusion. Moreover, as I think I've indicated several times in the past, it strikes me that with transaction costs as high as they are in home sales and the necessity to move if the home is sold, the incentive to sell a house is nowhere near what it is to sell a stock to take advantage of a capital gain. As I indicated earlier, the impact of immigration superimposed upon the difficulty of finding viable land for homebuilding is keeping significant upside pressure on home prices over and above the construction productivity issue. So the likelihood of any really important contraction in the housing area would in my view require a very major contraction in the economy overall.

Having said all of that, the general outlook still strikes me as being solid in an underlying sense, but without question there has been substantial deterioration and it's not going to be easy to read the significance of the corporate governance problems. They are turning out to have a much greater impact on the economy than I would have envisaged when the Enron issue first surfaced and even when WorldCom showed up. There is no evidence at this stage that the

problem has stabilized. Conceivably, it may stabilize after tomorrow when most of the reaffirmations of the quality of the corporate financial reports come in to the SEC. I doubt it. But I think it is too soon to say where it will go.

I have no doubt that everything will look just fine in retrospect if we look back in October and November of this year and we see that the growth rate was near the 2.7 or 3 percent now expected for the current quarter. If that's indeed what is happening, we can't be experiencing all the negative developments that are fostering the currently gloomy sentiment. But we can't know that at this point. In fact, most of the concerns that we have discussed are largely based, I think, on factors that we cannot capture in the Greenbook or in any of the models with which we are working.

I, like all others, think it is most premature to consider lowering interest rates in this context. If we lower rates from their current levels, we will have a greater distance to go to restore some reasonable level of noninflationary, non-accommodative short-term money market rates. But I must say even in that context that I agree with the Vice Chairman, who stated that, if we have to ease, he would not favor easing in 25 basis points increments because that would send the wrong signal. If we have to move, my inclination would be to move from 1.75 to 1.25 percent, but I don't think we're going to end up having to ease. I would recommend that we stay where we are with respect to rates today. But I do agree with those who have argued, and I believe with some justification, that it is essential that we at least recognize what is going on. Clearly, the risks are not balanced. They have turned from reasonably balanced, even though what you called it the last time was—

MR. FERGUSON. Uncomfortably.

CHAIRMAN GREENSPAN. To uncomfortably balanced. I would have said back then that they were reasonably balanced. Clearly, that is no longer the case, and I think we need to acknowledge that. In summary, I would hope for a resolution that holds rates unchanged but does shift the balance of risks statement toward weakness. Vice Chair.

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

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Wow! [Laughter] I certainly agree with leaving the rate unchanged. Uncertainty about financial statements has created more headwinds than I had expected, and now I have a feeling that they're going to last longer than a lot of people may be thinking. So if that means the balance of risks is toward weakness, I can live with that.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, as I said earlier, I don't favor easing policy further today. I would not favor moving the tilt either at this stage. To me the key factor—and many people have made this point—is that policy is already very accommodative. The real funds rate is already very close to zero if not at zero. Since we haven't experienced another really big negative shock that threatens the stability of financial markets to the extent that the September 11 shock did and since we're not facing significant further disinflation or a real threat of deflation yet, I would ask what we expect to accomplish by signaling an increased probability of further easing at some point fairly soon. I've thought about this, and the only thing that comes to mind is that we want to show the public that we feel its pain or share its fear and that we're not insensitive to the downside risks in the outlook. I can certainly understand that. But I don't think that's a persuasive argument in the current circumstance, given how accommodative our

policy already is. Moreover, and this is the key point I would make, I think there's a cost. I believe that changing the tilt today could cause some confusion. In my view, many people when they think about the economy are focused on whether or not it is going to move back into a recession. I think that's more or less the issue that they see us dealing with here. And if we move the tilt, that is going to suggest to a lot of people that we are putting higher odds now on the economy dropping back into recession than we probably as a group really are, even though I know we're less optimistic than we were. I worry that by trying to use the tilt to sort of create the appearance that we're doing something actually might reduce confidence rather than bolster confidence. So that would be my take on it.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Well, I have almost the opposite take. I think I would have been—if I were voting today—one among perhaps not many at this table who could have voted for an easing in policy. But I am perfectly willing to go along with your recommendation. I do think that things have changed significantly enough to bring into question whether or not monetary policy is sufficiently accommodative at this point. There are strong headwinds, and not to recognize them in our statement—whether by a change in the tilt or some language in the statement—would be to ignore what is out there and seem to be a little behind the curve. So I agree with your statement, and I agree with what you want to do with regard to the tilt.

CHAIRMAN GREENSPAN. Governor Kohn.

MR. KOHN. Mr. Chairman, I support both parts of your recommendation. Although I am somewhat concerned about the potential for subpar output growth going forward, I think the signs of that are relatively recent and derive from noisy high-frequency data and from developments in the financial markets, which could turn around, particularly after we get through

the middle of this month. So in my view it's far too early to ease policy at this point. There's a lot of uncertainty, as Governor Bernanke mentioned, and that in itself is perhaps enough to slow the Committee down even if we thought the economy was going to be sluggish going forward. I do favor the shift in the balance of risks because I believe the risks have, in fact, shifted. I think the inflation concerns that might have been inherent in our stance of policy have been pushed much further out into the future, in my mind beyond the foreseeable future perhaps. And that's partly because we do have some more downside risks. We've revised down the forecast. Nearly everybody around the table has said they've revised down their forecast for the next few quarters. And there are downside risks to those forecasts. So, I see more downside risks on the output side and less upside risks or certainly more distant upside risks on the inflation side.

Moreover, I think financial markets would welcome a shift in the balance of risks statement. It would reassure them that we understand that the landscape has changed. But it should be coupled with a restatement of our expectation that expansion will continue. This isn't about double-dips. Economic weakness in our statement refers to growth below potential not to double-dips, and we should reinforce that view. It would liberate markets to build in more ease if appropriate. Unlike President Broaddus, I don't see a zero real rate as a natural bound for monetary policy. If the economy is weak going forward, if output gaps appear to be increasing, if unemployment gaps look as if they might be increasing, even without a recession I would be in favor of easing policy. And I believe that's particularly important because of a point that President Broaddus has made before, the starting point for the economy. We already have very low inflation and a very low funds rate. Waiting to ease until the economy turned down or until a major shock hit us would risk running into a situation that would be hard to deal with. So I think we ought to move quickly if it becomes necessary. It's not necessary right now. And we

ought to make sure that the markets can behave in a stabilizing fashion, particularly in the current situation. Thank you.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. I endorse both parts of your recommendation. I obviously already spoke on the balance of risks issue. With respect to the question of moving policy going forward, I think I'm somewhere between Cathy Minehan and Don Kohn. On the one hand, the incoming data have been much weaker than one would have anticipated, but I also recognize that the weaker performance really involves just high-frequency data so it's appropriate to wait and see. But if we get evidence of persistent weakness, then we obviously should do the right thing. At this stage, though, I think changing the language is sufficient.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I can support your recommendation. As Vince reminded us, earlier in the year market participants had priced in a significant and relatively early tightening of policy. As it turned out, I think we were well advised not to act on that. Now they are pricing in some easing of policy soon if not immediately, and personally I think we are wise today not to react to that either. I would offer one caution about changing the bias in the risk statement, although I can certainly go along with it. It's one thing if we want to whipsaw ourselves a little by changing the forecast as the numbers come in. But I think we should be careful about having that feed into the financial markets and potentially the real economy. Now, obviously what we're talking about doing here is not likely to have a profound impact. Nevertheless, I think there is a potential for trying to overanalyze the incoming data and to exaggerate the possibility that somehow a new trend has been established.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Thank you, Mr. Chairman. I support the recommendation to keep the federal funds rate where it is, but I'd like to associate myself with the position that Al Broaddus spelled out for the balance of risks statement. Mr. Chairman, I interpret your commentary as saying that from what we know now and based on our best guess about the future, the federal funds rate will probably stay about where it is in the near term. I think that a balance of risks sentence biased toward weakness will be read by the markets as an indication of a rate cut to come. That's my prediction as to how the market is going to forecast.

It seems to me as a first step that the press statement could indicate that the evidence suggests that the economy has downshifted to a lower growth path. I think that the outlook for growth is still positive but it's lower than in the previous forecast. I'd also like to point out that there is ample room for long bond rates to fall. There is still an unusually large spread between the federal funds rate and, let's say, a ten-year Treasury bond as a benchmark. It seems to me that we could accomplish what we want to accomplish by trying to convey that our present view is that the policy target for the funds rate is likely to remain in its current neighborhood for a longer period than we had previously thought. That should at least help to reflect—I think accurately—what our position is. And if the market reads it that way, it should help to bring down longer-term rates. But I am concerned that the balance of risks toward weakness will be read by the market as a forecast of a cut in the funds rate at the next meeting or the one after that.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I agree with your recommendation with regard to the funds rate. At the time of the last meeting, the risks for the economy and inflation were fairly well balanced. But it seemed to me that there was some sense in the room that it would take quite a

bit to induce a further easing of policy and that the bar would be lower for shifting policy into a tightening mode. This time around I think we face a more evenly balanced set of risks.

Therefore, I have a preference for retaining a balanced statement of risks, and I believe that we could communicate our current concerns through the wording of the press statement without changing the actual balance of risks sentence.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. Mr. Chairman, I support your recommendation. I think where my perspective may differ from President Poole's is that I don't really want to tie our hands right now. I am concerned about weakness. I don't believe we should respond to what is going on in the market but rather to the implications that has in terms of consumer and business behavior. And if, with the new initiatives that the Congress has passed, we don't very quickly get aggressive actions against individuals who've committed some of these frauds, I am concerned that this problem could linger on and on. Furthermore, if we don't restore confidence in the markets, I think there will be some longer-term impact on business financing and consumer investing. So I would prefer to shift the balance of risks to weakness now because we don't know how people are going to react in these very unusual times. And I'd like to signal that, given the uncertainty, the risks we see in the outlook today are more to the downside.

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. I support both parts of the recommendation. I do think—and this relates to something that Governor Ferguson raised—that we have two roles here today. One is the monetary policy role. But we also have a de facto role at this time as one of the few bastions of credibility left in the country and particularly in Washington, D.C. So I would suggest that the

manner in which we describe our position today is particularly important. I think it has to be as much analytical as explanatory for that purpose.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Mr. Chairman, I support both parts of the recommendation. I think it would be premature to lower rates, though I have some sympathy for those who have some affinity for that position. On the balance of risks, I've been mulling this over for the last week or so and changing my view every few minutes! But in the final analysis I think I'll just describe my position by using a very homely statement: The bias toward weakness does reflect our discussion and in my view is an honest assessment of what we think, so in the end we probably ought to go with that.

Let me also say one word about housing. I'll try to be quick about it. I agree that there is no bubble. I agree that there is no productivity change in housing construction. So the relative price of housing is rising compared with income and other prices for what we'll call real reasons. But I am still puzzled by why, since people are both wealth holders and have to buy housing services, those whose homes have risen in relative value should spend more on other goods because of that. The only answer—the one that you've suggested and the one that seems to work—is the conversion of unrealized capital gains to realized gains. But it makes me uncomfortable to base so much on this conversion, of just switching the gains to money. I realize the empirical studies go against me. But I am just uncomfortable that the refinancing of housing should be the source of so much of the support for our recovery. In any case, I do think it is a weak reed. So, I'm not going to quarrel with anything you said, but I'm just puzzled by it and uneasy with it.

CHAIRMAN GREENSPAN. You sound like a true conservative.

MR. GRAMLICH. Either that or a true idiot! [Laughter]

MR. FERGUSON. Ned, I think there are different interpretations, and sometimes being called a conservative is a compliment. [Laughter] And I would not say you're a true idiot.

MR. GRAMLICH. Ben was saying earlier that he had read the transcripts of some recent meetings and there was a lot of laughter but he didn't hear much laughter today. I said it comes later in the meeting!

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. I can support your recommendation for no change in the fed funds rate at this meeting and a change in the balance of risks statement. I have a slight preference for leaving the balance of risks statement as is. As I noted earlier, however, I do believe that the risks have shifted toward economic weakness, so I can't argue about the change in the tilt. I do worry a little about giving the public and the markets the wrong signal, namely that we plan to change rates. I know it should not be viewed in that way, but it often is. That's the reality, I think. But I don't want to make too much of this. A shift in the balance of risks mirrors reality, so I'm quite happy to go along with the recommendation.

CHAIRMAN GREENSPAN. May I just say parenthetically that I don't deny that a balance of risks switch will have that effect. But if we get a few good numbers on orders or sales or in GDP or profits, I submit that the market will be way ahead of us.

MR. SANTOMERO. I agree.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. I support your recommendation on leaving the rate unchanged. I, too, have a slight preference for maintaining the balance of risk statement as it is. However, I acknowledge that the risks have shifted. Nevertheless, I still think, as we look at our projections

and the stance of both monetary and fiscal policy, that a lot of stimulus remains and that will carry the economy forward. But like others, I wouldn't fall on the sword on this issue because of all the uncertainties in the economy. On balance, though, I'd wait to see a little more evidence before changing that balance of risks statement because it is going to change expectations about future rate moves—although I agree that some good numbers would change expectations once again for everyone. I'd just make that comment.

CHAIRMAN GREENSPAN. Governor Bernanke.

MR. BERNANKE. Mr. Chairman, I concur with both parts of your recommendation. In particular, the weakening of the economy is quite evident to the public, and I think it's important that we show that the Federal Reserve recognizes that and is prepared to respond to it. I'd like to add that I also agree with you that if things take a turn for the worse, we should be prepared to act very aggressively. I'm not one who worries about zero bounds, for example. In fact, one might interpret the expected decline in the future federal funds rate as being not a certainty of a small decline but a small probability of a larger decline. So to summarize, I do concur with your proposal.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I support both parts of your recommendation. Nevertheless, I do believe that the bias statement is not serving us well and that we would be better off not having it. But we do have it, so we have to tell the truth about it. And the balance of risks has clearly shifted downward, so we have no choice but to acknowledge that.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I can be comfortable with what you suggest, but I would want to associate myself with the position that President Broaddus first expressed and a number

of people agreed with. I think we're still learning how to use both the bias and the press statement that we consider at the end of each meeting. I was looking forward more than usual to the distribution of the draft press statement, hoping that the word wizards had found some language short of a change in the bias that might convey the same message. I share the concern expressed by some other people that many observers, probably most, will read a change in the bias—at least until we get a string of good data—as suggesting that we're going to ease. Ironically, I think that's an added uncertainty that we really don't intend to convey today. But I accept the arguments on the other side, and were I voting, I certainly would not dissent today over the change in the balance of risks statement. Thank you.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I agree with your recommendation not to move rates at this time. The accommodative stance of monetary policy that we have in place is intended in part to protect us against the hopefully short-term slowdown that we've seen over the last month or six weeks. So with that insurance built in, I think the current level of the funds rate should hold us in good stead going forward. I agree very strongly with your point that if we do move, we should make a move of 50 basis points, not 25 basis points, because the catalyst would be some significant weakness in the economy, some sudden shock, or some risk of a deflationary environment.

On the tilt, I think it's a very close call. Good arguments have been made on both sides. On balance, I have a slight preference for conveying the message in the language of the press release rather than by shifting the tilt, but I certainly can live with the approach that you recommended. I do think that the markets will view this as at least a short-term increase in the probability that we will move the fed funds rate down at the next meeting. But as you said, with

other data coming in they could clearly move in the other direction as well. So as I indicated, I have a slight preference for the other approach, but I can live with your recommendation.

CHAIRMAN GREENSPAN. Thank you. Will you read the directive language that has no change in rates but shifts the balance of risks to weakness?

MR. BERNARD. This is from page 13 in the 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 maintaining the federal funds rate at an average of around 1¾ percent." And for the statement in the press release: "Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future."

CHAIRMAN GREENSPAN. Would you call the roll please?

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
Governor Bernanke	Yes
Governor Bies	Yes
Governor Ferguson	Yes
Governor Gramlich	Yes
President Jordan	Yes
Governor Kohn	Yes
President McTeer	Yes
Governor Olson	Yes
President Santomero	Yes
Governor Stern	Yes

CHAIRMAN GREENSPAN. Would you circulate the draft statement, which tries to capture that decision? [Pause]

VICE CHAIRMAN MCDONOUGH. Bravo. Silence indicates admiration.

CHAIRMAN GREENSPAN. Does anybody wish to make any comments relevant to the statement? If not, I will assume that it is adequate for our purposes and it will be released. Our next meeting is September 24. We do not have a formal program for lunch, but the usual exquisite cuisine is available for those who wish to stay!

MR. REINHART. Mr. Chairman, I just wanted to point out that August 14 is the deadline for corporations' SEC filings and today, August 13, is the deadline for your filings regarding special topics for the January 2003 meeting.

MS. MINEHAN. They both have the same importance, right, Vince?

MR. REINHART. My goal would be to distribute a memo to the Committee on Monday that lists the results of your returns. So there's still a little time to come in under the wire.

CHAIRMAN GREENSPAN. The meeting is officially adjourned.

END OF MEETING