

**Meeting of the Federal Open Market Committee on
December 14, 2004**

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., starting at 9:00 a.m. on Tuesday, December 14, 2004. Those present were the following:

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

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

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

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

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

Mr. Kos, Manager, System Open Market Account

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

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

Messrs. Clouse, Reifschneider, and Whitesell, Deputy Associate Directors, Divisions of Monetary Affairs, and Statistics, and Monetary Affairs, respectively, Board of Governors

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

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

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

Messrs. Brayton and Carpenter, Senior Economists, Divisions of Research and Statistics and Monetary Affairs, respectively, Board of Governors

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

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

Ms. Holcomb, First Vice President, Federal Reserve Bank of Dallas

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

Messrs. Elsasser, Peach, and Sullivan, Vice Presidents, Federal Reserve Banks of New York, New York, and Chicago, respectively

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

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CHAIRMAN GREENSPAN. Good morning, everyone. Normally, when I ask approval of the minutes, they are in the same form as the draft sent to you earlier. I just wanted to indicate that there is a change since that earlier communication, and that is the addition of the notation vote by the Committee authorizing President Santomero to accept the honor of the title “Cavaliere” to be awarded by the government of Italy. I believe that vote was affirmative. [Laughter] So, would somebody like to move approval of the minutes of our November meeting?

SPEAKER(?). So moved.

SPEAKER(?). Second.

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

MR. KOS.¹ Thank you, Mr. Chairman. With the outcome of this meeting firmly priced into markets, the intermeeting period was characterized by more than usual attention to exchange rate developments. Dollar sentiment was bearish for most of the period, and thus the market was caught offside by last week’s sudden appreciation. The behavior of Asian central banks, from both a policy and a portfolio perspective, gripped the markets during much of the period and continues to do so.

The top panel on page 1 graphs the three-month U.S. and euro-denominated deposit rates. The solid red and green lines depict Libor fixings. The dashed lines graph the three-month deposit rates nine months forward for both currencies. With the tightening cycle advancing in the United States, short-term rates—represented by the solid red line—are now higher than in the euro area. However, perhaps the more interesting point is what has happened to forward rates. At the time of your September meeting, nine-month forward rates for both dollar and euro deposit rates were about 2.6 percent. Since then forward dollar rates have risen along with generally positive data. Meanwhile, euro forward rates have declined and now sit very close to the cash rate. With economic data in Europe showing sluggishness and with the strength of the euro adversely affecting export prospects, the ECB’s earlier expected tightening has been priced out, and many in the market are talking about a possible easing.

Looking at a somewhat longer time frame, the bottom left panel graphs U.S.–German three-month interest rate differentials since the beginning of the year. Dollar interest rates have gone from being 120 basis points lower to being almost

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

$\frac{1}{4}$ percentage point higher. At the long end of the curve, as shown at the bottom right, the relationship is more volatile. But there, too, dollar interest rates are higher by about $\frac{1}{2}$ percentage point—with the most recent widening driven almost entirely by a fall in German yields, as recent data disappointed. I should note that Japanese yields, although not shown here, also have fallen modestly, as incoming data were disappointing there as well.

The favorable shift in interest rate differentials might have been expected to help the value of the dollar. However, as shown at the top of page 2, the dollar has been on a downward trend. In mid-November, comments about the current account by Secretary Snow and Chairman Greenspan in the days surrounding the G-20 meeting in Europe were interpreted by some as signaling acquiescence to the dollar's fall, though sentiment was so bearish at the time that perhaps any comments might have had the same response. With the market so one-sided, it did become vulnerable to a sudden reversal, even in the absence of any fundamental news. The extent of the positions can be seen in the middle panel, which graphs the IMM's net noncommercial positions for three major currencies—the euro, the yen, and sterling—against the dollar. After a rather uneventful summer, speculators began to build up short dollar positions in early fall. By mid-November sentiment was overwhelmingly bearish and positions extended. As some accounts began to reduce risk, there was position squaring in several so-called crowded trades, including these short dollar positions, which fed last week's appreciation. The dollar's fall is certainly affecting returns on U.S. assets for foreigners. The bottom panel graphs the return year to date for a variety of asset classes and for the U.S. dollar index. Returns for most asset classes cluster around 5 percent, with high-yield bonds being higher. But for foreign investors, returns for most classes are closer to zero, given the nearly 5 percent fall in the dollar.

Another focus of market attention has been the behavior of Asian central banks from both a policy and a portfolio perspective. Page 3 provides updates of two charts I showed at the last meeting. The top panel graphs the Chinese yuan spot rate—fixed at 8.28—and the one-, six-, and twelve-month forward rates derived from nondeliverable forwards that are traded offshore and settled in dollars. This is a small market, but it is one of the few indicators of speculative interest regarding the size and timing of a possible revaluation of the yuan. Since your last meeting, the forward discounts have widened, as speculation grew of a near-term change in the regime. This is despite Premier Wen's comments that any move to make the exchange rate more flexible would not come if there were pressure from foreigners or from the markets. That does place China's officials in a box since they have conceded the principle, and one would expect that markets will intermittently price in a change in the regime.

Meanwhile, other Asian countries have allowed some appreciation against the dollar—and therefore against the yuan—in recent months, as shown in the middle panel. However, the pace of reserve accumulation has again begun to rise, suggesting that the authorities are nearing their limits. Japan, on the other hand, has not

intervened, perhaps in part because the rise of the Korean won and other currencies means that Japan's effective exchange rate has not risen as much as the yen's bilateral rate against the dollar.

Investors have watched closely these countries' willingness to tolerate further appreciation. But they are watching at least as closely how these countries are managing the reserves they have accumulated. There are two dimensions to this question. First, are these central banks diversifying away from the dollar? Several weeks ago a Russian central bank official publicly disclosed that the Russian central bank had shifted some of its dollar reserves into euros. That announcement and—until recently—the steady decline in the dollar fed speculation that Asian central banks might act similarly. Of course, if there were a shift from dollars to euros, the immediate effect would be a further appreciation of the euro, which would result in an additional reduction in the value of the Asian central banks' remaining dollars. Also, a further appreciation of the euro is something the ECB might resist at some point. To date, several Asian central banks have said that they have no plans to change their currency allocations, though market participants are wary.

The second dimension of the question is whether central banks are diversifying their dollar holdings from Treasuries into other asset classes. Hard data on this point are hard to come by. Anecdotally, those central banks with large reserve holdings have been growing both their Treasury and non-Treasury holdings for some time, though it's fair to say that the growth rates of agency, MBS, and even corporate holdings have been faster than that for Treasuries. The bottom panel graphs the New York Fed's aggregate custody holdings for Treasury and agencies since the start of the year. I should stress that this is an incomplete data set since central banks also hold securities with other custodians. Nevertheless, this does suggest that—especially in recent weeks—there has been a spike in agency holdings whereas Treasury holdings have been flat. We are aware of one major account that sold outright some of its Treasuries and re-allocated into agencies. Since the buys and sells for such securities are conducted with different counterparties, it is entirely possible that those dealers seeing the sale of Treasuries may have extrapolated in thinking that this account was also selling the underlying dollars—and thus fed some of the rumors in recent weeks.

Turning to domestic markets on the next page, the short intermeeting period featured a continuation of recent trends. Spreads are low and, if anything, have narrowed further. Implied volatilities continued at very low levels, and the price of oil continued to fall while prices of equities rose. The top panel of page 4 graphs the two-year to ten-year spread. The yield curve has continued to flatten though there was a sharp, if brief, steepening in late November driven more by technical factors than any fundamental news. Once the unwinding subsided, the curve resumed its flattening trend and at 121 basis points is at its flattest level in more than three years. Financial conditions remain favorable. As noted, corporate and emerging-market spreads are narrow. The middle panel graphs the absolute yield level for the EMBI+ and High-Yield indexes since 1997. The combination of a lower Treasury curve and

narrower spreads has lowered absolute yields to levels where financial comedians are asking if the name of the high-yield index will need to be changed. Finally, mortgage spreads continue to trade at low levels, as shown in the bottom left panel. The large holdings of MBS previously accumulated by banks continue to attract attention on the theory that a sudden spread widening would trigger this group of investors to start liquidating these positions.

Turning to page 5, let me provide a quick update on the growth of outright Treasury holdings in the System Open Market Account. The top panel graphs the net expansion of the SOMA from 1994 through 2003. Not surprisingly, there is a correlation over the long term between the growth of currency in circulation and the growth of SOMA. During this ten-year period, currency in circulation grew by \$35 billion per year (averaging over the Y2K event). Through November 2004 it has increased by \$32 billion this year. Although similar in dollar magnitude to prior years, that represents a slowdown in currency growth from about 7¼ percent in the 1994-2003 period to just under 6 percent this year. The somewhat slower currency growth that has emerged in recent years appears to reflect weaker overseas demand. The bottom panel graphs the Federal Reserve's direct net currency shipments going back to 1990—a somewhat longer period than in the first two panels. I should note that these data cover only the Fed's shipments and receipts. We do not know how much currency left the country—or came back—via migrant workers, tourists, and other legal or illegal means, though we have no evidence to suggest that those relationships have changed in recent years.

In many years through 1997, foreign growth composed the bulk of overall currency growth. Starting in 1998, shipments overseas began to moderate, and averaging out Y2K effects, the overall trend of foreign shipments has been falling and in the last two years has turned negative. Without the significant shipments to Argentina and Iraq in recent years, these numbers would have been lower still.

Mr. Chairman, that concludes my prepared remarks. There were no foreign operations in the period. I will need approval of domestic operations, and I'd be happy to take any questions.

CHAIRMAN GREENSPAN. With respect to the direct net currency shipments abroad, recently I have seen reconciliations between other techniques that endeavor to get to the aggregate amount of currency held abroad and the direct currency shipments. Are those other techniques indicating much the same story? I presume, with the growth of currency in circulation slowing and with the foreign piece such a huge part of that, that a direct measure of shipments looks much like what we estimate is the total. Is that accurate?

MR. KOS. I believe so. But as I said, we don't see the currency that leaves the country—or that can come back in—by other means. There seems to be a correlation between the middle panel and the bottom panel, but again, there is a lot of slippage because of other ways currency can leave the country. But I have not seen a firm reconciliation.

CHAIRMAN GREENSPAN. The way we estimate foreign holdings from the stock of currency is not a bad technique. Indeed, as I recall, the several different measures yield roughly the same result. So, the implication is that the net change in that estimated stock less the direct shipments is, indeed, a presumed “other” component plus statistical error. Does that tend to be a small number or a large number?

MR. KOS. I can't say that I can tell you.

MR. MADIGAN. I don't have that either, Mr. Chairman, but I would note that our estimates of growth in foreign-held currency are actually still somewhat larger for this year than for domestic currency, despite the negative net shipments that Dino referred to. For instance, we are projecting that foreign currency is growing about 6¾ percent for 2004 as a whole, whereas domestic currency growth we estimate at about 4 percent.

CHAIRMAN GREENSPAN. So that suggests that there's an unexplained significant residual. On the IMM traders report, to what extent are the net long and short positions useful in anticipating changes in rates? My presumption is that, historically, if there was a relationship, it disappeared as soon as somebody observed it. What are the facts?

MR. KOS. We actually did some work on this. Bob, do you remember the paper that we did a few years ago?

MR. ELSASSER. I think the basic conclusion there was that those data do seem to have some predictive power, but they are released with such a long lag that they are not useful for traders on a real-time basis.

CHAIRMAN GREENSPAN. But there is other evidence that does suggest that, when everybody becomes absolutely committed to the view that a currency is going to move in one direction or the other, one can always make money on the other side of that transaction. At least that's my recollection of history. But I guess since nobody knows what these data are in real time, one can't make that statement.

MR. KOS. People do use these data sometimes as a contrary indicator—for the very reasons that you note.

CHAIRMAN GREENSPAN. But if they do see a relationship, it disappears.

MR. KOS. That's the risk.

CHAIRMAN GREENSPAN. Other questions for Dino?

MS. MINEHAN. With the possible exception of these positions vis-à-vis the dollar, there seem to be a remarkable number of indications—spreads are narrower, the yield curve is flatter, and so forth—that suggest that market participants see less risk. Yet the risks seem to be out there. We hear people talking about that all the time. Some of this betting against the dollar reflects the international risks having to do with the size of our deficit and the way the currency markets are going. There is a potential for markets to get upset about fiscal deficits going forward. There seem to be a lot of risks out there, but we don't see it in the curves much. Do people talk about that at all?

MR. KOS. Yes. The short answer is yes. They have observed—especially over the last year—any number of things that should have and did create uncertainty. Yet there was this dichotomy where volatilities were low and spreads were low. So yes, there has been this

dichotomy, and people talked about it. There's a certain amount of frustration about it as well, I think, because it doesn't make sense in terms of most people's mental models of how these things work.

MS. MINEHAN. Yes. A couple of people I talked to in the investment world characterized the situation as a sort of tight equilibrium that was balanced off against risk on both sides. They approach it with a sense of unease because they view it as not necessarily stable.

CHAIRMAN GREENSPAN. Any further comments or questions? If not, would somebody like to move to ratify the domestic open market operations?

SPEAKER(?). So moved.

CHAIRMAN GREENSPAN. Without objection, they are approved. We move on to Dave Stockton.

MR. STOCKTON. Thank you, Mr. Chairman. In brief, the news that we have received since the completion of the November Greenbook five weeks ago has been supportive of the view that the economy has been growing modestly above trend and will likely continue to do so into next year. Indeed, both the incoming data on economic activity and some of the key factors that condition the projection point to a more favorable outlook than was anticipated in our previous projection. A pickup in the pace of hiring and stronger growth of consumption led us to mark up the projected pace of real GDP growth in the second half of this year by $\frac{1}{4}$ percentage point, to $3\frac{3}{4}$ percent at an annual rate. Since the publication of last week's Greenbook, we received stronger-than-expected readings on retail sales and wholesale inventories and weaker-than-expected figures on international trade. On net, these data appear to be about a wash for current-quarter GDP.

Looking beyond the near term, higher equity values, larger gains in house prices, a lower exchange value of the dollar, and a drop in oil prices suggest greater upward impetus to spending and activity over the next two years. In fact, incorporating this more favorable configuration of financial and oil market developments into our projection would have resulted in output overshooting potential. In order to forestall that outcome, we raised the trajectory of the assumed federal funds rate, and we are now just slightly below the path implied by futures prices. I suppose that if I were truly in the holiday spirit I would give you a gift by stopping right here, because that is pretty much the story behind the forecast. But seasonally adjusted, I'm not feeling any more generous than usual.

So let me start with the labor market. The October and November employment reports did not provoke in us the same euphoria followed by disappointment that was apparent in the reactions of financial markets. Taken together, the employment increases in October and November were noticeably stronger than had been incorporated in the previous Greenbook and allayed our concerns that weakness in the labor market might sap the vigor of the expansion. As I noted at the last meeting, our November projection had put underlying gains in private payrolls in the second half of this year at around 100,000 per month. But it now looks as if hiring has been running around 160,000 per month, and we expect it to pick up to around 225,000 per month by the spring. Most other readings on the labor market also point to a gradual improvement. The only discordant note has been the increase in initial claims over the past two weeks. We are not yet inclined to read much into that increase, but it does highlight downside risks to the employment outlook.

Consumer spending also surprised us to the upside. In response to the incoming news, we raised the projected growth of real PCE by $\frac{1}{2}$ percentage point in the second half of this year, and yesterday's retail sales release suggests a further small upward adjustment of a few tenths to our fourth-quarter consumption forecast. We are now estimating that real PCE advanced at an annual rate of more than 5 percent in the third quarter and will increase at a $3\frac{1}{2}$ percent pace in the current quarter. That slowdown is more than accounted for by a drop-off in motor vehicle sales in October and November. With inventories remaining uncomfortably high, we are expecting that the automakers will be forced in coming months to adopt a combination of some cutback in production from current schedules and sweetened incentives to boost sales. Outside motor vehicles, real PCE is now projected to grow at a $4\frac{1}{4}$ percent annual rate in the current quarter, a bit faster than in the third quarter. The anecdotes about the holiday selling season have been mixed to downbeat in recent weeks. I don't think that we have ever been very successful in matching holiday anecdotes to the published data. Still, we've assumed a weak December for retail sales, in part on the basis of these stories and the dropback in weekly chain store sales.

In the business sector, outlays for capital equipment have continued to increase steeply, with real E&S up about 17 percent at an annual rate in the third quarter and projected to increase 11 percent in the fourth quarter. Taken together, those gains were close to our earlier expectations. In looking at our E&S forecast, it is clear that we are approaching something akin to a "moment of truth." A few years back, based on calibrated theoretical models and a healthy dose of judgment, we built into our forecast of equipment spending a noticeable effect from partial expensing. That effect included a boost to spending during the period when partial expensing was permitted, followed by a pothole after its expiration. Gee, it seemed pretty logical at the time. And even now, there is evidence to support our position. Real spending on equipment has exceeded the expectations of our econometric models that make no allowance for partial expensing—and by an amount close to that of our estimate of the expensing effect. Moreover, new orders for capital goods fell off in October and fell a bit more than is necessary to create our first-quarter dip in spending. And while the anecdotes have been underwhelming, we've always recognized that only a small

fraction of firms would be on a margin where this provision actually influenced their spending decisions.

But all that said, it just doesn't feel as if the risks are symmetric around this aspect of our projection. The probability that the effect will turn out to have been smaller than that incorporated in our projection seems larger to me than the probability that this effect will exceed our expectations. Part of my discomfort arises from the recognition that, if we had started out our forecast with a null hypothesis that partial expensing would have no effect on spending, I could easily imagine myself sitting here today arguing that the data and anecdotes had not contradicted that hypothesis either. I don't want to exaggerate the vulnerability of our GDP projection to this assumption. In fact, we have offset about two-thirds of the tax-induced swing in equipment spending in inventories and imports so that domestic production of capital goods is much less affected than spending. Still, if the partial-expensing effect turns out to be smaller than we have estimated and underlying demand for equipment correspondingly stronger, the economy is likely to carry somewhat greater momentum into early next year than is implicit in our forecast. While crossing one's fingers is not a forecasting methodology typically covered in graduate-level econometrics, that is what we will be doing over the next few months. [Laughter]

Of course, the momentum that the economy carries forward into next year will be affected to a much greater extent by the broader developments in the economic and financial environment than by the effects of partial expensing. And on that score, the key factors conditioning our projection have strengthened noticeably over the past five weeks. As you know, one of the key upside risks we saw to the projection was the possibility that the accommodative stance of monetary policy would be accompanied by sharper movements in asset markets than we were forecasting. Some of those risks may have manifested themselves of late, at least to some degree. The stock market is about 4 percent higher than in our previous projection; house prices are projected to average about 5 percent higher; the price of imported crude oil is about \$3 per barrel lower, on average, in 2005 and about \$2 per barrel lower in 2006; and although the dollar has retraced some of its earlier declines, by the time we closed the Greenbook last Wednesday, it was still below our previous projection. The increase in household net worth associated with higher prices for equities and houses provides a considerable boost to household spending over the projection period, as does the increase in real income stemming from the lower price of oil. Meanwhile, the weaker dollar is projected to give a lift to exports and to trim the growth of imports.

The only notable factor on the negative side of the ledger was the further downward revision that we made to our forecast of spending on high-tech equipment. While the news was not uniformly downbeat, enough of it was negative to make us take another hard look at our forecast. With relative prices for tech equipment not declining at the pace they had a few years back, with few signs of new applications that would substantially stimulate demand, and with domestic and foreign producers reportedly cautious about the outlook, we lowered our projection of the growth of real

high-tech equipment spending. We now project that the growth of spending on this equipment will equal, rather than exceed, its historical average going forward. We believe that this outlook better balances the risks.

On net, the positives for the economic outlook significantly outweighed the negatives and, as I noted earlier, without an adjustment to our policy assumption would have resulted in actual real GDP overshooting potential by the end of the projection period. As a consequence, we raised our path for the funds rate 50 basis points, bringing the assumed level to 2¾ percent by the end of next year and to 3¼ percent by the end of 2006. Our assumed path is now just ¼ percentage point, on average, below that implicit in the fed funds futures market. These adjustments altered the contour of our projection, with faster growth in real GDP now projected for next year, followed by a more noticeable slowing of growth in 2006 as the less accommodative stance of policy shows through.

The inflation picture has changed little over the intermeeting period. Our forecast for core CPI in October was right on the mark, as was our forecast for core PCE. Moreover, there have been only modest changes in the key determinants of inflation. The larger-than-expected drop in the price of oil is partly offset by the higher prices for non-oil imports. In our forecast, total PCE inflation is still expected to recede from 2½ percent this year to about 1¼ percent in 2005 and 2006, while core PCE inflation remains roughly unchanged at 1½ percent over the next two years. As in the previous forecast, that stability in core inflation is brought about by several small offsetting effects. A diminishing margin of slack and some slowing of structural productivity are expected to place slight upward pressure on inflation. But these effects are offset by some reversal of this year's jump in energy prices and a smaller projected rise in non-oil import prices.

At the last meeting, Vice Chairman Geithner asked, in effect, whether the benign outlook for inflation in our baseline and even in our alternative simulations reflected a lack of imagination on our part or, perhaps the unstated alternative, a lack of intelligence. [Laughter] I was at least grateful to implicitly be offered a choice—you know, cigarette or blindfold. In the end, I'm not certain that we can offer the Vice Chairman much comfort on the intelligence front. But we did attempt to exercise our imaginations better, and it is fair to say that, in surveying the landscape, some upside risks to inflation strike us as potentially more potent than others.

One risk is that economic growth will exceed our expectations, causing resource utilization to tighten more quickly than in the baseline projection. While that outcome certainly cannot be ruled out, we don't see the implications for inflation as being especially large, at least over the two-year time frame of our projection. As we have highlighted in the past, inflation simply is not very sensitive to the output gap in our models; the effect is not zero, but it is nonetheless small. Moreover, a corollary to this observation is that, if we have mis-estimated the natural rate of unemployment or the output gap, we don't think the consequences for inflation would be large over

the next eight quarters—again because inflation does not appear to be especially sensitive to resource utilization.

Another risk might be that the upward pressure on inflation from rising commodity and materials prices will intensify in the coming year. Oil prices have certainly surprised us and participants in futures markets this year. Moreover, a steeper slide in the dollar or more rapid improvement in industrial activity here or abroad could produce more significant pressures in commodities markets. If sharp increases in materials costs were to continue, an increasing fraction of firms that to date have absorbed these costs may attempt to pass them on to customers. Based on quotes from futures markets, we don't see a continuation of rapid gains in commodity prices as the most likely outcome, and given the small share of costs accounted for by raw materials, the consequences of an upside surprise do not loom especially large. Nonetheless, it does seem a risk worth closely monitoring.

In our view, a more prominent and sizable upside risk to the projection is that firms will act more aggressively to raise prices in order to limit the damage done to their profit margins by slowing productivity and rising unit labor costs. Those tendencies could be amplified if productivity slows more sharply than we are projecting. As you know, we showed a simulation combining these developments in the Greenbook, and the consequence was an acceleration of core PCE prices to 2¼ percent by 2006, ¾ percentage point above the baseline forecast and at the outer edge of our 70 percent confidence interval. We don't think that the evidence favors such an outcome, but we see this as an important vulnerability in our otherwise sanguine outlook.

More broadly, we are trying to remain especially alert to developments that would suggest that this year's price shocks will propagate forward into higher underlying inflation. In addition to the possibility of slower growth of labor productivity, any signs of a significant pickup in nominal wages would have troubling implications for costs and prices. But the broad measures of hourly labor compensation have been running a very steady 4 percent or so over the past year, with little indication of an imminent takeoff. Inflation expectations also deserve close scrutiny. Inflation compensation as measured by the five-year TIPS spread has moved up in recent months, but five- to ten-year inflation compensation has barely budged. Moreover, survey measures—either short-term or long-term—have changed little over the past year. At this juncture, we see still few signs that this year's upturn in inflation is the beginning of a process of more-pronounced deterioration. Obviously, the size of the confidence intervals surrounding our forecast admits a reasonably wide range of outcomes over the next two years, both to the upside and to the downside of our inflation projection. Although we are comfortable with our outlook for inflation, we leave it to the Committee to decide whether this forecast deserves a holiday turkey or whether it is the holiday turkey! Karen will continue our presentation.

MS. JOHNSON. At this time of year, when persons old and young are looking for tangible evidence of whether they have been naughty or nice during the past

twelve months, I cannot resist taking joy in pointing out that some force, perhaps from the North Pole, has given the forecasters in the International Division the opportunity to say something that we have been waiting to say for a long time: “As we forecast in the previous Greenbook, global oil prices have fallen on balance over the intermeeting period.” [Laughter] Indeed, they have fallen a bit more than we forecast, with the result that our forecast path for U.S. oil import prices has shifted down about \$3 per barrel in 2005 and \$2 per barrel in 2006. One consequence of recent developments is that the futures curve for WTI prices and our projected path for the average price of imported oil are flatter than they have been in the past several months, with only a relatively small further net change expected in oil prices from now through the end of 2006. At the same time, uncertainty about future oil prices seems to be quite high. The expected prices for WTI for the January contract and the June contract for next year are both around \$41. But the probability distribution around the mean price for June is very wide, with the $\frac{2}{3}$ probability interval ranging from \$32 per barrel to \$50 per barrel.

With the projected path for oil prices fairly flat, the implications of global oil prices for growth and inflation abroad consist mainly of the future effects of oil price developments that have already occurred. Despite their recent declines, oil prices remain elevated from their levels one year ago. We judge that the slowing of activity in several foreign economies in the third quarter is due at least in part to the net increase in oil prices this year. The negative effects on output growth were relatively greater for the Asian emerging-market economies, which tend to be more dependent on imported oil than other regions, although these economies have also felt the slowdown in the global high-tech sector. Over time, we expect the transitory influence of the spike in oil prices to dissipate and average real GDP growth abroad to return to an annual rate of about $3\frac{1}{4}$ percent. For the industrial countries and the emerging-market economies, headline inflation will be up a bit in the near term and then subsequently edge back down, reflecting the path of oil prices.

During most of the intermeeting period, the dollar continued the downward trend that had resumed in mid-September, with the index of major currencies reaching a point early last week that was 12 percent below its May peak and a nine-year low. Market participants pointed to heightened concerns about the financing burden of the widening U.S. trade deficit as a major factor driving the dollar’s slide. At the time that we were putting the finishing touches on the December baseline forecast, recent exchange rate moves indicated that we should lower the path for the real value of the broad index of the dollar about 3 percent. However, subsequently the dollar has significantly reversed its intermeeting move in a sharp appreciation. No particular data release or event seems to have triggered the climb of the dollar. Market participants point to incentives for traders to take profits and to eliminate previously established short dollar positions ahead of the year-end.

Our baseline December forecast incorporates the lower path projected for the dollar directly in U.S. trade prices and volumes and, as a consequence, in the outlook for domestic activity and inflation in a complex way. Of course, daily fluctuations in

the dollar cannot be anticipated and could easily put us back at the December Greenbook starting level. However, had we not revised the path for the dollar and so left it unchanged from that in the November Greenbook, our trade equations suggest that the partial effect of this change alone would have been to increase the negative contribution of net exports to U.S. real GDP growth about 0.15 percentage point in 2005 and 0.1 in 2006 relative to what is currently in the December Greenbook. With such a higher path for the dollar, import price inflation in the baseline would have been noticeably lower in the near term but little changed in 2006. By the fourth quarter of 2006, the partial effect of a higher dollar path would be to widen the projected current account deficit about \$35 billion.

In addition to the moves in oil prices and the exchange value of the dollar, the other major feature of the international forecast at this time is that we have again revised down projected foreign growth, particularly in the near term. As mentioned earlier, to some degree this reflects the consequences of elevated oil prices. But it also reflects more-fundamental shortfalls in macroeconomic performance in some regions—for example the euro area, where we have lowered our forecast for real GDP growth throughout the forecast period. Persistent weakness in domestic demand in the euro area is a vulnerability that restrains global recovery and undercuts the adjustment of U.S. external deficits.

Weak domestic spending in the euro area is associated primarily with Germany. One factor that is thought to be at least partly responsible is the extensive discussion of and, at least some progress on, implementation of structural reforms in the participating countries. For example, German pension reform appears to be creating incentives for higher savings on the part of households, as the prospects of less-generous pensions or the uncertainty about how the reformed system will function increase the perceived need for private assets. Given the very large unfunded public liabilities associated with social insurance systems in Europe, successful reform and higher personal savings would be helpful. However, for those savings to be realized in higher capital stocks and improved German output growth, private investment spending must also be stimulated. Such a response might require some reduction in interest rates, led by easing on the part of the ECB, in order to maintain utilization of macroeconomic resources during the implementation of reforms. Action on the part of the ECB is made less likely, however, by the continued recording of headline inflation above the target ceiling of 2 percent. Euro-area inflation is “stuck” at 2 percent in part because governments, particularly the German government, are turning to increases in administered prices as they seek higher revenue to keep overall budget deficits from rising even further. On balance, our outlook for the euro area during the forecast period is slow growth, at about 1¾ percent, as the long-run positive benefits of the structural reform efforts are either yet to arrive or are overwhelmed by negative, short-run consequences.

We have also revised down our projection for near-term growth in Japan. Recently released GDP data and current indicators paint a picture of real GDP expansion in Japan that is not as strong as we and the markets had expected. Growth

should rebound from less than ½ percent at an annual rate in the second half of this year to only about 1½ percent annual rate during 2005.

This morning, trade data for October were released. The trade deficit came in at \$55.5 billion, up \$4.5 billion from September and noticeably larger than both we and the markets had anticipated. The increase in the deficit primarily reflected a surge in merchandise imports; exports increased only modestly. These data will no doubt lead us to revise down our projection for real net exports in the current quarter, although we obviously have not had time to digest fully the implications for the outlook. A rough, back-of-the-envelope calculation suggests that the contribution of real net exports to U.S. GDP growth could be revised down enough to bring the negative contribution in the current quarter to around ½ percentage point. This number should be taken with a grain of salt, however, as we are reluctant to rely too heavily on one month's worth of volatile data. That concludes our presentation. Dave and I will be happy to answer your questions.

CHAIRMAN GREENSPAN. Dave, you put down finger-crossing as a serious econometric technique. I want to communicate that in my experience the t-value is quite high. [Laughter]

MR. STOCKTON. I'm so glad to hear that. [Laughter]

CHAIRMAN GREENSPAN. Questions for our colleagues? You realize that, if there are no questions, this is a historic occasion! [Laughter] Hearing none, who would like to start our discussion? President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. Since we're making history today, the Seventh District's economy continued to firm, and the strength appears broad-based. Our business contacts again report increasing production, strong new orders, and growing backlogs. Labor market conditions are improving, although they're still not robust. Our temporary-help firms report that orders are strong for professional and technical help, but growth is a bit less rapid in the light industrial and clerical sectors.

We recently held our eighteenth Annual Economic Outlook Symposium. Twenty-six economists submitted forecasts this year, and they were a bit more pessimistic than the Blue Chip forecast. The consensus outlook is for GDP growth of 3.1 percent in 2005 and for the CPI to rise

2.4 percent next year. Not surprisingly, a number of the participants in the symposium make a living in the auto industry. Their outlook for light vehicle sales in 2005 is 16.8 million units, a pace virtually unchanged from 2004. If the Big Three continue to lose market share, this pace would imply declines in their sales, and such declines would be a challenge for our District, given the heavy presence of Big Three production. Two of our directors, who are major parts suppliers, are working off the assumption that Big Three production in the first quarter will be 7 percent below that of a year ago but said they wouldn't be surprised if the actual cuts were as much as 10 percent.

Turning to the national outlook, on balance the data we have received during the past few weeks haven't materially changed our views about the economy. We continue to expect that growth will average a bit above potential over the forecast period. Our best guess is that there is still some meaningful resource slack in the economy, so our outlook for inflation is relatively benign. The fact that higher prices for energy and other inputs did not markedly boost core inflation is certainly consistent with this view.

With regard to risks, I'm still concerned that factors such as high energy prices and business caution could continue to hold back growth in job creation. However, I'm also concerned about some inflation risk. We know that there is a great deal of uncertainty about the size of resource gaps. What if they're not as large as we think? After all, we've been expecting big increases in employment as the gaps in labor markets shrink. But it has been three years since the recession ended, and even in the years since employment began to head up, payrolls have increased only a bit faster than the working-age population, and labor force participation has been flat during this period. It's possible that this is as good as it gets. The participation rates simply may have overshot trend in the late '90s by more than we thought and, therefore, the rate may not rise much above its current level. The answer to this question regarding resource gaps is not obvious at this time, as David

mentioned in his comments. But we cannot rule out the possibility that there is less resource slack in the economy than we think and that we've been reading the inflation data with too much complacency. Whether inflation picks up during the next eight quarters or after the next eight quarters, either scenario would be of concern. Of course, even if we discount this risk, policy is still highly accommodative, so at this meeting my view is that we should continue on our current course. It's still too early to signal an imminent pause; that will be a key question for next year.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Thank you, Mr. Chairman. My contacts are essentially saying that they could just replay the tape from our November conversations. The situation is not much changed; the outlook remains pretty favorable. Let me comment particularly on some evidence on demand in the labor market. When I was talking to my contacts at the time of the last FOMC meeting, a number of them noted the strength of demand in the technical area—both IT and accounting—and demand for MBAs. So what I did this time was to call placement directors at two MBA programs, and I thought those conversations gave me some interesting insights into what's going on in that regard. One of the programs is what I think we'd call a first-tier MBA program. The number of companies that came to that campus reached a recent high of 222 in the fall of 2000. By 2002, the number had dropped to 126. It was 149 last year and 169 this year. So there has been a very substantial increase in the number of companies coming to hire. A contact at a second-tier program had the same kind of information, with the number of firms recruiting on their campus up 12 to 15 percent over last year. Particularly noteworthy was the fact that consulting firms are coming back into the market, which hadn't occurred for a good long time. At the lower skill level, my Wal-Mart contact says that they continue to have loads of applicants for positions as associates

when they open new stores. So I think that the labor market is beginning to tighten at the upper skill levels.

On the overall outlook, I agree with the Greenbook, subject to the usual caveats about standard errors. I think it's important to understand that the expansion is not fragile. I think there's a growing amount of business confidence, forward planning, and maybe even very early signs of exuberance when you look at the recovery of IPOs and at merger and acquisition activity. And the demand for employees at the higher skill levels suggests that companies are really gearing up, with a pretty solid outlook going forward.

I do think that the inflation risks are tilted slightly to the upside. I don't foresee an outbreak of inflation, but if we're going to see a miss there, I think it's more likely to be on the upside than the downside. If we view changes in oil prices and exchange rates as exogenous shocks—and certainly the timing has to be viewed as exogenous—then we would expect over time a gradual absorption of the pressures that are coming from them. Those effects look pretty pervasive; they are spread throughout the economy. I think a better view of what's going on here is that oil and exchange rates should be regarded as fundamentally endogenous variables and that they reflect an environment of expansionary policy continued over a sustained period of time. I believe we're on a good course to prevent that from getting out of hand, but those are two very, very important influences on the price performance of the economy going forward. The pass-throughs occur slowly, but they do occur eventually. Therefore, I think we should not relax simply because recent oil prices are off their highs. The long-term oil futures are up about 50 percent or more from where they were a few years ago. So there has been a very important fundamental change, I think, in the economics in that market. Thank you.

CHAIRMAN GREENSPAN. President Yellen.

MS. YELLEN. Thank you, Mr. Chairman. Economic activity in the District is expanding at a moderately strong pace, closely mirroring that in the nation. Housing markets remain especially robust, and consumer spending at stores and on travel is solid. The high volume of international trade flowing through the District has resulted in backlogs at our ports in southern California. In addition, there have been some reports that firms are facing difficulty in getting access to enough trucks and railroad cars. Not surprisingly, shipping prices have risen.

Turning to the national economy, I've been heartened by recent economic data, which for the most part have been positive. The November employment report was disappointing, but taken in the context of the last several months of job growth and other data, I have become more confident that the economy has found solid footing.

Looking forward, the decline in the dollar and the recent retreat in oil prices add further support to aggregate demand. Even so, it is notable that output growth so far has only moderately exceeded potential despite huge doses of fiscal and monetary medicine. And the Greenbook, though more upbeat this time than last, forecasts a similar pattern for 2005, even with only a gradual removal of monetary accommodation.

Turning to inflation, the 2005 Greenbook forecast of core PCE inflation of about 1½ percent and core CPI inflation of 2 percent strikes me as very reasonable. In support of this view, our contacts tell us that consumer prices remain relatively stable. Indeed, our contacts see continued competitive pressures to control costs. Such pressures were evident in labor negotiations at grocery stores in southern California earlier this year and more recently at major hotels in the Bay area. I see the risks to inflation from uncertainty about the future paths of the dollar and oil prices. Another risk, which I've mentioned before, relates to the high markup of prices over unit labor costs. A reversion to more-normal levels could result in a significant reduction in the rate of inflation.

Finally, what happens to productivity growth is also important for the inflation outlook, as the Greenbook alternative simulations demonstrate.

I would like to focus the remainder of my comments on productivity and its implication for inflation and monetary policy. As we discussed at the last meeting, the recent moderation in the pace of price declines for high-tech goods, coupled with weakness in high-tech investment last quarter, hints at the possibility of less-robust productivity growth going forward. If this turns out to be the case, we would expect some upward pressure on inflation. I would like to emphasize, however, that there is a real chance that productivity growth over the next few years will come in higher than anticipated in the Greenbook. Over the past four years, labor productivity growth in the nonfarm business sector has averaged nearly 4 percent—about 1½ percentage points above its pace over 1996-2000, in spite of a sharp drop-off in capital deepening after 2000. Some people argue that improved productivity growth since 2000 is largely temporary and will reverse over the next few years. For example, the recent surge in productivity may reflect the fact that businesses have been extremely cautious in adding workers. Proponents of this view expect caution to dissipate and productivity growth to slow as firms become more confident about the outlook.

But if business caution in making long-term commitments were the primary motive for weak job growth, we would expect—but do not see—employment expanding along other margins, such as the workweek. One reason for optimism about the underlying productivity trend is that multifactor productivity during the second half of the 1990s was probably greater than estimates derived from standard growth accounting. We now realize that a considerable amount of the investment during the late 1990s had a low or even a negative rate of return, biasing up standard estimates of the contribution to productivity growth from capital deepening.

Moreover, all signs suggest that businesses are continuing to adapt and reorganize their practices in order to take full advantage of the opportunities afforded by new ICT technologies, and this process seems likely to continue playing out for some time. For example, one of our major banks indicated that through ongoing use of technology they have been able to support growth in customers and services with fewer staff. A further example is the continuing expansion of Wal-Mart and other big box stores—a trend that has had a dramatic effect on productivity growth in the retail and wholesale sectors.

Finally, there is evidence suggesting that the extraordinarily high rates of investment during the second half of the 1990s were disruptive to businesses. According to one estimate, such adjustment costs reduced productivity growth about $\frac{1}{2}$ percentage point during that period. All in all, it's entirely possible that productivity growth, both structural and actual, could average around $3\frac{1}{4}$ percent over the next two years, as in an alternative Greenbook simulation. This pace is about equal to the average rate of productivity growth during the last seven years, including periods of both high and low investment. In the Greenbook simulation that combines such a step-up in productivity growth and a declining markup, inflation falls to $\frac{3}{4}$ percent in the second half of next year and remains at that level. Such an outcome is troubling, given our concerns about the effects of deflation and difficulties in conducting monetary policy in such an environment.

So, in summary, I consider the 2.7 percent Greenbook estimate of structural productivity growth as reasonable and the risks to inflation as balanced. But there is significant upside productivity potential and associated downside risks to inflation. Given the costs of an unexpected and substantial decline in inflation, these risks should be a significant concern. For today's meeting, it seems entirely sensible to raise the funds rate 25 basis points and to craft a statement that leaves our options open to eventualities.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. Economic activity in the Third District continues to expand at a moderate pace. Reports from our manufacturers have been mostly positive. Our November business outlook survey (BOS) index of general activity stood at 20.7, which was down slightly from October. However, the index in our December BOS, which will be released Thursday, has rebounded to 29.6. So we're still seeing expansion in the region's manufacturing sector. The new orders and shipments indexes remain at healthy levels, and the employment index continues to strengthen.

Looking beyond our formal surveys, retail sales of general merchandise in our region are showing continued moderate growth this holiday season, at a pace consistent with retailers' expectations. This growth has been in most store types and merchandise lines. Retailers in our region expect current dollar holiday sales this year to be 4 percent higher than last year, which is similar to the National Retail Federation's forecast of a 4.5 percent gain. On the margin, however, sales of luxury goods continue to show better year-over-year increases than sales of other items.

Turning to construction, nonresidential construction remains soft. We had a bit of an improvement last month, but it was fleeting. It's probably best to describe this sector as having bottomed out without any kind of sustained improvement yet. Nonetheless, commercial real estate firms expect office vacancy rates to move down somewhat in the year ahead in most parts of the region. At the same time, they continue to report declines in effective rents, as landlords compete for new tenants and lease renewals. As a result, some commercial real estate investors are becoming concerned that prices for buildings have risen to a level inconsistent with the underlying fundamentals.

In the residential real estate sector, prices continue to accelerate in each of the three states in our region. Area builders report that they are raising prices for new homes, in contrast to some other parts of the nation where it is reported that developers are beginning to cut prices or offer discounted upgrades as incentives to spur sales. Looking ahead, builders and real estate agents expect the pace of sales to remain roughly steady. They anticipate rising employment and incomes to cushion the effect of increases in mortgage rates as long as the upturn in rates does not exceed 1 or 2 percentage points.

Payroll employment in each of our three states grew in October, the latest month for which we have state-level data. Growth in October was somewhat slower than in the second and third quarters, but payrolls went up in all major industry groups except manufacturing and information services. Employment growth in New Jersey and Delaware continues to outpace that of the nation. Pennsylvania continues to exhibit the weakest labor market in our region. Looking ahead, our staff forecast calls for moderate acceleration in employment growth and a decline in unemployment rates in each of our three states over the next year.

On the inflation front, some reports suggest increasing industrial goods price pressure. This is what we hear from our board, and this is what businesses are reporting in their comments to us around the District. In our business outlook survey, the price indexes remained at high levels, and firms reported higher prices for their own manufactured goods and higher production costs. For example, more than 90 percent of the executives polled in our November BOS expected prices of raw materials, including energy, to increase next year. In all, the outlook among our contacts in the region's business community is positive. They expect growth to continue at about its current pace through the winter.

Turning to the nation, data released since our last meeting have generally been on the positive side. Household spending and business investment have been revised upward, suggesting positive momentum. Recent retail sales numbers were encouraging. Housing construction remains relatively strong, and manufacturing remains on solid footing. While the November employment report was a bit on the soft side, the pattern of payroll growth over the past several months, allowing for the usual monthly volatility of the data, shows continued improvement in the labor market. Payroll growth has averaged over 185,000 jobs per month so far this year, about in line with the forecasts. While there likely is still some slack in labor markets, this is being worked off. By the way, for those of you who put some value in the NAIRU model, the recent staff analysis of NAIRU estimates at our Bank suggests that there may be less slack in the labor market than we assumed. The other positive developments for aggregate demand since the last meeting are the decline in oil prices and the depreciation of the dollar, as we know.

My outlook for economic growth is broadly consistent with that of the Greenbook. I, too, expect growth in the neighborhood of 4 percent next year, and I'm more comfortable with the fed funds rate path built into this Greenbook than I was with the path of the last one. However, even with the steeper funds rate path, I see somewhat more inflation risk. The dollar could depreciate more and the pass-through to final prices could be larger than is incorporated into the baseline forecast. I do recall that we discussed at our last meeting the worldwide phenomenon of a reduction in the pass-through rate. Nonetheless, I think we need to list this as a risk to our forecast. In this regard, as David Stockton noted, five-year inflation compensation based on the Treasury indexed security has moved up, even while six-to-ten-year inflation compensation has been stable. One interpretation of the divergence is that the markets believe that the FOMC will respond to inflationary pressures and keep prices stable in the long run, but only after we see that inflation has

risen. I would prefer that we be more forward-looking than this implies. This, of course, argues for maintaining our strategy of gradually removing policy accommodation to bring policy back to a neutral stance. The facts are that policy remains accommodative, the forecast is for continued growth in the neighborhood of 4 percent, and there is some positive inflation risk. All this suggests to me that it is prudent to continue on our upward path for the funds rate.

Before closing, I'd like to point out that the Bluebook's measure of the real fed funds rate uses lagged core PCE. By this measure, we have made some progress in moving the real funds rate north. However, ex ante measures of the real rate, based on the forecast of inflation, show less progress by the Committee in removing policy accommodation. I would ask the Committee to remember 1994. At that time, the FOMC waited to see a year's worth of strong employment data before starting to raise rates, on the grounds that falling inflation meant that the real rate was rising. Then once the FOMC started to increase rates, it had to do so quite sharply over the year. Of course, this time we began raising rates earlier than last time, which may allow us to follow a more gradual path. However, remember, this time inflation has been increasing, and the real rate has been moving up only a little. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. The meetings with our Sixth District boards of directors were particularly timely this cycle, just concluding at the end of last week. I would note three issues and impressions that came from those discussions.

First, the directors' general outlook for the economy was decidedly positive and more solid and broad-based than has been the case for some time. There even seem to be some new stirrings in commercial real estate. And more of our bankers are reporting some increase in business lending, especially in small and middle markets. I was particularly struck by the degree to which much of

the business caution that remains was attributed by many to all of the time and attention being devoted to the Sarbanes–Oxley governance work. One gets the sense that, once some of the initial adjustment to that legislation is behind us, perhaps—just perhaps—some of the caution we have talked so much about will begin to dissipate.

Second, I was struck by the degree of talk about price increases that had been put in place or were being planned. While some of those were directly attributed to the cost of oil and other energy costs, there was just more widespread conversation about the determination to get some price adjustment.

Third, I was intrigued by an oil price observation from one of our New Orleans directors, who is a senior executive for one of the largest U.S. chemical companies. I had been under the impression that less-developed countries like China, because they are “energy efficiency disadvantaged,” would be relatively more hurt by the past rise of oil prices than the United States. However, this director related that, during a recent visit to China to discuss a new joint venture plant to produce an input to the manufacture of plastic goods, his staff couldn’t reconcile the financials that were being presented. The reason was that the energy price assumption in those projections seemed to be unreasonably low. To make a long story short, the Chinese were using oil prices that were about \$10 less a barrel than West Texas intermediate crude. When queried about this, it seems that the refineries built in developing Asia over the last fifteen years were designed to process sour crude, which is presently trading at a price that is \$8 to \$10 below that of sweet crude. This means that the area has a temporary, as well as a potential absolute, energy price advantage. Sour crude is not in short supply. Moreover, U.S. plants can’t handle it. The story seems totally consistent with the discussion in the Greenbook of substantial differences in the prices of sour and sweet crude.

At the national level, I find myself characterizing the pace of growth as somewhat more robust than the “moderate pace” language we used in our post-FOMC statement last time. With GDP having expanded at an average of more than 4 percent for the past six quarters and a forecast for more of the same, I think we could be even more positive in describing the path we seem to be on. Although we continue to puzzle and even worry about job growth, as Tony just noted we have averaged about 185,000 new jobs a month over the past eleven months. This has been enough to allow the unemployment rate to drift lower over the course of the year. Although continued productivity gains and a general reluctance by businesses to hire until absolutely necessary suggest that a substantially greater base of new job creation is probably not likely, we should continue to make further gains in working down the unemployment rate unless we have significant changes in the participation rate or in immigration policy.

I cannot point to any alarming developments with respect to inflation, but the anecdotal reports I just shared from across our District suggest a possible shift in the prospects for widespread price increases, and that gives me pause. I’d also note that five-to-ten-year inflation expectations, while reasonably well anchored, have drifted up steadily in 2003 and 2004 to nearly 2¾ percent.

Finally, the substantial run-up in house prices, which we have followed in Florida and also see in the populous Northeast and West Coast of the United States, may be at least partially attributable to unusually low mortgage rates influenced by our very accommodative policy, which has been in place for some time. Those developments and the risks associated with the run-up in house prices probably deserve further study and thought as we decide how to posture policy.

I continue to be comfortable with the policy path we’re on. And barring some surprise, I judge that we still have a considerable way to go to get back to a more neutral stance. My concern is that, with a real fed funds rate that continues to be near zero, we could unintentionally be

encouraging further imbalances in both the inflation environment and in the international sector. I hope we will not try to signal that we may soon pause in our removal of policy accommodation.

Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. New England's economy continues to improve at a reasonable pace. Employment is growing, and all states report job levels above those of a year ago. Unemployment dropped sharply in the region in September and maintained a rate about 1 percentage point below that of the nation in October as well, so it wasn't just a fluke. Despite this, concerns remain, as reflected in a new softening in consumer and business confidence. Major industry groups, in particular manufacturing and information services, continue to lose jobs compared with a year ago. Financial activities posted a small loss as well, and the large professional and business services sector was flat, in major contrast to the picture nationally. The region seems to be buffeted by the ups and downs in IT spending on both equipment and software and the impact of continued consolidation in financial services. Manufacturing export growth slowed in the third quarter after a strong second quarter, even with the decline in the dollar. With the Fleet/Bank of America and Manulife/John Hancock mergers, downtown office vacancy rates in Boston widened a bit, in contrast with the nation as a whole, and rents declined.

On a more positive note, the fall tourism season was apparently a good one. And casual observations of malls during this holiday season suggest that consumers are spending at a good clip, despite the confidence readings. Retail contacts report solid readings on sales, and housing markets remain strong, though some softness at the high end continues. First District business service companies report improved conditions, with demand strengthening for temporary employment firms, particularly in the areas of engineering and IT. Beyond temporary services, software and IT

employers also saw demand growth, though the uncertainty I noted before continued to weigh on their outlook. Even with the overall rather tepid employment picture, especially as it relates to levels of job growth, highly skilled labor remains in short supply, and firms report difficulty in hiring the right employee for key positions.

Turning to the nation, growth seems remarkably good. After a pause on the consumer side in the late spring or early summer, consumer spending and business investment show considerable strength overall. High-tech spending has fallen off a bit, to be sure, but that apparently reflects an inventory turn in that industry. Labor markets are bouncy, but for the past six to nine months or so they seem to have been delivering an average monthly level of job growth that will actually reduce, if not eliminate, slack in labor markets over the next year and a half to two years. Increased housing wealth and a decrease in the price of oil puts money in consumer pockets as well. Financial markets are supportive of continuing growth, with equity markets turning up and longer-term interest rates and spreads low. Indeed, the proliferation of hedge funds and the narrowness of credit spreads suggest that liquidity abounds, which could have its obvious downside. Even the fall of the dollar hasn't seemed to do much more than provide, through its stimulative effect, some greater assurance that output will not be overly affected by waning fiscal stimulus in 2005.

Our forecast, like that of the Greenbook, sees this rather halcyon current situation continuing through 2005 and into 2006, with excess capacity gradually disappearing, unemployment at least stable but likely trending down, core inflation relatively flat, and overall inflation at less than 2 percent. Now, as I consider both of these forecasts, I am reminded of Dave's crossed fingers and also the reggae tune "Don't Worry, Be Happy." Even when the Greenbook considers alternative scenarios, it has to work to get much variation in outcome. Yet real risks are out there; it's just not easy to see them in the context and period of our forecasts. For one, anecdotes continue to abound

about increased pricing pressure due to rising import prices—not only for oil but other commodities as well—and increased costs of labor. It's hard to make our forecasts anticipate much inflation pressure, however, largely because of the embedded assumptions about the size of the output gap and the related strong structural productivity growth. I think it may be wise to be humble about those assumptions. Another risk involves the fiscal deficit. The latest government appropriations bill may have reined in spending and reduced the deficit in the short run. But it's hard to see how the federal deficit can remain contained, given reasonable assumptions about discretionary spending growth; the resolution of the growing negative effect of the AMT (alternative minimum tax); the likely continuation of the Bush tax cuts; and the likely continuation, unfortunately, of the Iraq War, not to mention plans to address Social Security.

In part reflecting this, the value of the dollar has declined. It may be likely to fall more as the country's current account deficit approaches new highs as a percent of GDP. The differential impact of this depreciation, boosting U.S. growth but hitting the euro and the euro-area growth harder than elsewhere, can only exacerbate a very touchy international situation strained already by differing attitudes toward the war, among other things. Growth in the rest of the world has slipped in the context of rising oil prices and the dollar's decline. And a needed adjustment in the Chinese currency, which could help things in Asia, seems unlikely or at least remote.

So I find myself in a bit of a quandary. Are things as good as they seem in the forecast before us, or do we stand an increasing chance of a very unpleasant, though possibly unforecastable, surprise? And in what direction will that surprise push economic activity—to increased inflation, slower growth, increased market instability, or some combination of all of these?

I'm having some trouble figuring out how to close this. [Laughter] I do sense increased risks out there. On the other hand, I don't think there's any choice for us at this meeting. I think

that the U.S. economy is on an upward trajectory and that policy has to come out of its current very accommodative stance. In effect, as I look at both sides of the risks here, I think our moving in that direction makes the economy internally a little more resilient. It takes a bit more thinking on the part of markets to deal with risks in an environment of rising interest rates. And I believe that's the right way for us to go over the near term, though I do think we need to be cautious about an increasing set of risks, both nationally and internationally. Frankly, as for what we say, I would like to take it down to as little as possible about forward-looking things and make it as clean and clear as we possibly can.

CHAIRMAN GREENSPAN. President Pianalto.

MS. PIANALTO. Thank you, Mr. Chairman. I want to start my comments this morning with a somewhat troubling statistic, and that is that the PNC Bank's Twelve Days of Christmas price index jumped 2.4 percent. It has been reported that a surge in French hen prices more than offset a modest drop in the cost of turtle doves. [Laughter] If you look at their core index, which I'm told excludes the highly volatile swans-a-swimming component, that index was actually up 3.1 percent from a year ago. [Laughter]

With that, I'll turn to my District report. In my report at our last meeting, I noted that business activity in the Fourth District did not seem representative of what we've been hearing at the national level. And judging by the most recent Beige Book, my region still seems to be more economically challenged than the rest of the nation. During the intermeeting period, I spent a significant amount of time talking to members of the business community. And from my conversations, I sense a continued disconnect between the strong growth reports that I'm getting, especially from the larger international manufacturers, and the continued soggy performance of our District's labor markets. Companies report that a lot of growth in orders and production is taking

place. It just isn't always being met with much job growth, and indeed, the activity itself isn't always occurring in the Fourth District. Firms that report ample capacity are seeing some squeeze in profit margins as they are able only to partially pass along some of their rising costs to customers. Others have been able to maintain their profits by finding yet more ways to absorb the cost pressures through productivity enhancements. And some businesses that are feeling capacity constraints, including the steel producers and the capital goods makers, say they are actually successfully passing cost pressures up the production lines.

But where I might ordinarily hear that these firms that are at capacity are gearing up to expand their local production capabilities, what I'm now commonly hearing are stories that these firms are choosing instead to expand their production capacity abroad, especially in Southeast Asia and China. One interpretation of this information is that some industries are still in the midst of a rather wrenching and likely protracted structural change, and the Fourth District is as close to ground zero in that transformation as one can get. It may take a long time yet before we see sustained significant employment gains in our area. And while this global realignment is under way, I think it might be more challenging than usual to accurately judge capacity utilization and inflationary break points.

If I've been following the past several Greenbooks correctly, the staff has had to put more monetary restraint into its projections to hold the inflation rate steady, because over the next two years it now seems that aggregate demand is growing somewhat faster and cyclical productivity is growing somewhat slower than previously. I found the alternative scenarios about productivity growth and cost pass-throughs to be very informative as I thought about the risks to the outlook. Each of these variables, of course, is very difficult to predict. I am more optimistic than the baseline Greenbook projections about productivity because of the comments I've been hearing from my

business contacts. But I am also hearing from my business contacts that they are having greater success in passing costs along to their customers. These forces, of course, have offsetting implications for the inflation outlook, and they do bear close scrutiny in the months ahead.

We have been removing our policy accommodation at a gradual and steady pace. As we've done so, I have become more satisfied about the balance of risks to our goals. Clearly, there are uncertainties about how the economic situation is evolving, and my preference in this environment is to avoid the risk of unexpected increases in inflation. I am fairly confident that the economy is going to continue to expand at a pace that's consistent with a rising equilibrium real rate over time, and I think it's a good idea for people to expect that environment until we see strong evidence to the contrary. So I think that today we should take the steps that the market anticipates, and I would also make as few changes as possible to our statement. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, let me start briefly with my reaction to the national economy where I think, as discussed in the Greenbook, growth remains above trend and, barring unexpected events, is likely to remain above trend for the next couple of years. If this is correct, we will gradually approach our long-run potential GDP. More specifically, we expect that growth will be near but slightly below 4 percent this year and next. With trend growth of about $3\frac{1}{4}$ percent, we estimate that we approach potential at the rate of about $\frac{3}{4}$ percentage point per year. This outlook is similar, as I said, to the Greenbook and to the December Blue Chip consensus forecast as well.

Several factors obviously contribute to this; they've been mentioned, and I'll only touch on them. They include our continued accommodative monetary policy, strong consumer spending that seems to be continuing, and labor markets that are in better shape than we thought—

notwithstanding, as some have commented, the recent claims numbers. Moreover, wealth is higher, as reflected in the stock market and housing prices. And, of course, oil prices have declined.

I think the evidence from our District supports this outlook. Headed into Thanksgiving, retailers were generally optimistic about the holiday shopping season. Almost all of the mall managers we contacted just last week said the holiday season had gotten off to a good, though not spectacular, start, with traffic and sales up several percentage points from a year ago. Travel and tourism activity have also been very solid, and Rocky Mountain resort owners expect a big increase in foreign ski visits this winter due to the lower dollar. In addition, manufacturing firms remain quite optimistic about future activity and plan moderate increases in capital spending and employment during the first half of next year.

Let me briefly mention our agricultural economy, which will enjoy a record-breaking year in 2004. Farm income is 25 percent above last year's record high and 50 percent above previous 2004 estimates. With historically high livestock prices, the bulk of the income gains have come from that sector. In addition, crop production for corn, soybeans, wheat, and so forth, was up 12 to 25 percent this year, with corn and soybean producers posting record years. Even with these large supplies, prices remain well above their ten-year average. This record farm income has translated into higher land values. In the Tenth District, ranch land values have soared 10 percent above levels of a year ago. Non-irrigated cropland values are up 7 percent from a year ago, and irrigated cropland values are up 5 percent. As a result, equipment sales are also surging. For example, in October, sales of large equipment ranged anywhere from 25 to 50 percent above year-ago levels. Finally, analysts expect equipment sales to increase in December, as farmers and ranchers take advantage of purchases to cut their tax bills.

Turning to the inflation outlook, inflation remains modest, although there are some signs that it may be rising, as others have noted. Core PCE inflation is 1½ percent over the most recent twelve-month period, and core CPI inflation is 2 percent. We have seen some increases in core inflation over the last couple of months. In addition, as others have noted, even though five- to ten-year inflation compensation remains relatively stable, five-year inflation compensation has increased. Finally, while oil prices have decreased—a positive—the dollar continues on balance to depreciate. District manufacturers continue to expect upward pressure on producer prices. For the twelfth month in a row, a net positive percentage of firms raised output prices; this follows three straight years of constant or falling output prices. In addition, the future finished goods price index rose to its second highest reading on record in November, trailing only the peak of April 2004. With sluggish employment growth and increased layoffs, wage pressures do remain slight.

These results, on balance, suggest to me at least that we should continue steadily moving the federal funds rate closer to what we might consider a long-run neutral level. In addition, I would submit that the risk of higher inflation than in the Greenbook baseline is large enough that we should be thinking about continuing to raise rates on a systematic basis—and by more than assumed in the Greenbook. First, the Greenbook forecasts that the output gap will be eliminated by the end of 2006 and that core PCE inflation will be 1½ percent or just under that, and yet the real fed funds rate is only 1.85 percent. Since this is below the Board staff's medium-run equilibrium fed funds rate—what I'll call neutral—we should expect higher inflation beginning in 2006. Second, we know that all forecasts have error bands, and the Greenbook provides enough information that we can calculate the probability that the output gap is eliminated in 2005 or early 2006. I would submit that the probability is large enough that we should be concerned about higher inflation in these years. And third, the federal funds rate remains below neutral for the entire forecast period. My

point is that the output gap is being eliminated and, when this occurs, the risk of inflation, of course, rises.

Therefore, I think we should be moving the federal funds rate at a fairly steady pace toward the lower bound at least of estimates of neutral—barring any shocks, of course. Once we get close to what most consider the lower bound of neutral, we can become more cautious at that point and begin to speak of pauses. I'd submit, however, that we are not yet at that point and that we should not become overly cautious at this time. Thank you.

CHAIRMAN GREENSPAN. President Lacker.

MR. LACKER. Thank you, Mr. Chairman. The Fifth District economy continued to expand at a moderate pace in recent weeks. Our service firms reported solid growth in revenues over the last two months, while retailers told us that sales have been flat. In particular, big ticket sales remain weak, and car sales are said to be soft.

District manufacturers reported that growth in shipments and new orders have tailed off over the last month. Shipments were basically flat in November. Although building permits were off the pace of a year ago, housing markets remained generally strong in our District. In labor markets, our information indicates job gains in services and retail but virtually unchanged manufacturing employment in November. Price increases at District firms have trended higher, though they are generally remaining under 2 percent, according to our contacts. There was a notable change in the tone in manufacturing firms regarding pricing, however. They are now increasingly saying that they can pass through price increases to their customers, unlike earlier in the year when they said price increases were more difficult to pass along.

Turning to the national picture, data received in recent weeks also indicate that economic recovery has continued at a reasonably healthy pace. Consumer spending has advanced at a pretty

solid trend rate in recent months, capital spending has been fairly brisk, and housing keeps coming in on the strong side. Every passing month of growth at this pace raises my confidence in the staying power of the expansion. The Greenbook expects real GDP to expand around 3½ to 4 percent through 2006, and the output gap is expected to close gradually by then, with PCE inflation remaining stable around 1½ percent. This is a relatively attractive outlook, and it's one I'm comfortable subscribing to.

I was particularly relieved to see the elimination of the disconnect that was in the November Greenbook between the staff's projection and market expectations regarding the future path of the federal funds rate. Since the November meeting, that disconnect has been resolved through an increase of about ½ percentage point in the Greenbook's projected rate path, putting it only a little below market expectations of the future funds rate. This was a favorable way of closing the gap, since it was accompanied by an upward revision in expected growth in the Greenbook and reflects more confidence in the strength of the recovery going forward.

Another disconnect remains, however, that eventually must be resolved. The Greenbook sees CPI inflation leveling off at about 1¾ percent in 2006, and yet the Greenbook also reports survey estimates of ten-year-ahead expected CPI inflation in the 2½ to 3 percent range. Moreover, the Bluebook reports expectations measures of between 2½ and 3 percent based on inflation-indexed Treasury spreads. So it seems that a range of measures are telling us that inflation will be noticeably greater than we think it will be. This inflation disconnect will be resolved eventually one way or another, as I said. We may get lucky and see market expectations drift down to a level consistent with 1¾ percent on the CPI, or we may not be so lucky.

One interpretation of the persistence of inflation expectations at these levels is that the public believes that our long-run tolerance range for CPI inflation extends up to 3 percent or more.

If that's the case, it may be difficult for us to resist an upward drift in inflation as the economy recovers. Moreover, we can't be sure that expected inflation won't drift up still further, if actual inflation begins to drift up. But if we're unwilling to tolerate CPI inflation near 3 percent, then we may need to maintain tighter monetary policy than otherwise to ensure that the disconnect between the public's expectation of inflation and ours is resolved in our favor. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. Comments from directors and from a wide range of contacts indicate further improvement in the District economy—indeed some acceleration recently—and the improvement is quite broadly based. Given that, let me just comment on a couple of developments that seem particularly relevant. There have been in the District sustained, albeit moderate, gains in employment for better than a year now. Hiring plans are positive, according to our most recent survey, and some skills are now in short supply. The investment outlook appears to have improved recently. Some projects that were on the back burner, according to business contacts, have now been moved forward. In general, I think businessmen are feeling a bit more upbeat, and that is fueling some enthusiasm for further investment. The final point I would mention about the District economy is that, despite tightening labor markets, wage increases remain subdued—generally in the 2 to 3 percent range—and price pressures are modest as well.

As far as the national economy is concerned, I think it's perhaps at least worth noting that the current expansion is now into its fourth year, and recently at least things have been turning out pretty much as we expected. Now, that might be a reason to worry, but I prefer to look on the bright side of that. I agree with a point that Dave Stockton mentioned—that the fundamentals supporting further economic growth from here forward are distinctly positive. If I were writing down a GDP

forecast at the moment, I might write down something a little stronger than the Greenbook forecast for both 2005 and 2006.

On the inflation side, I do expect inflation to remain low, but I must admit that I'm a little less confident about that than I was a few months ago. If I ask myself why, I think it has mostly to do with the dollar. It's not so much that I'm concerned about the pass-through, narrowly defined; it's really more a concern about the changing nature of the competitive environment implied by the declining dollar. And that gives me a bit of pause as I contemplate inflation prospects. But I think that's a pretty slim reed to hang all that much on, so I personally would stick with a low inflation forecast for now.

Having said all that, it seems to me that the policy course is pretty clear here. We should continue with the policy path that we've been on. Thank you.

CHAIRMAN GREENSPAN. First Vice President Holcomb.

MS. HOLCOMB. Thank you, Mr. Chairman. Since the last meeting, there is more evidence that the Texas recovery is solidly on track. October employment growth was the strongest since the end of last year, and the most recent Beige Book confirms increased optimism in the business community. This tone of optimism was reinforced by comments from our directors at last Thursday's board meeting. That was a meeting of all four of our boards, and this positive view was seen across almost all regions of our District and the many industries represented by our directors.

So far this year, through October, Texas employment is up an annualized rate of 1.3 percent, slightly less than in the nation. Temporary employment jumped sharply in October, mirroring a trend that was seen in the nation. That bodes well for the recovery as a leading indicator of future job growth. Indeed, Beige Book contacts reported an unusual number of temporary workers finding permanent positions. In addition, our directors reported increased hiring by various sizes of firms.

Reports from the high-tech sector have been mixed. There continue to be a number of layoffs at all types of high-tech firms, including semiconductor production, telecommunications, and computer services. However, this appears primarily to reflect continued reorganizing of the industry. A director representing the tech sector reported improved profitability in the industry and an expectation of a manageable and sustainable growth rate of 5 to 10 percent in 2005. Continued restructuring of the airline industry is providing headwinds for the Texas recovery. The state has three major air carriers reducing employment and wages. This represents ongoing restructuring of the industry as well as specific plans aimed at offsetting high fuel costs. Housing sales and prices softened slightly over the last six weeks, although some areas of the state have seen no slowing in residential construction. Our housing industry contacts are optimistic for next year but say that a stronger rate of job growth is needed to meet sales expectations. Office markets have continued to improve over the last six weeks.

Energy drilling activity has continued to improve in the District, with the industry reporting higher prices, growing backlogs of work, and some shortages of workers and equipment. Global demand for oil has not been sufficient to sop up the increase in world oil output. Slowing economic activity in Europe, Asia, and Latin America is expected to continue to put downward pressure on oil prices, as noted earlier, unless OPEC is able to curtail output. Mild weather in the natural-gas-consuming regions of the nation has pushed natural gas prices below \$6.00. Natural gas inventories are very high. If we have a relatively mild winter, natural gas prices could fall further. The Texas leading index was down in October but has increased strongly over the last three months. The index is forecasting 2004 employment growth of just under 1.5 percent and 2005 job growth of about 1.9 percent. These rates are below historical levels but reflect the improving trend that will allow job growth to finally meet or exceed that of the nation.

We are in basic agreement with the Greenbook forecast of continued growth during the upcoming year. The Blue Chip consensus forecast paints a similar picture, although it has a somewhat slower pace of growth. The fall of the index of leading indicators over five consecutive months is becoming a minor source of concern. Historically, declines of this size and duration have been associated with growth slowdowns. But given the absence of signs of a slowdown elsewhere in the data, the Dallas research staff has discounted the signal from the index of leading indicators. Of some concern also are recent developments on the inflation front, most notably the monthly numbers on core CPI inflation in September and October. Survey and market measures of inflation expectations, both short-term and long-term, remain a bit higher than preferred. Given the expected inflation trajectory for 2005 and 2006 shown in the Greenbook, recent inflation does not set off alarms.

On balance, we favor a continuation of the recent monetary policy path with an increase in the funds rate at this meeting. Since the real federal funds rate is still below its long-term neutral level, we recognize that some tightening will be needed. Ultimately, two months of higher core CPI inflation numbers and a small uptick in the core PCE numbers are not likely to be a problem. But if the markets see us pausing in the face of those numbers, that could create a problem. And since the economy appears to still be on a solid growth path and monetary policy remains accommodative, this is not the time to pause.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN GEITHNER. Thank you, Mr. Chairman. I'm overwhelmed, as always, by the intelligence and imagination of the staff, [laughter] and I don't have too much to add. Our view of the outlook hasn't changed much since our last meeting, and we're very close to the Greenbook on most dimensions of the forecast. The sentiment in New York seems to have become

a bit more positive over the last few months. Our forthcoming Empire survey for December has very strong readings and shows a very substantial improvement in most measures—orders, shipments, employment, and general conditions.

Nationally, we see more momentum in demand growth going into the new year. The main fundamentals of an expansion at slightly above trend growth seem intact. Global demand growth is a little softer but still pretty good. Our forecast for real GDP growth remains between 3½ and 4 percent for '05 and '06, with core PCE in the neighborhood of 1½ percent, with a path for monetary policy close to that now reflected in the market. We see the risks as roughly balanced around this forecast, with a bit less downside risk to growth and somewhat greater probability of a higher inflation outcome than we thought a few months ago.

We're at least one quarter and perhaps two quarters now into a different constellation of factors affecting inflation fundamentals: productivity growth slowing significantly, unit labor costs rising at a rate perhaps slightly above that of core PCE, and margins starting to come in a bit. Even allowing for the normal fog that surrounds these judgments, this constellation of factors seems likely to continue over at least part of the forecast period. This transition comes on top of an environment with significant other cost pressures in the pipeline, a declining dollar, a smaller output gap—with the gap perhaps now within the margin of error—and demand growth, as I said, slightly above trend.

Inflation expectations are sticking at a level somewhat above what we consider comfortable or consistent with our implicit inflation target, even though they have come off a bit since our last meeting. So in this context, I think the overall stance of monetary policy should continue to be directed at moving the real fed funds rate higher, with a significant positive slope to the path of the fed funds rate for the forecast period. I don't see a compelling reason to seek to alter the market's

expectations today for the near-term path of the funds rate. This suggests a signal today that is neutral to present market expectations, which I think implies very little change to the structure or content of our statement.

Now, would leaving market expectations unchanged today risk leaving the stance of monetary policy too tight and jeopardize the expansion? I think that seems unlikely. Might we end up having to move further and faster in '05 than is now priced into the futures path? Possibly. On balance, I think the probability that we will end up moving along a path that is slightly steeper than is now priced in seems to exceed the probability that we'd move on a path that is softer than what is now priced in. But we don't face that choice today. I think the best way of avoiding a more damaging adjustment to balance sheets or a more damaging adjustment to the overall economy, as we move on this path to equilibrium, is to continue to make sure we move far enough fast enough that we don't raise the risk that we end up having to catch up and move more abruptly in response to a rise in expectations. Thank you.

CHAIRMAN GREENSPAN. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. As the Greenbook noted, the news on actual and prospective demand since the last meeting has been mostly on the positive side. Consumption has proven surprisingly, at least to me, resilient to higher energy prices, supported by rising housing and equity wealth and continued low intermediate- and long-term interest rates. The higher level of wealth and lower energy prices should bolster growth going forward. Absent a sharp move in the dollar, longer-term interest rates, wealth, or oil prices, I don't see any forces that are likely to shift recent demand patterns enough to throw economic activity off a track that's about in line with the staff forecast—that is, a gradual further erosion of slack as the federal funds rate rises on a trajectory similar to that expected by the market.

I think the more difficult question that many of us have been addressing at this meeting is what the inflation outlook would be that might accompany such an output path. As solid growth becomes more entrenched and the output gap narrows, the locus of our concern naturally tends to shift away from supporting growth and, other things being equal, the balance of risks around stable inflation moves in the direction of faster price increases. Among the other things that aren't equal, however, is monetary policy. In effect, our policy tightening, both actual and expected, is designed to keep inflation down and those inflation risks balanced. And in my view, so far the odds favor our success with a measured pace of tightening.

Concerns about higher inflation seem to be based importantly on pipeline pressures, as reflected in more-rapid increases in PPIs at various levels of production, on the effects of the lower dollar on import prices, and on the possibility of slower trend productivity growth, as well as on the most recent couple of months of core CPI data. However, staff briefings yesterday and a few months ago showed just how little of the pipeline pressures and dollar depreciation tends to pass through to core consumer prices. There's a lot of uncertainty about structural productivity, as several of us have mentioned. We've had only one quarter of slower productivity growth after about half a dozen quarters of growth above the presumed trend. And even a couple of quarters of slowdown in productivity growth would tell us very little about underlying trends, especially if, as the staff believes, the level of productivity is above the long-run trend.

Moreover, a number of influences are weighing on the side of holding inflation down, and some of these have received additional support in recent months. Increases in nominal wages and compensation have remained moderate despite the strength in productivity growth in recent years and despite higher headline inflation of late. To my mind, this tends to confirm that there is, indeed, slack in labor markets. Markups of prices over unit labor costs have stayed quite high through the

third quarter—near record levels for nonfarm businesses—and these markups would be expected to absorb the initial cost effects of a slowdown in trend productivity should that occur, giving us time to react to oncoming cost pressures. And measures of long-term inflation expectations have remained remarkably stable.

I don't want to sound complacent here. There are upside risks, but I believe if they do end up predominating, we will have time to react before inflation rises materially. And in my view they are balanced on the other side, so long as the evidence continues to support the existence of slack that is disappearing only gradually and so long as long-term inflation expectations remain anchored. Moreover, I don't see the cost of missing to one side or the other of stable inflation as being especially skewed, given the current level of inflation. That is, I would not see 2 or 2½ percent core PCE inflation as a substantially worse outcome than 1 or ½ percent on core PCE inflation. Of course, one's evaluation of implications of the two possibilities would depend critically on how they came about—the role of demand and productivity. But, in general, I would have at least as much confidence in our ability to truncate rising PCE inflation at 2 percent as in our ability to stop falling inflation at 1 percent.

One risk I neglected that Governor Gramlich highlighted last meeting—and it has played an important role in our collective fretting about the current account—is that of a substantial fall in the dollar that is much larger than assumed in the staff forecast. Surely, this is an asymmetric and nontrivial risk that at some point could well put significant upward pressure on prices. I'd be very cautious, however, about leaning on the tighter side in anticipation of such a development. First, the roller-coaster dollar action over the intermeeting period was a nice illustration of the futility of trying to predict the timing and dimension of any foreign exchange movement. Second, the appropriate policy response to a drop in the dollar will depend on the response of other asset

prices—the extent to which bond and stock prices also react to the tapering-off in demand for dollar assets. And third, the dollar isn't the only asset that risks a price correction, and some of the other candidates would call for a policy response in an easing direction.

Recent gains in house pricing have been astonishing. Visiting bankers have told us that investment demand is playing an increasing role in this market, and while slower increases may be the most likely outcome, surely by this point there is a much fatter tail on the side of a considerable softness or even decline in such prices. In such a situation, saving rates might increase sharply.

I also find the recent behavior of bond yields hard to understand. While this Committee has become increasingly confident of the vigor of the expansion over recent months, long-term yields have actually declined, and most of this decrease is accounted for by the decreases in real rates. For a while, this movement seemed to reflect the expectation that higher oil prices would sap demand and flatten the trajectory of our tightening, but the softness in yields has persisted over the last intermeeting period even as oil prices and the dollar fell. I don't believe this decline represents expectations of central bank buying; it's just too widespread across instruments. A backup in bond rates in response to unexpected strength in activity or prices would play an important stabilizing role, but I see a nontrivial risk that something else will trigger a reassessment by markets and a noticeable upward movement in real rates that could damp the expansion.

Finally, given these crosscurrents and uncertainties, I remain convinced that our best approach to asset-price concerns is to react, possibly aggressively, to the combination of asset-price movements as it occurs. Such a strategy can be reasonably successful in counteracting the effects of even a large movement in asset prices, and it avoids making policy errors by acting in anticipation of asset-price changes that don't occur or are quite delayed.

The net of all this is that I would remain on the measured path of policy tightening we've been following. At the last meeting, I was concerned that we would soon need to prepare the markets for stepping off the "tightening at every meeting" treadmill. In light of the strength in demand and overall easing of financial conditions over the intermeeting period, however, I no longer believe that such preparations need begin with the announcement for this meeting. But given my assessment of inflation risks, I also don't think we should be planning on moving up faster than the market anticipates, which does have us taking a break from time to time. How to signal this flexibility in the announcement remains a problem, but a problem for a future meeting. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. The incoming data have provided sufficient reason for the staff to raise the baseline forecast. Real consumer spending, excluding motor vehicles, has increased at a solid pace of late, and yesterday's retail sales report reinforces the notion that households are still ready to propel the economy forward. On the investment side, housing sales and starts have also remained at elevated levels, and orders and shipments of nondefense capital goods have been trending upward. Internationally, the dollar has fallen, and once we get past the usual J-curve effects, that should give some impetus to the export sector. And oil prices have moderated, reducing a potential drag on future growth. Inflation expectations, as measured by the TIPS market for the five-to-ten-year range, are well contained. Frankly, if that were the entire story, one could indeed settle in for a long winter's nap.

Unfortunately, in many ways that is not the entire story. While the data have been, on balance, better than many had expected at our last meeting, there are some signs that we should not discount all the risks. For much of this fall, I have been particularly worried about both the pace of

technological change and the actual amount of slack in the labor market, with the related implications for productivity growth and inflationary pressures. As Dave indicated in his opening remarks, the staff has captured this range of concerns in a scenario entitled “greater cost pass-through with lower structural productivity.” Giving some credibility to the scenario, I note, as Dave did, that the staff has marked down the forecast for growth in real high-tech investment to only about its 1980-96 average. This downshift in the forecast is reinforced by the current orders survey indicating that two major manufacturers of productivity-enhancing equipment characterized recent increases in orders as falling well below expectations. At 30 percent, the percentage of NFIB survey respondents planning to make capital expenditures is near the low end of its ten-year range. I’ve also heard from a private-sector contact of my own of a sudden weakness in demand for cutting-edge automated machine tools. This contact has an 80 percent market share for a key component that is used in nearly all automated machine tools, and he has experienced an unprecedented 30 percent cancellation for deliveries of that critical part in Q1 of next year and is expecting softness through almost all of 2005. Finally, I believe that the slowing in Japan and emerging Asia, as I think Karen suggested, is indicative of the slowdown in the productivity-improving high-tech sector.

Just as we may be experiencing a slowing in capital deepening, unit labor costs in the nonfarm business sector experienced a pickup in the most recent four-quarter period, after having put in several successive four-quarter declines. Additionally, the data show quarter-over-quarter increases in unit labor costs of 1.9 percent in Q2 of this year and 2.2 percent in Q3, both at an annual rate.

Market signals, as well, may be consistent with some worry about both a pickup in inflation and a moderation in productivity growth. Two developments may be noteworthy in this regard.

First, for reasons that we do not fully understand, while longer-term inflation expectations are well contained, inflation compensation over the next five years has moved up noticeably since its low point in 2003. Some of that is an unwinding of the disinflation concerns of 2003. However, the level of inflation compensation for the next five years, at 2.6 percent, has already equaled or slightly exceeded its levels of 2000 and 1999, when we were concerned about inflation risks. Given the limited role of foreign buying in the TIPS market compared with the nominal market, the five-year TIPS is probably a relatively pure measure of domestic expectations for inflation compensation. The other interesting phenomenon for the markets is the flattening of the yield curve. While the level of rates is also generally lower than in the period between 1995 and 2000, as Dino indicated in the opening remarks, the two- to ten-year nominal spread has fallen from around 250 basis points to around 120 basis points now, which is the lowest level in three years. The more steeply sloping earlier curve indicated bad times leading to good times. The flattening of the slope recently might indicate okay times leading to okay times, which is basically a continuation of growth at or around trend. But the fact that the level of the rates is lower, as I think Don was implying, might indicate that the expected trend growth in the economy is also lower.

Now, I put all this together to conclude that the baseline forecast is a reasonable basis for policymaking today. Incoming data and the changed forecast, as well as market expectations, all seem to suggest that we should continue to move policy from its current accommodative stance at the previously announced measured pace. In addition, conditions are not so dramatically different from the last meeting that they warrant a major change in our statement. Janet Yellen, in her remarks, gave a very reasonable explanation of why it is that productivity growth might, in fact, increase, with a particular focus on multifactor productivity and some risk to inflation on the downside. However, based on my read, I also still put some weight on the slowdown in capital

investment and capital deepening, which suggests that we should be vigilant to the risk of slower productivity growth, higher unit labor costs, and a higher pass-through. The data and the market both seem to support that prudence. Recognizing the uncertainty around this general topic but also the importance that growth or a slowing of growth in productivity might play, I'm sure we will return to this discussion again in 2005. Thank you.

CHAIRMAN GREENSPAN. Why don't we break for coffee at this time.

[Coffee break]

CHAIRMAN GREENSPAN. Governor Bernanke.

MR. BERNANKE. Thank you, Mr. Chairman. Overall, the intermeeting data suggest a pickup in the pace of the expansion in output and employment, with fewer downside risks to growth. Inflation risks have also moved slightly to the upside, I think, but falling oil prices help to make any really significant increase in inflation unlikely. I don't think the shift in the outlook warrants a change in the balance of risks, at least not at this meeting, but for me these developments clinch the case for continuing our policy of reducing accommodation at a measured pace.

I'd like to add a few comments on the current account and the dollar. An important question for monetary policy is how long the current configuration—the large current account deficit and relatively slow adjustment of the dollar and real interest rates—can persist. If this configuration were the result of cyclical forces or other short-term factors like currency manipulation, then the expected half-life of the adjustment process might be short. However, I think the U.S. external deficit is largely a secular phenomenon which, consequently, is likely to evolve relatively slowly.

The key factor underlying the U.S. external deficit, in my view, is excess global savings. Advanced industrial nations with aging populations, notably Japan and Western Europe, need to save for demographic reasons. Absent sufficient investment opportunities at home, they can do this

only by running current account surpluses. Ideally, the savings of these mature industrial economies would fund investment in developing and emerging-market economies. However, in part because of the financial crises of the 1990s, emerging-market economies are either unable or unwilling to accept large capital inflows, resulting in an economically perverse situation in which countries like Korea, Brazil, and Argentina have become significant exporters rather than importers of financial capital. The United States is the recipient of massive savings inflows because, to a first approximation, global savings have nowhere else to go. As neither the demographic factors driving saving in mature industrial economies nor the inability of emerging markets to absorb large capital inflows is likely to change soon, these inflows are likely to persist.

Is the situation sustainable? I think it can be sustained for some years, though time does not permit me to seriously address that issue today. It is worth observing, however, that contrary to the perception that the U.S. current account is being driven by an unsustainable consumption binge, Americans are not consuming beyond their means. As a result of rising stock and house prices, over the past year U.S. net national wealth—that is, net both of foreign borrowing and of governmental saving—has increased about \$3.3 trillion, or around 30 percent of GDP. That's a number which, incidentally, goes some way toward explaining the continuing strength of consumption spending. If there is a causal relationship between the current account deficit and U.S. consumption, it's principally from the former to the latter, as large savings inflows have lowered real rates and thus raised asset values in the United States.

I draw two somewhat contradictory conclusions for monetary policy. First, it's quite possible—even likely—that a U.S. current account adjustment will play out gradually over a number of years. The staff's assumption of a slowly depreciating dollar is, therefore, the right one for our planning purposes. We should not attempt to forecast swings in the dollar or base our policy

on a presumption that a rapid depreciation is likely in the near term. Let's see what the dollar does and then respond as necessary to fulfill our mandate.

However, while a slow unwinding of the current account deficit and relatively gradual adjustment of the dollar may be the most likely outcome, in a world of herding and momentum trading, financial accidents can happen. A panicky flight from the dollar, whether justified in some fundamental sense or not, would be very harmful. Hence, my second, and I should emphasize, very tentative conclusion: When facing a closely balanced policy decision, we are probably better off erring slightly on the side of tightness rather than on the side of ease. A higher rate makes short-term dollar assets more attractive and raises the cost of shorting the currency, lowering the risk of a sudden depreciation. All else being equal, a very slight bias toward a higher funds rate may thus provide a bit of insurance against a financial accident in the foreign exchange market. Thank you.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. There has been much discussion lately of our measured pace. Are we slavishly raising the funds rate 25 points per meeting or following some other strategy? Frankly, it is hard to think about this question without knowing where we are ultimately going. Many seem to feel that our ultimate target is the equilibrium funds rate, but whether we use a three-year or seven-year horizon, or some other construct, this equilibrium is only a measure, not a policy goal. We could raise rates to equilibrium, beyond it, or short of it. The answer depends on economic considerations. So let me try to analyze our rate strategy in terms of these economic considerations, focusing, just as Governor Bernanke did, on global economics over a slightly longer period than we usually consider.

My goal is to rebalance the world economy, ultimately stabilizing U.S. international debt-to-GDP ratios while preserving price stability and at least proximate full employment around the

globe. A more ambitious goal might be to let capital on net start to flow away from the United States and more toward the emerging-market world, but such a goal is too ambitious even to think about now. Governor Bernanke, I think, would say “unwise” even to think about now. For now, I just want to limit the inflow ultimately to the United States to a pace that is likely to be sustainable in the long run. A necessary part of this rebalancing is that the dollar has to fall enough to ultimately eliminate the U.S. trade deficit, the condition for stabilizing debt-to-GDP ratios. I’m not talking about any of the preemptive strategies discussed in the international finance memo. I think the memo is right that these are unlikely to work. I am talking about how monetary and fiscal policy should act to facilitate this rebalancing while, as said above, preserving price stability and proximate full employment. It is harder than one would think to accomplish this rebalancing because Americans seem to be chronic overspenders while the rest of the world seems to be chronically underspending, and I think this would be true even apart from demographics.

The most straightforward part of the plan involves Europe. European economies are already operating at less than full employment, and their employment problems only worsen if their currency rises. They just have to stimulate their economies by some combination of monetary and fiscal policy. If that involves modifying the Stability and Growth Pact or the normal modus operandi of the ECB, so be it. One would normally think that structural policies would be a neutral to a negative as demand stimulators, in line with that anecdote that Karen told us this morning, but it’s possible that European laws are so rigid that structural policies may boost demand as well.

Asia is more complicated. First off, the Asian economies should let the normal adjustment process work by permitting their currencies to appreciate. If they don’t, they will just continue in this likely unsustainable situation with the ultimate adjustment probably becoming even more costly. If they do let the adjustment process work, Japan will definitely have to stimulate demand.

Not being aware of a way to set interest rates below zero, this probably means fiscal stimulation, presumably a tax cut. I realize that Japan's debt-to-GDP ratio is large and rising sharply, but that's happening anyway. It seems to me that Japan should let the equilibration process work and at least try to find some way other than by exports to stimulate domestic spending. Other Asian economies should also let the adjustment proceed and stimulate their own domestic spending enough to preserve high employment.

For the United States, the situation is complicated in a different way. My own preferred approach would be to have fiscal tightening to raise national saving and perhaps even monetary accommodation to keep at full employment. We should recognize that the fiscal tightening and lowering of interest rates would likely add to the fall in the dollar. In the press lately there have been many statements implying that fiscal tightening is an alternative to a falling dollar. In particular, Europeans seem to think that if we would only cut our deficits, the euro wouldn't rise so much. No way. Fiscal tightening would normally start or be part of a process that leads to a falling dollar. The two are complements much more than substitutes.

In the unfortunately likely case that fiscal tightening does not occur, there would have to be monetary tightening in the United States to offset the new export demand from the fallen dollar, as discussed by Dave earlier. Such a response would fulfill the Fed's mandate, but it would be less preferred, at least to me, from a national or world standpoint because it would not raise—and could lower—national saving. With no net capital inflows, this means lower domestic investment.

To return to the central question, with this overall design, should we continue raising the funds rate, and how fast? One outcome that would persuade me to sit still for a while, or maybe raise it at a gentle rate, would be the desirable prospect of real fiscal tightening in this country. I haven't been one of the Committee's doves in recent meetings, but if we had the real fiscal

tightening and higher national saving, I'd happily join the flock of doves and argue that the Fed should try to keep the economy at full employment by pausing or perhaps even lowering interest rates.

On the other side, a much less desirable outcome that could also persuade me to sit still is if Europe and Japan don't come through with the desired expansionary policy. If neither stimulates their economy sufficiently or is able to stimulate their economy sufficiently, world demand could easily be deficient, and there could be a world slowdown, possibly even recession. In such circumstances, the Fed also might well have to leave rates alone for a while. But between these two extremes, there is a broad middle ground—not much fiscal tightening here and a world economy growing at moderate nonrecessionary rates—which is essentially the Greenbook forecast. In such a case, U.S. demand will be bolstered by the combination of a falling dollar and expansionary fiscal policy, and we should continue raising rates at a measured pace. Hence, I am still in favor of this strategy but willing to change my position if I see, among other things, either credible U.S. budget tightening on the good side or signs of a world slowdown on the bad side.

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. Thank you, Mr. Chairman. There are two perspectives that I'd like to add, one from the banking community and the other a follow-up on the fiscal issue. If I were to compare the discussions I've had with bankers on what they see in the economy to the comments that I've heard around the room, I'd say there is a notable difference. People around the room have described the economy in terms ranging from "decidedly positive" on the upside to "reasonable" on the downside, whereas the bankers I've talked would come down more on the side of "reasonable" than "decidedly positive." If there is a significant expansion taking place in the business sector, it's happening outside the banking industry in terms of their C&I lending. C&I lending is growing, but

there's a strong sense that it reflects a greater appetite for risk-taking in the lending portfolio as opposed to an expansion of business.

As others of you have suggested, a lot of the demand for business lending has come from the smaller entities. Larger entities that have the option of either expanding here or offshore are as apt as not to expand offshore. The entities that do not have that option, of course, are expanding through borrowing at domestic banks. U.S. banks also have taken on more M&A lending—which more typically had been the purview of the capital markets—as a result of the relatively low demand they've found for typical C&I loans. There are a couple of exceptions to that. Of course, the most notable exception is in commercial real estate. And yet, in condominium development in particular, several bankers have reported that the growth in volume of new condo starts is absolutely unsustainable. Moreover, the end of the cycle is typically when you see conversions of apartments, and that is rampant, particularly in some markets—to the point where there almost assuredly needs to be an adjustment in the near future. All that said, however, there still is nothing in that observation that would suggest that we should alter our pace of removing monetary policy accommodation. We should continue moving at the same pace that we have been.

With respect to Washington, D.C., and the willingness to take on some fiscal discipline, there are two points that would suggest a somewhat more positive outlook in that regard. The first is the reaffirmation of John Snow as Treasury Secretary. A presidential election, especially the re-election of a President, is an opportunity for wholesale change, and indeed, that has occurred. The fact that John Snow stayed on even after he was hung out to dry for a while suggests that this White House did not seek the great at the expense of the good. It also suggests that there is an effort to move relatively quickly on the agenda that flows through the Department of the Treasury, and that agenda certainly includes tax reform. Governor Gramlich expressed concern at the last meeting that

tax reform may be, in fact, explicitly tax reduction; that has not yet been fully fleshed out, but nonetheless the team is in place to move forward. The President is also discussing, at least in part, alternatives on Social Security, which suggests a greater willingness to attack that one fundamental issue that really needs to be addressed.

The second point that I think is positive has to do with the intelligence reform legislation that was passed last week. Now, one wouldn't ordinarily think that there would be a correlation between intelligence reform and fiscal responsibility. However, the passage of that legislation did send an important signal, and that is that a Republican House, a Republican Senate, and a Republican White House are willing to work together. Two weeks ago that was not clear. The impediments to enacting that legislation came from within the Republican ranks, and many people in Washington see the fact that the Congress moved very quickly to pass the bill as a suggestion that, indeed, the Republicans may work as a team at taking direction from the White House. That, taken along with the fact that certain of the fiscal responsibility issues such as tax reform, Social Security, and Medicare are considered a priority, I think bodes well. Thank you.

CHAIRMAN GREENSPAN. Governor Bies has laryngitis, as I'm sure you're all aware, and Debbie Danker will read her prepared statement.

MS. BIES (as read by Ms. Danker). The aspect of the economy that I want to focus on is the improving outlook for consumer spending. After a significant slowing in the second quarter, real consumer spending grew by a healthy 5.1 percent annual rate in the third quarter and advanced strongly in the last two months. While early indicators of holiday spending imply not as bright a time as retailers have anticipated, particularly for lower-price retailers, inventories appear to be closely managed. The expectation for a strong year in 2005 for retail sales seems more firmly grounded than earlier this fall. Since the last FOMC meeting, oil prices have fallen significantly,

which should put more discretionary spending power in the wallets of consumers and help the cash flow of businesses that are heavy users of petroleum products.

Over the past three months, payroll employment gains have exceeded their average pace of the past twelve months. The stronger pace of employment gains will expand the income base to support continued consumption growth. While consumers should increase saving out of current income for their long-term financial health, there are few signs that they are willing to build their assets and defer spending at the current time. Long-term interest rates are still low by historical standards and have not provided enough incentive to encourage significant growth in longer-term bank deposits. Strongly rising housing prices have increased assets, and the resumption in growth of equity prices in the stock market will provide another leg to support increased net worth. If recent behavior patterns continue, therefore, consumers will be able to increase spending and show growth of assets, without significant increases in the short-term saving rate. Thus, I have greater confidence in the pace of economic growth in the next few quarters, and I believe that we should continue to remove accommodation by raising the fed funds rate by 25 basis points today.

CHAIRMAN GREENSPAN. Thank you. I will call on Brian Madigan.

MR. MADIGAN.² Thank you, Mr. Chairman. Financial markets were subject to a number of crosscurrents over the intermeeting period. Nonetheless, most financial market prices showed relatively small net movements over the period. As indicated in the top left-hand panel of exhibit 1, line 1, yields on short-term Treasury coupon issues were up somewhat as investors concluded that a pause in policy tightening was not imminent. At the ten-year mark, however, yields on nominal Treasuries (line 3) and TIPS (line 5) declined modestly, apparently reflecting in part investors' sense that growth in real activity was likely to be a bit less vigorous than they had previously anticipated. As noted, implied inflation expectations for the next five years continued to edge higher, while those for the succeeding five years were little changed. Meanwhile, the Wilshire index (line 6) rose 2½ percent, while the Nasdaq (line 7) rose 4 percent, with equity prices supported particularly by falling oil prices. Risk spreads on corporate, GSE, and emerging-market debt, not shown, declined virtually across the board.

² The materials used by Mr. Madigan are appended to this transcript (appendix 2).

As portrayed in the top right-hand panel, money market futures rates indicate that the expected path of monetary policy edged up on balance for the next year but declined slightly over a longer period, roughly consistent with the flattening of the Treasury yield curve. Futures quotes imply that a $\frac{1}{4}$ point firming today is essentially built into market interest rates, and as indicated by the first bullet in the middle panel, a Desk survey taken last week similarly reveals that all twenty-two primary dealers expect a 25 basis point move today. All of the dealers also think that you will retain the assessment that the risks to both sustainable growth and price stability are balanced and that you will keep the “measured pace” language. And the survey responses and conversations with the dealers indicate that none expects you to use today’s announcement to signal a pause in tightening going forward.

Still, market participants do not think you will tighten $\frac{1}{4}$ point at each meeting indefinitely into the new year. As noted in the bottom panel, two of the primary dealers expect you to pause in February—even absent a signal today—and seven anticipate that you will do so in March. Futures quotes can be interpreted as implying that you will most likely tighten 25 basis points in February, pause in March, and slow your pace to roughly a $\frac{1}{4}$ point move at every other meeting over the rest of the year. The quarterly average funds rates in the Blue Chip consensus released on December 1 suggest that private forecasters expect a bit faster pace of tightening than built into futures rates, but that consensus still is consistent with your pausing twice before the fall. The issue of whether and how soon to slow the pace of policy tightening was the theme of the Bluebook presented to the Committee for this meeting. Alternative A was distinguished by a pause at this meeting. Alternatives B and C both involved a $\frac{1}{4}$ point firming today, but only alternative B included language that would suggest a pause in the near term.

A case for continuing to firm policy by raising the target funds rate another $\frac{1}{4}$ point at this meeting is summarized in the top panel of exhibit 2. Most importantly, the expansion now seems to be well entrenched, with labor market conditions improving gradually. The forces that had previously been restraining spending appear to have weakened considerably, and the Committee might thus believe that it can continue to reduce the unusual degree of monetary accommodation put in place in the past several years without jeopardizing satisfactory growth. The Committee might also be concerned about a possible buildup of inflationary pressures for several reasons. For instance, members may feel that the staff could be overly optimistic regarding trend productivity and worry that slowing productivity could begin to put upward pressure on unit labor costs. Also, some anecdotal information suggests that increased business costs continue to put upward pressures on prices in some industries. Moreover, actual inflation has risen over the past year, and the recent inflation data have tended to come in a bit above market expectations, potentially giving momentum to inflation expectations. Indeed, while long-term inflation expectations have been essentially flat, the rise in actual inflation apparently has fed through to some degree into shorter-term expectations. Finally, ongoing downward pressures on the dollar seem to have augmented market concerns about

inflation. All of these factors suggest the possibility of some upside risks to the staff inflation forecast.

The Committee may also interpret the staff's revised estimates of equilibrium real interest rates as pointing toward continued monetary tightening over time. The estimates of short-run r^* presented in the middle panel suggest that equilibrium real rates have climbed sharply since early 2003 as the economy has strengthened. Although your monetary policy actions have boosted the actual real rate as well, that increase has lagged the advance in measures of r^* . Consequently, the actual rate remains a bit below the 70 percent confidence interval of the model-based estimates (the darker blue band) and noticeably below the estimate implicit in the Greenbook forecast (the dashed line). These measures suggest that policy will need to be firmed substantially over time; but as emphasized in the Bluebook and the staff memos, the estimates of equilibrium real rates should not be interpreted as prescriptions for the current stance of monetary policy. Rather, these measures estimate the real funds rate that, if maintained over the next three years, would close the output gap at the end of that time period. Interpreted a bit more loosely, the r^* estimates attempt to measure the weighted average real rate over the next several years consistent with closing the output gap at the end of that period and thus do not have a direct implication for the setting of the funds rate today.

Even assuming that such estimates are accurate, bringing the real rate quickly to some estimate of r^* would likely be undesirable for several reasons. First, the Committee might be dissatisfied with the persistence of a positive output gap for another three years. Second, the Committee might be concerned about the downward pressure on inflation that could result from that persistence. And, third, for a variety of reasons the Committee may consider gradual adjustment of the funds rate toward its ultimate equilibrium to be the preferred policy approach. From that perspective, these r^* estimates may be most useful in providing a benchmark for thinking about the appropriate trajectory of policy over the next several years, for example, by considering the average amount of stimulus that ought to be applied during that period as policy moves gradually toward a stance thought likely to be consistent with medium-run equilibrium. But even if you find these measures generally helpful in thinking about policy, as we obviously hope, you will still need to weigh a number of other factors in setting policy—for example, how your outlook differs from those embedded in the models and the Greenbook, how quickly any output gap should be closed, where inflation is now relative to your preferred level, and where it would end up under a policy derived from considering these measures.

The question of the appropriate trajectory of policy going forward is what motivated the staff to present alternatives B and C as distinct policy choices in this Bluebook. As noted in the bottom left-hand panel, if the Committee believes that policy tightening can proceed at a slower pace than it has over the past six months, it might wish to combine a $\frac{1}{4}$ point move at this meeting with a signal of a possible pause in the firming process before long. Policymakers might think that the process of firming can now proceed at a slower pace for at least several reasons. First, some

output gap apparently remains, and it does not appear to be closing particularly rapidly. Second, the four rate hikes so far may be seen as having already reduced significantly the degree of policy accommodation. That would be the case if, for instance, members had a weaker outlook than the models and thought short-run r^* was near the lower edge of the 70 percent confidence band in the middle panel. A relatively low r^* could result from a continuation of the range of factors that have apparently been restraining the expansion over the past few years—for example, the persistence of unusual business caution. Such considerations might incline the Committee to shift to a somewhat slower pace of policy firming and signal such a shift today through the wording suggested under alternative B.

However, policymakers may instead believe that the recent pace of tightening should be maintained, at least for a while longer, or even stepped up—and consequently that, as in alternative C, the Committee should not give any signal at this meeting of an imminent pause. As noted in the right-hand panel, the existing degree of policy accommodation is substantial, at least as judged by the difference between the real funds rate and the range of point estimates indicated by the red band in the middle panel. All economists agree that monetary policy works with long lags, and members may be concerned that the considerable amount of monetary stimulus could be cumulating into an inflationary impetus that will become fully evident only with the passage of time. Policymakers may see the recent inflation data, as well as the downward pressures on the dollar, as possibly the leading edge of a ramp-up in underlying inflation trends. Finally, the seemingly buoyant attitudes toward risk in financial markets may argue at the margin for a firmer path of policy.

Your last exhibit repeats table 1 from the Bluebook. Should the Committee wish to suggest the possibility of a pause at an upcoming meeting, as in alternative B, it could do so by indicating, as shown by the red text, that “the Committee’s policy actions since mid-2004 have resulted in a significant reduction in the degree of monetary policy accommodation” while noting that “nonetheless, the . . . stance of monetary policy remains somewhat accommodative.” The economic description could be updated by referring to the “earlier” rise in energy prices and by indicating that labor market conditions “continue to improve gradually.” Although market participants appear to anticipate some slowing in the pace of policy firming in 2005, few if any expect you to signal a downshift today. Hence, selection of this alternative likely would lead investors to mark up the probability of a near-term pause. Short- and intermediate-term interest rates would likely decline noticeably, stock prices could rise, and downward pressure on the dollar could resume.

If the Committee, in contrast, believes that policy tightening should continue at the recent pace—and perhaps even wishes to allow for a potential acceleration in policy tightening—and hence does not wish to signal the possibility of a pause, only modest changes to the statement would appear necessary, as in alternative C. Choice of this alternative today likely would have minimal market impact. Should the Committee harbor significant concerns about inflation, it could indicate that “the earlier rise in energy prices and an escalation of business costs have the potential to

contribute to upward pressure on prices.” It could also state that “labor market conditions continue to improve,” thereby hinting that conditions on the real side of the economy are not likely to impede continued policy tightening at upcoming meetings.

In closing, it might also be worth noting that the Committee would not necessarily have to signal a pause in advance through its announcement. First, the phrase “measured pace” presumably was intended, at least originally, to allow for the possibility that policy might not be firmed at each meeting—although some market participants have come to read it as implying regular policy moves. Second, the market’s expectations for policy have not been completely immobilized by the existing language. Market yields still fluctuate to some degree with incoming economic and financial information, given the implicit conditionality in the language, and thus markets could come to anticipate a pause—even without a signal—should the data point fairly clearly toward the desirability of a slower pace of tightening.

CHAIRMAN GREENSPAN. Questions for Brian?

MS. MINEHAN. Just a clarification. You have alternative C and then you actually have an alternative C', with alternative C focusing on energy prices as a growth issue—or at least having a potential impact on growth—and C' focusing on energy prices and business costs as an inflation issue.

MR. MADIGAN. Yes. I wouldn't focus solely on energy costs, but that was the intent—to highlight that in particular as well as other elements of costs that are putting pressure on prices.

MS. MINEHAN. What would sentence 3 look like under alternative C'? That wasn't very clear.

MR. MADIGAN. We'd simply say, “Output appears to be growing at a moderate pace, but the earlier rise in energy prices and an acceleration of business costs have the potential to contribute to upward pressure on prices.”

MS. MINEHAN. So you'd have “moderate pace” and “prices” juxtaposed there. Then you'd have, “Labor market conditions continue to improve.”

MR. MADIGAN. That's correct.

CHAIRMAN GREENSPAN. Further questions of Brian? [Pause] I actually have very little to add to what has been said so far. It is probably worthwhile reiterating, to emphasize it, that the policy we have been engaged in is largely the consequence of the fact that we've had a very shallow recession and we have not had a recovery that is typical of historical experience. In the past, we've had rebounds that involved an ongoing process comparable to other cyclical recoveries, so the forecasting of the recovery has been a lot easier than we have found it to be in recent months. This time, without the typical rebound, we've been getting a set of endogenous forces that impacted with modest exogenous forces to produce not very great changes in the economy. Indeed, if one goes back and looks at a Greenbook from earlier this year, the economy doesn't look all that much different from what we are seeing now. So not having a considerable history to draw upon to make judgments about various potential outcomes—and one cannot readily project the underlying trends and assume that a particular outlook is going to materialize—we end up in a period where our forecasting is somewhat befogged.

We can put down a whole series of numbers. We can allow our econometric models just to run their equations and see what they tell us about the underlying forces affecting the outlook. But I suspect that we will find the resulting forecasts not very useful or accurate when looked at in retrospect. That leads me to the conclusion that we should continue our policy of “opportunistic de-accommodation,” as I like to call it, so that we are moving toward a position where we will be better set to respond to what might happen to the economy either way. It's almost like the tennis player who has to move sharply to his right to hit a shot and tries to go back to the center of the court as quickly as possible to be in a position to handle shots coming in any direction. If we can bring the funds rate up to a level that we feel confident is putting us in the center of the court—ready to respond to shots in any quadrant—I suspect that we will find ourselves in as good a

position as we are likely to get. I think we will find that trying to fine-tune policy to the forecast is a very difficult game to play. We can seduce ourselves into believing that the relative accuracy of the forecast is something we can count on in the future. History suggests otherwise.

So, I think we probably would be best positioned if we implement alternative C—go with an increase of 25 basis points in the funds rate and make only those changes in paragraph 3 that are essential to bring it up to date. Therefore, I would recommend alternative C with the statement as stipulated for that alternative. President Hoenig.

MR. HOENIG. I support your recommendation.

CHAIRMAN GREENSPAN. President Moskow.

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

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I, too, support your recommendation, and I agree that this is not the time to try to fine-tune the signal. I don't think the case is sufficiently compelling to do that.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, I support your recommendation. I would note, given the expectation I think we all have that another 25 basis points may be appropriate at the next meeting, that any change in wording is going to send a mixed signal that will be confusing. So I support alternative C.

CHAIRMAN GREENSPAN. Governor Bernanke.

MR. BERNANKE. I support the recommendation.

CHAIRMAN GREENSPAN. First Vice President Holcomb.

MS. HOLCOMB. I support the recommendation.

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. I support the recommendation.

CHAIRMAN GREENSPAN. Governor Bies, raise your hand, please. [Laughter]

[Secretary's note: Governor Bies indicated her support of the recommendation.]

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I support your recommendation. I would say, again, that I don't think "moderate pace" actually describes the conversation around the table this morning. But I agree with others that this is not the time to play with a word like that.

CHAIRMAN GREENSPAN. President Santomero.

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

CHAIRMAN GREENSPAN. President Pianalto.

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

CHAIRMAN GREENSPAN. President Lacker.

MR. LACKER. I support your recommendation, Mr. Chairman. I'm happy to finish the year holding the all-time Committee record for highest fraction of meetings at which I've raised interest rates. [Laughter]

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I support your recommendation. I could have gone with a simpler version of sentence 3 that would say, "Output appears to be growing at a moderate pace, and labor market conditions continue to improve," because I think the reference to the earlier rise in energy prices and the gradual nature of the improvement in labor market conditions tends to soften that statement. I'd prefer something that's a bit more "middle of the road." But that said, I'm willing to go with your recommendation.

CHAIRMAN GREENSPAN. Could I interpose here? I would just note that we do have one slightly negative statistic—one that historically has always been exceptionally useful—and that is the initial claims for unemployment insurance. They've gone up in the last couple of weeks. We think it's a Thanksgiving seasonal-adjustment problem. But in the past when data series have moved and we have tried to say "Well, it's a statistical aberration of this form or that form," we have often found in retrospect that it wasn't. So that's one minor cloud sitting out there, which we ought to keep in mind. I would hope, and I presume, that it's going to reverse. But that has not always been our experience.

MS. MINEHAN. I don't want to debate the data with you because you're far better at analyzing them than I am. [Laughter] But I do take some comfort in the average monthly growth in payroll employment over the entire year.

CHAIRMAN GREENSPAN. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. I support your recommendation. I see an important difference between us and the tennis player. When the tennis player runs back to the center of the court, the ball is already flying over the net. His running to the center of the court doesn't affect the way the game turns out. [Laughter] As we raise the funds rate and move back to center, so to speak, that move can affect how things will come out. So I would not run back to the center of the court just to run back to the center, nor would I go either way if I thought the game wasn't going to turn out to be right.

CHAIRMAN GREENSPAN. I acknowledge your superior strategy. [Laughter]

MR. KOHN. I'm not in favor of tightening so that we can ease at some point in the future. I'm in favor of tightening because it's the right thing to do now.

CHAIRMAN GREENSPAN. I was referring mainly to the possibility that we might look back in retrospect and find that real underlying inflation had been moving faster than we had expected. I'm merely suggesting to you that if our paradigm—which specifies that slowed productivity does not affect prices until it takes its full cut out of profit margins—is wrong and we end up with rising unit labor costs and rising inflation, we will be very pleased that we did, in fact, move the rate structure up. But I agree with you. I don't believe we want to move the rate structure up in order to move it down. That doesn't strike me as a very plausible scenario.

MR. KOHN. Thank you for that clarification, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. Thank you, Mr. Chairman. I support your recommendation. However, if I could substitute my own analogy for change—

VICE CHAIRMAN GEITHNER. Oh, no! [Laughter]

CHAIRMAN GREENSPAN. I rule that the Vice Chair is out of order! [Laughter]

MR. GRAMLICH. The ship is sailing along, but I do think there's an iceberg out there. Now, we may avoid it. I don't want to say we're going to hit it, but I do think one is out there.

CHAIRMAN GREENSPAN. I'm sorry I raised the analogy. [Laughter] Governor Ferguson.

MR. FERGUSON. I'll simplify things again and just support your recommendation.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN GEITHNER. I support your recommendation.

CHAIRMAN GREENSPAN. President Yellen.

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

CHAIRMAN GREENSPAN. The Secretary will read the appropriate language.

MS. DANKER. I'm reading from the Bluebook, page 13, for the directive wording: "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 2¼ percent." And then the risk-assessment language, which is in the table that was handed out, is unchanged. It reads: "The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal. With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

CHAIRMAN GREENSPAN. The press statement clearly is the statement referenced in the table under alternative C. I won't distribute these copies unless somebody needs to check the wording. Would you call the roll, please?

MS. DANKER.

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

CHAIRMAN GREENSPAN. Let's have a short recess so that the Board of Governors can address the requests of the Bank directors for discount rate changes.

[Recess]

CHAIRMAN GREENSPAN. We'll turn now to Mr. Reinhart.

MR. REINHART.³ Thank you, Mr. Chairman. In the not inconsiderable number of discussions of communications policies over the past few years, members have often brought the meeting minutes into the mix. For those in favor of expediting the release of the minutes, the benefits of such a change, as listed in the top left box of your first exhibit, include providing more timely and nuanced information about the economic outlook and monetary policy choice. In particular, releasing the minutes well before the following meeting would help prevent situations in which market participants incorrectly interpret the lagged minutes as reflecting current Committee thinking.

The minutes convey the range of views within the Committee, and expediting their release could be seen as an advantage for a few reasons. After their release, market participants will be able to put individual statements by policymakers into perspective according to the description in the minutes of the spectrum of members' preferences. In addition, policymakers might be more willing to speak publicly about a wider range of policy possibilities if they can point to a mention of those possibilities in the minutes, thereby improving public communications. In addition, if members thought the expedited minutes provided a sufficiently complete and timely explication of the policy decision, the policy statement released after the meeting could potentially be shortened.

Some members might not be convinced by such arguments, perhaps for the reasons given in the box at the top right. Expedited release could lead to undue market attention to the minutes, particularly so if early release were taken as a sign that policymakers attached enhanced importance to them. Moreover, members might be concerned that any resulting increased attention could complicate the Committee's deliberations. In particular, members might conceivably alter their discussion at the meeting in order to be sure certain views were represented in the minutes. It is also conceivable that a member would offer support for a given policy decision only in return for agreement on a particular reference in the minutes. If an adverse dynamic of increased market attention and increased contention within the Committee set in, the result might be that the minutes would become sanitized and increasingly unhelpful over time.

A last objection has been that it may be operationally difficult to manage expediting the minutes. (In that regard, though, I note that, as described in the memo by Brian Doyle circulated last week, two central banks—the Bank of England and the Swedish Riksbank—have succeeded in releasing minutes about two weeks after their policy meetings. To be sure, though, the policy committees of those institutions are smaller than the FOMC, and their memberships are not so geographically dispersed.) To address concerns about operational difficulty, this January the Committee directed

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

its Secretariat to conduct an experiment in expediting the minutes. As shown in the middle panel, for the typical FOMC cycle, we posted a first draft for your consideration seven working days after the meeting. Based on your feedback, we produced two more drafts over the next week, with the goal of gathering indications of your intention to approve the final draft in time to meet a hypothetical publication deadline of two o'clock on Friday afternoon.

In order to meet this schedule and to assess the experiment, as noted in the bottom panel, staff changed the process of producing the minutes in several ways. We contracted with a private firm to produce transcripts quickly. (This change also provides an important redundancy in our operations that was previously lacking.) We distributed drafting responsibilities among more staff so that work could be done along parallel streams. And we've provided more systematic feedback on your comments in the final week to make it more likely that the revision process comes to closure by the deadline. To make it easier for a geographically dispersed membership to approve the minutes in a relatively short time frame, staff developed a procedure for secure, chad-free, voting. Lastly, we collaborated with staff members in Public Affairs at the Board and the Markets Group at the Federal Reserve Bank of New York to assess the likely market reaction had the minutes been released early. This involved internally generating representative headlines and wire-service stories about the minutes consistent with the current environment and asking staff familiar with financial markets to hazard a guess as to the likely market response.

I take away four lessons, listed in exhibit 2, from this experience. First, using more resources to produce and distribute the minutes soon after the meeting is helpful in ensuring that they are a true and accurate record of your discussion. In particular, memories are still fresh, and information arriving after the meeting is less likely to shade the summary of the discussion. Second, not all FOMC participants were familiar with all the rules governing the drafting of the minutes. There's been an oral tradition enforcing a hierarchy of "a few," "several," "many," and "most" Committee members and defining whether speakers are described as "members" or not. To make this process a bit more transparent, last week I circulated a guide to the preparation of the minutes drafted by your Deputy Secretary, Debbie Danker. Third, the expedited schedule poses the risk that not all members will be able to vote by the deadline. Given complicated travel schedules and holidays, on two of six occasions this year I was able to reach only eleven members by the time the minutes would have been released to the public. That, however, does not strike me as a particularly serious problem given that the results of the notation vote would not be reported until the subsequent set of minutes. As long as we have the approval of a majority of members, the minutes can be released on time, and we can note the subsequent concurrence or dissent with that decision by those who could not be reached in the following set of minutes. A more serious risk is that the schedule may be too tight to achieve a consensus by the publication deadline, a risk that is elevated if some members have significant and contradictory comments on the first and second drafts. My last observation is that Friday afternoon is a terrible time to release the minutes. On two occasions, the minutes would have been released on the same day as a

surprising employment report and probably would have added to the already significant market volatility. In addition, financial markets tend to be thin on Friday afternoon, elevating the possibility of an outsized reaction.

This was a limited experiment, and in the bottom panel I've listed several aspects of a new regime that went untested. In particular, the experiment was conducted over a period in which there were no significant disagreements among members about the direction of policy, perhaps leading to a false sense of security about the ease with which a drafting consensus could be achieved. Nor has there been an intermeeting conference call this year, so we did not have to work through procedures to handle that contingency. Such a possibility does not seem to pose an insurmountable obstacle, though. I would suggest that, as a rule, the minutes relate information available from the close of the prior meeting to the close of the current meeting. Thus, the description of an intermeeting conference call would be included in the minutes of the next regularly scheduled meeting. If the Committee wanted to ensure the continued timely release of information, it could acknowledge a meeting held outside its regular schedule in the subsequent policy announcement.

Because the experiment stopped short of actually releasing the statement early, it remains unclear how much increased scrutiny more-timely minutes will receive or how members will adjust their editing behavior. It is also unclear how the public will react to the inclusion in the minutes of conditional statements, such as heightened interest in certain key data releases or the possibility of an intermeeting conference call. That said, the minutes do not often include such conditional statements. Moreover, when they do, they tend to expand on statements already made public in the Committee policy announcement, implying that the information content of such conditional statements in the minutes would seem to be limited.

On the last exhibit, I've listed three possibilities for today's meeting. As one possibility, the Committee could vote today to expedite the release of the minutes. If so, I recommend beginning expedited release with the minutes of the February 2005 meeting and adopting a schedule of releasing the minutes of regular meetings three weeks after the day of the policy decision. By beginning with the February meeting, the decision would be noted in the minutes of today's meeting, which would be released soon after the February meeting and thus give the public advance notice of the new policy. Adding a few days to the schedule by releasing the minutes after three weeks would give staff more time to draft and participants more time to comment. Such a schedule would also position the release in the middle of the week, which would be less likely to cause difficulties. You might alternatively decide that the experiment has not been conclusive enough and decide to extend it. If so, I recommend shifting to a three-week schedule because it seems more sustainable. Lastly, you might not have liked what you saw in the experiment or feel that the risks are too great to establish the precedent of early release. If you do stop the experiment, I recommend continuing approximately the same production and internal distribution schedule so that the minutes are prepared while the memory of the meeting is still fresh.

About one thing I am sure: If you decide to expedite the minutes, you will be setting a precedent that will make it hard to go back to lagged release if the results prove disappointing. In such procedural matters, you have tended to go forward only if a preponderance of participants supports the change. To facilitate your discussion, I have asked President Poole and Governor Kohn to make the case, respectively, for maintaining the status quo and for expediting the minutes. So I first turn to President Poole.

MR. POOLE. Thank you. Let me start with three preliminary comments. First, I congratulate the staff on the way this experiment was conducted. I think that we've learned a lot from it, and I think that the early drafting of the minutes, in any event, will survive and should survive. So I want to start with that observation. Second, as noted, I do not favor early release of the minutes. But I do regard the issue as being fairly closely drawn. I want to be clear that my opposition to early release is not based on a slippery slope argument. I don't see that early release is going to lead to other demands for information that would be harmful. So I've decided this case on its own merits. In my view, early release reinforces a favorable posture of openness but does not create substantive improvement in communication. Also, early release has risks and could not be easily withdrawn if it is unsuccessful. Instead, the outcome in that case, I believe, would be to make the minutes more vague and, therefore, less useful than they are now.

Here is the structure of my argument. Our aim in communications policy should be to move in the direction of perfecting the rational expectations macroeconomic equilibrium. The key to better communications for political accountability is continued policy success. Any change in communications policy that may on the surface appear to enhance political accountability but, in fact, interferes with policy success will not, in the end, serve the purpose of enhanced political accountability. In particular, miscommunication with markets will damage rather than enhance political accountability. The problem of improving communication for the purpose of improving monetary policy outcomes is reasonably well defined and will be the basis of my argument.

Now, to move in the direction of perfecting the equilibrium, an important goal is to encourage market reaction to new information that matches the FOMC's reaction to the same information. The issue is not primarily the market's reaction to new information between one meeting and the next but, instead, to new information over a span of quarters and even years. We want the market and the Committee to assess monetary policy implications of information the same way. The flow of new information is continuous. The Committee meets at discrete intervals. When the market reacts appropriately to new information, the economy has an important built-in stabilizer. This goal is quite different from conditioning the market to expect a certain policy decision at the next FOMC meeting. Such conditioning may be necessary and useful, but it should not come at the expense of enhancing the market understanding of the fundamentals of monetary policy.

Here are some principles that I believe should apply to the minutes. First, it is extremely important that the minutes be faithful to the transcript. Eventually, the two will be carefully compared. Second, the minutes should not themselves be a market disturbance. Markets may react, of course, to the minutes, but the reaction should be helpful and not harmful to the achievement of policy goals. My concern is not undue attention to the minutes but misinterpretation of them. The issue is not whether interest rates will respond to the minutes but whether the response will be in the correct direction and amount. If there is never a market response to the minutes, then we can conclude that the minutes are not providing useful information.

I'm convinced—and this is the third principle—that there are times when the most constructive thing the FOMC can do is to remain quiet. Minutes released before the next FOMC meeting will always be an event. Minutes released on the current schedule are, at most, a minor event to the market. I think we should be careful about periods like the fall of 1998, when Long-

term Capital Management was imploding. For example, the minutes of the meeting of August 18, 1998, contained this sentence: “In the view of one of these members, the trend in monetary growth along with indications of rising speculative imbalances and excesses in various markets for financial and nonfinancial assets called for a prompt firming of monetary policy.” Would such a statement have been helpful in providing clear guidance to the market as to how the Committee would likely respond to developments in the financial markets? Would the statement have been ignored as it represented the view of only one member? I’m quite sure that the sentence would not have been helpful. I don’t know whether it would have been ignored. Suppose the Committee were closely split in such circumstances, and it was not just the view of one member. Disclosure of a close split would not be helpful. Could the minutes be true to the transcript without disclosing the split? I think we all agree that we can coalesce behind the majority view on a Committee led, of course, by the Chairman, but we do not want to stifle discussion of competing views around the table. In short, it is not hard for me to imagine circumstances in which the expectation of early release of the minutes would inhibit discussion. I would feel more comfortable about early release if the staff had reviewed the transcripts and minutes for the last twenty years or so, looking for examples of discussions that might have been awkward under a policy of early release.

Now, I’ve said that early release of the minutes will be a market event. What I mean is that the minutes will be an event in the same way that the Chairman’s testimony is an event. I believe that the focus of market attention will be on the implications of the minutes for the policy action at the next FOMC meeting. The current release schedule for the minutes has the advantage of focusing attention on the Committee’s thinking and not on the probable policy decision at the next meeting. The advantage of relying on speeches and testimony—rather than minutes with a fixed release schedule and the constraint that minutes must be faithful to the transcript—is that speeches

and testimony can be crafted to be more or less explicit, depending on circumstances, and they can be adjusted right up to the time of delivery. Quite frankly, with early release of the minutes, I believe that in circumstances like the fall of 1998 the openness of discussions at the FOMC meeting and/or the nature of the minutes will be affected.

My view on the nature of market attention to the minutes under early release is that the financial press talks mostly to traders and traders care little about anything other than the very short run. Traders want clues about the Committee's likely decision at the next meeting, and they really don't care very much about the fundamentals of monetary policy. Providing clues about our next meeting ought not to be our main interest in communicating with the markets.

I'll finish with some unresolved issues. We've already talked about what happens with minutes of meetings held between regularly scheduled meetings. And incidentally, we might find ourselves with a problem of how we justify a delayed release rather than a three-week publication schedule for those. Could the Committee discuss the possibility of an intermeeting policy action as it did at its meetings of December 19, 2000, and March 20, 2001? Those discussions were disclosed in the minutes of the meetings. I think the Committee could not discuss the possibility of an intermeeting consultation unless the special meeting was going to be held before the release date of the minutes. To release minutes in which there is a discussion of the possibility of a policy action before the next regular meeting would create market uncertainty that would not be constructive.

In sum, I do not believe that early release of the minutes will assist measurably in communicating the fundamentals of monetary policy, working toward further perfecting the rational expectations macroeconomic equilibrium. I believe that early minutes will be read primarily for clues about the Committee's probable action at its next meeting. Finally, I believe that early release will at times be a market disturber, when the Committee would be better off remaining quiet.

Moreover, I think it will inhibit the discussion of certain issues at regular meetings. However, let me restate my view that the issue on early release is closely drawn, and I'm not predicting disaster. And I do believe that a Fed posture of openness and transparency is appropriate. Thank you.

MR. KOHN. I think we should speed up release of the minutes to about three weeks after the meeting, along the lines of the new schedule that Vincent suggested. I agree that there are risks and potential costs, but I think they are partly within our ability to control and they are outweighed by the potential gains. Potential gains come from the more timely release of the additional information that Vincent referred to. I do think that this information, by aligning the minutes better in time with the information that we use for our decision, will help key market reactions to better match the FOMC's reaction to the same information. The minutes contain a more complete explanation of why we reached our decision, including how we are looking at future developments, than ever will be possible in an announcement. They give a much finer reading on what the Committee views as risks and skews in the outlook than can be conveyed by a one- or two-sentence balance of risk statement. They give a sense of alternative perspectives of Committee members, and this has been missing, for the most part, as the number of dissents has dwindled in recent years.

I think diverse views further fill out the picture of the issues the Committee is focused on and where it sees the risks. An earlier understanding of the Committee's rationale and range of views should help the public interpret the economic situation as it develops over the latter half of the intermeeting period and more broadly to interpret our reactions to incoming data. The release would be another news event—I entirely agree with Bill there—and markets may not always react in ways we find desirable. This may prove uncomfortable from time to time, but I'm convinced that, on average, over time market reactions to the information in the minutes will reinforce our policy and help us achieve our objectives.

Earlier release of the minutes should prove useful for other aspects of our intermeeting communication. I think it's helpful to have another Committee document in the public domain. There are already a lot of intermeeting events in the speeches and interviews that we do. The minutes should assist markets to put our individual speeches and interviews in better perspective, making it less likely that markets will make the mistake of thinking that any of us, except for the Chairman, is speaking for the Committee. I've found it useful in speeches, and especially in answering questions in public, to reference the minutes or the announcement. And having this document published earlier will give us more opportunity to utilize this method of putting our own remarks in the overall context and to reinforce the Committee's message.

I would not want to trade early release of the minutes for a shorter, less forward-looking announcement on the day of the meeting. I think there are useful things we can say about the future in that statement. I count the experience of the last five years—including the last year and a half or so of interest rate guidance—as successes in that regard. We've provided information that has helped the markets make accurate policy predictions, and in my view we have not constrained our ability to take needed policy action. Cutting back on the announcement would leave a three-week void in which markets would have less guidance from us, but I recognize that we've had a difficult time deciding on what and how much to say in that statement. There is no consensus on which way to go next in this regard, and announcements have evolved, and are likely to continue to evolve, slowly. All these tendencies argue that the value of the minutes to supplement the announcement is likely to increase over time.

The main negatives, as Bill stressed, are the potential feedback on the minutes and even more seriously on the deliberations of the Committee. We cannot adopt a new transparency tool that would in any way make the Committee discussion less useful and productive. I do think the

experiment, together with the extra time embedded in Vincent's proposal, should take care of the concerns about whether the Committee could converge on an agreed-upon document in the time allotted. And Vincent has explained how intermeeting conference calls would be handled.

With regard to the feedback on the minutes or discussion, I think we should remember that these are minutes, not transcripts. Artful wording can make them comprehensive and truthful records of what we discuss and of the reasons for our decisions, without including information that would endanger financial stability. We should continue to err on the side of comprehensive coverage. We should not cut the minutes back. My experience as Secretary was that, on those occasions when I debated how much to include of a particular discussion, the Committee benefited over time from a fuller, more comprehensive set of minutes, even at the risk of some near-term discomfort, because the ability to reference the minutes in later testimonies and public discussions was so useful.

In our last discussion, some of us expressed concern that expedited minutes would constrain conditional or contingent deliberations for fear of how they would be reflected in the minutes. I read the policy paragraphs in the minutes for the last two years—not the last twenty years, I confess, Bill. But in the last few years, the paragraphs relating to our policy discussions contain few, if any, contingent statements that aren't foreshadowed by the announcement. In fact, in thinking about your examples of December 2000 and March 2001, in both of those cases the announcement said that we would be monitoring developments carefully. So I think the announcement foreshadowed what the minutes said about the possibility of an intermeeting move.

In terms of conditionality, I couldn't find anything in looking at the minutes of the last few years that I felt would have done the Committee harm if it had been released earlier. Now, I didn't look back twenty years. Conditionality in the minutes is usually implicit, not explicit. Discussion

does give the readers a better sense of the variables that are informing the Committee's decisions at that moment, and they don't typically say "if x occurs, then we will do y." Moreover, as I noted a few seconds ago, there are always ways of covering discussions without contributing to instability; I think we do that already. As a consequence, earlier release of the minutes should not deter the Committee from a free discussion of alternative outcomes and their policy implications.

Finally, this is under our control. We will be setting the precedents over the next couple of years that will guide future Committees. I think we can discipline ourselves to maximize the gains and minimize the potential costs of this exercise. Thank you.

CHAIRMAN GREENSPAN. Thank you. The floor is now open for discussion.

MR. FERGUSON. I'll speak first, partially because I've spent five years working with Vincent on getting us to this happy place, and I don't share his sighing about it. I think expediting the release of the minutes is a useful step for the Committee to take. My views on this, I must admit, have changed. The last time we discussed this, I was opposed to early release. This time—though I agree with Bill that it is a very close call—I have moved slightly to the point that I think it is, on balance, a good thing to do.

The benefits are ones that I think Don has pointed out. The minutes will be more contemporaneous in time with the relevant meeting. They are a more subtle, nuanced, varied representation of what transpired at the meeting than we can possibly provide in a one-page statement. They also have the benefit of giving us a touchstone on which to review other commentary; they may actually in some sense drown out some commentary and highlight others. I agree there will be costs. I've worried a great deal—and I continue to worry—about the high attention that is likely to be paid to these minutes, particularly since I think of them primarily as a reflection of historical relevance not necessarily a predictor of the future. But they do talk about

what has happened. I also worry about a point that Bill made very clearly, which is the risk that these minutes, since they will be an “event” where the Committee is involved in the markets between meetings, would drown out other news when in fact—in terms of future policy deliberations—that news might be more important than anything that was in the minutes. There are some costs that I think we can manage without much difficulty. For example, on the question of whether or not the minutes gradually will become smooth and polished and not be an accurate reflection of what transpired at the meeting, I think we and the staff can manage that.

So given the close call, why did I move from thinking this wasn’t a good idea to thinking it is, on balance, a reasonable idea? The answer ultimately is just the reality of life. We already are in the markets between meetings. Currently we have to be in the markets between meetings with an old set of minutes as opposed to a more relevant set of minutes. Unfortunately, in spite of our efforts to educate the markets that this document is historical and does not relate to what has happened in the past six, seven, or eight weeks, they still react—perhaps more than they should, though sometimes appropriately—to the information that’s in the minutes. And they get it wrong, I think, about as often as they get it right.

So recognizing that we are in a position—contrary perhaps to the position I’d like to be in—where we’re interacting as a Committee both on the day of the meeting and then whenever the minutes are released, on balance I think it makes sense to have those minutes be a little more contemporaneous and a little fresher, as opposed to being very much out of tune. I say that because in either case the markets treat them, sometimes appropriately and at other times inappropriately, as a reflection of the Committee’s views. So my views on this issue have changed; I’ve moved to preferring, on balance, to release the minutes earlier. And I think this experiment has been very, very useful in that regard.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. I've felt for a long time that the minutes, given the way we currently handle the timing of their release, are an unappreciated or at least underappreciated asset. So I continue to strongly favor moving up the release date. I think Don basically made the case, so let me just quickly summarize things as I see them.

In my experience, the minutes are accurate, they are comprehensive, and they are valuable. They illustrate the thinking of the Committee, and they get into the issues that we discuss when we consider policy. I think all of that is important to communicate to the public. In short, I believe it would improve communication to release the minutes earlier, when people would have an incentive to take a real interest in them. And that, to me, is the reason for doing it.

I agree that there are some potential downsides, and I don't want to overstate or exaggerate the benefits. But I do believe that, on balance, the benefits are rather compelling. I also think that it's certainly possible from time to time that market participants will read something in the minutes that we believe is innocuous and make a lot more of it than we would. But in my view we shouldn't be so paternalistic and worry that, if market participants don't get it right every time, something has gone seriously wrong. Most market participants are smart, sophisticated people, and I think, on balance, they will get it right most of the time; and when they don't, that's their business.

CHAIRMAN GREENSPAN. Governor Bernanke.

MR. BERNANKE. I support the expedited release of the minutes. I think we should point out that on a number of occasions this year the delayed release of the minutes has actually confused the market—stepped on our message from the most recent meeting by sending a somewhat different signal. And although I don't have a lot of market contacts, a number of them did contact me at those times and asked, "What's going on here?" Second, I would put more weight on the notion

that we all have to go out and give speeches and talks and answer questions and we worry about giving the wrong signal and confusing the market. It would be a comfort to have a Committee document out there to which we can refer and which the market can use for putting our remarks in perspective. That will reduce the risk that we all face of inadvertently moving the market or creating a misimpression. And finally, I would just note, as Vincent's study showed, that a number of other central banks have used this practice effectively and have not had serious problems with it.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN GEITHNER. I support early release. We don't have to do this, but I think it's the sensible thing to do, and I think it's the sensible time to do it. I can't improve on the arguments made in favor of it by Don, Gary, and Ben. I would say, Bill, that the argument you led off with is sort of an argument for extending the delay and taking release of the minutes out of the time frame when they would be viewed as having any signal value for the future stance of monetary policy. You weren't advocating that, but I think it's awkward to suggest that we should release the minutes outside the time period of the meeting to which they relate. In my view it's better to take the risk of some noise added to the signal by releasing the minutes between meetings, closer to the relevant meeting, than to have the risk that the release comes after a new policy decision has been made and thus creates broad confusion about how to interpret the minutes in that context. Generally I think early release will add more perspective to our views about the outlook for inflation and output growth and will provide more context to the range of views across the Committee. Therefore, I believe it will give people a better sense of the factors shaping our decision, and in that sense, I think it would be helpful.

CHAIRMAN GREENSPAN. Governor Hoenig.

MR. HOENIG. I support early release of the minutes, Mr. Chairman. I have for some time. I think it will give a better sense of the Committee's views and the process of its thinking with regard to policy, and I believe that will serve the market well.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I think the experiment to date has been a very good one. It has produced a much higher quality initial product because it's written closer to the time of the meeting. Personally, I have had no problem keeping with the tight schedule, despite a couple of late comments on my part, and I want to congratulate the staff on the work they've done to make the process more efficient. I think we really have—no matter what we do with it—a higher quality product for both the transcript and the minutes as a result. So I would continue doing what we're doing, no matter what decision comes out of this discussion today.

On the issue of early release, I think we've been conducting this experiment in the best of times, as President Poole mentioned. Our statement has provided what the market has seen as near-term assurance; absent really off-the-chart data, market participants have some sense that policy will continue in a particular direction. So, in that regard, releasing the minutes early in this environment probably wouldn't have had a whole lot of effect. They would generally have confirmed what the market knew already.

Now, I'd always looked at releasing the minutes early as kind of a quid pro quo for taking out of the statement the wording that we've had in there for the best part of the last year or so orienting the market toward the gradual nature of our doing what we're going to do. As I think back over my years on the Committee, when we started to mention the tilt and then the measured pace and gradual nature of removing policy accommodation, it was basically to give the markets a sense of some conditioning around our actions.

I have felt that, if we release the minutes early, the markets will get their conditioning from the minutes; they wouldn't need it in the statement released after the meeting. We wouldn't have to try to figure out all the delicate wording that's a shorthand way of trying to tell the market more than we need to tell them. I think the recent past has been a period of time when we've needed to tell the market something about our expected policy path, but going forward that need is not likely to be so great. The future direction of policy won't be so clear to us. And the market, in fact, ought to be arriving at its own thoughts about the direction of policy and taking out insurance in case it is wrong rather than looking to particular statements of ours for the reasons to go in a certain direction.

So I view the two communications as a package. I thought we'd take a lot of the forward-looking commentary out of the statement—the “measured pace” language, certainly—in return for releasing the minutes earlier. That could have some good effects; Don has gone into them. It could have some bad effects. There could be a timing issue where we end up releasing the minutes when something else is going on and we'd have two additional points of noise. But I thought of this as a package. So I'm finding it hard to think about releasing the minutes with the continuation of the “measured pace” language in the statement. I'd rather change the two things at the same time.

In that regard, if it's going to take us a while to decide how to change the statement, I would continue the experiment on the minutes and keep asking ourselves the question that President Poole mentioned, both for now and in the past: Are there reasons that expediting the release of the minutes has more of a downside risk than we now appreciate? So I'd be in favor of the middle road here. I recognize that it's a difficult decision to make, and I wouldn't make it now. I'd make it when we're ready to change the statement, which I hope we'll be able to do sooner rather than later. And in the interim, I'd continue the experiment.

CHAIRMAN GREENSPAN. Governor Gramlich.

MR. GRAMLICH. I would support early release. I would do it unequivocally. Unlike Cathy, I don't view this as something under the conservation of law and information here. So if we give out more information sooner, I don't think we have to take anything back. In particular, I think the statements are working very well now, and I wouldn't change those in the least. I just plain support early release.

Let me make three other quick points. Bill mentioned that, if we didn't have early release of the minutes, we'd still have a number of speeches as a communication tool. Well, member speeches are member speeches; they are not statements from the whole Committee. I don't think the two are equivalent, and I'd rather have something from the whole Committee. On the question of whether the market would misinterpret the data, I can't see how bringing the minutes closer to when the data came out would increase misinterpretation. This is a point Don made. I think it would reduce misinterpretation. And, third, I'd like to support a point that Ben made, which is that, when the minutes come out after we've given the statement for the next meeting, there's inevitably confusion about that. It has happened several times, and with early release of the minutes we get away from that. So, to me, it's becoming clearer and clearer that we ought to go to early release and that we shouldn't do anything to our statement.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, like Roger, I was in the group originally that was very uneasy about this. But I've come to the other side and believe that, on balance, it is probably the thing to do.

Let me mention just a couple of thoughts, without completely repeating what others have said. I would also commend Vincent and the staff and Bill and Don for helping us understand some of the issues involved. I was thinking that more and more over the last few years—starting with

Dave and his staff and our own staff—we have used the concept of error bands around our forecasts. And it seems to me that there are, in fact, distinct opinion bands around our views in a meeting. I've been among those who have been very uncomfortable trying to boil down our post-meeting statement to a few phrases. I share some of Cathy's feeling that, if we're going to release the minutes earlier, we might like to have a tradeoff at some point and that might be the way to accomplish it. I agree completely with the point that Ben, Roger, and Tim all made about the fact that we're making speeches anyway and the market is analyzing what we say. I've found myself over and over again a week or two after a meeting, when it's time to go back out and hit the street again, wishing that the minutes were in play so that they could provide a frame of reference for my comments. I think it's a distinct advantage to have the minutes in the public domain earlier.

Finally, I'd note a couple of nuances that perhaps could go unsaid. One of them I say with some trepidation. In the original discussion, I raised some concern about not knowing what happens after all the comments come in or how they get resolved. Vincent has done a nice job of telling me what he did in terms of the disposition of my comments. But I have no concept of what other comments came in and what kind of process he went through behind the scenes to take them into account. I don't mean that as a lack of confidence in either Vincent or you, Mr. Chairman, to tailor the final minutes appropriately. They've turned out pretty well. But there may be other Secretariats or other Chairmen that I'd be a little uncomfortable just turning loose and giving a blank check. In the last discussion of this you suggested that it might be possible to have a small editing committee so that somebody would know what kind of comments were coming in and how they were handled. So that issue of how differences are resolved when various comments come in still makes me a little uneasy.

Let me make one final comment. If we're not going to release the minutes early but continue to produce them early, I wonder if we don't leave ourselves a little vulnerable to criticism if somebody outside finds out that we have, in fact, produced them but have put them on a shelf. If the minutes are in final form and people find out about that, I think we're really vulnerable to somebody saying, "Why didn't you release them?" So I don't know whether that halfway house works or not. Thanks.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I think that the experiment was very helpful. My own feeling is that releasing the minutes early will provide useful information to the markets. I think it will help us communicate better. I agree, as others have said, that it will be very helpful in our speeches and interviews. And other central banks are doing it. Also, strictly from the standpoint of logic, we are producing minutes, and we are going to release them at some point. We now know that we have the technical ability to release them earlier than we have been. It's rather difficult to argue that we should delay releasing them because we think people are going to misuse the information. That just doesn't hang together from a logical standpoint. I don't know that we could pass the "red face" test in making that argument in public.

I agree with Cathy in that I would also very much like to take out the forward-looking statements in our announcements. But as for the idea of packaging these two changes together, I think it would be very difficult to accomplish just in terms of trying to get agreement among the Committee. It's difficult enough to get agreement on one piece of this let alone two pieces at the same time. So I just don't know if it's practical to try to do that. If we decide to go this route, I do have one minor suggestion on the announcement. But why don't I hold off on that until we decide whether we're going to do this or not.

CHAIRMAN GREENSPAN. President Lacker.

MR. LACKER. I strongly support expedited release for a lot of the reasons that Governor Kohn and others have expressed. I have a general predilection toward more transparency; the more information in the markets, the better. I just want to make three points. One is that bringing this information out earlier in time would resolve uncertainty earlier. If we see any market reaction to this, for the most part it would just represent a shift in the timing of market volatility. It doesn't seem to me likely that on net, in any global sense, it's going to add any market volatility. So we shouldn't let the magnitude of perceived market reactions dissuade us or give us second thoughts down the road. The second point I want to make is that I do see this as alleviating some of the pressure on the Committee with regard to the drafting of the statement. But, Cathy, I think this cuts both ways. After expedited release of the minutes, the statement will stand as the Committee's latest communication for only three weeks. To some extent, that could make it easier to communicate and agree on phrasing rather than harder, since only three weeks are at stake rather than an entire intermeeting period. I agree with Don. I wouldn't want to see the extent of the communication we do in the statement cut down. Finally, there's one tiny detail that I hesitate to bring up, but it sort of surprised me. If it were up to me, I'd like to see it changed. Apparently, it's the tradition that nonmembers' policy statements are excluded from the minutes as they're written. Now, I don't remember ever noticing this before, and I can't remember seeing it in the orientation package I got. [Laughter]

CHAIRMAN GREENSPAN. Is that true?

MR. REINHART. In the last several paragraphs, which bear only on the policy decision, a statement refers only to comments made by members. Before that, in the discussion of the outlook, the minutes reflect the entire go-around, so it includes all participants at the table.

CHAIRMAN GREENSPAN. I think that's the logically necessary position for this Committee to take.

MR. LACKER. Which one?

CHAIRMAN GREENSPAN. The one just enunciated by Vincent.

MR. REINHART. In the material Debbie circulated last week, the proposal was to make the distinction sharper by talking about members and other participants in the earlier section. But, again, when it comes to who voted on the policy decision, it's only members.

CHAIRMAN GREENSPAN. Suppose we had a situation in which the nonmembers held different views from those who voted but then we show a unanimous vote. We'd get a lot of comments as to why the indicated vote was wrong. We can't do it that way. The voting members have one privilege and one privilege only: They get to vote on the policy at that particular point and on the nature of the statement. The discussion of what is going on in the economy and the issues that are on the table and the relevance for potential future policy changes is a full Committee discussion. But the specific policy decision that is reported is the vote of the then-Committee. And the membership of the Committee changes from time to time.

MR. LACKER. Mr. Chairman, let me just say a couple of things. First, there is this mechanism for distinguishing between members and nonmembers. So a view about policy could easily be attributed to a nonmember. Second, many statements about the economy by members as well as by other participants seem integrally linked with their statements about policy. Today's meeting, I think, was an excellent example of that. Third, I view the purpose of the minutes as a means to communicate to the public the deliberations that occurred at the meeting, rather than the deliberations of the Committee—

CHAIRMAN GREENSPAN. No, that is not the purpose. The purpose is essentially to give the reasons why we voted the way we did.

MR. LACKER. Well, that's a different philosophy; I'll grant that.

CHAIRMAN GREENSPAN. It has always been that way. The point is that, if you divide the Committee into two separate groups and then discuss what those who voted on the particular statement thought and what those who didn't vote thought, we are actually no longer talking about the Federal Open Market Committee. The Federal Open Market Committee is composed of the twelve members who have the right to vote at a particular time. That's the law. We can't get around it.

MR. LACKER. May I ask a clarifying question?

CHAIRMAN GREENSPAN. Yes.

MR. LACKER. Vincent, in the discussion in the minutes that refers to the first part of the meeting on the outlook, where you use the terms "most," "many," and "several," is the denominator—

MR. REINHART. It is nineteen.

MS. MINEHAN. Could I just say something? We are really discussing two things here. One is the issue of members versus nonmembers—I would use the terms voting members and other members, but be that as it may—and whether you discuss all of their perspectives in the last part of the minutes on the policy discussion. Then there's the other question, which relates to the change that Vincent and Debbie proposed, about whether to call certain people "other participants" in the first part of the discussion. I think that's pushing it a bit. I don't mind, if I'm not a voting member, not having my views included in the comments on policy. That doesn't bother me. But to draw a distinction between members and other participants in—

CHAIRMAN GREENSPAN. Well, you don't have to do that. The basic statement is that in that last section of the minutes we are merely stipulating "the reasons for the policy decision." In that context, only the views of those who actually voted on the policy are included, and we don't make reference to anybody else.

MS. MINEHAN. That's exactly what I am suggesting to you to do.

CHAIRMAN GREENSPAN. That's indeed what we do.

MR. REINHART. In trying to actually write down what was the oral tradition, we did find that not everybody agreed on what it was. One thing was clear: As the Chairman said, the last two paragraphs essentially are viewed as explaining the vote of the Committee. Hence, in those paragraphs, the "members" we talk about are the members of the Committee.

MS. MINEHAN. Right.

MR. REINHART. The problem is if you want to represent everyone's views in the discussion of the economy several paragraphs earlier and you refer to them as "members." Then you've used the same word to describe two different sets of people.

MS. MINEHAN. Are you using "members" in that different way now?

MR. REINHART. Yes. Unfortunately, it turned out that the rule was that anyone in the discussion was called a member up to the last couple of paragraphs, and then only members were called members in the last couple of paragraphs. That seemed to be an unsupportable inconsistency. We didn't want to exclude nonmembers' characterizations of the economy and the risks to the outlook, and one way to do that would be to call them "participants."

SPEAKER(?). Can't you call the group in the last few paragraphs voting members?

MS. MINEHAN. Yes, right. Why not call them voting members as opposed to members?

CHAIRMAN GREENSPAN. The definition of the Federal Open Market Committee is statutory, and there is no such thing as a nonvoting member of the Federal Open Market Committee.

MR. REINHART. I was rapped on the knuckles by Joe Coyne fifteen years ago on exactly that point. The membership of the Committee is twelve people, and there is no such thing as a nonvoting member.

MR. SANTOMERO. Why not call everyone participants in the first part of the—?

MR. REINHART. We're quite happy to do that, yes.

SPEAKER(?). That's what he's proposing.

MR. REINHART. That's the proposal.

MS. MINEHAN. That works.

MR. REINHART. So up to paragraph 21, or whatever paragraph number it is, if you express a view you're a participant in the meeting. If you express a view that is included in the last couple of paragraphs of the minutes, it's there because you are a member.

MS. MINEHAN. You're a member, right. Okay.

CHAIRMAN GREENSPAN. Okay. President Yellen.

MS. YELLEN. Well, just briefly, I'd say that I definitely support the publication of the minutes on an expedited schedule, given that it is feasible. And I agree completely with Don's analysis of the benefits. It does seem to me that, in moving toward perfecting a rational expectations kind of equilibrium, the minutes released in a timely fashion, when they're still relevant, contain enough information about the Committee's reaction to data and how it processes those data that it should help the market improve its understanding of the rationale for policy. And that includes the fact that there isn't unanimity on the Committee; there is a range of opinions about the outlook and the risks. Just in the brief time that I've been back on the Committee, there have

been occasions when the minutes were released at a point when they were actually misleading because the views of the Committee had changed. I've found that unfortunate.

Let me respond to Cathy's point. While I can understand that, if the Committee decides to move back to more formulaic language in the statement and to omit any reference to a consensus about future policy, some might view earlier release of the minutes as a substitute for those kinds of statements. But I would consider that both unnecessary and unfortunate. I support Ned's comments about that, in that I think it's actually quite helpful to have an explicit statement about the Committee's consensus view regarding future policy. So I would not like to see this become a simultaneous decision to forgo that in favor of the earlier release of the minutes.

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. I have two comments. First of all, I see the decision as, on average, a four-week acceleration of the release of the minutes, and therefore I think there are two considerations. One is, Is there a logistical problem with early release? Having had Vincent track me down when I've been away from the office at times, I realize that there is a burden in meeting the publication deadline. But from what I'm hearing, that is not an insurmountable problem. The second is, Will there be any significant changes in the minutes as a result of that acceleration? We won't really know the answer to that until we get into it, and I think I'd support Don's evaluation that it probably is a manageable issue. Also, of course, the first time that we release the minutes early it will be an early release. From there on, it will be a scheduled release. So I think we will get the early release only once. [Laughter]

Finally, I don't see this decision and the language in the statement as a package. I think on balance the market would tend to see a less forward-looking statement as a net reduction in our communication, and I think we would have to reverse that policy. That gets back to a point that Bill

made earlier, which is that we can't retreat. I'm an incrementalist because we can never go back. I think our communication policies will continue to evolve. There is no end game. There is no destination. We ought to make this move but do it in complete isolation and not have any other corresponding moves along with it.

CHAIRMAN GREENSPAN. President Pianalto.

MS. PIANALTO. Like President Minehan, I thought the experiment on early release of the minutes was motivated by the struggle that we were having in capturing the full sense of the Committee in the few words that are allowed in the press statement. I also have been uncomfortable with the code words that we've been using in that press statement. And those code words have proven awkward to remove without sending unintended signals to the markets. So I still prefer a shorter post-meeting statement with the early release of the minutes.

I also agree with President Minehan—especially after reading Vincent's list of untested aspects of the experiment—that we've been conducting it in the best of times. That led me to come to this meeting in favor of what Cathy referred to as the middle-of-the-road ground. Let's extend the experiment through circumstances that might not be considered the best of times. I know that this is an unpopular position, but I thought we were going to continue to perfect our communication strategy and that this would all be one package. I can see, however, in listening to my colleagues, that I'm in a minority in that view. Nevertheless, I did want to take a more middle-of-the-road approach and continue to improve our communications.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. When I proposed the experiment on early release of the minutes, I thought that we were addressing a few questions. The first one was, Can we do it? Do we need to change the process? Can we all focus our attention on the minutes, given the time constraints? And

given the new proposed process, were we comfortable with what would be released? I think that was the experiment. I think we learned a lot from that experiment, but not everything. We learned, for example, that we shouldn't move to releasing the minutes on a Friday. We also decided that we ought to plan to publish the minutes three weeks after the meeting. Quite frankly, I think that's a good addition of a few extra days to allow for contingencies. I believe we would have had a harder time meeting the publication goal ex post if we had started releasing the minutes on the previous Friday.

But one never learns everything from an experiment. So if there are things left on the table, it shouldn't surprise us. Nevertheless, we now have a new process for producing the minutes that is more timely. It brings more resources to the work, has hastened attention to it, and actually is a discussion that's more symptomatic of the time when the minutes would be released. I, therefore, endorse the release of the minutes in a more timely fashion. I know there's some concern about market reactions. Most market participants are grown-ups; they'll sort that out. I guess I trust markets enough to think that they'll figure out how to do it. I also share the concern addressed by President Guynn that, if we have these minutes and put them on the shelf and then take them out several weeks later, it's just a matter of time before someone says, "Why are you doing that?"

So, first of all, I think early release is the right thing to do. I now know we can do it. And I think not doing it puts us in a situation of less disclosure than seems appropriate. Having said all that, I think we should do it.

CHAIRMAN GREENSPAN. When we started this process, frankly, I was quite dubious that this would be a successful operation. I'm pleased to say that I was mistaken. I thought the staff ran an exceptionally effective demonstration that this is a feasible operation. In the course of discussing the different alternatives as we went forward in the various iterations, I think we

probably enhanced our understanding of the process and how it was functioning. So in that regard, I think the experiment has worked.

I'm not concerned, as you are, Cathy, about the question of the tradeoff with respect to the statements and the minutes, largely because I don't look at the forward-looking statements as something we'll be continuing in the future. I look at that as an historical aberration that enabled us to do forward-looking projections and stick with them, because we had this extraordinary period of increasing productivity growth for a long period of time. That essentially put us in a position of significant control over inflation—indeed, we had declining unit labor costs—which enabled us to effectively say that we were not concerned about inflation for the period ahead, knowing that productivity growth doesn't change all that quickly. We were, therefore, able to engage in an experiment with our statements that lasted for well over a year.

I submit to you that that was the aberration and that the future will not look that way. We are going to find, when we eventually unwind from this “measured pace” approach that we're not going to be able—credibly—to reproduce that kind of description of monetary policy in the future, at least not without very extraordinary events occurring. So I think the issue is moot. When this period has ended and we've reached where we wish to go with this policy of “de-accommodation,” I think we will go back to a very short term, balanced focus and give the type of indication of Federal Reserve policy that existed in the past.

I think that there are risks to moving forward on this early release of the minutes, but I agree with the way Bill put it—namely, that it's a close call. The way I would phrase it essentially is that, if we move forward and we find out in retrospect that it was a mistake, the cost is not all that large. It's certainly not as large as I think it would be were we to decide to move the transcript timing from five years to six weeks and found out that we were wrong. Since we cannot reverse in either case, I

think the costs in the latter case would be far greater than if we to move to the three-week window on the minutes and find out that was a mistake. We can live with that; I think we can live with it in a way that might require us to change the way we handle the minutes or what we say in the minutes. But it's not going to be a big deal.

So I would lean toward following Vincent's recommendation that we begin expedited release of the minutes at the February 2005 meeting and maintain a schedule of releasing the minutes of regular meetings three weeks after the day of the policy decision. Since I perceive that that's largely the accepted view of this Committee, I'd suggest that we put that on the table for a vote. Call the roll.

MS. DANKER.

Chairman Greenspan	Yes
Vice Chairman Geithner	Yes
Governor Bernanke	Yes
Governor Bies	Yes
Governor Gramlich	Yes
President Hoenig	Yes
Governor Kohn	Yes
President Minehan	Yes, I guess. [Laughter]

CHAIRMAN GREENSPAN. This, incidentally, is a full vote of both the Presidents and the Governors on the grounds that it's a decision that relates to the policy of the Committee, and all members and potential members, in my judgment, should vote.

MS. DANKER. Okay. I'll pick up the others in a moment.

Governor Olson	Yes
President Pianalto	I can't repeat Cathy's way of saying yes, but—

CHAIRMAN GREENSPAN. "Yes, I guess" is a formal vote.

MS. PIANALTO. Okay. Yes.

MS. DANKER.

President Poole	I'm persuaded. Yes
President Guynn	Yes
President Lacker	Yes
President Moskow	Yes
President Santomero	Yes
President Stern	Yes
President Yellen	Yes
First Vice President Holcomb	Yes

CHAIRMAN GREENSPAN. I just want to congratulate Vincent on an extraordinarily well-done job.

MR. MOSCOW. Mr. Chairman? I congratulate you, too, Vincent, but may I make one minor suggestion?

CHAIRMAN GREENSPAN. Yes.

MR. MOSKOW. Instead of waiting to announce this in the minutes that will come out right after the February meeting, I would announce it early in January for several reasons. One, I think it would give more time to the markets to be aware of this change. If we put it in the minutes of this meeting, which would be released after our February meeting, that would give market participants about twelve trading days before a new set of minutes—those for the February meeting—will be released. Second—and I hate to say this—there's always a chance of a leak. I would hate to see this come out before we announce it.

CHAIRMAN GREENSPAN. I think that's a good point. But let me ask this: What are the reasons not to announce it earlier?

MR. GRAMLICH. Yes. Let me take that a step further. What if we put something about this in our statement today?

MS. MINEHAN. Exactly.

MR. MOSKOW. I would strongly support that, if you can do it. I would do it as soon as possible. I thought you'd want to draft some wording and have the Committee look at it first.

CHAIRMAN GREENSPAN. Let me put it this way. I heard no discussion here that in any way would preclude announcing this decision today, given that we've come to a conclusion and that it was effectively unanimous—with a couple of “I guess” votes. [Laughter] So unless there's an objection, I would submit that it's certainly possible to do this today. We have the time to put a sentence in the statement indicating what the Committee concluded and voted on regarding this issue today.

MR. REINHART. One possibility, Mr. Chairman, is basically to pick up the language that you, in fact, voted on: “The Committee voted unanimously to begin expedited release of the minutes with the minutes of the February 2005 meeting and to maintain a schedule of releasing the minutes of regular meetings three weeks after the date of the policy decision.” I would also suggest that we put more detail, in terms of a paragraph or two, in the minutes of this meeting, so that market participants will know what is coming. You will have precluded the possibility of a leak, and market participants will get more explanation at a later date.

MR. MOSKOW. Fine. That's excellent.

MR. KOHN. Mr. Chairman, will there be a question of why we're not proceeding with early release of the minutes for this meeting?

CHAIRMAN GREENSPAN. I'd say it's because the discussion of this issue occurred subsequent to the vote on the policy decision.

MR. SANTOMERO. Should there be some discussion about nineteen votes versus twelve in that statement?

CHAIRMAN GREENSPAN. Let me go back. That would be the answer, but we could certainly move it up if—

MR. GRAMLICH. As long as we're into this, what's the problem? If we can release the February minutes in three weeks, why can't we release today's minutes in three weeks?

MR. REINHART. We could release these minutes in three weeks, if you so direct. I thought there were certain advantages to having a paragraph or two explaining why the Committee made this decision and giving details of how the Committee would do this going forward before those in the market actually got the first release.

CHAIRMAN GREENSPAN. Is that really necessary?

MR. REINHART. Not if you say it isn't. [Laughter]

CHAIRMAN GREENSPAN. Well, I think the logic of our decision forces us into the position of doing precisely what Governor Gramlich is suggesting. Let me ask, Are there any dissents to actually releasing the minutes of today's meeting on an expedited basis?

MS. MINEHAN. May I suggest one possible benefit of waiting?

CHAIRMAN GREENSPAN. By all means, go ahead.

MS. MINEHAN. You can all shout it down, but it occurs to me that one possible benefit is to give people who follow our every word—and there are many people around who do—a longer period of time to get used to the idea and to read the minutes of some previous meetings in the context of what was going on at the time. They could calm themselves down in time to get the February minutes three weeks after the meeting.

CHAIRMAN GREENSPAN. Three weeks is a long time. [Laughter]

MS. MINEHAN. All right. I'm willing to be shouted down on that. But that's the only reason I can think of for waiting.

CHAIRMAN GREENSPAN. Are there any arguments that anyone can think of? The date these minutes would be released would be January 4. If it were Christmas Day, I think it would create a problem.

MR. FERGUSON. Mr. Chairman, either we are going to do this or we aren't. We can't start out by immediately saying, "Oh, well, that date is not very convenient."

CHAIRMAN GREENSPAN. Let's at least think of what we intend to do. The proposition currently on the table is (1) to announce that we're going to release the minutes early and (2) to do it in three weeks. I haven't heard serious objections, nor have I heard serious reasons—which are far more important—not to proceed. So unless I hear objections from anybody, I would read it as the consensus of this Committee to make the statement that we're going to do it and to actually do it as of January 4. Is that acceptable to everybody?

SEVERAL. Yes.

CHAIRMAN GREENSPAN. So be it.

VICE CHAIRMAN GEITHNER. Mr. Chairman, just one more question or suggestion for Vincent. Maybe you've already considered this. When you release the minutes for the first time, you might want to consider adding some of the Secretariat's clarifying information about the conventions in the language—an explanation of some of the terminology. I don't know if you were intending to do that, but I think it would be helpful

MR. REINHART. I did want to make clear the distinction between "participants" and "members."

VICE CHAIRMAN GEITHNER. And the hierarchy of the language around the terms "majority" and "several" and so forth might be helpful, too.

MR. REINHART. We thought of making a little index card that we could hand out to Fed watchers. [Laughter]

MS. MINEHAN. We can expect to be asked if we are one of the “few” or one of the “many.”

CHAIRMAN GREENSPAN. May we leave that issue of explaining the terminology to the Secretariat to make a judgment on?

SEVERAL. Yes.

CHAIRMAN GREENSPAN. In that event, I want to confirm that the dates of our next meeting are Tuesday and Wednesday, February 1 and 2, 2005. This meeting is adjourned, and we are off to have lunch with our former colleague, Bob McTeer.

END OF MEETING