

**Meeting of the Federal Open Market Committee on
November 1, 2005**

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., at 9:00 a.m. on Tuesday, November 1, 2005. Those present were the following:

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

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

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

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

Messrs. Connors, Freeman, and Madigan, Ms. Mester, Messrs. Oliner, Rosenblum, Tracy, Rolnick, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

Mr. Nelson, Section Chief, Division of Monetary Affairs, Board of Governors

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

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

Mr. Werkema, First Vice President, Federal Reserve Bank of Chicago

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

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

Mr. Krane and Ms. Mucciolo, Vice Presidents, Federal Reserve Banks of Chicago and New York, respectively

Mr. Hetzel, Senior Economist, Federal Reserve Bank of Richmond

**Transcript of the Federal Open Market Committee Meeting on
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CHAIRMAN GREENSPAN. Good morning, everyone. Before we get started, I just want to thank you for what was an extraordinary evening for me and also a big surprise. I appreciate not only that all of you showed up but, as best I can judge, that virtually everyone else who was physically able to do so also showed up. So, it was great.

On to official business. Mr. Kos, please.

MR. KOS.¹ Thank you, Mr. Chairman. The now lengthy period of tight spreads and low volatilities continued in the intermeeting period. That was despite some unexpected credit events, another hurricane, and increased talk about upside inflation risks.

The top panel on page 1 graphs the 3-month deposit rate in black and the same rate three and nine months forward in red. The 3- and 9-month forward rates rose 47 and 53 basis points, respectively, as market participants absorbed incoming data and, even more, comments by Committee members expressing heightened levels of concern about upside inflation risks.

Many market participants now assume that the Committee will tighten during each of the next four meetings, including the first meeting to be presided over by the new Chairman. The tone of market expectations—at least among traders as opposed to Street economists—has changed a bit. Earlier this summer the betting was about where the co-called “neutral” rate resides. The assumption was that the Committee would stop in that neighborhood. Now, with increased concern about inflation, the question of where neutrality resides is slowly being superseded by a new question: How far beyond “neutral” will policy need to go to dampen inflationary pressures?

The yield curve rose across maturities, as shown in the middle panel. The 2-year Treasury yield rose 40 basis points while the 10-year yield rose 30, apparently affected in part by MBS-related hedging flows. The 2-year yield is at its highest level since May 2001. The shape of the curve narrowed by 10 basis points and sits at a relatively narrow 17 basis points.

While the conversation in markets was about inflation, interestingly, break-even inflation rates from TIPS [Treasury inflation-protected securities] were little

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

changed, as seen in the bottom panel. The 2-year break-even inflation [BEI] rate had risen over the summer as energy prices rallied; but it plateaued and came off a bit as the price of oil headed back down. The 10-year BEI was little changed. This suggests that the rise in nominal yields was an increase in real rates and suggestive of tightened financial conditions. The sluggishness in equity markets until this past Friday was consistent with this view.

The behavior of break-even rates also calls into question some of the instant analysis surrounding Ben Bernanke's nomination last Monday. While some analysts were quick to attribute the rise in nominal yields last week to the nomination—on the basis of some perceived squishiness on inflation—the rise in real yields, which had already been in train, and the flatness of BEIs do not bear this out.

If there is some suggestion that financial conditions are tightening, the evidence elsewhere was mixed. Certainly, yields in other major economies have been moving higher since the end of the summer, as shown in the top panel of page 2. Long-term sovereign yields in the U.K., Canada, and Germany—the latter as a proxy for the euro area—have been rising recently. The rise of nearly 40 basis points in German yields has been particularly noteworthy and may reflect upgraded forecasts for European growth in general and improved sentiment toward Germany, notwithstanding a messy election outcome that leaves prospects for reform uncertain.

Even Japanese yields have been rising recently. Investors are increasingly contemplating that maybe, just maybe, after so many false starts, this time the recovery is for real. The better economic tempo and heightened probabilities that sometime in the next 12 months the CPI will no longer be preceded by a negative sign are leading more investors to take a defensive posture toward Japanese bonds.

Expectations about near-term policy in those same countries are broadly consistent with the movement in longer-dated yields. The middle panel graphs March 2006 futures prices for short-dated interest rates for the U.S., U.K., Canada and the euro area. Short sterling futures are flat—in itself noteworthy, given that the Bank of England most recently eased policy. The others are all moving upward to varying degrees. The middle right panel graphs the December 2006 euro-yen deposit futures contract, which has also risen as the market tries to anticipate the end of the Bank of Japan's [BOJ] quantitative easing policy, now expected by the market—and the BOJ, as reported in the monthly report yesterday—to be sometime in the fiscal year beginning on April 1.

If the developed world provides evidence that financial conditions are tightening, the same cannot be said for the emerging markets. The EMBI [Emerging Market Bond Index] spread was little changed and is at historically tight levels. Despite higher dollar rates, the central banks of Brazil and Mexico

have both been able to ease monetary policy—albeit from high levels—in recent days and weeks, as reflected in the bottom panels. Brazil and Colombia have managed to issue local-currency-denominated debt in the international market at attractive rates, as have some private borrowers in Asia. This decoupling from policy rates in the major economies stands in sharp contrast to previous cycles. And to emerging market bulls, it reflects a better policy mix, higher reserves, and a strong global economy.

As with emerging markets, the byword in domestic credit markets seemed to be “what, me worry?” Despite some high-profile bankruptcies in airlines, auto parts, and the surprise collapse of Refco, credit markets were not flustered and took the news in stride. As shown in the top panels on page 3, both investment-grade and high-yield spreads moved only slightly and remained at historically tight levels.

The bankruptcies of Delta and Northwest were dismissed, having been long expected. The Delphi bankruptcy was also broadly expected. And yet when it happened, protection for General Motors in the CDS [credit default swap] market temporarily shot higher, as shown in the middle panel. The prospect that GM might have to absorb billions of dollars of additional pension costs got traders’ attention. Ford Motor CDS rates were also affected. But the broader Dow Jones CDX high-yield index—comprised of 100 single names—was little changed.

One collapse that was not expected was that of Refco, whose fraud was made public the morning of October 10 and which filed for bankruptcy on October 17. Refco is a small corporate bond issuer but it does have linkages to firms across Wall Street. All in all, the stress emanating from Refco was limited. The rather busy graph at the bottom of page 3 depicts credit default swap rates for eight major financial firms since January. Note the temporary increase in the price of protection for these firms in the spring, when GM and Ford were downgraded and the so-called “correlation trades” began to go bad. In contrast, the Refco news did not even register a blip in CDS rates.

Overall, markets are posing something of a puzzle. The rise in real yields and the fall in equity prices for most of September and October suggest a tightening of financial conditions. There were both expected and unexpected bankruptcy filings. Yet both emerging markets and domestic credit markets were unfazed, and money continues to seek higher-yielding assets. Maybe it really is different this time. Then again, maybe the reaction will come with a lag that is longer than usual.

Mr. Chairman, there were no foreign operations in this period. I will need a vote to approve domestic operations.

CHAIRMAN GREENSPAN. Thank you. I notice that we still don't endeavor to calculate the implicit 2- or 5-year break-even inflation rates—subtracting out the implicit CPI forecast from what the futures markets are telling us about energy prices to get inferentially what the CPI ex food and energy would be if one presumes that the energy futures markets are arbitrated against the TIPS.

MR. KOS. I may be wrong, but didn't we do—

MR. REINHART. We have a cottage industry, Mr. Chairman.

CHAIRMAN GREENSPAN. I don't recall seeing any calculations recently.

MR. KOS. I think this question came up about a year ago, and Vincent was summarizing the work that had been done.

MR. REINHART. What we do is take the energy futures curve, take the weight in the CPI—

CHAIRMAN GREENSPAN. Yes, but I never saw the result.

MR. REINHART. Actually, Governor Ferguson saw something very similar just this week.

CHAIRMAN GREENSPAN. That still doesn't answer my question! [Laughter]

MR. REINHART. I guess the answer is that you do have a need to know, and you will!

[Laughter]

CHAIRMAN GREENSPAN. Well, can you just give me a hint as to what I'm going to learn?

MR. REINHART. In previous episodes, increases in spot oil prices had brought the spot rate well above the longer-ahead futures rate, which implied that market participants were expecting inflation compensation to be going down because of the anticipated decline in energy prices. Relative to those episodes, this time around the curve is relatively flat, so you don't have that. And it's a more permanent effect. It affects the very near-term part of the curve, but it's a relatively small weight in the total.

CHAIRMAN GREENSPAN. Okay. Thank you. On page 2 in the upper left-hand chart, I notice that the relationship among these sovereign debt yields, which we've been looking at for a long time, have gradually morphed from fairly low correlation to extremely high correlation.

Do we have any rolling correlation coefficients that suggest when that happened and the presumptive hypotheses as to why? Are we looking at the same issues that I inadvertently called a conundrum early this year? Or is this going back well before then?

MR. KOS. You know, I haven't looked at the rolling correlation coefficients recently. Certainly, there have been episodes, going back at least a decade, when these rates moved very, very closely; 1994 was a period—

CHAIRMAN GREENSPAN. For a while.

MR. KOS. Right. Then the correlation sort of breaks down and then it starts up again. I don't know if Karen knows more about a date, but over the past couple of years they have been moving pretty tightly.

MS. JOHNSON. I would say that has been the case since moving out of the recession—since early 2003 or something like that. We benchmark this correlation from time to time. I don't know that we've done it quite as a rolling correlation but we easily could, and we will.

CHAIRMAN GREENSPAN. You know, the rolling coefficient is a measure of the degree of globalization.

MS. JOHNSON. It is. It's also, though, indicative of the nature of the shocks that are perceived by market participants. So, to the extent those are idiosyncratic to individual countries, it tends to cause the correlation to fall apart. To the extent they are perceived to be global, those rates move together.

On top of that is the issue of whether or not portfolio holders are holding a sufficiently diverse portfolio that any adjustment they might make in response to a shock is going to be spread across markets, because they're going to rebalance and they're going to achieve the new risk-return mix that they're looking for. And there's some of that going on. That's, I think, what you mean by the term globalization—that portfolio holders, by the way they adjust their portfolios, do some of this. But it's certainly true that this comes and goes a bit, and we can look to see how the correlation coefficient has developed.

CHAIRMAN GREENSPAN. I've had the vague impression that it's been exceptionally tight over the most recent period, more so than I recall. This chart doesn't suggest spikes of any type, but it suggests just plain old-fashioned arbitrage.

On the Brazilian and Colombian issuances you referred to, I presume these were issued in their local currencies?

MR. KOS. Denominated in local currencies?

CHAIRMAN GREENSPAN. Yes.

MR. KOS. The Brazilian issue was denominated in *reals*, but actually the payments will be in dollars. It's indexed back to *reals*, so the exchange rate risk is wholly with the investor.

CHAIRMAN GREENSPAN. Why are they doing that? Why not just pay off in *reals*?

MR. KOS. Well, they are able to get a much more attractive rate. The spread that they're able to get—

CHAIRMAN GREENSPAN. Do you mean the principal is guaranteed in dollars?

MR. KOS. The principal is repaid in dollars.

CHAIRMAN GREENSPAN. You mean it's guaranteed in—

MR. KOS. No. The payment is in dollars.

CHAIRMAN GREENSPAN. Okay.

MR. KOS. But it's indexed to the exchange rate.

CHAIRMAN GREENSPAN. Wait a second.

MR. KOS. In other words, the flow of payments you receive is in dollars. When you get your money back, you will be paid dollars.

CHAIRMAN GREENSPAN. For the old Brady bonds the principal was guaranteed in dollars. That is not what this is.

MR. KOS. That's right.

CHAIRMAN GREENSPAN. Well, it's not clear to me why they are doing that. If you have a freely floating exchange rate—if I understand what you're telling me—the holder can just as easily get the payment in *reals* and convert it to dollars.

MR. KOS. For reasons that I can't fully explain, the spread that Brazil was able to get by doing it this way has been much tighter.

MS. JOHNSON. Well, I think these securities were targeted to international investors more. I find it a little puzzling why it works this way, but it was not the case that these were sold into the domestic market and happened to be bought by international folk and, therefore, isn't that a good sign. These were really targeted for foreign investors, denominated in the domestic currencies, so as to give them the Brazilian interest rate and the Colombian interest rate. It is thought that people who are searching for yield would want to add these sorts of securities to their portfolios, and they did.

CHAIRMAN GREENSPAN. But isn't the only difference that should exist the transaction cost of the conversion of the currency?

MR. REINHART. Mr. Chairman, there is also conversion risk. That is, a sovereign government at a later date could limit what its currency could be used for. Witness all the capital controls in the '50s and '60s.

CHAIRMAN GREENSPAN. Yes.

MR. REINHART. So, in principle, if you're guaranteed the payments in dollars, you know you'll get dollars rather than *reals* that perhaps couldn't be used for as many things later on.

CHAIRMAN GREENSPAN. You really begin to get a multiple exchange rate type of thing. So that would explain part of it. If that's the case, however, does the investor know which particular exchange rate he will be hit with? It doesn't strike me that that's a great defense.

MS. JOHNSON. No. You are basically taking on country risk and exchange rate risk when you buy these issues.

CHAIRMAN GREENSPAN. Is the Colombian issue the same?

MR. KOS. I'm not as familiar with the Colombian one. I don't remember the details of that.

MS. JOHNSON. I'm not sure either. In Colombia's case, given that there is to a certain extent a dollar component of their economy—

CHAIRMAN GREENSPAN. This is not the status of the Mexican peso issue of several years ago, which was just a pure local currency for the first time ever.

VICE CHAIRMAN GEITHNER. Actually, I believe Colombia's was pure local currency, domestic, at a 10-year maturity for the first time in a long time.

CHAIRMAN GREENSPAN. On the bottom of page 3, are these brokerage sector CDS? Is this the mix of their individual portfolios or their estimates of the total market?

MR. KOS. No, no. This is if you want to buy protection on, say, Lehman Brothers or Bear Stearns. This is the price of protection on these firms.

CHAIRMAN GREENSPAN. Oh, this is the actual credit default swap on Lehman Brothers or on—

MR. KOS. Yes, all eight of them.

CHAIRMAN GREENSPAN. This tells you a good deal about the individual firms. That's interesting.

VICE CHAIRMAN GEITHNER. There's a moral hazard in there, too, if you look at it.

[Laughter]

CHAIRMAN GREENSPAN. I'm going back in the private sector. I've got to know who's risky! [Laughter] That was off the record. [Laughter]

MR. KOS. This comes from a private-sector firm, so there's no inside information here.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN GEITHNER. Dino, did I hear you correctly? What is the probability of a move in March?

MR. KOS. The probability, based on fed funds futures, I think is pretty low right now. My point was more about the way that people in the markets are slowly coming to view the situation. In this cycle, they've been looking two to three meetings ahead. But the next few meetings are a bit different, obviously. I believe traders are thinking that the policy moves over the next couple of meetings are more or less baked in the cake. The new Chairman won't want to be in the position where he has to "stop" and confirm the dovish suspicions of some of the folks out there. So that gets you to the next four meetings, basically. But that fourth one I don't think is in the fed funds futures.

MR. REINHART. Mr. Vice Chairman, the expected funds rate in April, which is a fairly clean reading on the March meeting—is about 5 or 6 basis points above 4½ percent. So that puts a 25 percent probability of action there.

CHAIRMAN GREENSPAN. President Lacker.

MR. LACKER. Yes. I apologize for even asking this. I may have become color-blind this morning, but I can't tell which firms are which at the bottom of page 3. There are two tiers, right? Don't tell me all of them, but which ones are at the bottom?

MR. KOS. It's Citigroup and Bank of America.

MR. LACKER. Thanks.

CHAIRMAN GREENSPAN. Obviously, we've created a full array of insights, which has evoked no questions. [Laughter] We're going to run out of time.

MR. KOS. I do need a vote.

CHAIRMAN GREENSPAN. You do need a vote. Vice Chair.

VICE CHAIRMAN GEITHNER. So moved.

CHAIRMAN GREENSPAN. Without objection, the transactions of the Desk are approved.

We'll turn now to Mr. Stockton and Ms. Johnson.

MR. STOCKTON. Thank you, Mr. Chairman. Most people that I know really seem to dislike how early holiday decorations go up at the shopping malls these days. Not me. I'm a forward-looking kind of guy who likes to plan ahead. You folks are already on my mind, and I know what would make the perfect holiday gift for you this year: The answers to two questions. How much more will monetary policy need to be tightened to secure stable prices and maximum employment? And, how will you know when you have reached that point? Unfortunately, Nieman Marcus is not carrying that gift this year, so you will have to settle for the usual from me—another Greenbook forecast. Yes, I know that's about as exciting as a new pair of socks on Christmas morning. But on the assumption that it's the thought that counts, I'll offer my thoughts on those questions this morning.

Obviously, there is an explicit answer in the Greenbook to the question of how much farther tightening will need to proceed, and our answer is not much farther. We have assumed that the funds rate tops out at 4¼ percent by the end of the year—a figure only slightly below current market expectations that place the peak at a bit above 4½ percent. In setting that path, we needed to consider both the current momentum of the economy and the principal forces likely to be shaping the contours of aggregate demand over the next two years.

At the time of the September Greenbook, we had expected Hurricane Katrina to exert noticeable restraint on economic activity over the remainder of the second half. The anticipated drag reflected disruptions to production in the region, as well as the broader response of consumer spending to the steep run-up in retail energy prices that followed in the wake of the storm. But we saw this shock as hitting an economy that had retained considerable momentum over the summer months and did not think that it would be of sufficient dimension to derail the expansion.

Since then we have grappled with the effects of Hurricane Rita, which further slammed the energy-producing sector in the Gulf Coast and put added upward pressure most notably on the price of natural gas, and Hurricane Wilma, which caused disruption and property damage in Florida. Much as we had anticipated six weeks ago, we are now in a thick data fog that makes it difficult to separate the underlying trend in the economy from the influence of the storms. But we are feeling increasingly comfortable arguing that the data support our earlier view that the economy would retain its momentum this fall.

To begin, payroll employment fell in September, but that decline was not as large as we had expected, and the BLS [Bureau of Labor Statistics] noted that employment gains outside the areas affected by Katrina were on pace with those earlier in the year. Industrial production took a very large hit in September from the combined effects of the hurricanes and the Boeing strike, but absent those factors, factory output apparently would have picked up noticeably in that month. And reports from purchasing managers indicate that these gains are likely to continue in the period immediately ahead.

As you know, we received the BEA's [Bureau of Economic Analysis] advance estimate of third-quarter GDP last week after the Greenbook was completed. Real GDP is estimated to have increased 3.8 percent at an annual rate last quarter, about ½ percentage point above our forecast. At this point, we have found no major reasons to quarrel with the BEA and would probably revise up our forecast of the third quarter toward their estimate. We also didn't see much in that release that would cause us to revise our projected increase in real GDP of 3½ percent in the fourth quarter. In any event, taking all of this information together, we see the economy as having been at least as strong, if not a bit stronger, than we had anticipated in the September Greenbook.

We project activity to advance at a $3\frac{3}{4}$ percent pace in the first half of 2006, similar to that in the second half of this year. We are expecting that rebuilding efforts and government transfer payments will be providing a noticeable lift to activity during that period. But aside from those influences, broader macroeconomic forces are projected to slow the pace of activity as we move through 2006 and 2007. Tighter monetary policy, waning wealth effects—including a slowdown in house price appreciation—and diminishing fiscal stimulus all work to brake the current momentum in activity. Those effects are only partly offset by some support to disposable incomes and spending from a projected fall in energy prices. All told, the growth of real GDP is expected to be close to the pace of potential during the next two years—a bit above it in 2006 and a bit below it in 2007.

Viewed from a slightly different perspective, the gradual but steady tightening of monetary policy over the past year and a half has moved the real federal funds rate into the range of estimates of the equilibrium real rate. That assessment is not idiosyncratic to the Greenbook. The model-based estimates that we provide to you in the Bluebook are in the same ballpark.

These estimates of the equilibrium real rate remain a bit to the low side of historical norms, but that seems reasonable to us for two reasons. First, the investment share of output has recovered over the past several years, but it remains below trend. Second, and perhaps more importantly, the external sector continues to siphon off a noticeable portion of domestic demand. These influences persist in our projection, suggesting to us that real rates will need to be a little lower than usual over the next two years. Of course, it is worth remembering that a 70 percent confidence interval around the estimates of the equilibrium real rate is 2 percentage points wide—so there is plenty of scope for reasonable women and men to come to different views on this issue. That is especially so because the estimates of r^* do not indicate the level of rates necessary to produce any specific desired rate of inflation.

Those wide confidence intervals suggest that the answer to the second question, how will you know when an appropriate stopping point has been reached, will be far from obvious. After all, under our baseline projection, real GDP will be growing at a $3\frac{3}{4}$ percent rate in the first half of next year—faster than potential. To be sure, as I noted earlier, we will attribute that to rebuilding effects, but it will be hard to have much conviction about our ability to estimate the size of those effects. Moreover, on our forecast, core PCE [personal consumption expenditures] inflation will be edging up early next year to a pace just shy of $2\frac{1}{2}$ percent.

The difficulty is that the case for stopping soon is predicated on developments that remain forecasts rather than facts. For example, any diminishment of the impetus to household spending from rising wealth will depend importantly on the course of house prices. We are projecting house prices to decelerate from this

year's 10 percent increase to 4 percent in 2006 and 2½ percent in 2007. We seem to be hearing with greater frequency anecdotes of some cooling in housing markets, but that certainly is not yet evident in the data.

Fiscal policy also is an important element in the projected slowing of economic activity over the next two years. After hurricane-related spending tails off over the first half of next year, we are expecting real federal purchases to be about flat over the remainder of the projection period. We have been encouraged by the heightened concern being expressed by many on Capitol Hill about the deteriorating fiscal picture and the need for greater spending discipline. Indeed, our assumed \$85 billion hurricane-relief package that appeared so modest compared with the figures being bandied about at the time of the last meeting is looking pretty good right now. But whether that translates into more durable discipline is obviously open to question. So the bottom line is that, as we move into next year, you are likely to have data in hand that continue to suggest solid expansion, but a forecast of some noticeable slowing by the second half of next year and into 2007.

Confronted with this situation, one could approach the staff projection in a manner similar to that with which President Reagan approached the Soviet Union—trust, but verify. In other words, continue to tighten until the data show more convincingly the effects of policy restraint. Along those lines, we included in the Greenbook a simulation that laid out the consequences of steadily raising the funds rate to 5 percent by the meeting in May 2006. This additional tightening drops the growth of real GDP to just a bit above 2¼ percent late next year and into 2007; and with growth below that of potential, the unemployment rate rises to about 5½ percent by the end of the projection period. Core PCE inflation edges down to 1¾ percent that year, and further disinflation would be in train beyond the forecast horizon. Depending on your policy preferences, this outcome might not even be characterized as an “overshooting” but rather simply establishing more firmly a core inflation rate comfortably below 2 percent.

Of course, there are considerable risks surrounding the baseline projection, and some of those risks would be amplified by a more aggressive tightening of policy. One obvious concern is that at some point the tightening of policy could trigger a more pronounced retrenchment in spending and activity.

In that regard, there are a few straws in the wind worthy of your attention, most of which are centered in the household sector. Motor vehicle sales have dropped off sharply since July, and consumer spending excluding motor vehicles slowed noticeably over the same period and is estimated to have actually declined in September. So we are heading into the fourth quarter on a weak note. The softening of spending has also coincided with a steep drop in consumer sentiment. And all of this has occurred in advance of households receiving some very hefty heating bills this winter.

Should these developments portend a more sustained weakening in consumer spending, there could be consequences for business sentiment as well; business attitudes never seemed to shift convincingly from caution to exuberance in this expansion, and the continued solid gains in capital spending that underpin our forecast might not materialize if the strength and durability of the economic expansion were called into question.

I should stress that this is not how we are reading the recent data. The slump in motor vehicle sales looks to us like a payback for the extraordinary spike that occurred this summer; the drop in other consumer spending in September most likely reflected the disruptions associated with hurricanes; and declines in consumer sentiment, like the stock market, have predicted many more recessions than have actually occurred over the years. We don't yet see the signs of cyclical contraction. But then again, if truth be told, we rarely do much in advance.

Of course, we see some prominent risks on the other side of our baseline projection, and some of those risks would be moderated by a more aggressive tightening of policy. One risk is that we are underestimating the underlying strength of the expansion, and that left unattended this momentum will carry the economy beyond its potential. Certainly, last week's stronger-than-expected estimate of third-quarter real GDP provides some support to this concern. With margins of slack in both product and labor markets already slim and with pressures on business costs intense, an overshooting could result in a further deterioration in the inflation picture. Our view that the aggregate supply curve is relatively flat implies the deterioration in inflation would probably be small, but it also implies that wringing out the added inflation would be costly. Furthermore, any tendency for inflation expectations to come unmoored would simply compound the costs of moving inflation back into a more comfortable zone.

While I acknowledge these concerns, I don't, in fact, believe that the risks to our inflation projection are skewed to the upside. As you know from reading the Greenbook, we are expecting that the further run-up in energy prices in recent months will pass through into core inflation early next year and that the higher headline inflation that we have experienced this year and last will result in some modest increase in inflation expectations that feed back into the growth of labor costs.

However, to date, indications of a noticeable deterioration in inflation expectations are largely limited to the very recent step-up in the Michigan Survey measures, which occurred in the wake of the spike in gasoline prices in September. And last week's news on labor costs was a touch to the low side of our expectations and certainly provided few hints of any sizable acceleration. If inflation expectations remain firmly anchored, then there may be little to no increase in core price inflation next year. So, in sum, I am confident that we will be wrong, but I don't know in which direction.

You know, the only drawback to shopping early is that you have longer to second-guess your choices. After working on these remarks over the past few days, I have begun to wonder whether 19 pairs of socks would not have been the more considerate gift. [Laughter]

Karen will continue our remarks.

MS. JOHNSON. The staff forecast for real GDP growth and inflation abroad is little changed this time from the forecast in the September Greenbook. This is the case despite additional hurricanes, volatile energy prices, and a notable rise in long-term interest rates in several foreign industrial countries during the intermeeting period. The futures path for WTI [West Texas intermediate] crude oil prices retraced somewhat in October. Accordingly, we have incorporated into this forecast global oil prices through 2007 that are about \$2 per barrel lower than in the previous forecast. Nevertheless, the outlook for global crude oil prices remains elevated at about \$60 per barrel for WTI and is more than \$8 above the level six months ago.

Clearly, factors related to crude oil supply have contributed at times to upward pressure on global crude oil prices. In addition to disruptions as a result of the hurricanes, there are market concerns about the change in leadership in Saudi Arabia, politics in Iran, Venezuela, and Russia, and reduced production as a result of violence in Iraq. However, the trend increase since 2003 in not only spot prices but also in far futures prices occurred despite expansion of global oil production, evidence that underlying global demand for crude oil is also importantly responsible for the price pressures. This persistent, strong, underlying demand for energy reflects fundamental robustness in global economic activity—perhaps more than has been generally recognized. As a consequence, we have observed during this year further moves up in energy prices and in prices for nonfuel primary commodities along with average real growth abroad that has remained moderately strong, although a bit below the rapid pace of 2004.

As in September, we are calling for real GDP abroad on average to expand at about 3 percent in the current quarter, following growth at that pace in the third quarter, and to accelerate a bit in 2006 and 2007. This favorable picture incorporates a return to steady expansion in Japan and solid, albeit slightly moderating, growth in the emerging Asian region. In addition, real growth in Mexico should recover from a disappointing outcome during the first half of this year.

Our judgment that the pace of foreign economic activity remains firm is reflected in a range of positive indicators in Canada, including employment, industrial production, monthly GDP, a rebound in manufacturing orders in August, and a high pace of housing starts. Japan's Tankan business conditions index moved up again in September, with projections of capital spending this year and forecasts of sales and profits all revised up. Indicators for the euro area are

mixed, but in Germany industrial orders have come in strong and the October Ifo measure of business climate jumped to a five-year peak. Among the emerging-market economies, Chinese industrial production accelerated through September, and retail sales growth remained above 12 percent. Korean real GDP growth rose to 7.5 percent in the third quarter, and Brazil continues to enjoy very strong export sales.

The mix of sustained global growth and upward shifts in commodity prices, particularly crude oil prices, naturally heightens concerns about higher consumer price inflation. Headline inflation rates abroad have moved up significantly with the rise in crude oil prices. Our outlook, however, is for these prices to decelerate over the forecast period given our projection (and that of the futures markets) that crude oil prices will be about flat next year and edge down in 2007 and given that the effects of previous increases in crude prices on inflation will wane and then end. Such an outcome depends upon an absence of significant second-round effects of oil prices on domestic prices and wages abroad. To date, core inflation in the major foreign countries confirms this is the case.

The combination of continued growth and contained inflation pressures sounds optimistic. Rest assured, we have found numerous risks about which to worry. The elevated energy prices could sap consumer demand more than we expect, undermining the pace of real growth. In the face of higher costs, business spending on new capital could falter, particularly in emerging Asia where few countries have petroleum production sectors. Wage demands could react to the increase in headline inflation and threaten to ignite a set of second- and third-round effects. We do not see evidence of these developments at this time, but it is too soon to conclude that the danger of such actions has passed.

A second feature of the international forecast that merits a few minutes is the approximately neutral contribution of real net exports to U.S. real GDP growth in the third quarter, following a positive contribution in the second quarter. The third-quarter NIPA [national income and product accounts] data released last Friday imply a slightly smaller, less positive, contribution than we had incorporated in the Greenbook baseline forecast or in the September forecast. However, in the current quarter, compared with the September forecast, we are assuming a greater rebound in exports and have reduced our assessment of the extent to which the external sector will provide a drag on GDP growth. Accordingly, we expect that on a four-quarter change basis, the external sector will record a slightly positive contribution to U.S. real GDP growth for the year—the first annual positive contribution since 1995. However, we are not ready to declare that external adjustment has arrived, and we expect a return to a small drag on U.S. growth from the external sector in the current quarter and on balance over the forecast period.

On a quarterly basis, both imports and exports are highly variable. Seasonally adjusted real oil imports impart notable quarter-to-quarter variance to real

imports. But recently we have experienced weakness in other components of real imports. During this intermeeting period, imports again surprised us on the downside, with August data for nominal imports much weaker than expected. This negative surprise included both goods and services, and within goods, it was particularly the case for imports of consumer goods and industrial supplies. For the near-term forecast we have included some effects as a result of the hurricanes and the disruption to general trade they caused. As a result, there is some implicit payback in the forecast for real imports in the fourth quarter. Nevertheless, compared with the September Greenbook, we have lowered the growth of real imports in 2006 and 2007 in response to the somewhat softer outlook for U.S. activity and to a higher path for import prices.

Growth of third-quarter real exports was also revised down, although not by enough to offset weaker imports. Hurricane effects also figure in our estimate for third-quarter exports. More significant has been the recent strike at Boeing. We judge that the strike had a more pronounced impact on September's exports than we previously thought, leading us to weaken real exports for last quarter. But the rapid conclusion of that strike also led us to strengthen real exports for the current quarter. For 2006 and 2007, we expect export growth will average a bit above 5 percent per year, consistent with our outlook for steady real output growth abroad.

In sum, actual trade data through August, our estimates of how the turbulent weather of recent months has affected exports and imports, and our projections of global primary commodity prices, particularly crude oil, combine to imply unusual quarter-to-quarter fluctuations in growth of real exports and real imports. Some of these developments have surprised us since the September Greenbook. Going forward, however, we expect that the transitory weather effects will fade by early 2006. We look for real exports and imports to expand at similar rates on balance in 2006 and 2007. With imports substantially greater than exports, this outcome implies a negative contribution from the external sector of about $\frac{1}{3}$ percentage point each year.

David and I will be happy to take your questions.

CHAIRMAN GREENSPAN. Are any commentators looking at the movement of the real trade deficit and raising the issue of J-curve possibilities?

MS. JOHNSON. Well, that's always present for a time.

CHAIRMAN GREENSPAN. I've seen almost none of it. That's all.

MS. JOHNSON. But for example, our J-curve effects last for two or three quarters after the exchange rate changes. People look for this in particular when the dollar is coming down, and the

dollar decline ended last December, roughly. So I would say there is presently very little J-curve in the pipeline. There may be a little bit from the dollar's rise, but the dollar hasn't risen so very much.

CHAIRMAN GREENSPAN. But this downturn is somewhat unusual.

MS. JOHNSON. In nominal imports, but it's sort of going the wrong way. You might say it's the effect of six months of slight dollar depreciation; it could be. But oddly, import prices have been higher than anybody was expecting. So pieces just don't fit for the J-curve. And I think the effect of the dollar depreciation that occurred through the end of 2004 has largely gone away.

CHAIRMAN GREENSPAN. It is the import price data which really undercut it.

MS. JOHNSON. Yes.

CHAIRMAN GREENSPAN. President Lacker.

MR. LACKER. Dave, I would like to ask a little more about the Greenbook baseline. First, tell me more by way of characterizing the path of inflation expectations. And second, characterize the forces and the relative weights that bring core inflation down in the second half for next year.

MR. STOCKTON. Certainly. Basically, embedded in this forecast is some implicit deterioration in inflation expectations or underlying inflation momentum on the order of about $\frac{1}{2}$ percentage point from the end of 2003 into 2006. We think we need some of that to explain the pickup in actual core inflation that we've had, which has been a deterioration of about a percentage point. Some of that follows from the fact that higher headline inflation probably has fed back a bit into inflation expectations, so we think there has been some slight deterioration there on net. With energy prices flattening out and then turning down, we have some very low headline inflation numbers coming soon; that will start to appear around the turn of the year. So we think some of the pickup that has occurred is likely to unwind, first, as the indirect effects of the higher energy prices—which we think will still be a small plus early next year—start to wash out by later next

year. As headline inflation comes down, that will reduce somewhat underlying inflation momentum, and we have inflation expectations moving back down into 2006. It's a pretty small move. The deceleration we're projecting in 2007 from 2¼ percent to 2 percent reflects mostly the indirect effects of energy prices and some slowdown in import prices. But we would think that that inflation expectations process, which we have built into this forecast and which is relatively minor, would begin to unwind later in the forecast period.

MR. LACKER. How much of the acceleration that you describe in inflation expectations occurs from here out? You talked about a certain amount from '03 to now.

MR. STOCKTON. A couple of tenths. One of the reasons for raising this issue is that it remains a matter of considerable uncertainty on our part. And I think a good case could be made that we haven't really seen much sign yet of any underlying inflation being built into the labor cost side especially. That's still just a part of our forecast. The pickup we're projecting in compensation costs is, in part, a feed-through of higher headline inflation. It's also, in part, a feed-through of better productivity finding its way eventually into real wages. But we haven't really seen it yet. So I think a case could be made that even the small amount that we have built in could be overdoing it. And that's one of the reasons we wanted an alternative simulation in the Greenbook in which we showed you what would happen if we're wrong about that.

Obviously, on the other side, it's hard to know whether or not your actions and your statements perhaps have been the key factors keeping overall inflation expectations relatively well contained. Your actions and communications about policy intentions may have, in essence, conditioned both the wage- and price-setting environment in which workers and firms currently find themselves.

On the other side of our forecast, if you were to stop tightening soon and communicate that basically the inflation situation wasn't a problem, there is some risk that observers would interpret that to mean you would be more likely to acquiesce to higher inflation going forward. And that could feed through to expectations. So we also showed a simulation in which things deteriorate more noticeably on our funds rate assumption than we built into the baseline.

As I said, I feel that we've balanced the risks. As I looked ahead and asked myself if no change in inflation expectations going forward would be a balanced forecast—meaning, “is it just as likely that they'll be going down as going up over the next year?”—I didn't think that scenario, in fact, had balanced risks. So we felt comfortable building in a little more upside on the thought that that would probably better balance the risks given the inflation pressures that are currently confronting firms and workers.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. David, I had a question for you about the forecast that activity is going to slow in the second half of '06 and '07. You talked about the reasons for the slowdown, which were tighter monetary policy, a slowing in house price appreciation, and diminishing fiscal stimulus. In the Monday morning briefing, you threw in the stock market as well—waning impetus from household wealth in terms of both the stock market and the housing components. I thought the Greenbook had an assumption of 6 percent growth in the stock market per year. I wonder if you could talk about that.

MR. STOCKTON. It does, indeed. In essence, what is going on with the stock market is that we've had a net stimulus in the economy this year coming from the run-up in the stock market that occurred last year; so there are lagged effects of that earlier increase on spending. Going forward it

goes from a net stimulus to more of a neutral effect because we've made basically a neutral assumption about the stock market going forward.

That contrasts with the housing market, where we think we're getting a lot of net stimulus right now. But in our forecast of a slowdown to 4 percent, that moves toward neutrality, and then the 2 percent rise in house prices that we're forecasting for 2007 actually would impose a little bit of restraint on overall spending at that point.

MR. MOSKOW. So when you look at those two factors, which is more important?

MR. STOCKTON. This is probably putting far too fine a point on it, but they're both about equal in the forecast in terms of their overall effects—in terms of the underlying thrust or the underlying restraint that is being put on growth going forward.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. I'd like to renew a plea that I've made a couple of times over the years. I think everybody in this room believes that a vigorously competitive international sector is good for growth and, therefore, I bristle when you talk about that in terms of a drag on growth and a negative contribution to GDP. You're talking about an arithmetic way of adding up the GDP account. But what's happening is that vigorous growth in demand is being partially met from abroad, and that's not necessarily bad for growth. So I bristle when I hear it put this way because some of this ends up filtering into our public discourse. And even though we may understand that we're talking about the arithmetic statement of the GDP account, it seems misleading. So I want to mention that.

MS. JOHNSON. I take your point.

MR. POOLE. Secondly, and this goes in part to the question President Moskow asked, we have somewhat of a mixed situation in terms of the forecast. When I first came in 1998, there was a staff forecast of the stock market. In fact, I remember that at the time the stock market was forecast

to go down, and many aspects of the Greenbook forecast were predicated on a decline in the stock market. Of course, eventually the stock market did go down, but it didn't go down in 1998 or 1999.

Now we have, I think, an appropriate standard type of assumption here. The stock market is forecast on a sort of equilibrium basis, and we're not independently trying to have a stock market forecast. We do the same thing on oil prices. But we don't do that on some other important parts of the forecast, such as exchange rates and the federal funds rate.

To me, the most useful baseline forecast would be to put together the Greenbook on a consistent set of assumptions on those kinds of things. Then I'd value the staff input as to where they believe the federal funds rate, the exchange rate, and everything else will likely come out differently from the expectation in the market. But to me we have a somewhat muddled situation in terms of the internal consistency here. Dave Stockton and I have talked about this several times over the years, but maybe there could be a survey of the Committee on what we would find most useful as the assumptions for things like exchange rates, the stock market, oil prices—all of those things where there are market forecasts available. What would be the most useful to the Committee in terms of the baseline assumption for the Greenbook?

MS. JOHNSON. I'm sure Vincent would be prepared to organize a survey and would respect the Committee's wishes.

MR. POOLE. I don't know whether I'm the only one who would find that useful. But at any rate, I offer that proposal.

MS. JOHNSON. Let me make one point, if I may. We have wrestled with the notion of what constitutes a neutral assumption about the exchange rate, and it is not obvious because we know that the forward rates implied by interest rate differentials are very, very poor forecasters. Everybody knows that. So, taking that as an assumption and giving it weight—and having it run through the

forecast—does not seem attractive to us. But the alternative is an approach that is kind of “consistent with the other pieces of the forecast and neutral.” It’s a tough call. We have clung to something that is close to, but not exactly, the random walk version of things for a while now. We certainly don’t see our exchange rate forecast as having a determining effect such that we’re driving the forecast by making this assumption. We try not to do that.

MR. POOLE. But I think you could set up whatever standard you believe would be most useful and stick to it consistently over time and then explain how your views may differ from the standard assumption that you use. That’s more or less what you do with a number of things. And I emphasize the stock market as a very important example because of the influence of wealth on consumption.

MR. STOCKTON. On the house price front, obviously, there aren’t market signals. But we’ve confronted the very same problem of trying to forecast an asset price that we don’t have enormous confidence in. So the approach that we have taken is that we presented a few models at the special briefing last July—some models that rely more on the momentum in underlying house prices and other models that take seriously some sort of error correction to a rent-price ratio to bring that ratio back into equilibrium. And our forecast is a mix of those various approaches.

I guess I’d plead guilty in the sense that our house price forecast, along with our rent forecast, does imply by the end of the projection horizon a little of what we view as the current over-valuation diminishing. But mostly that forecast is fairly neutral in that our assessment of over-valuation pretty much involves prices holding at that higher level going forward. It gets a little worse in the near term and then gets a little better a bit further out. But it is an element of the forecast that obviously is important and about which there is considerable uncertainty.

CHAIRMAN GREENSPAN. President Fisher.

MR. FISHER. Karen, I didn't bristle, but my ears pricked up when you mentioned Mexico. This is not a major point, but well before the hurricanes we noticed a disconnect between the standard presumed correlation of, say, 90 percent—Mexican GDP to U.S. industrial production. Something has weakened in Mexico. We're analyzing it. It could be the onset of the sexennial event, the presidential election. But, for example, our El Paso folks report that with the Delphi announcement some 60,000 Mexican maquiladora workers have been affected. And your comments on Mexican economic growth or your assumptions seem to be somewhat different than what we're hearing anecdotally and what we're finding in our research in Dallas. I just wanted to point that out and offer our input. If we can be of assistance there, we'd be glad to do so.

MS. JOHNSON. Okay. We appreciate that. I recognize that the outcome in Mexico during the first half of this year certainly raises questions, because Mexico has not enjoyed the level of production that would have been consistent with previous relationships to U.S. GDP. So whether or not Mexico will, in fact, strengthen is certainly a risk in the forecast.

CHAIRMAN GREENSPAN. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. I'd like to talk a little bit to the point Bill made, especially if we're going to do a survey of Committee members. I like the way we're getting the forecast now. The staff has a view of forces of aggregate demand, potential supply, and inflation pressures, and they take that view and fold in some course of Federal Reserve policy that will produce an outcome that we see in the Greenbook. And in some cases, for some types of prices, they think they can't do any better than the market so they just put in the market forecast. Other prices, like bond yields, etc., are endogenous; stock prices are endogenous to the process.

If we ask the staff to put together a forecast that had their view of demand and supply and inflation pressures, together with market prices—which may be built on a different view of supply

and demand and market prices—I'm not sure what we'd get in the end. We'd get an outcome that could look very strange from time to time when their view and the market's view differ. And then we would want to know what we would have to do in order to produce something that looked more sensible.

Right now, we have your fed funds forecast in there. If we went the other way, I would ask for another forecast that incorporated how the staff thought market prices would evolve. There's no perfect way of doing this. But I'm a little more comfortable with the way it is done now than I would be in the other case.

MR. POOLE. If I could respond very quickly, something is going to look very strange one way or the other when the views are very different. And what can look strange now is a course of long-term interest rates that is not what's in the market. So something is going to look strange one way or the other. The question is: What is the best way to convey the staff's view about where the world is going? What is the clearest way and what is most useful for the Committee?

CHAIRMAN GREENSPAN. President Lacker.

MR. LACKER. Yes. On this point, what President Poole is suggesting is well posed. It's a forecast conditioned on replicating sort of an arbitrage-free set of observable financial asset prices going forward. I don't want it, though, because I want a mixture of the information that is conveyed by the market and the staff's judgment. I want a combination of that. The approach you suggest is a useful exercise to ponder. But as long as the staff is clear about how their assumptions differ from those embodied in market prices, I'd rather see a combination, personally.

CHAIRMAN GREENSPAN. David, have you learned anything more in the last 24 hours on the issue of the miss on producers' durable equipment?

MR. STOCKTON. We haven't learned any more. We are not inclined to discount that figure. We saw nothing in the details to suggest that that would be appropriate. It looks to us like a translation miss between the BEA's more detailed construction of the figures out of the orders and shipments figures and some deflation issues. I think at this point we probably would be closer to 3.6 than to 3.8. Karen's people think they would be inclined to be just a little lower than the BEA's current estimate, and we would as well. We learned a bit about deflation on the residential side that would suggest we'd probably be a little lower than the BEA. But all of that is small potatoes. The basic story is that it still looks to us to have been stronger than we were expecting and probably suggests a little more underlying strength than was implicit in our forecast for the second half of the year.

CHAIRMAN GREENSPAN. All right. Are there any further questions for our colleagues? If not, would somebody like to start? President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. The Seventh District economy expanded at a somewhat better pace since the last meeting, though it is still lagging the rest of the country. However, for the Chicago economy, particularly the South Side [laughter], it was the best October in 88 years! President Fisher and I had a side wager, but I'll let him fill you in on the details of that.

MR. FISHER. I lost.

MR. MOSKOW. In our contact calls for this round, energy prices were a pervasive concern. So far they've had a limited effect on consumer spending, but our contacts worry that high heating bills will take a bigger bite out of sales in the coming months. In contrast, we're seeing the impact on costs right now. Nearly every contact reported pressures from higher energy prices. There are many examples, but here's one that seemed a bit more surprising than others. A large specialty retailer noted that the wholesale cost of furniture had increased due to higher prices for polyfoam,

which is a petroleum derivative. He said that in 30 years in the furniture business, this is the first time that the stuffing cost more than the fabric or the frame. [Laughter]

Labor markets are also starting to generate cost pressures. For example, both Manpower and Kelly report signs of tighter labor markets. These contacts say that many firms, after having been very cautious about hiring, now feel they have pushed productivity growth as far as it can go and, accordingly, finally feel they need to hire more permanent employees, particularly in office jobs. Our contacts see this as a further sign that firms are more confident about demand. One of the staffing services firms said that they are paying higher wages and also spending more on recruiting and retention bonuses. And several of our directors report that they're budgeting larger salary increases for 2006, in the range of one-half to a full percentage point higher than this year.

The consensus among our contacts was that only a portion of these higher costs has been passed through to prices, at least so far. Several reported that labor costs are mostly eating into margins, which is what we've been expecting. But more price increases may be coming. A home goods retailer noted that they had set their current list prices last spring. When they decide how to price their products for next year, they'll take into account the fuel cost outlook at that time.

There has been no let-up in the auto industry's woes. Our contacts say that higher oil prices seem to have frozen consumers, and showroom traffic is down. There have been some interesting developments with regard to labor costs in the auto industry. GM's recent renegotiation of its health care liabilities, if ratified, would be the UAW's [United Auto Workers] first major mid-contract give-back in history. Ford and DaimlerChrysler will be demanding similar concessions. Indeed, it might be that the Delphi bankruptcy has helped the industry at least get the ball rolling on some meaningful restructuring of labor contracts. However, these are very contentious issues, and there's

a clear possibility of a strike at Delphi that could seriously disrupt the auto industry, particularly General Motors.

For the national outlook, the last six weeks of data have confirmed that the dislocations from Katrina and Rita have had a limited impact on aggregate economic activity. Outside the areas affected by the hurricanes, labor markets are improving at a pace similar to earlier in the year. And I'm getting favorable impressions of business sentiment from my contacts, which is a good sign for hiring and capital spending. However, there is a risk that the recent sluggishness in consumer expenditures and low levels of confidence may be foreshadowing a period of somewhat softer growth in consumption. Households have further run down savings to maintain spending in the face of higher energy prices, and it's very difficult to gauge how this might influence consumption going forward.

With regard to inflation, the readings on core prices in the last quarter were good. Given all that I've heard in recent weeks, though, it seems likely that past increases in energy and material costs will soon begin to show through more clearly in prices downstream, as is forecast in the Greenbook. Furthermore, labor markets have tightened. As I noted, many of my business contacts are planning for larger increases in wages and benefits next year. They can only absorb these higher costs in margins for so long. Finally, there's a chance that increases in costs and prices will result in a meaningful rise in longer-run inflation expectations, which would be a risk to the longer-run Greenbook forecast.

All of these risks add up to increasing the funds rate by 25 basis points again today. Looking ahead, I think we should continue tightening. At least we are comfortably in the middle of a neutral range, and there's a possibility we're going to have to go further. There's a good deal of uncertainty about how to quantify the equilibrium funds rate and the degree of policy accommodation. The

Bluebook suggests that a 4 percent nominal funds rate might be the midpoint of the range, but I'm personally skeptical that the rate is that low. This is going to be an important issue for us to consider going forward. I'm glad that we at least started the discussion earlier today, and I hope we'll continue it later in the meeting.

CHAIRMAN GREENSPAN. President Fisher.

MR. FISHER. Mr. Chairman, growth in the Eleventh District, if anything, has been accelerating in recent months—picking up steam. We appear to be the beneficiary of the natural disasters that have taken place on the Gulf Coast, and that continued, incidentally, through Wilma. A small example is that the grapefruit growers have definitely benefited from the destruction of grapefruit crops in Florida, which was nearly total. If I were to paraphrase Yogi Berra, who said the future isn't what it used to be, I think I would be on the mark because we're now much more confident.

One of the most articulate, smartest, and at the same time conservative, bankers in our District, Dick Evans of Cullen/Frost, says that building contacts are reporting the busiest business activity in 30 or 40 years in our state. At the very front end, which is site work for land development, one of his clients, an engineer, reported that in his entire business career he's never been busier. So we are proceeding on all pistons, and we're beginning to see it reflected particularly in real estate prices. The market has gone from a buyer's market to a seller's market almost overnight. In the Gulf area of Padre Island, for example, record prices are now suddenly appearing overnight.

So in summary, the bankers and the business community in the Eleventh District, as I reported at the last session, are still frisky, Mr. Chairman. Indeed, their tails are wagging at an accelerated pace and I hope—to paraphrase another “Berra-ism,” which is that history isn't what it used to be—

that history doesn't repeat itself here. But we certainly have a much more enthusiastic business community.

I want to turn now to a broader perspective, based on our calls to headquarters of companies that operate throughout the nation as well as in our District. At the last FOMC meeting, Mr. Chairman, you mentioned gasoline prices having a very visible impact as one of the few commodities that consumers look at for price comparisons. In talking to our retailers, that is clearly the case. In sharing with President Poole our contacts with Wal-Mart, I talked to the new CEO of U.S. Wal-Mart yesterday, and he noted that while October same-store sales were up 4.2 percent, the consumption pattern had shifted. Because of gasoline prices, people are making fewer trips to the stores but they're buying larger amounts.

And we have a leading indicator ourselves in Harvey Rosenblum, who is the wine connoisseur amongst our research leaders in Dallas. I've noticed that he, since he lives in a dry district of Dallas—we still have prohibition in parts of Texas—is making less frequent trips to the wine store but is buying in greater volume. Perhaps that's because of the questions we're asking him! [Laughter]

Wal-Mart, 7-Eleven, and Dollar General all report that heavier items transported by truck—dog food and bottled water are just two examples—are under tremendous price pressure due to rising fuel costs. And these higher prices are being passed on, although sometimes offset by consumers substituting private label items for brand name products. American Airlines is passing on their fuel costs. They managed to raise their average fare 8 percent in the third quarter. Once again we hear them talking about \$25 attachments to confirmation fees for standby passengers. Hovnanian and Centex, two of the largest builders, report rising costs of locally sourced materials delivered by truck, adding to price pressures of labor and materials for roofing, siding, and windows. We're seeing fuel prices affect also the transportation costs that are charged and passed

on by the express companies. UPS reports—and I don't think this is public information—that they're targeting rate increases, pre-fuel charge, of 4 percent to be set in early November, knowing that the U.S. Postal Service will be pricing in an increase of 5 percent plus at the beginning of the new year.

There are some potential mitigating factors here. 7-Eleven, Exxon, Wal-Mart's Sam's Club stores, and other gas retailers report that the margin they are retaining on their gas sales—and 53 percent of 7-Eleven's revenue comes from gasoline sales now—is still running 30 cents versus 13 to 14 cents normally. They expect to hold these margins as long as they can, or at least until volatility is dampened; but as gas prices ease, this could possibly be a cushion that will provide some relief for retailers. And the correlation is quite direct. At 7-Eleven, for example, they can walk you through, week by week, the effect on sales of each downward movement in the price of gasoline. Three weeks ago they had an increase in sales volume of 2 percent; two weeks ago, 4 percent; and this last week, 6 percent. So we may have a little bit of relief coming from the reduction of margins that might occur as the margins go from 30 to 13 to 14 cents.

It's still clear from our discussions with business operators that price pressures are building. A rising percentage of companies are experiencing price increases for what they sell as well as for what they buy, along the lines that President Moskow mentioned. We see it particularly in chemicals, as he mentioned. Caustic soda, formerly priced at \$450 a dry ton, is now \$800 a dry ton. Polyethylene, formerly priced at 38 cents a pound, is now priced at 55 cents a pound. I hope this is expunged later, but Exxon's CEO told me that they will take every measure they can to pass through, and I quote, "sizable increases" on that front in every place that they can. Perhaps the best indicator of what's happening in the chemical industry is Pioneer Core Alkaline Company, which was filing for bankruptcy and is now "printing money," according to their CEO. Wal-Mart expects

to pass along price increases for all resin-based products, such as garden chairs and outdoor tables, in the spring. The rails appear to be planning, according to BNSF's CEO, a price increase of 5 to 6 percent before fuel surcharges next year.

And of interest in all of our discussions is that we're hearing what President Moskow is hearing, which is that there are pressures on the wage front. To be sure, they are mitigated by Delphi, Northwest Airlines, and also GM. But the numbers we're hearing from the rails, from the Belo Corporation, a large broadcaster, and others on labor prices are negotiation targets of about 3 percent, with a heavy focus on health care running in the 9 to 10 percent range.

I think probably the best summary, Mr. Chairman, came from the CEO of Wal-Mart U.S. He said that "previously we were deflating and we can still offset a little bit through China, although to a lesser degree than before." He said "we will early-discount like all retailers, moving our discount season, largely in terms of announcements, up to November 1. But at best we hope to 'hold the line' on prices." That's a direct quote.

So I feel that the heightened inflationary pressures that we talked about last time are lurking. Against that background, I favor further tightening to contain inflationary impulses and expectations. I have some comments on the statement, but we can speak about that later. The bottom line is that one can sense, even though we don't see it in the data, inflation pressures creeping up like little cat's feet. Thank you.

CHAIRMAN GREENSPAN. President Yellen.

MS. YELLEN. Thank you, Mr. Chairman. At our last meeting I was optimistic that we would avoid a brush with stagflation despite the higher energy prices and the setback in production from Katrina. Developments during the intermediate period have generally reinforced my

optimistic view. Although considerable uncertainty still clouds the outlook, I regard reports on both real economic activity and inflation to be generally encouraging.

On the real side, it now appears more likely that the disruptions caused by the hurricanes will be transitory. Oil and wholesale gasoline prices, for example, have fallen below their August levels before Katrina. Furthermore, rebuilding has been gathering steam quickly, and spending outside of the Gulf region remains robust. In the Greenbook, the effect of this encouraging news about the underlying vigor of the economy has been held in check by the assumption of tighter financial conditions, so the path for GDP is little revised.

With respect to the prospects for inflation, I remain more optimistic than the baseline Greenbook projection. David suggested in his remarks that it was possible to make a case for inflation doing better than the Greenbook projection, and I will pursue that case now. Certainly, the latest data have been favorable. Over the six months ending in September, the core CPI increased only 1.3 percent at an annual rate, while the core PCE price index was up 1.5 percent. These data raise the question: Where is the energy price pass-through? PCE energy prices have been rising at double digit rates for more than a year, but they have left remarkably little imprint on core inflation.

At our last meeting, I described some econometric evidence showing that since the early 1980s, changes in real oil prices have not had an appreciable effect on core inflation. Today I thought I would cite some reports from our business contacts that appear to be generally in line with this result. They do note that there has been some success in passing energy cost increases down the supply chain but, given competitive pressures and the lack of pricing power, they tell us that the buck usually stops before the consumer.

I thought I would give you an example inspired by the season. A large pumpkin grower/processor [laughter] near Portland has seen a 20 percent jump in the price of plastic packaging

materials. She reports that she can pass these costs on to the small retailers she serves, but they are not able to charge consumers more for retail pumpkin products. So this Thanksgiving you need not worry about paying more for your pumpkin pies. Obviously, forecasting beyond that is hazardous, but looking out toward Christmas, I thought I would note that one of the country's largest growers of poinsettias is on our Advisory Council, and he is highly confident that there will be little pass-through of energy costs into retail poinsettia prices. [Laughter]

Also in contrast to the Greenbook, I see no significant pressure for higher inflation coming from increased inflation expectations. In particular, despite the surge in energy costs this year, current estimates of inflation compensation, both over the next five years and the subsequent five-year period, remain at the same average level that prevailed during the first half of this year. A further sign that inflation expectations remain well contained can be found in the continued subdued growth of wages and salaries. Last Friday's reading on the ECI [Employment Cost Index] I thought revealed no evidence of any pass-through of higher headline inflation or higher inflation expectations to labor compensation. So I see no indication of the '70s style wage-price spiral in the offing.

Overall, I judge our credibility to be very much intact. Of course, our credibility going forward does depend on continued vigilance. The economy now appears to be close to full employment, with a good deal of momentum. And annual core inflation, at least as judged by the core PCE measure, remains near the upper end of my comfort zone and, arguably, inflation risks are tilted somewhat to the upside. So with respect to policy, I support at a minimum the removal of any remaining policy accommodation. The Bluebook shows that the funds rate has finally entered a broad zone of plausible neutral rates, but under the circumstances, I personally would be more

comfortable with a policy position toward the center of this zone. So a few more increases, including one today, seem to me likely to be required.

In implementing monetary policy, it seems to me that actions matter, but so do words, and I wanted to briefly open up the question of the statement. I think for today the words of alternative B should suffice, but Vincent has repeatedly suggested, and a number of you have emphasized, that we need to consider how to modify the statement language. Several elements of this statement have expiration dates that are quickly approaching. So I think it's an important issue for us to discuss.

As we go forward, I see three problems with using the kind of language that is in alternative B. First, it refers to policy accommodation, which will arguably soon be exhausted. Second, it refers to a "measured pace," when at some point presumably we will reach a stopping point in this tightening cycle. And, third, it now contains a near-tautological balance of risk statement that I think serves no obvious policy purpose. Of course, these three problems could be fixed at different meetings. For example, if the inflation picture sours, the "measured pace" language could continue to be used well past the elimination of the policy accommodation phrase. As Governor Gramlich feared, the balance of risk statements could outlive us all! [Laughter]

Still, trying to fix all of these three problems at once has some appeal, and I thought that alternative C did just that. It eliminates the balance of risk statement and the policy accommodation language; and it substitutes a new forward-looking policy statement for the "measured pace" phrasing. My main criticism of alternative C is that it jettisons any mention of the conditionality of our actions on future data, and I believe such conditionality is always worth highlighting and particularly deserving of emphasis now, toward the end of our tightening cycle.

I believe that a good model for future statements would have three sections: a policy decision, a descriptive rationale, and a bit of forward-looking policy guidance. The policy guidance should

be nuanced—tailored to prevailing circumstances and explicitly conditional—and it should not include a formulaic balance of risk statement. Let me give a concrete example based on alternative C. If the Committee believes, for example, that further tightening remains necessary once policy is no longer accommodative, it could state, following the rationale section, that “under these conditions the Committee perceives that further policy firming is likely to be necessary,” or “will be necessary,” or “might be necessary.” “Nonetheless, the Committee will respond to any changes in economic prospects to fulfill its obligation to maintain price stability and foster sustainable growth.”

Once the Committee feels that further tightening is not necessary, it could state that “under these conditions the Committee perceives that the current stance of monetary policy will likely remain appropriate going forward. Nonetheless, the Committee will respond to any changes in economic prospects, and so forth, to fulfill its obligations.” In any case, I hope that this proposal might be useful in jump-starting our discussion of these issues.

CHAIRMAN GREENSPAN. President Lacker.

MR. LACKER. Thank you, Mr. Chairman. Recent data confirm that economic activity was growing at a solid pace pre-Katrina, and we appear to have remained on track since then, at least on an ex-hurricane basis. The direct effects of the storms appear to be limited to the disruption of productive capacity along the Gulf Coast. Outside of the affected regions, real activity continues to expand, as suggested by the September industrial production report and the third-quarter GDP figures.

In our District, there are few signs that this year’s hurricanes have directly affected real economic activity. In fact, we’ve seen a broad pickup in activity since August. Our October manufacturing survey indicates that shipments, orders, and employment grew at or above the previous month’s pace. Services firms also reported strengthening revenue growth in both

September and October, and retail sales increased moderately in both months, as broad sales increases outweighed a drop in auto and light truck sales.

Concerns about the macroeconomic effects of these hurricanes obviously center on the significant bulge in energy prices. The continued growth in nominal consumer spending ex-autos since Katrina is evidence that the effects of energy price increases have not yet dampened household demand, and there seems to be little indication of a hurricane-induced downshift in investment demand either. So the evidence is consistent with my hypothesis that the hurricanes are essentially a supply disruption with little independent effect on demand, and thus, the real interest rate path should be, if anything, higher than it otherwise would be.

A second concern regarding the macroeconomic effects of the hurricanes is the potential for energy prices to pass through to core inflation. Here the recent news on core prices has been encouraging. Core PCE inflation came in at 1.3 percent for the third quarter and has averaged 1.5 percent since March, right where I think we would like it to be. One would expect most of the pass-through to take a couple of months to materialize, however, and in that regard there are several unsettling signs worth noting. Within the Fifth District, for example, our surveys show a surge in prices paid for both manufacturing and services over the last two months. Moreover, the average reported rate of increase in prices received in both surveys has accelerated significantly in September and October.

Consistent with these quantitative signals, a larger number of our contacts now say they're able to pass through part or all of their increasing costs to their customers. In addition, the average rate of price increase our respondents see for six months ahead has also surged, and our index for expected wage increases in manufacturing has skyrocketed to over 56 for October. This diffusion index has a midpoint of zero, and it had been averaging below 30 recently. So a reading of 56 is

consistent with the anticipation of a fairly broad-based upswing in inflation, although obviously it could just be a false alarm.

Another unsettling sign is the recent behavior of TIPS inflation compensation measures. These have drifted up a couple of tenths since June and are now bouncing around in the neighborhood of 2.6. So I think we were right to downgrade inflation expectations from “well contained” to merely “contained” in our last statement, and I think we should view a further erosion of inflation expectations as unwelcome.

The extent to which energy price increases pass through to core inflation is fundamentally determined by the public’s expectations regarding future monetary policy. My sense is that we have just a brief window to head off such pass-through should it threaten. The Greenbook does foresee significant pass-through, with the core PCE inflation rising to 2.4 percent in the first half of next year and then gradually falling back down to under 2 percent. Inflation expectations appear to trace out a similar hump-shaped path. In the face of this outcome, the Greenbook has us raising the funds rate to 4¼ percent in December and then stopping there for a year, at least ¼ point short of where markets expect us to go.

I would question the plausibility of this joint outcome. First, I do not think we would or should stand by while inflation prospects erode as noticeably as they do in the Greenbook. Nor do I think we could count on inflation expectations to gently drift back down after surging as the Greenbook expects—at least not without forceful action on our part.

For today, I’m comfortable with the alternative B statement. But should more definite signs of pass-through emerge in coming months, we should be prepared to communicate forcefully and convincingly our intention not to accommodate a deterioration in core inflation of the magnitude portrayed in the Greenbook.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. Economic conditions in New England have bounced around a little bit over the last year or so. Right now they show a few signs of flattening out. Surveys of both consumer and business confidence show some current strength, but opinions about activity six months from now either remain at a low level in the case of consumers or, for businesses, turned negative for the first time in the last five years.

Worries about fuel and benefits costs, interest rate increases, and the war in Iraq are most often mentioned by contacts as shaping a less-than-rosy outlook. And when you talk to them about big profit margins, they look at you with a puzzled expression, wondering what business you are talking about because that's certainly not the case for their business. I think there's some difference of opinion when looking at your own numbers versus the numbers in the aggregate.

Anyway, for the present, most firms do report profits, with those serving the defense industry making notable headway. Consumers are spending, if not on cars then on housing, though at least according to one survey they perceive rising pressures on their personal finances. And core inflation in the Boston area is surprisingly low relative to the nation. It's usually higher. Thus, there's a sense in which the region may be experiencing a period of calm before a possible storm of negative trends.

Employment in the region dropped in September, and the unemployment rate rose. The employment decline was widespread by state and involved, in part, the usual suspects of trade and manufacturing, but about half reflected government workers in Maine. September government employment can move around a lot, depending on the hiring of teachers for kindergarten through 12th grade. So it's probably wise to take this drop in jobs with a grain of salt. Many of our contacts

report that skilled labor is hard to find and expensive. There are continuing references to caution in hiring and a desire not to add a single new employee until it's necessary to do so.

Both businesses and consumers are concerned about the impact of high heating oil, natural gas, and gasoline prices. Local heating oil companies that have provided lock-in rates for the winter in the past will not do so now, likely feeding into concerns. Despite many fervent prayers for the opposite, the winter is expected to be a bad one. And that forecast was underlined by the early snowfalls in northern New England a couple weeks ago and by the flurries in Massachusetts over the weekend. Certainly this is good in terms of prospects for skiing revenues, but not so good for general optimism, given concerns about energy.

Finally, let me say a word about residential real estate markets. The Boston area is often mentioned as having bubble-like characteristics. This is an obvious concern, given the problems the region experienced with falling prices and related banking failures in the early '90s. However, there's good reason to assume that recent rising prices in New England reflect a lack of supply and an older, wealthier population capable of supporting both a primary and a secondary residence, rather than a fundamentally unstable situation. And some of the froth is fading. Home prices continue to escalate but are currently increasing at about the same pace as in the nation as a whole rather than leading it. Four out of the eight other regions of the country are now experiencing more rapid escalation.

Contacts in the real estate industry report two trends. First, there was a rather abrupt softening in the high-end suburban markets this summer, with escalating supply and the advent of a buyer's market—something not seen in several years. The other trend is an increase in the supply of multifamily units, particularly condominiums, and a marked upturn in condo inventory. Thus, most contacts think real estate markets appear to be returning to a more reasonable place gradually, with

much of the change at the high end. This could feed into some concerns about spending in the future and could certainly make people feel less wealthy. But given where it seems to be centered, it doesn't appear likely to do a lot of near-term damage.

Turning to the national scene, incoming data appear to confirm the underlying strength of the U.S. economy. Separating out the impact of several hurricanes is not easy. Readings on unemployment and business spending net of hurricane effects seem consistent with the continuation of solid growth through the remainder of 2005. The strength of consumer outlays remains a question, given the now 2-month downturn in confidence and the fact that the outsized motor vehicle purchases that had supported such outlays in the third quarter are falling off their highs. However, labor market data seem consistent with continued strength in hiring. One would suppose that, at least in the near term, working consumers will be spending consumers, especially if confidence improves in the face of waning energy prices—or at least prices for gasoline. Finally, I take the continued strength in housing as a sign that, under it all, consumers still have the confidence to make rather long-term investments.

Our forecast in Boston for the next year and into '07 differs little from the Greenbook's. Assuming energy prices subside, or at a minimum that we don't have any new shocks, growth should pick up in the spring, as the impact of the energy tax on consumers eases and as rebuilding in hurricane-ravaged areas accelerates. Over the same 6-month or so period through the winter into spring, low inventory levels are likely to be replenished, feeding factory activity. Growth outside the United States is, on balance, expected to be positive as well. Employment growth should return to its pre-Katrina monthly pace, and the remaining slack in the U.S. economy should wane. The post-Katrina "throw money at it" attitude in Washington seems to have moderated, but a fiscal stimulus of some size appears likely. Our best guess on inflation mirrors the Greenbook's as well:

The worrisome headline numbers on both the CPI and the PCE moderate; the feed-through to core inflation ticks up but then moderates through the year; and this process pulls in on the upward trajectory of near-term inflation expectations.

There are obvious risks here. Energy-based headline inflation could feed more strongly into the core, and inflation expectations could remain elevated. We could see the moderate trends in wage and salary growth, as measured by the ECI, begin to take off. However, I'm hopeful, along the same lines that President Yellen is, that inflation expectations will moderate, as gasoline prices have, and that we won't see even as big a feed-through to the ECI data as the Greenbook projects. However, if a big rise in wages were to occur, it would set red lights flashing on everybody's economic dashboard.

If we are lucky, our rather benign forecast for the next year will work out. If we're not, we could be looking at both rising inflation and falling growth, as one of the alternative scenarios highlights. In that regard, we need to pay careful attention to incoming data on expectations, compensation, and core inflation. If they're blinking yellow or green, we may be on track. If red predominates, the risks have clearly escalated.

It certainly seems clear that managing such risks in the near term involves placing a premium on remaining credible regarding inflation. Doing so should moderate price growth by tightening financial conditions and should result in better pricing of risk. It should also convince consumers that inflation will not continue to exacerbate the growing strain on their pocketbooks. It should moderate inflation expectations and limit the feed-through into wage and salary growth.

But we also need to take care not to overdo. There are downside risks. With a small amount of additional tightening in the mix, the Greenbook sees growth at below potential in late '06, a widening output gap in '07, and a tick up in unemployment. One key cause of this is a general

slowing in real estate markets and a decline in relative household wealth. The related expected rise in personal saving may be just what the doctor ordered to start the process of reining in the excesses in the U.S. economy, but I think we do need to take care about dispensing excessive amounts of inflation medicine.

In my view, we're not at a tipping point as yet. Our process of measured steps toward removing the remaining accommodation should continue for a time, taking us closer to the middle of the range of equilibrium rates. But we should also begin to consider when we might have moved enough and how we might prepare markets for that. In that regard, I was interested in the proposal that President Yellen had for an evolution in our statement. I think it's going to take some time to absorb what she has recommended. Maybe this meeting is not the meeting to make a change. I'm probably comfortable with alternative B. A couple of meetings ago, the Chairman suggested that I take on the task—because I was opening my mouth at the time—of putting some proposals on the table, and I've been dragging my heels. I'm more than happy to work with President Yellen on the direction she's trying to take the statement. Thank you.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. Let me first share some thoughts on recent economic developments in our Southeast region. As you would expect, we've continued to assess the regional and national implications of Hurricane Katrina, and now Hurricanes Rita and Wilma, which have added to our woes.

The recent employment statistics serve as a real-time barometer of the hit our region has taken. Across the states involved, through September our District has lost approximately 300,000 jobs from the storms. Ironically, businesses in the affected areas trying to restart their operations are, in many cases, desperate to hire workers. On a trip from the New Orleans Airport into

downtown New Orleans, one sees help wanted signs on every corner. The inability to get evacuees from the area back into local housing has clearly slowed the process of business recovery. In fact, if one thing related to the storms now stands out, it's the lingering uncertainty on several fronts and what now looks to us to be a longer rebuilding and recovery period.

Indications are that it could well be several more months before oil and gas production and processing return to near normal. The latest reports from our contacts indicate that almost 7 percent of U.S. daily oil production and 9½ percent of U.S. natural gas production remain shut in. The assessment of damage and the repairs to pipeline and production facilities in the Gulf continue to be hampered by equipment and labor shortages. Louisiana refineries are slowly coming back on line, but by current estimates up to 6 percent of total U.S. refining capacity will remain off line until at least early next year. And U.S. refineries are reportedly now operating at only about 80 percent of capacity. The situation with respect to natural gas is even less clear than for refined products, and there remains widespread concern that potential shortages over the winter could keep natural gas prices elevated for a while.

At the time of our last meeting, I expressed concern about the impact of the storms on shipping and port facilities. It now appears that activity is slowly returning to the Port of New Orleans, constrained by labor availability and access to land transportation. By and large, ships that were inbound to New Orleans were diverted to other ports, so there wasn't as much disruption to the nation's imports as there was to those exports that depended upon the Mississippi River and Louisiana ports.

At the last meeting I also indicated that while we expected a significant regional hit to output, that would quickly be replaced by spending on cleanup and rebuilding. This is generally happening, but the large-scale reconstruction is now not expected to get under way until the first quarter of next

year when insurance assessments have been completed and comprehensive plans are put in place. Commercial contractors note that there was a strong backlog of work prior to the hurricanes; and this, coupled with labor shortages, will constrain the pace of rebuilding at least for a while.

At the national level, I agree with the Greenbook's assessment that despite our heartaches along the Gulf Coast, the national economy seems to have remained relatively strong. And this was reinforced by last Friday's initial reading of third-quarter real GDP.

I view the economy as continuing on a path of about trend. However, I continue to wonder how the consumer will respond to higher energy prices. So far, the impact hasn't been great, but there may be some important substitution effects when the consumer is faced with substantially higher heating costs during the winter on top of still-elevated gasoline prices. Spending may not decline, but more household funds may be allocated to energy and less to other goods and services, and this could cause second-round effects in terms of cutbacks in production and investment. In addition, we do know that auto sales dropped early in the fourth quarter, due in part to energy concerns but also due to a retreat from employee pricing.

I've gotten some recent and interesting anecdotal information that is consistent with my concern about consumption and consumer substitution effects. Last week I chatted with a major wholesale supplier of groceries who has seen a significant recent pickup in business. He noted that core wholesale grocery sales are notoriously steady and boring, and he attributed the measurable pickup in recent weeks to the fact that more people were likely eating in and, hence, were buying more groceries. Similarly, an Atlanta director who is president of a major building materials and consumer products firm noted that his away-from-home product sales—staples like paper towels and toilet tissue sold to restaurants—were slowing and that retail home product sales were up. He interpreted that as consistent with the stay-at-home sentiment expressed by the grocery wholesaler.

This same director, however, also commented on how serious the price pressures were due to energy and freight costs. His company experienced a substantial earnings decline in the third quarter, as he wasn't able to pass on all of his cost increases to his customers. Taken together, recent data and these kinds of anecdotes suggest to me that downside risks to consumer spending still remain elevated.

This brings me to the inflation risk, which is my major concern. As already noted by a number of people, we experienced a significant increase in both headline CPI and PPI inflation last month, which was expected. This was largely due to energy and, in my view, is likely to be temporary. At the same time, the core measures remained relatively stable, but the anecdotes about growing price pressures and actual or intended price increases seem to be at odds with this continuing, going forward. I note, too, like others, that the Greenbook has built in more of a pass-through of energy and other price increases into core inflation next year.

There are some possible explanations that we've all given at one time or another for this seeming disconnect, including the fact that the economy is relatively more energy-efficient and that we are evolving into a more service-oriented economy so that energy is a much less direct component of consumption. And perhaps most importantly, there's the fact that intense competition is limiting the ability to pass input price increases through to customers—for instance, the difficulty I noted earlier that the consumer products firm was having in passing on energy costs. A large athletic apparel manufacturer in our District, the Russell Corporation, attributed a large share of their third-quarter earnings decline to higher costs for poly-cotton blends that could not be passed on, very specifically because of intense foreign competition.

But these questions about pricing power are not, in my view, reasons to be complacent about the inflation outlook. The real funds rate is still low, there is substantial monetary accommodation

in the system, and significant fiscal spending associated with hurricane-related rebuilding has yet to come on stream.

My concern is that deviating from our path of gradually removing policy accommodation at this time could signal that we are less concerned about inflation and, therefore, cause some deterioration in inflation expectations. It is this threat that I think we need to guard against. I view the cost of ratcheting down inflation expectations, should they get out of hand, as being great. So I'd argue that we need to continue on our current path, at least for a while longer, including raising our fed funds target rate by 25 basis points today.

As several of us have said today and in previous recent meetings, deciding what to say following today's meeting may be more difficult than deciding what to do. Realizing that our discussion of the statement often gets truncated, I also want to put down a brief marker. Given my concern about keeping inflation expectations in check, I would prefer a statement that is somewhere between Bluebook alternatives B and C. I'm concerned that "C" is too strong, but I am particularly uncomfortable with the balance of risk characterization in option B. President Yellen has just offered some attractive statement language for us to consider, and I think it's terribly important that we make time at this meeting or at some other meeting in the near future to begin to talk about that seriously. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Santomero.

MR. SANTOMERO. Thank you, Mr. Chairman. The Third District's economy continues to expand, with growth moderating toward its potential pace. After accelerating in the second quarter, employment growth in the region decelerated in the third quarter back toward its first-quarter pace. But unemployment rates remained steady for the three-state region and remained lower than the national average.

Consumer spending for general merchandise has held steady. There is some anecdotal evidence that consumers are limiting discretionary spending due to higher energy costs. And there is some concern among retailers that fourth-quarter sales may come in below plan because of subdued consumer sentiment and higher winter heating bills.

Construction continues to be a strong sector for our regional economy. Housing construction and sales remain strong in the District, and nonresidential construction has been on an improving trend since the beginning of the year—with the usual month-to-month volatility.

Regional manufacturing activity accelerated in October. The index of general activity in our manufacturing survey rebounded sharply from 2.2 in September to 17.3 in October. The other forward-looking indices in the survey, including those for new orders and shipments, also showed a nice bounce, as did the index of future activity. Perhaps the improvement in expectations should have been expected, since our September survey was taken in the early days after the Katrina event. Indeed, in response to special questions, half of our firms reported that they had experienced some change in demand or problems related to the Gulf Coast hurricanes. The changes in demand, some positive and some negative, were generally slight. Problems relating to obtaining energy and other materials, as well as transportation problems, were characterized as being somewhat more significant. Despite these problems, our firms did experience an increase in activity last month.

Again, the most troubling aspect of our latest survey is the significant increase in price indices. The prices paid index rose sharply in October for the second consecutive month and is at its highest level since 1980. The prices received index also jumped last month, suggesting that some of the higher-priced inputs are being passed on to consumers. The core PCE and core CPI share a correlation with our prices received index of about 0.6. While most of this correlation is driven by

the high-inflation period of the late 1970s and early 1980s, I think these early indications of possible pass-through bear watching.

In my view, the national economy seems to be evolving along the lines we had expected at our last meeting. The economy appears to have weathered the hurricane in reasonably good shape. And, abstracting from those hurricane effects, the economy has retained a good bit of positive momentum. Of course, uncertainty remains about the magnitude of the hurricane effects, so there's a wider band of uncertainty around the economic outlook than there was pre-hurricane. On the negative side, higher winter heating bills could result in significantly slower consumer demand. But on the positive side, next year's rebuilding activity could result in a bigger boost to activity than expected. The growth risks seem to be balanced, and these hurricane effects are most likely to be temporary.

The bigger risk, in my view, is on the inflation side. Core inflation remains contained at this point, and empirical studies suggest energy price pass-through to the core has typically been small. Where we've gotten into trouble during the earlier energy price shocks is when we've let inflation expectations get away from us. Indeed, the only departure between headline inflation and core CPI inflation as large as the current one occurred during past energy price shocks. In those cases, accommodative monetary policy resulted in rapid increases in core inflation.

We cannot allow inflation expectations to become unanchored, and I don't believe we will. As the energy infrastructure is rebuilt and energy markets stabilize, much of the run-up in headline inflation should reverse itself, as many people have suggested. This will help keep inflation and inflation expectations contained. We've already seen a decline in crude oil and gasoline prices. The latter is particularly welcome, as it could buoy consumer sentiment as we head toward the buying season.

Nonetheless, in my view, inflation pressures remain elevated. So the prudent course of action today is to continue to gradually move rates up nearer to the range of the equilibrium real rate. As we near that range, our language is going to have to evolve, as a number of us have indicated. I don't think today is the day for a major change in language, but I would welcome the discussion that many have suggested we need to have. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, thank you. My views on the national outlook remain pretty much unchanged from the last meeting. I think growth will be somewhat slower in the second half of this year and then stronger next year due to the reconstruction activity. The rise in energy prices will have a dampening effect on growth to some degree. Nonetheless, the resilience that the U.S. economy has so far experienced following the hurricanes suggests that real GDP will grow at above trend, at least over the near-term forecast period. Several other factors are consistent with that: Financial conditions remain supportive; fiscal policy is stimulative; and as I've noted and many have already mentioned here today, there is a momentum in the economy.

Evidence from the Tenth District is consistent with this outlook. District manufacturing activity continues to expand at a solid pace, and capital spending plans at District factories have rebounded, after dipping slightly following the hurricanes. As a further sign of solid business confidence, hiring announcements for District businesses have exceeded layoff announcements by a wide margin since the last meeting.

On the negative side, though, higher energy prices have eroded consumer confidence in our region as well as nationally, leading to somewhat slower consumer spending. For example, retailers contacted in the first half of October reported sales were generally unchanged from a year ago, a marked change from the summer when many stores were reporting solid year-over-year growth in

sales. Homes in some parts of our District have been taking a little longer to sell, causing some builders to lower their prices or at least increase the incentives around the sales efforts.

Turning to inflation, let me talk a little bit about evidence from our District, because we are seeing further inflationary pressures. Wage pressures, while still modest, are beginning to show through. Manufacturers are reporting sharply higher costs for natural gas and petroleum-based raw materials. Some of our manufacturers are also reporting increased costs of building materials, such as steel and lumber, as a result of the reconstruction effort elsewhere. But adding to this, District manufacturers are finding it somewhat easier, as others have noted, to pass their higher costs on to customers. For example, in the special question we asked this month, 30 percent of the firms said that their pricing power had increased over the last three months, but only 14 percent said their pricing power had decreased. Retailers have also been showing somewhat greater determination to raise prices to cover their higher costs, although the retail price increases have been mostly modest so far.

With this said, I want to tell Dave that I think today's report on the Greenbook and the discussion have been very, very helpful. It's beginning to redirect the discussion from one of a clear position of removing accommodation to a discussion of the correct range for the fed funds rate and where it should fall if we are to maintain stable prices and sustainable growth.

Obviously, I share with others here the view that inflation is currently the main concern. Energy is an obvious pressure, there is strong momentum in much of the economy, and there are some signs of changing inflationary expectations. I think this is something we have to be alert to. But since our policy actions today have their final effects months in the future, I think it's also important that we begin to address inflation and whether the rise is transitory because of the energy effect, or whether we are, in fact, seeing some inflationary pressures that will become embedded

going forward. If it is transitory, then the question is, I think legitimately, where should we stop? What is the right range? Is it near where we are now or should it go higher?

For now, my own views are that we should be moving the funds rate somewhat higher, as others have suggested, and that this perhaps would be a reasonable place to stop. What exactly is the appropriate area, I think, should be a continued focus of this Committee's discussions in the meetings ahead. I would also share the sentiment that we need to carefully rethink the FOMC statement coming out of these meetings. I think it is becoming badly out of date and, as a result, may lose credibility. So now is the time to start a serious discussion about changing it. I welcome Janet's comments and others here today. Thank you.

CHAIRMAN GREENSPAN. President Pianalto.

MS. PIANALTO. Thank you, Mr. Chairman. The worst position for a central banker to be in is depicted in the Greenbook's stagflation scenario. I don't think we're headed there, but just knowing that it has a nontrivial probability is somewhat disturbing. And indeed, I've started to get questions from business people in the Fourth District on whether I'm concerned about stagflation.

With that possibility in mind, I'd like to speak first about the real economy and then make a few comments about inflation. During this intermeeting period, I've had a number of conversations with directors, obviously, but we've also held several economic forums and business advisory council meetings. From these conversations, I've concluded that the business conditions in the Fourth District are mixed.

First, I'll comment on the positive news. Steel producers report that sales in most product lines are doing very well. Commercial construction activity in the District picked up recently, albeit from a relatively low level. Trucking and shipping firms continue to report that business is brisk and that they're having a difficult time finding qualified drivers. Many firms report that they are

planning to step up their capital spending next year, and investments—in foreign operations especially—continue unabated.

Now for the not-so-positive news. The problems in the automobile industry appear to be deepening, as signified by the Delphi bankruptcy filing. Ford, GM, and a host of their suppliers are concentrated in my District, and their restructuring activities are almost certainly going to be a drag on regional growth for a while. In fact, there appear to be a lot of mergers, acquisitions, and restructurings taking place in the manufacturing sector, as was pointed out by President Moskow.

Certainly, the companies that rely heavily on natural gas and petrochemical feedstocks are facing severe margin pressures. One of my directors from a large multinational chemical company reports that the U.S. coatings industry is becoming globally uncompetitive due to the price and availability of natural gas in the United States.

Moreover, as others have mentioned, many business leaders are quite anxious about the impact of home heating bills in the coming months on consumer spending. Some retailers are being especially cautious about their inventories, and companies further down the supply chain tell me that they can quickly pull back capital spending projects if the need arises.

Although the comments that I've been hearing about the real economy vary a lot by industry, I hear a much more consistent commentary when it comes to the pricing environment. Everyone I've spoken with is worried about the effects of higher energy prices and pricing psychology more generally. It's a fact that energy and other input costs have been rising. Some of these costs are now being passed through successfully, and I'm concerned that the climate has become more receptive to pass-through than at any time in recent memory.

One of my directors reported that she has been trying unsuccessfully to raise prices to a particular customer for the past several years. Two weeks ago that customer called her to say that

he knew she was going to have to raise prices in this environment and he was just hoping to get a heads-up on how much those price increases would be and when they would come. What that customer had previously regarded as unacceptable was now acknowledged as inevitable. An executive of a software company that specializes in solutions to steel companies told me that he is increasing his prices because his customers are finally making plenty of money, so they're now willing to accept his price increases. To paraphrase him and others: "Now that the train is leaving the station, you'd better get on with as much luggage as you can carry." [Laughter]

Shortages of some raw materials are also likely to add price pressures in coming months. Several people reported that their suppliers are invoking force majeure clauses in contracts. Their suppliers are facing shortages of some raw materials, preventing them from meeting their contract obligations. These people tell me that they've not encountered such circumstances in 30 years of doing business, and they are concerned about where prices are headed.

I've not been as alarmed about inflationary pressures as my business contacts because core measures have been very favorable. And I expect the headline numbers to improve next year. But I can't refrain from noting something about the policy environment that's implied by the Greenbook baseline projection. An awkward feature of that projection is the trajectory of the headline and core inflation measures in 2006. After telling the public that they should ignore headline numbers and pay attention instead to core inflation statistics, this Committee would be holding the fed funds rate steady during a year in which labor costs and core price measures are expected to accelerate from their current pace. This might indeed be the correct policy, but it might appear to the public that we are tolerating a rise in core inflation. Such a situation could pose some additional communication challenges for us next year. So, like others, I know it's time for us to start focusing on how we

communicate these issues. But for today, I believe the appropriate action for us is to continue to remove our policy accommodation. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. Changes in District economic conditions have been small recently and seemingly largely offset each other. So the economy overall continues on a positive path.

Housing activity, especially the pace of sales, has been slowing recently, although to some extent that is seasonal. But I think it's fair to say that overall some of the vigor in housing is in the process of diminishing. In contrast, commercial real estate development has been picking up modestly and in a number of locations throughout the District, and developers seem more optimistic than they have for some time. Manufacturing activity is continuing to advance. The mining and energy industries are operating at high levels of capacity, as you would expect. And employment is increasing, except at Northwest Airlines.

I don't think the underlying fundamentals of inflation have changed recently, but there are a few more reports in the District of the ability to pass through cost increases—more reports than I had been hearing formerly. Also, at a meeting of our Advisory Council on Small Business and Labor, there were more reports of products on allocation than I had expected to hear. While there are ready substitutes for some of these products, for others, like concrete, that's not quite the case. And that will be, without question, constraining activity relative to what otherwise would have occurred.

As far as the national economy is concerned, I don't have any material disagreement with the Greenbook assessment of the outlook although, if left to my own devices, I might write down a little more real growth in the next several quarters. My sense is that the economy has a good deal of

positive momentum to it, as others have observed, and spending associated with recovery from Hurricane Katrina will add to that. I am also encouraged on balance by the modest reports on core measures of inflation for the last couple of quarters. So, overall, both the current state of the economy and its prospects look favorable to me. Core inflation may tick up a bit, as depicted in the Greenbook, but I would expect that to be temporary. And as far as the risks of stagflation are concerned, while I certainly wouldn't dismiss that as a possibility—and I would acknowledge that the episode in the mid- and late-1970s initially, as I recall, snuck up on policymakers—it's hard for me to develop a stagflation scenario without serious monetary policy errors. And that's in our power to avoid.

Against that background, I would favor another $\frac{1}{4}$ percentage point increase in the funds rate at this meeting. I would also endorse the comments of President Yellen about the need to review and make some significant changes to the statement accompanying our decision. And I think there may be some urgency to that. One way of viewing that, at least as I've been thinking about it, is that if we continue on the path we're on, we'll be looking at a nominal federal funds rate of $4\frac{1}{2}$ percent before long and a real rate north of 2 percent. At that point, are we still going to be willing to talk about removing policy accommodation? Will we be willing to do it at $4\frac{1}{4}$? Today we'll be at 4 percent, so I don't think the time is far off when we're going to have to confront these issues.

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Thank you, Mr. Chairman. Let me say at the outset—to try to put some organizing structure into my anecdotal reports—that the reports on activity are almost uniformly on the strong side. And I think the reports on inflation are almost uniformly on the upside rather than the downside. There is somewhat of an asymmetry to the reports I hear.

Let me talk about Wal-Mart first. Before the hurricanes, let's say in early August, Wal-Mart was anticipating growth in same-store sales of about 5 percent year-over-year. So they would have expected October to come in about 5 percent above October of last year. Once they saw the hurricanes and had other information, including the big spike in energy prices—of course, they believe that energy prices have a major impact on the income available to the people who shop at Wal-Mart—they were expecting October to come in at about 1 percent. In fact, October same-store sales rose by about 4 percent, excluding gasoline. So sales were much stronger than they would have anticipated, given the information that they had. Moreover, they saw a pickup in demand for higher price point items. In various discretionary categories, such as televisions, for example, more of the higher-priced goods were being sold.

I have a contact with a large West Coast software company, and that company is disappointed in the large enterprise segment of its business but is seeing surprising strength in the consumer sector, including a shift in the consumer sector toward more expensive equipment. The example cited was that in the back-to-school market for the high school and college segments, there were more purchases of laptops, which are more expensive than desktop computers.

My contacts in the package-delivery industry are anticipating a very strong holiday season; indeed, they are expecting demand in the peak week prior to Christmas to outrun capacity. The expectation that they will not have enough capacity in place is due in part to the rapid growth in Internet sales and the home deliveries associated with that. Also, they pointed to a particularly large unexplained increase in business in the Chicago area recently, both inbound and outbound. They have no idea why. I said I would consult with my colleague on the FOMC to see if he has any insight. So maybe during the coffee break he can tell me what's going on in Chicago. I don't think the World Series was enough to create this outcome. [Laughter]

MR. MOSKOW. Don't underestimate it. [Laughter]

MR. POOLE. Another example that I thought was quite interesting was that UPS is actually shifting its over-the-road shipments away from the piggyback rail system to long-distance trucks in order to gain shorter transit time. My contact said that the railroads are simply unwilling to put the investment into their track and equipment and operating systems to match the delivery times. Obviously, it's much less fuel-efficient to ship by truck, but the pressure on delivery times was leading UPS to switch its operations in that direction.

On the price front, my Wal-Mart contact said that general merchandise prices are still falling a little bit. Food prices have been up about 1½ percent over the last year. However, Wal-Mart noted that its suppliers—I think this would be primarily domestic suppliers—have indicated that they expect to take some price increases after January 1, although not enough to completely cover their cost increases. Wal-Mart is not seeing price increases on goods that are sourced abroad, particularly from China of course. Wal-Mart has continued to absorb increases in transportation costs and utility costs. That's the story for retailers generally. It's obvious that they're not going to absorb those costs forever, but they have been doing so temporarily. My Wal-Mart contact also noted that their construction costs for new stores and other facilities are rising in a range of 10 to 15 percent.

And in a recent luncheon in St. Louis with local real estate people, house builders, and others in the business, many said that they also see substantial upward pressure on construction costs. It's not just the cost of land—or ground, as the homebuilders put it—but materials and labor costs are under substantial upward pressure.

One other thing that I thought was interesting came from my contact at UPS, where they've just completed—I think the negotiations are completed—negotiations with their pilots. Apparently the pilots had no increases at all in 2003 and 2004, but UPS is going to pay retroactive increases in a

lump sum. And I suspect that these lump sum payments will escape inclusion in the ECI measurement, given the way the ECI is put together. I see Dave Stockton shaking his head. The other thing that was really quite surprising is that they are paying signing bonuses for new airplane captains of \$45,000 to \$60,000. You would think, with all the pilots being released from the passenger airlines, that they wouldn't have any trouble hiring pilots. But apparently the strength of the union is such that it has been able to work that deal as part of the settlement. UPS is anticipating that their pilots, now making \$190 per hour, will be up to \$223 per hour in 2006. They will be the highest paid pilots in the industry.

The one other thing I would say is that I share the Greenbook forecast, but I do believe that the inflation risks are asymmetric. It's much easier for me to imagine a ½ point forecast error with inflation coming in on the high side, rather than the low side, of the point forecast. I think that's where I'll stop now. Thank you.

CHAIRMAN GREENSPAN. All right. Shall we break for coffee? Let's come back in a reasonable period of time.

[Coffee break]

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN GEITHNER. We view the balance of developments since the last meeting as strengthening the case for further firming of monetary policy. The underlying pace of demand growth seems reasonably strong—a bit stronger than we thought at our last meeting. The inflation outlook to us looks largely the same as it did in September, with the expected path of core inflation higher than we would like and some risk of further acceleration.

On the assumption that we increase the fed funds rate on the higher trajectory now priced into market expectations, our forecast is for growth to continue at a pace just above our estimates of

potential in '06—somewhere between 3 and 3.5 percent—and for the rate of increase in the core PCE to stay in the vicinity of 2 percent. Of course, this has to be considered an implausibly benign view of the world [laughter] and the expansion still faces a familiar array of risks. But we don't see evidence yet of a substantial slowdown in demand nor of a troubling acceleration in underlying inflation.

The balance of risks in this forecast has changed a bit. I'm a little less concerned that the cumulative rise in energy prices will itself bring about a more substantial and extended slowdown in growth, although that obviously has to remain a concern and possibly the principal risk to the growth outlook. We believe that the modest expected tightening of financial conditions will have less of a dampening effect on demand growth than the Greenbook assumes. We don't see strong evidence yet of a significant deceleration in housing price appreciation or expectations of that outcome in household spending behavior, although both would be desirable. The evidence of strong stability in the growth of household consumption is, in a sense, borrowing against a future cushion, and that perhaps raises the probability of a more adverse path to future consumption. But it's not here yet.

As in September, the relative probabilities of alternative inflation outcomes still seem slightly skewed to the upside, thus probably justifying more cumulative firming in monetary conditions. Core PCE has remained moderate, compensation growth modest, productivity growth strong, and long-term inflation expectations reassuringly low. But the size of the rise in headline inflation and the deterioration in near-term expectations creates the possibility of some further drift up in underlying inflation if, as we expect, the labor market firms further and unit labor costs eventually start to rise more rapidly. We're seeing some drift upward in core inflation outside of the United States.

On balance, to us this suggests we need to make sure that the market remains confident we'll do enough to bring inflation and inflation expectations down over the next two years. To put it differently, we should make sure that we take out enough insurance to avoid a more adverse inflation outcome, and in this sense we should be pleased that the market has raised its estimate of the terminal fed funds rate to around 4½ percent. Our statement today, I believe, should be designed to be neutral to those expectations, rather than to raise or lower the expected path.

I do think it would be helpful if the minutes reflected some discussion today about the approaching need—the approaching need, not the need today—for some changes in the structure of the statement. We've been very fortunate to date in how well we have managed this transition in monetary policy, with the market expecting a sustained period of tightening but its expectation of the terminal fed funds rate varying with changes in the outlook. Our decision to put a soft, qualified, conditional ceiling on the fed funds rate path at 25 basis points a meeting has not cost us to date any erosion in long-term credibility, though it probably has encouraged the market's investors to take more duration risk. The remarkable stability in quarterly GDP growth and in core inflation we've seen has tended to reinforce expectations about the outlook for monetary policy, adding an unusual degree of certainty about the likely path of the fed funds rate.

This has to change. As we become less certain about the path ahead, that increase in uncertainty needs to get built into market expectations. The question is when and how we alter our statement to reflect this. So far, the dominant strategy before us has been to keep moving 25 basis points, to signal that we will continue to do so, and to defer any major changes to the structure of the statement until we are confident we have made our last move. Now, this may turn out to be the optimal choice, but the language feels increasingly stale. And it may be better, in fact, to change the language before we are forced to, when we still believe we have some firming ahead of us. This

might make the transition ahead more gentle. It would give us more than one shot at recalibrating the signal, and it might help bring the market's uncertainty about what's ahead more in line with our own.

There are two areas where changes in the statement seem indicated. The first is in how we characterize the rationale for our action. There we have some room to become more explicit about our view of the outlook relative to our objectives without going all the way to a fully articulated, quantitative forecast. The second, of course, is in the end of the statement. If the world in December looks about how it looks now, with a high probability of one or more moves still ahead of us, we could, for example, replace the last three sentences of the statement with two which state our views more simply. They would state first that the outlook for growth and inflation suggests that further monetary policy firming is likely to be necessary, and, second, that the Committee will respond to changes in economic prospects as needed to maintain price stability so as to achieve sustainable growth.

This would get us out of some of the risks of repeating "measured" going forward. It would help address some of the problems in using the word "accommodation" to signal tightening. And it would eliminate the awkwardness in the superfluous balance of risk sentence we now have. This would allow an easy evolution to a more neutral signal when that becomes appropriate—with a simple statement that policy is now roughly appropriate but that we will act as necessary to achieve our objectives going forward.

Of course, the world may look different in December, and we have to assess then what makes the most sense. I don't know that we can say with confidence today that evolution in December is ideal or necessary, but I think we need to prepare ourselves and the markets for some evolution.

Thank you.

CHAIRMAN GREENSPAN. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. Unlike President Geithner, I view the incoming information over the intermeeting period as having mixed implications for what might be required from us to keep inflation in check. On the one hand, demand and output, as he noted, appear to be continuing to grow at a pace that over time is likely to gradually put added pressure on resources. Apparently, the tightening of monetary policy, the rise in energy prices, and the appreciation of the dollar in the first half of the year were not enough to slow growth to trend in the third quarter. And the September employment report and October data on initial claims suggest that the underlying pace of job creation has been maintained going into the fourth quarter. Moreover, demand over the next few quarters, as many of you pointed out, should be boosted by the ramping up of rebuilding efforts.

Still, conditions do seem to be in place for a moderation in growth over the intermediate term. Financial conditions have tightened. Interest rates have moved higher; in response the exchange rate has firmed and stock prices have dropped a little. All of the increase since the last meeting was in real interest rates, and most of the rise didn't seem to be in response to data, but rather to our own speeches, making it unambiguously restraining. In addition, volatilities have backed up a little and risk spreads have widened just a little since the middle of the summer, suggesting that investors are a bit less confident about the future, even if they're still too confident.

Data and anecdotes on housing markets hint at some moderation, and that began even before the recent rise in rates, perhaps as a consequence of the earlier increases in interest rates as well as the elevated level of house prices relative to incomes. Home equity loans at banks actually fell last month, suggesting that equity extraction is no longer so attractive. But as best we can tell, without a new repeat-sales index, the rate of increase in the prices of existing single-family homes has not

slowed, while price increases for condos have moderated very little and remain quite high. All in all, we seem to have reached an inflection point in the housing market, fortunately. And house price increases, working through the wealth channel and as an inducement to construction, should be less of a stimulus to demand in the future, though how much and how fast is a very open question.

Higher energy prices could take something off of consumption, even after gasoline prices decline in coming months. Natural gas prices will be elevated through the winter heating season. And the negative results of consumer sentiment surveys—which persisted into October, even as gas prices declined—could be suggesting a more marked response than we've seen over the past few years of increases.

In the staff forecasts these forces slow the economy to a rate of growth slightly below its potential, even with a slight easing of financial conditions as policy firms less than the market has built in. It's as good a guess as any and better than any forecast I might make. Given the range of uncertainty, however, the important point for us at this meeting is that growth is likely to slow to closer to the rate of growth of potential, but it's probably going to take at least a couple more policy firmings.

The news on prices and costs has been more favorable for the inflation outlook. Core inflation has been damped, despite substantial increases in energy prices before the hurricanes. Because the increases in the prices of petroleum and petroleum products have been large and sustained, they are more likely to show through to core prices than at any time since 1980. But I'm encouraged by the lack of much response so far this year. And energy prices themselves have eased off much more than expected when we last met.

Pass-through effects of past increases in energy prices in the staff forecast are magnified and persist for a time because of the associated increase in inflation expectations. In this regard, the

results of the Michigan Survey are cautionary, but long-run forward measures of inflation compensation in the market have risen only modestly, and they do remain well below their levels of last year and the early part of this year. I suspect that household inflation expectations will ease back if gasoline prices retreat, as they are expected to.

Business labor costs are probably not putting much upward pressure on prices. The trend in ECI compensation continues to be favorable, including wages and salaries increasing at a 2½ percent rate for several quarters now. The lack of upward pressure is especially noteworthy in the face of huge increases in consumer energy costs, and it seems inconsistent with tightness in labor markets that might begin to escalate costs at prevailing levels of resource utilization. And productivity growth in the third quarter was strong, holding down the rise in unit labor costs. In the Greenbook, compensation and core prices accelerate noticeably over coming quarters. In my view, incoming price and compensation data raise the odds that the pickup could be a bit smaller, with inflation settling at a slightly lower level if output follows the Greenbook path.

On attitudes, we've had competing anecdotes at this meeting. Most of you—I think the majority of you—seem to suggest that businesses are sensing some increased pricing power. That would, if it's true, support the staff forecast; but it hasn't shown through in actual prices paid by consumers as of yet. Because the economy seems to have a good deal of forward momentum at a time when resource utilization is high, and because higher energy prices do threaten to feed through to core prices and inflation expectations, we need to continue firming until we have some better indications that conditions are in place to keep inflation restrained.

Underlying trends in output and employment will be obscured by the effects of the hurricanes, including the onset of rebuilding efforts, and this circumstance probably amplifies the already present danger of overshooting with our policy. I'm not sure myself how useful estimates of r^* , the

neutral federal funds rate, will be in reducing the risk of overshooting. They do provide a rough guide that we're in the neighborhood, but I don't think they're a very precise measurement. In that regard, I myself am not uncomfortable retaining the "accommodative" language until we decide we don't need to tighten anymore. I've defined accommodative for my own purposes as too low [laughter]—too low to accomplish my objectives.

I think we can mitigate the risk of overshooting in policy by keeping our eyes on the underlying drivers of resource utilization and demand—such as housing prices and household reaction to energy prices, as well as cost pressures and inflation expectations. And I do think the "measured pace" of tightening has been helpful in this regard as well, in contrast to 1994 and 1995 when tightening picked up at the end and I think the risk of overshooting increased. I'm comfortable with tightening again at this meeting and signaling that we do not think we are finished removing accommodation. But just what we should signal about our expectations for the future will require a fresh look at each meeting, and I support the general sentiment that we need to look at our language very, very carefully going forward. Thank you.

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. Thank you, Mr. Chairman. In preparation for today's meeting, I surveyed the CEOs of three large regional banks in the Southeast, the head of the Bankers' Bank in Texas, and a banker in Biloxi, Mississippi, hoping primarily to get an idea of the rate of recovery, although to a certain extent to get a reading on the amount of devastation from the storm. The way to look at it, I think, is to do it in bands going out from the point of the storm where the greatest damage occurred.

The banker in Biloxi reminded me—maybe informed me—that although most of the publicity was about New Orleans, the damage to the Mississippi Gulf Coast may have been at least as bad. I see President Guynn nodding in the affirmative to that. From the beach to 600 yards in, everything

is gone from the Alabama coast to the Louisiana border. They are experiencing at the moment 24 percent unemployment and labor shortages, simultaneously, due to the fact that people can't stay in the area when they have lost their houses in addition to their jobs. In his judgment, 25 percent of his customers have left the area. So some restaurants there are on reduced hours because they do not have the labor to keep them open. It is this banker's expectation that it will be five years before the city of Biloxi recovers and that it will recover only because of a change the legislature has granted, allowing the gaming industry to move their operations from offshore barges to on land. There's going to be a significant transition in the mix as a result of that. It is the gaming industry, and more broadly the service industry, on which the recovery will be based.

If you go from that immediate band out one more, to the areas not quite as heavily impacted by the storm, you get a completely different picture. In the estimation of one bank with a significant Alabama presence and a significant Southeast presence, it was about three weeks between the time the storm hit until the banking activity—consumer and commercial loans—was pretty much back to normal. The remarkable fact, which they hadn't expected because it was completely different from other hurricane experiences, is that the number of checking accounts—two different banks gave this information—has doubled. This activity has doubled.

Compare that to the Biloxi area where, over the years, hurricanes have generally been good for banking, because what the banks do during the recovery process is recycle or, if you will, intermediate, insurance checks. That is now happening more broadly throughout the region, but it also suggests that a very significant realignment or redistribution of population is taking place throughout that area.

Similar to the experience that President Fisher noted, housing units as far away as Atlanta are filling up, as they are certainly in Houston and in other areas. Baton Rouge, Louisiana, has doubled

in size; and it appears, based on the apartment rentals and home purchases, that that is at least semi-permanent. More broadly, skilled workers throughout the Southeast are flocking into the storm-impacted areas, the attraction being the difference in wage rates they can receive. A side implication of that is that construction projects in other parts of the Southeast have been delayed or in some cases postponed, both because of the unavailability of labor and also the increase in prices of building supplies.

Pulling it all together, the information I've received fairly well corroborates the Greenbook in terms of the impact of the storm—namely, that outside of the most heavily impacted area, economic activity proceeded largely unabated. And it suggests that we are clearly seeing evidence of price pressures, both in wages and in building materials. That being the case, it does seem that a 25 basis point increase in the funds rate at today's meeting would be appropriate, describing the rationale for doing it in the language of alternative B. But I strongly support President Yellen's suggestion that we look at how we communicate what we do. Six or eight months ago, when I thought about approaching the point where we were close to a position we would define as equilibrium, I was comfortable that we'd have a clear sense at that time as to where we were going and what I could be looking for. But I don't. And I don't know if that's consistent with just where we are in the cycle, so the decisions are tougher, or if it's because we are getting some mixed signals at this point when we are close to a transition.

I have heard this morning a very strong indication of the need to guard against inflation and to identify inflationary pressures. I've also heard a very good explanation for the fact that long-term inflationary expectations in particular, as Governor Kohn suggested, are well contained. But I think we are at the confluence of a number of events, one of which is that we are clearly reaching the point where our policy will cease to be accommodative. Second, we are clearly reaching the point

where the wording of the statement has outlived its usefulness. And third, we are approaching a transition in leadership. And I think all of us are aware that while there perhaps have been weaknesses in our communication, and maybe even in our analysis, there has been enormous confidence in our leadership.

In my experience, the only time that this body has significantly confused the market is when we have tried to make a change both in our position and our communication simultaneously. If we add in a transition in leadership, I would hope that if there is any miscommunication it would attach to the communication, not to the transition. So in my view, December will not be too early to think about the confluence of all of those events. But for today, I certainly support the 25 basis point increase and the definition of it in alternative B. Thank you.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. Thank you, Mr. Chairman. What I'd like to do today is to talk a little bit more about some recent trends in consumer borrowing information, which a few people have already mentioned, and then just make some general comments on the economy and on inflation.

As a couple of you have already noted, the data on consumer borrowing have shown a lot of noise, as I would call it, in the last couple months. Overall, we're seeing a slowing in the rapid rate of growth. It's still growing in general, but the pace of growth is slowing. So it raises the question of what is really happening here. Are consumers saying that they are nearing the point at which they really can't absorb any more debt? Or are changes in underwriting under way that are slowing the pace of growth?

As you know, the Senior Loan Officer Survey, covered in the supplement to the Greenbook, reported only modest changes in demand for credit; it was modestly lower. And to the extent that this could reflect consumer demand, we know that motor vehicles sales have slowed in the last

couple of months, as the big incentives came off. Also, we're beginning to see a moderation in the pace of increase in median housing prices. So that could be consistent with a slowing in demand.

On the other hand, if we look at the chart in the Greenbook on bankruptcy filings, there was a huge spike in the week prior to October 17, just before the new bankruptcy law went into effect. And that could have front-loaded anywhere from three to four quarters of bankruptcy filings, as everybody tried to get in before the law changed. We saw a tremendous increase at that point. It doesn't reflect what the banks are showing in the quality of their credit or in the securitized transactions that are out there in the market where delinquency rates have basically been fairly stable. So this was a blip up ahead of what our normal leading indicators are showing.

On home equity lines, I find the numbers really remarkable. Home equity lines grew 31 percent in 2003, 44 percent in 2004, slowed to 17 percent growth in the first half of this year, and now, as Governor Kohn just mentioned, have shown declines in September and October. So the question is: What is happening with these home equity lines? As you know, the banking agencies collectively put out common guidance in May regarding home equity lines. There was really nothing new in this guidance. It just pulled together what was out there to remind everybody what safe and sound lending practices are. We know that the vast majority of banks follow these sound procedures in almost all of their lending. So I felt comforted that in the Senior Loan Officer Survey only a few banks said they had changed their underwriting standards because of the new guidance. That to me says that we did really focus on the outliers, which was our intention. So I don't believe that this reining in of home equity lines is due to underwriting changes. We know that home equity lines have been used not only to extract equity for spending but also increasingly for downpayments on purchases of homes—more so than in the past. So again, this could reflect something more that is going on.

As you know, the banking agencies later this quarter are going to issue some guidance on mortgages and on loans for commercial real estate. Again, our intention is not to signal alarm that overall credit quality and underwriting are poor, but to call attention to some lending practices at the limit that are raising some concerns. So at the margin it could have some impact on the pace of lending, but we think overall things are in pretty good shape.

The other point I want to make is about credit card lending. More than a year ago now, both the OCC [Office of the Comptroller of the Currency] and the Fed started to raise questions about underwriting and credit advances for borrowers who go over their lines of credit and about minimum payments expected on credit card balances. A growing number of customers were not being required to cover late payment fees or fees for going over their credit line and actually were into negative amortization when their outstanding balances exceeded their lines of credit.

We've given the banks quite a bit of time to figure out how to get into compliance with these guidelines. Some started doing so toward the end of last year and some will be doing it later this year; so they are moving at their own pace. The change in practices will slow credit growth for some clients—the ones who chronically are over their lines and who have paid only the minimum monthly fee. Again, we don't expect this to be widespread, but it could be a factor in some of these bankruptcy filings. People who have been at the fringe of being overextended are realizing that they're going to have to get their borrowings down.

Now let me shift my focus to the overall economy. I find that the pace of the expansion has been quite resilient, given everything that we've been through in the past year. Recently, despite significant difficulties, whether it was hurricanes or the spike in oil prices, growth continued at a sound pace in the mid-3 percent range. And the staff forecast shows more of that next year.

Inflation has slowed in the last couple of months, but I've focused a bit on the nature of the developments there. As you know, some of the slowdown has been in prices of services. And with some of the trends we're seeing in core elements of inflation, getting a number over 2 percent, as the forecast has, begins to give me some concern. So I look at that and at the forecast for a continued rise in labor compensation costs. A potential slowdown in productivity also suggests that we need to be much more attentive to what's going on in terms of cost pressures on the labor front that could affect workers' expectations of compensation increases. So I think it's even more important for us to watch inflation in the next few months.

I support raising the funds rate today. I also support the dialogue, as President Yellen outlined, on the elements of our communication so that we have an orderly transition. We ought to look carefully at every word in our statement. While it will be parsed when we make changes, at least all of us will have had some time to think about the changes. And I would hope that we have that dialogue at our next meeting.

CHAIRMAN GREENSPAN. Governor Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. Like others, I am somewhat, though not fully, reassured by the incoming data. The economy clearly appears to be on an expansionary track, not having been seriously damaged by the seriously damaging hurricanes. Additionally, readings of core inflation have been surprisingly benign, given everything we know from our models and the anecdotal data we've heard from others on the cumulative effect of the rise in energy prices. More importantly, during the intermeeting period, inflation expectations for both the next five years and for the 5- to 10-year horizons are little changed. At least they have not changed much since the last meeting and could reasonably be described, as they were at the time, as being contained.

As the earlier dialogue between Vincent and the Chairman indicated, I did ask the staff to give me some information on how inflation expectations and energy prices interact. Let me summarize just three points from that data. First, of all the categories of energy prices—spot crude, gasoline, far futures, natural gas, and heating oil—it seems that spot crude is the one that drives inflation expectations most firmly. Second, as Vincent indicated, across the 2-year, 5-year, and 10-year horizons for inflation expectations, the 2-year horizon is really the one that is most heavily influenced by spot crude oil prices. And third, as I think Vincent said, even there the impact on inflation expectations of spot crude in the 2-year horizon is relatively muted: A 1 percent increase in spot crude oil prices, at least in these models, tends to go to a 0.7 basis point increase in inflation expectations. So while we're aware of the importance of energy prices, it turns out that in terms of driving inflation expectations, there are many other things that are equally important.

Having said all of that, let me now turn to the broader issues of import at this meeting, which are what to do and also what to say. Someone quoted Yogi Berra. I'm going to quote that equally famous poet, Archilochus, whom some of you may recall from the 7th century B.C. [Laughter]

CHAIRMAN GREENSPAN. I knew him well. [Laughter]

MR. FERGUSON. He famously said, "The fox knows many little things, but the hedgehog knows one big thing." The reason that's important here is that while the various readings we've had on the incoming data are extremely important, in some ways they are in the category of "many little things." And the one big thing—the big thing that Dave noted in his opening remarks—is that the staff now has a forecast for the next 18 to 24 months of an economy that, with just one or two more tightening moves, is likely to enter a phase of growth below trend, with inflation pressures gradually subsiding. I think this is really the first time in this period that the outlook shows, after the long and

variable lags, the impact of the cumulative tightening that we've undertaken. And the forecast does indeed show that the economy is likely to slowly respond to our tightening regime.

I find this actually quite credible because I believe, as does the staff, that the funds rate is probably within the range of its equilibrium real level and will certainly be within that range with one or two or more tightenings. I think it's fairly important to put that on the table. While I fully respect Don's view that one can't put too much weight on these point estimates, I think it is important for a Committee of our sort to have some sense of whether or not we're in the range of equilibrium.

Having said that, I do think a number of forces are pulling and pushing against the economy and leading us to this level. Here I would pick up on a point that President Lacker made—and I certainly agree with him—that the impact of these hurricanes is more likely to have been on the supply side than on the demand side. However, I would say that that's a partial equilibrium analysis. And *ceteris paribus* is clearly not *paribus* in this case, because there are a number of forces that are also driving the demand side independently of the hurricanes. Let me just highlight two or three of them. One I continue to be worried about is the mystery of what it is that's driving businesses. Dave raised in his opening remarks the point I've made a few times—that the investment/GDP ratio still seems relatively low, certainly compared to its level in the last decade. There is some survey evidence that CEOs and CFOs still have some uncertainty. Anecdotal discussions that I and some others have had suggest that some of this uncertainty has to do with whether or not to invest in the United States or overseas. And the second part of the uncertainty is still, I think, a lingering concern that these elevated energy prices will eventually play through to lower demand.

While others may disagree, I think the large negative net equity issuance and the willingness of businesses to repurchase shares or to engage in cash-financed mergers, against the backdrop of

ample liquidity, is primarily a sign that businesses are somewhat skeptical about their ability to reward shareholders with a reasonable future return on internal investment. And, therefore, they may be holding back on investment. I'd also say that the slightly negative guidance from businesses during this earnings season reinforces this view that there's some downward pressure that shows up in a slightly lower equilibrium rate than we would have had otherwise.

Second, I would pick up on a point that both Don Kohn and Sue Bies made having to do with developments in the housing sector, and why for households in particular there is a sudden fall-off in the demand for HELOCs [home equity lines of credit]. Again, I think that creates a little bit of downward pressure on the neutral rate.

We may also see during the next couple of years an increase in the saving rate, both for the reasons that the staff talked about and also due to continuing uncertainty about pensions, which has surely been very much in the newspapers. I think that, plus the ongoing discussions about Social Security reform, will perhaps drive households to save more.

And finally, to pick up on Karen's point—a point that we haven't talked about much today—I think net exports during the forecast horizon are likely, if anything, to continue to be a drag, if I can use that word, though I understand your mathematical point.

MR. POOLE. Please don't. [Laughter]

MR. FERGUSON. They will be an arithmetic subtraction from measured GDP in the U.S. economy. I think all of the conditions that have driven that in the past, including foreign exchange rates, relative interest rates, and most importantly the productivity story and an absence of domestic absorption overseas, are likely to result in the external sector being an arithmetic subtraction from GDP more so than an addition.

In my view, all of those things lead to a credible story that says we are, or soon will be, in the range of the neutral rate. But what does all that mean? I think it means that we should clearly be vigilant about inflation because there are some upside pressures, but I agree with Cathy and others that we don't have to be vigilantes about inflation. To put it another way, I think the scenario in the Greenbook that has us going to an interest rate of 5 percent, driving the economy to a growth rate that's far below potential, opening up an output gap, and having unemployment of 5.5 percent, is not something that we need to embrace. In fact, it's something that we need to be cautious about.

So that's my view on what to do. The implication, obviously, is that I'm quite comfortable with a 25 basis point move today, and I won't preclude future discussion by suggesting what we ought to do going forward. But I don't find the Greenbook implicit assumption terribly unattractive.

The second question then, obviously, is what to say. I applaud Janet for opening that topic. In my view it's important for it to be on the table. I come out at a different place from where Janet comes out and also from where I think Don comes out. I'm not comfortable keeping this language until we think we're done, because I'm not sure we'll ever really know that with enough certainty. I think the language does need to evolve. I agree with Tim's view that it seems a little stale at this stage. I would very much be in the camp of favoring some forward-looking language of one sort or another. The sort that I prefer is the kind of language that deals with the outlook in terms of our dual mandate, with respect to both growth and inflation. I know that in the period I've been here there were times when growth and inflation were not pointing in the same direction or when the risks to our growth and inflation objectives differed substantially. So I think we need to separate them.

I recognize that the market only wants to know what's going to happen with regard to interest rates. From years of discussion around this table, I think most of us, myself included, are perhaps a

little uncomfortable going that far with our forward-looking language, because we know that there are many factors that can change the outlook between one meeting and another. So I'd be very cautious about that.

I do encourage us to have this discussion in an orderly fashion between now and December, and maybe again between December and January. But having said all of that, Mr. Chairman, I think what to do and what to say today are fairly clear. Thank you.

CHAIRMAN GREENSPAN. Thank you. Mr. Reinhart.

MR. REINHART.² Thank you, Mr. Chairman. I'll be referring to the materials that Carol Low is distributing.

Over the intermeeting period, market participants marked up their expectations of your coming actions, as seen in the drift upward of Eurodollar futures rates in the top panel of the first exhibit. The rate for contracts ending this year, the black line, and next year, the red line, rose 40 and 50 basis points, respectively. Three factors apparently came into play. First, the economic effects of the spate of hurricanes this fall seem less momentous now, at least to market participants, than they did on September 20, the date of your last meeting. Essentially, a portion of the worries about the economy that lowered rates in advance of the September meeting was rolled back. Second, data releases, on net, were read as evidence that the economy had considerable momentum in advance of the landfall of Hurricane Katrina. And third, many of you expressed concerns in public about inflation risks, and those statements were taken as a warning of more tightening than previously anticipated.

The net result was to shift up the path expected for the federal funds rate, plotted as the solid black line in the middle left panel, by $\frac{3}{8}$ to $\frac{1}{2}$ percentage point relative to that prevailing before the September meeting, but by only $\frac{1}{8}$ to $\frac{1}{4}$ percentage point relative to the August meeting. The funds rate is now anticipated to peak at about $4\frac{1}{2}$ percent in futures markets, which is a touch below long-run expectations of the funds rate suggested by the Blue Chip survey. As shown in the middle right panel, the surveyed economists see the terminal funds rate at around $4\frac{3}{4}$ percent. That same survey, however, suggests that economists pitch a pretty big tent, in that about 50 percent of their responses span a range from $4\frac{1}{4}$ to $5\frac{1}{4}$ percent.

This ratcheting higher of policy expectations was associated with a tightening of financial conditions more generally, seen in the bottom panels as the rise in longer-

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

term Treasury yields, decline in stock prices, and appreciation of the foreign exchange value of the dollar.

If you are worried that this financial market reaction was overdone, thereby imparting too much financial restraint, you might favor holding the intended funds rate at $3\frac{3}{4}$ percent today—the subject of the left-hand panels of exhibit 2. As noted in the first bullet at the top and in the middle panel, the staff forecast of the growth of real GDP for 2006 has been marked down over the course of the year. You may see reasons why this might happen again—say, because the economic dislocation from the hurricanes could be larger than expected or because household spending could sag as real estate values stop escalating, or even decline, and as consumer confidence, plotted in the bottom left panel, sinks further. If so, the shock in financial markets in reaction to alternative A would certainly realign market expectations lower. Indeed, even if you viewed inaction today as likely to be merely a pause in the process of firming, it might be difficult to convey that to the public, making it likely that the rotation downward in rate expectations could be considerable.

More probably, you'll find the arguments for tightening $\frac{1}{4}$ point—in the right hand side of the exhibit—to be more compelling. In particular, as the top bullet point and the middle panel relate, you might view the upward drift in the staff's inflation forecast for 2006 over the course of the year as signaling that the risks to the price outlook are on the upside. A number of you have noted at previous meetings that inflation was running on the high side of your comfort zone, suggesting that the prospect of any further rise would be especially unwelcome. In that regard, you might consider the pickup in the Michigan Survey responses of near- and longer-term inflation expectations, plotted at the lower right, as evidence of such an unfolding dynamic.

A $\frac{1}{4}$ point firming might be seen as sufficient at this time to keep inflation contained, as long as it was expected to be followed by at least a few more moves going forward. The difference between alternatives B and C in the Bluebook hinges on how many more tightening moves you see in your future—which could be conveyed by the language of the statement. With the aid of exhibit 3, I'd like to cover some of the same ground as President Yellen, but more colorfully, if I say so myself. [Laughter]

This exhibit takes as a starting point the statement issued in September. Among the pertinent questions are:

1. Is productivity growth still robust (the red text)?
2. If the nominal funds rate moves up to 4 percent, will policy still be accommodative (the green text)?
3. If policy remains accommodative, are you likely to remove that accommodation at a measured pace (the blue text)?
4. Is there an appropriate path of monetary policy that will balance the risks to your dual objectives in the face of a supply shock? (By now, I've used up much of my color palette—but I think it's the purple text.)

I would remind you that, even if you do not want to address some of these questions this afternoon, the passage of time could ultimately force you to do so. An earlier, rather than later, dialogue about these issues would provide the opportunity to use the minutes to forewarn the world of changes in language that has been unchanged for so long that the public might be forgiven for thinking it was carved in stone.

Exhibit 4 provides some perspective on these questions, starting with the table at the upper left listing the four-quarter growth of output per hour over the past few years. The 4 percent growth rate of productivity in the third quarter pulled the four-quarter change to 3 percent. While the FOMC statement refers to underlying, not actual, productivity growth, this performance may well make you comfortable retaining the “robust” characterization. In that regard, as can be seen in the chart at the upper right, the private-sector economists in the Blue Chip panel continue to see output growing at better than a 3 percent pace in the long run, an assessment that has been essentially unchanged over the period the Committee has asserted that underlying productivity growth has been robust.

As for assessing the degree of policy accommodation, the middle panel shows that bringing the nominal funds rate to 4 percent would place the real funds rate at the midpoint of the range of the staff’s estimates of its equilibrium level. There are three reasons, listed in the bottom left panel, why you might think that describing policy as accommodative is nonetheless appropriate, beyond Governor Kohn’s gutting the word of any meaning. [Laughter]

First, you might believe that the staff is underestimating the vigor of aggregate demand, perhaps because we’ve penciled in too big a drag on consumption from higher energy prices and an as-yet-unobserved slowing in home-price appreciation. If so, your personal estimate of the equilibrium real rate of interest would be to the north of that plotted in the chart. Second, you might believe that the real rate should be calculated based on a forward-looking proxy for inflation expectations, not the backward-looking four-quarter actual core inflation rate used in the chart. If you also believe that an inflation scare has pulled expected inflation above its recent pace, then the real rate lies to the south of that plotted here. Third, the gap between estimates of the equilibrium real rate and its actual level may not be an appropriate measure of policy accommodation at all. Mechanically, the staff calculates the equilibrium real rate by determining, within a given model, the level of the real rate that would close the output gap in about three years. You might view the path of the output gap in the transition to its ultimate closure as unlikely to unwind current pressures on inflation or maybe even as consistent with pressures building for a while. That is, if you waited three years’ time to close the output gap, you might not like the inflation rate likely to prevail then.

The chart in the lower right panel showing the recent jump in energy prices is a reminder that you might label the current set of forces impinging on the economy as a supply shock. As the textbooks tell us, a supply shock confronts monetary

policymakers with unpleasant alternatives, as it tends to weaken aggregate demand and put upward pressure on inflation. In such circumstances, there might not be an appropriate path of policy that balances the risks to your dual objectives. That is, you might have to accept—and relate to the public in your statement—unbalanced risks.

Exhibit 5 presents four alternatives for the language in the relevant part of the Committee's statement. As in the top panel, you can limp along at this meeting with the current wording, reassured by the fact that this would likely preserve something close to the current path of expected future tightening, because few market participants anticipate any change.

As in the second panel, you can get out of the business of characterizing the degree of policy accommodation by describing the change, not the level, of the funds rate. Thus, you could say that “. . . policy firming can continue at a pace that is likely to be measured,” which implicitly admits the possibility that you may have to impose policy restraint, on net, to check inflation. This could establish the precedent of providing guidance by writing a fresh characterization of the odds of your likely future action at each meeting, appropriately conditioned on the economic outlook. I know that I discourage easily, but I'd like to point out that this was exactly what you were doing with the addition of the “measured pace” language in May 2004. But if the policy outlook does not change materially from meeting to meeting, fresh language can get hardened pretty quickly.

As in the third panel, you can replace the current risk assessment with a formula based on an unchanged stance of policy, thus providing a coarse signal of your likely future action. My argument for tilting at this windmill one more time is that such a formula both provides some transparency about your intentions and should simplify the process of the Committee coming to closure on the language of the statement at each meeting. In my view, prior efforts to find a satisfactory formula to provide guidance about your future policy intentions ran aground because most proposals were too ambitious by incorporating assessments of levels and changes of the Committee's dual objectives. A simpler formula—perhaps even couched in terms of interest rates rather than the Committee's goals—is more likely to last. If it is not specific enough on some occasions, you've got the rationale part of the statement and the minutes to provide a more nuanced view.

The fourth panel would be appropriate if you wanted to scrap the risk assessment entirely. However, reflecting on the discussion of the Committee and its succession of subcommittees on this subject over the years, I think those of you who prefer the simplicity of this alternative may be tilting at your own windmill. By my count, enough members seem to believe that there is some role for words in narrowing market uncertainty about your future action to make such guidance a durable feature of the statement for some time to come.

It has been a feature of my briefings for what seems to be a long time to remind the Committee that a discussion of your communications policy is warranted. I now

know the wisdom of the maxim from the “Monkey’s Paw,” “Be careful what you ask for, you might get it.” Because you have spent some time discussing the issue, the minutes will have to address the topic.

It is also pretty clear that this conversation will continue in December. To inform that discussion I propose circulating a survey fairly shortly to probe your views on key principles governing the statement of the sort Governor Ferguson discussed. My goal is to get back to the Committee before the December meeting with a summary of the results to make it easier to find the middle ground among the various views that have been expressed.

For your convenience, the last exhibit updates Table 1 from the Bluebook. Relative to what you saw there, we’ve taken comments from some members that I think simplify the discussion of the outlook in rows 2 and 3.

CHAIRMAN GREENSPAN. Questions for Vincent?

MS. YELLEN. Vincent, I have a question that concerns alternative C in Table 1.

Currently, the only part of the FOMC statement that the Committee votes on is the balance of risk section, and that now includes the forward-looking “measured pace” language. My sense is that, to the extent we continue to have forward-looking language in the statement, it’s something the Committee should vote on. But in looking at alternative C, what you did there was to move the forward-looking language into the descriptive rationale part of the statement, which in my understanding is not subject to a vote. To me there’s a governance issue there that I find troubling, and I wondered if you would comment on it. Was your expectation in alternative C that the forward-looking language would not be voted on? Or do you envision the Committee voting on the entire statement? So, my question has to do with governance.

MR. REINHART. I think it’s a governance issue for the Committee to decide. I was presuming that you would continue to vote on at least a portion of the statement, the part that contains the forward-looking language. But it is an open issue why you vote only on a part of the statement and not the entire document.

MS. YELLEN. Is there a reason why the vote now does not cover the rationale sentences?

MR. REINHART. What the Committee voted on has changed over time. Initially, starting February 4, 1994, the statement issued was explicitly the Chairman's statement describing what the Committee did. Somewhere about a year and a half later that characterization was dropped, and it became less clear whether it was the Committee's statement or the Chairman's statement. By 1997 or 1998, market participants generally viewed it as the Committee's statement. Most of the people sitting around this table, I think, viewed it as the Committee's statement.

When we last rethought what the Committee voted on, it seemed important to bring into the statement the forward-looking guidance, the risk assessment portion, and that's why we did that. So, it has evolved. I assume that it will evolve again if you change the basic structure of the statement.

MR. MOSKOW. Vincent, I had a question on a different part of this. You raised the issue of whether you should use the inflation projection in your calculation of the equilibrium federal funds rate instead of the backward-looking inflation numbers that you use. I was wondering if you could elaborate on that a bit. I certainly would think that the forecast would be a better measure to put in here than the backward-looking figures. What is the argument or the logic for putting the backward-looking inflation numbers in there?

MR. REINHART. The main one, which has been reflected somewhat in the conversation already, is that it's hard to know what inflation expectations are. We don't have a consistent proxy over the entire period. And it's not obvious that if you took the entire sample and estimated your model using measures of inflation expectations that you necessarily would have a different gap right now because you would not only change the actual expected real funds rate, but you'd also change your estimate of the equilibrium real funds rate.

MR. MOSKOW. Maybe I misstated my question. I'm not talking about an inflation expectations forecast but the inflation forecast you have. Why not put that in the model?

MR. REINHART. Among other things, the staff inflation forecast is judgmental and need not be accepted by the Committee. I think computationally you're talking about something, if you wanted to go to the FRB/US model, that would be difficult to do and—

CHAIRMAN GREENSPAN. If you put in an inflation forecast, you've just targeted inflation to a point, not a range. That's what will happen. We'll be locked in to explaining why we didn't move on either side of the forecast. I think it's very tricky.

MR. REINHART. Let me also say, President Moskow, that the passage of time is helping in terms of providing other measures of the equilibrium real funds rate. We now have indexed debt quotes. We use them to back out an estimate of the equilibrium real funds rate. We don't have a long enough time series to know its properties as, say, a predictor of aggregate demand or inflation. Over time, I would think that would become a more standard feature of our analysis, although this analysis is done in Dave Stockton's area, and I wouldn't want to commit his resources. [Laughter]

MR. MOSKOW. You probably did. Thank you.

CHAIRMAN GREENSPAN. I think we're missing an opportunity as fiscal agent for the federal government to have an audience for this meeting and collect revenues, which could probably balance the budget! [Laughter] President Fisher.

MR. FISHER. Setting aside the governance issues that Janet raised, it seems to me that the key operative phrase and the change in alternative C is taking out "accommodation can be removed at a pace that is likely to be measured" and replacing it with "likely making further policy firming necessary." I'm of the school that we likely have a little bit further to go, partially driven by our own analysis of the inflation trend—meaning PCE inflation data—that we do in Dallas. But I'm

curious as to what the staff ventures might be the market reaction to this particular wording change. Would changing this language to “making further policy firming necessary” sound as if we have a more severe situation on our hands that we are worried about? What’s your judgment?

MR. REINHART. In talking about market reaction to potential statement wording, you’re getting as far from economic science as what we do here, and that’s pretty far. It is hard to say, and maybe I’ll ask Dino to help here, too. But our presumption was that using the “firming” word would send a signal that you envision not stopping at what you think is the neutral rate but going above that, and so market participants would raise their sights for how much you would tighten. But that’s only a guess, and that’s the guess we put in the Bluebook.

MR. KOS. I think that’s right. I believe it would be viewed as very hawkish because you’ve taken out the accommodative language and you’re talking about firming. So I think Vincent is right that it would be taken as a very hawkish statement.

MR. REINHART. I guess I would like to make a couple points about that. When you think about the language, the characterization of “accommodation” and the “measured pace” are linked. So if you were, for instance, to take out “accommodation” while leaving in something about “measured pace,” that would signal that you’re going past the firming now anticipated. On the other hand, if you left in “accommodation” but took out “measured pace,” market participants would probably view that as an indication that you want to pick up the pace of tightening—that is, start doing 50 basis points.

The other thing I would like to mention is that this proposal really is, in a sense, “back to the future.” The Committee at one point did signal its intentions about the possible future direction of its next action in the form of the directive. And the experience back in 1998, when the directive became part of the Committee’s statement, was that market participants didn’t deal with the

conditional nature of that directive very well. If you were leaning in one direction, they tended to just slam into that corner. So the purpose of the old balance of risk language was to step back from there by talking about the Committee's goals. So, those are all among the things that the Committee would have to consider in framing new statement language.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, since Vincent has raised the question of process, and I get the sense that we're probably not prepared today to deal substantively with changing the statement, I'm wondering out loud if we shouldn't try to go even further than Vincent has suggested between now and the next meeting. Perhaps we should try to get ourselves in a position at least a couple of weeks before the next meeting where we have some viable optional language worked out that we could make operative at the next meeting if we choose to.

It has been pretty clear that we're not going to have a very productive discussion today on the statement—or next time either, unless we do some work on it in advance. Given the amount of thinking that has been done on this and the suggestions Janet has made and Tim has made, I think we ought to be able in a couple or three weeks to get something on the table that we could all look at if we truly want to have an option that we could exercise, if we choose, at the December meeting. So I just want to push on the process side a little bit and ask if we could do that.

CHAIRMAN GREENSPAN. I think that's precisely the direction in which Vincent is going at this point.

MR. REINHART. I really didn't want to promise too much in my prepared remarks.

MR. GUYNN. I would push a little bit.

MR. REINHART. The sequence I envision is first surveying you on general principles. Are you comfortable with putting in forward-looking language? If there's forward-looking language,

would you prefer it to be about interest rates or the risks to your objectives? There are differences of opinion on a number of those basic questions. Then once those survey results are collated—to see if there really is a middle ground or if there are a couple of distinct alternatives that lend themselves to these questions—I'd send a document around.

MR. GUYNN. But we need to have that more than a couple of days before the meeting if we're really going to have something that's workable. I guess it sounds like what you have in mind is what I'm hoping we can do. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Further questions? To quote somebody from last night, why don't I proceed? [Laughter]

Something very unusual is occurring both in the economy and, as a consequence, in monetary policy deliberations. Essentially, this surprisingly long—and I must say in retrospect rather successful—interval of incremental measured changes over a protracted period of time, has turned out a lot better than I think we could conceivably have imagined. But it's clearly coming to an end. And I think the reason it's coming to an end is that our grasp on what's going on in the world is a little more tenuous than it was when we started. You may recall that we had a general view of the way we thought the world was going to work in the spring of 2004 when we started to indicate that we were going to tighten. The markets all began to respond. The duration measures, the convexity measures, and all the various forward-looking measures were adjusting the whole structure of interest rates in the context of how we and the rest of the world thought the world was working.

Then suddenly the whole thing crumbled. It crumbled because there was essentially an X factor out there which we had not anticipated—a disinflationary force. And we worried about that. It resurfaced this year, and I think we finally concluded that it reflected essentially the significant increase in the active workforce in the market economy. That increase was a result of over 100

million people from the former Soviet Union coming from a centrally planned, isolated economy and being added into the world market economy. Even larger, but a little later was the addition of a workforce of 750 million in China, as that country began moving in the direction of market forces. And more lately, India—although India is a bit laggard in this respect.

The consequence, of course, was to double the number of workers in the labor force who are participating in world markets. They are not necessarily wholly involved in tradable goods, but there has been a definite shift in the structure in the world labor force. These are educated, but not highly productive workers; and obviously, they are producing a much smaller fraction of world output in these emerging nations than is coming from the developed world. But what we are observing is this phenomenon where unit labor costs are undergoing for the world as a whole a significant but one-time change.

If we had the data, which we would have only very crudely, we could make a judgment as to what bringing all of these people into the workforce does to world unit labor costs. Indeed, we have all sorts of examples of what's happening at the margin, not the least of which is in the United States. In Germany the impact of workers from the Czech Republic, Slovakia, and Poland is very pronounced. It's very pronounced in the United States and in a lot of countries as a result of China's workforce.

What we are clearly seeing are disinflationary forces that are reflected in inflation premiums in the longer tranches of the interest rate market. So, the tenth-year tranche of the 10-year note has been really quite suppressed and only very recently has moved up.

We know without actual data that the shift, which politically occurred in a very short period of time, cannot occur that rapidly economically. There has been a gradual absorption of all of these people into the labor force. And we know that it is, indeed, a one-time event. When you're

experiencing gradualism from a one-time event, the rate of change at which the transition is occurring has a very significant impact. I would argue—looking at world inflationary patterns and the high correlations between core inflation worldwide and the remarkable decline in inflation in the emerging world—that this is a global process. Even in earlier periods when we had low inflation in the developed world, we had huge problems in the developed world. We do not even have that anymore.

We have, as we were discussing very early in the meeting, this convergence of interest rates, so that what we are looking at is quite evidently a global phenomenon. And when we try to reconcile, as we are trying to do, the anecdotal evidence of these inflation pressures that we're seeing with what's coming out of our models, there is a dissonance. In other words, the models are not consistent with an anecdotal example of the kind President Fisher was talking about in terms of the surge in prices in Texas. A lot of you have noted similar examples. It goes beyond the issue of a mere pass-through of energy costs. Energy costs are being passed through, we know, and because profit margins generally are not being squeezed by it, we're essentially seeing a full pass-through. But because the productivity in the use of energy is clearly improving, the pass-through is in fact partial.

There's more to this story, though, than we're observing because energy is a much less significant factor than it used to be. Indeed, we've just had a decline in the last two months of 57 cents a gallon at the pump for regular gasoline. Now, that is clearly going to have effects, though we're not quite sure what they will be. But it strikes me that our real policy problems involve how to make a judgment as to what phase we're in of this disinflationary set of pressures. When does it eventually come to an end—or more exactly, when do we get enough of the adjustment so that the adjustments thereafter slow down? What that means is that the disinflationary effect on just the

normal rise in structural unit labor costs worldwide is easing. In other words, if there's a lot of pressure, that pressure will keep the inflation rate down. But the deflationary pressure eases as we complete the process, and we begin to get—and would expect to get—a gradual rise in core inflation. And that is what we're getting. That's not to say that we're getting a rise in core inflation. What we have to do, I think, is come to grips with a very large element of uncertainty regarding how this process is emerging and how it's going to come out. I do think that the indications of the rise in core inflation, as modest as it is, may be—and I underline the word “may”—a sign that the first difference of that adjustment process is changing. Yet we're not getting it in the inflation compensation. To be sure, as I said, the 10-year tranche has moved up 20 to 25 basis points. It's not a big deal; indeed, a good part of that could be real and probably is.

So we're really delving into areas where our past experience is not all that helpful. If in the spring of 2004 the big surge in expectations in terms of where the 10-year note was going to end up and where the mortgage rate was going to end up had actually materialized, we'd be in a different world today. And that world would be based a lot on the way our old models worked and the way certain relationships have worked in history. But there is something new here with which we have to come to grips. And strangely enough, the most beneficial way to address this particular subject in our communication, in my judgment, is through the statement. In the statement, we are, indeed, recognizing the elements of uncertainty with which we are confronted. The surety we had and went forward on starting in the spring of 2004—in terms of how we were viewing developments and the appropriate policy to follow—has proceeded literally almost unchanged. That's really quite a remarkable stretch. But it's over. Or I should say it's about on the edge of being over because we can no longer be as sure as we were about the intermediate-term outlook.

I feel a little queasy about using the word “accommodative” for a 4 percent federal funds rate largely because, as you may recall, we didn’t get to “accommodative” until we went from 2 percent to 1¾ percent in the earlier period. So I find that Don has the obvious solution to all of this. “Accommodative” is the state we wanted to leave for whatever reason and, therefore, raised the rate. [Laughter]

In any event, yes, I do think that we need to move today. I wouldn’t worry about the statement being stale. It has been stale for a very long time. [Laughter] And it’s not going to change that much. I think at the December meeting we’ve got to make some fundamental choices, and it would certainly be helpful if we could come together and essentially complete the structure of what we are going to do—if not in actuality at least the conceptual underpinnings of it—so that we will be on a new path with new wording. And depending on how Vincent decides he wants to read your responses to his questionnaire, perhaps we will have a new statement. [Laughter] So that’s the direction I would suggest we take.

Now, the actual wording of the proposed statement, I think, is slightly different from what we have here, isn’t it?

MR. REINHART. No. The one in my briefing material is—

CHAIRMAN GREENSPAN. But I thought there was a semicolon somewhere.

MR. REINHART. This has the semicolon. [Laughter] The latest version is the one in the last exhibit of the handout that was distributed just prior to my briefing.

CHAIRMAN GREENSPAN. My apologies. So everyone has actually seen this. If it is acceptable, this is the statement we will be going with. I would, therefore, put it as a suggestion that we move 25 basis points and use the alternative B statement as is. Governor Kohn.

MR. KOHN. I agree with your recommendations—moving 25 basis points, sticking with this language, and giving full consideration to new language between now and the next meeting. I'm actually not as worried as some others about the statement being stale. It has been accomplishing our objectives, I think, in an amazingly successful way. Markets have correctly interpreted what we're talking about and what we're doing. We haven't had the slip-ups that we had when we were changing language a lot.

CHAIRMAN GREENSPAN. When we try to be original!

VICE CHAIRMAN GEITHNER. I withdraw the word "stale." [Laughter]

MR. KOHN. No, it has been unchanged for quite a while; I agree with that. But we can defer this discussion.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. I agree with what you are proposing.

CHAIRMAN GREENSPAN. President Pianalto.

MS. PIANALTO. I support your recommendations.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I support your recommendation as well. And I'd like to think that this discussion will get in the minutes so that if the words change in December—let me put some odds on the fact that they will change somehow—it won't come as a big surprise to people.

CHAIRMAN GREENSPAN. We want to be reasonably clear in which direction we may change it rather than leave the question open. Just to say we're going to change but we're not going to tell you how, I think will create substantial unnecessary uncertainty.

MS. MINEHAN. Well, should we take some of your thoughts in terms of how the minutes are written? My understanding of what you said—and what I think I heard around the table,

although not explicitly—was that the statement would have a sense of greater uncertainty about it. It would be moving in the direction of not promising as much going forward. Now, maybe I'm reading too much into what you said.

CHAIRMAN GREENSPAN. That's what I did say. That's what I believe.

MS. MINEHAN. Yes.

CHAIRMAN GREENSPAN. I can't speak for the rest of the Committee in that respect, but we'll all be vetting the minutes so we can try to do our best in conveying our thoughts. My only concern is not to introduce a new uncertainty in the process since we've done exceptionally well for so long. Being innovative has less value than I think we've realized.

VICE CHAIRMAN GEITHNER. May I just add to that comment? I think we need to be careful not to telegraph in the minutes any change until we have a little more confidence about how we want the statement to evolve. So I think the minutes can reflect the fact that we're discussing, as the world hopes we're discussing, what evolution might be sensible. We're not—

CHAIRMAN GREENSPAN. The term is "ongoing discussion." That will clarify it. That's basically saying: Don't take this as some dramatic change.

MS. MINEHAN. Then it's not a surprise; if something different comes out, it would be the result of an ongoing discussion.

CHAIRMAN GREENSPAN. Yes. President Santomero.

MR. SANTOMERO. I support your recommendations. Just to continue on this topic, I think we all have to be careful, number one, to read what's in the minutes and, number two, to think about what we're going to say when we're asked about the minutes and what it is the minutes are communicating. We know there's going to be a rash of questions about what it means. And I think

we just have to be prepared for what we as individuals are going to say to the press when they ask about what is that ongoing conversation.

VICE CHAIRMAN GEITHNER. But, Mr. Chairman, may I say something?

CHAIRMAN GREENSPAN. Yes.

VICE CHAIRMAN GEITHNER. I don't think we normally take it upon ourselves to try to interpret the minutes for the world. We let the minutes speak for themselves, and we convey whatever personal views we have about what we think going forward, but—

MR. SANTOMERO. All I'm pointing out is that the press is going to say, "You talked about changing. What do you mean by that?" I think we all just have to be prepared to recognize that that's an inevitable part of mentioning in the minutes ongoing discussions about change. Perhaps it's obvious to all, but it will be a new area of inquiry by the press, and we have to recognize that.

CHAIRMAN GREENSPAN. We might want to get involved in that as we proceed with the minutes and see where, in fact, everybody is. Perhaps we can give, implicitly at least, some guidance as to what we all ought to be doing when the minutes come out. President Lacker.

MR. LACKER. I support your recommendations, Mr. Chairman, and I support the statement. I just want to register a thought or two about language. As we approach December, I recognize that the change in language that everyone is anticipating is a change that would be associated with stopping or at some point moderating the pace at which we increase the funds rate. I, like Don Kohn, have always interpreted "accommodation" to mean the rate is less than what we think it's going to be after the next meeting. I can't think of another coherent way to interpret that. I think that is always what it has meant.

In that regard, there are lots of words that people use that involve implicit counterfactuals. The word "neutral" is one, for example; the word "equilibrium" is another one. I understand very

well the mechanics of what the Bluebook does, but that to me doesn't correspond to a path our economy could conceivably get to from where we are now. So it has always troubled me for us to make reference to these fairly complicated and elaborate counterfactual simulations in describing interest rates. And I'd be reluctant to go in the direction of the formulaic option that Vincent put before us yet again—with compliments for his persistence—that makes reference to something that's clearly off the equilibrium path.

Let me mention another thought about language. I recognize that some around this table don't share as heightened a sense of concern about an uptick in core inflation as I do. My fear is that that has some positive probability. And if at some point we feel about a rise in core, if it should move up, the way we felt about a fall in core in mid-2003, I think we would find it desirable to communicate our dissatisfaction with that and our intention to prevent it. Obviously, our sequence of communications in mid-2003 had some fits and starts, but it was ultimately the communication of our intentions that stabilized expectations. That established sort of an effective floor to the level of inflation that market participants thought we were willing to tolerate. And I worry about changing the statement in a way that everyone associates with a pause when there's still a likelihood out there that we may have to engage in a communication exercise of another sort. I'll leave it at that.

CHAIRMAN GREENSPAN. President Fisher.

MR. FISHER. Well, I accept your suggestion, Mr. Chairman. I was just thinking about the introduction you provided, which is something I've been consumed with because I'm supposed to give a lecture at Harvard on Thursday night on the globalization of monetary policy. I'm worried about the phenomenon that you described—it's one of the reasons I feel quite hawkish even relative to President Lacker—and the direction in which it is proceeding. Let me cite a small data point. The retailers will tell you that they got 10 percent relief last year from China but that they're only

getting 5 percent relief now. Now, where that number comes from, I'm not quite sure. But the point is that the disinflationary mitigating factor is being reduced, and yet we have no sense of the measure of capacity or of the utilization of capacity outside our own borders, particularly in the parts of the world you spoke of. And I want to make sure, however we word things and whatever we communicate in the minutes, that we don't close the door to still be very vigilant, though not vigilantes, on the inflation front. But I accept and support your recommendation.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I agree with your recommendation on the rates and I support your plan to review the language, as we've all talked about here or, as you put it, to continue our ongoing discussion of the language going forward.

Just a comment on the point—I forget who said this but I think it was Tim—that the statement speaks for itself and the minutes speak for themselves. I agree completely with that. And I think it is important, as we give talks and answer questions, that we make it clear that our comments represent our own personal views. They are not interpretations of the minutes. They are to be read as “In my view, X or Y...” I think that is a very important distinction to make going forward.

Let me add just one final point. I, too, am concerned about inflation, as we all are around this table. And I must say that I think the costs of inflation coming in above the Greenbook forecast now outweigh the costs of inflation coming in below the Greenbook forecast going forward.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I support all parts of the recommendation—the change in the funds rate, the existing language, and the possibility that we will alter the familiar language at the next meeting.

CHAIRMAN GREENSPAN. Governor Olson.

MR. OLSON. I support the recommendation, Mr. Chairman. With respect to the language, what I think I'm supporting is the process by which we will be looking at what changes would be appropriate. But I certainly agree that the next meeting is the appropriate time to look at it and that in order to do that we need some intermediate communication about the options.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, there are words and phrases that I'm not as comfortable with as I'd like to be, particularly the part dealing with inflation risk. The word "potential" has crept into the sentence in terms of inflation pressures; I see those pressures as clearly there and not just potential. But I certainly can support your recommendation and I look forward to a discussion between meetings of how to fundamentally restructure the statement we're using. Thank you.

CHAIRMAN GREENSPAN. President Yellen.

MS. YELLEN. Mr. Chairman, I support your recommendation for the policy move and also the statement today. And I look forward to more detailed discussions about revising the statement going forward.

CHAIRMAN GREENSPAN. Governor Bies.

MS. BIES. Mr. Chairman, I support the 25 basis point increase and the language in alternative B, and I look forward to seeing how Vincent will help get a consensus within this group. One thing I've learned is that whenever we try to tinker with this, we end up with a wide variety of viewpoints around the table. So I wish him good patience with all of us as he tries to get our comments in.

CHAIRMAN GREENSPAN. He can find agreement where none exists! [Laughter]
Governor Ferguson.

MR. FERGUSON. Mr. Chairman, I support your recommendation of 25 basis points. I support the language in alternative B. On the issue of what we should say about the minutes, I would caution all of us to be very careful because the real answer is we don't know. To say much more than "ongoing discussion" perhaps is signaling more than anyone wants to or should.

On the question of whether or not we should wait until we're fully done tightening before we change the language, I think that will create an incredible gong reverberation that says, "Boy, they've changed the language. They must think they're really done." In my view, the reality is that if we change the language before we think we're really done, then the language can evolve in a way that may be more helpful.

Having broken my sword on this issue over several years with the help of Don and then Vincent, I, too, look forward [laughter] to seeing the wisdom of Vincent. And I admire the way he will bite the hand that feeds him. [Laughter]

CHAIRMAN GREENSPAN. President Poole.

MR. POOLE. Mr. Chairman, I support your recommendation on the rate and the language for today. I'd like to make just a couple of other points. There has been a lot of discussion in the newspapers and among people I talk to about the influence of the remarks in our speeches regarding our concern about inflation risk. That clearly, I think, has made a difference to market sentiment.

And with respect to the neutral rate, I hope that we don't start making statements that we regard the neutral rate as being a narrow range or a number. These calculations come from a model. One way of looking at this is that if the neutral rate has averaged about X over some historical period, we might anticipate that that would be the average going forward. However, the rate that is consistent with equilibrium at any moment of time has varied a lot. If we look at 2002 or 2003, for example, the rate was low and yet the economy was barely moving forward. If we look at 1983,

that was a period of vigorous recovery from the 1981-82 recession, and the real federal funds rate was about 6 percent. So the rate that at any moment of time is consistent with equilibrium can vary widely, and I hope we don't give the impression that the neutral rate is some narrow little target toward which we are likely to go. We talk about it as an average of historical experience. I think we could really be misleading the market as to where we're likely to end up if we leave the impression that it's in the neighborhood of 4½ or 4¾ percent or any other such number that we might mention.

Secondly, I'd like to point out that the Greenbook forecast for the core PCE inflation rate next year, fourth quarter to fourth quarter, is 2.3 percent. And there is a view abroad in the marketplace that some members of the Committee have an explicit target range in mind for that measure of 1 to 2 percent. Others will say that by revealed preference the Committee has made clear its preference for an inflation target of 1 to 2 percent. And if we, in fact, consistently start getting year-to-year inflation rates that are noticeably above 2, we are going to produce a market reaction that we need to be aware of—one that may well be ahead of us—and understand where that may take us. Thank you.

CHAIRMAN GREENSPAN. Vice Chair.

VICE CHAIRMAN GEITHNER. I support your recommendation to raise the fed funds rate 25 basis points and to use the language of alternative B. And I want to clarify just for the record, given what Mike Kelley said last night, that in not rushing immediately to compliment you on the brilliance of your proposal I'm not implying any less confidence [laughter] but actually more confidence.

CHAIRMAN GREENSPAN. Let the record show that I had an enigmatic expression.
[Laughter]

Ms. Danker, would you read the appropriate language?

MS. DANKER. I'm reading the directive wording from page 24 of the Bluebook: "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 4 percent."

And the assessment of risk, unchanged from the September statement, is: "The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

CHAIRMAN GREENSPAN. Call the roll, please.

MS. DANKER.

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

MR. SANTOMERO. I have a question. I think you read the assessment of risk without the word "remaining" in it. Maybe I misunderstood what you read.

MS. DANKER. I read it from this table as unchanged from September.

MR. SANTOMERO. Which one are we voting on—with remaining or without remaining?

SEVERAL. Without remaining.

MR. SANTOMERO. I just wanted to make sure. I got confused about what we were looking at in that line. That's fine. My vote stands.

CHAIRMAN GREENSPAN. Let's have a recess, and the Board of Governors will convene in my office.

[Recess]

CHAIRMAN GREENSPAN. The Board passed unanimously the requests of all 12 Reserve Banks for an increase in the discount rate to 5 percent.

Our next meeting is Tuesday, December 13, 2005. Shall we go to lunch?

END OF MEETING