The Federal Reserve Board

Minutes of the Federal Open Market Committee

September 24, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 24, 2002, at 9:00 a.m.

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

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

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

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

Messrs. Connors, Howard, and Lindsey, Ms. Mester, Messrs. Oliner, Rolnick, Rosenblum, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

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

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

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

Mr. Moore, First Vice President, Federal Reserve Bank of San Francisco

Messrs. Eisenbeis, Fuhrer, Hakkio, Judd, Lacker, and Steindel, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Boston, Kansas City, San Francisco, Richmond, and New York respectively

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

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By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 13, 2002, were approved.

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

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period August 13, 2002, through September 23, 2002. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that the economy continued to expand in the third quarter, though the tenor of incoming reports was mixed. Data on household and business spending had been solid for the most part, and residential construction remained high. Motor vehicle production provided a sizable boost to economic activity, but other factory output changed little on net. Employment continued to expand unevenly, while labor productivity remained on a strong upward trend. Overall price inflation had fallen over the past year, reflecting favorable developments in the food and energy sectors and a decline in core inflation.

Aggregate labor market conditions had been mixed in recent months. While nonfarm payroll employment registered further small gains in July and August, the aggregate hours worked by production or nonsupervisory workers declined on balance over the two-month period. The manufacturing and retail trade sectors registered sharp job losses in August, but those were more than offset by hiring in the services and construction sectors. A hefty increase in government jobs at the federal, state, and local levels also boosted payroll employment. The civilian unemployment rate fell to 5.7 percent in August despite advances in claims for unemployment insurance.

Industrial production declined in August, largely offsetting July's rise. Excluding motor vehicles, manufacturing output was unchanged in both July and August after sizable advances in the first half of the year. Production in the high-tech sector jumped in August, the manufacture of aircraft and parts fell further, and output in the remainder of the industrial sector was mixed. Capacity utilization in manufacturing changed little in August and was substantially below its long-run average.

Retail sales remained relatively brisk in August despite further decreases in stock prices and consumer confidence. Households boosted their already high level of spending on motor vehicles in response to zero percent financing and larger cash incentives offered by auto manufacturers, and household purchases of goods other than motor vehicles continued to advance at a moderate pace. According to the latest available data, outlays for services rose moderately in July.

Residential housing activity slowed a little in July and August from the robust pace of the second quarter as further declines in mortgage rates apparently helped to support housing activity in an environment of sluggish employment and diminishing household wealth. Starts of single-family units fell in August to their lowest rate since last November, while starts in the multifamily sector in the July-August period were at their average rate for the first half of the year. Sales of new single-family homes posted a record high in July, and the inventory of unsold new homes remained low. Sales of existing single-family homes in July partially retraced a large drop in June.

Based on the limited information available, business investment in equipment and software seemed to be advancing at a solid pace in the third quarter. This reflected an acceleration in spending that was associated importantly with notably stronger motor vehicle sales and a halt to the contraction in aircraft expenditures. Outside the transportation sector, outlays on equipment continued to expand at a moderate pace; in addition, the level of orders in July (latest data) moved above shipments for the first time since early last year, and the backlog of unfilled orders edged up. Nonresidential construction activity remained on a steep downtrend in July, with further reductions of spending in all major categories except office buildings.

The book value of manufacturing and trade inventories excluding motor vehicles registered a second straight monthly gain in July after many months of heavy liquidation. Despite the rise in stocks, gains in sales and shipments drove inventory-sales ratios to even lower levels across the manufacturing, wholesale, and retail sectors. Survey and anecdotal information suggested that few industries were burdened with sizable inventory overhangs.

The U.S. trade deficit in goods and services narrowed appreciably in July after two quarters of large increases. The smaller deficit in July reflected continued strong expansion of the value of exports coupled with a decrease in the value of imports. The step-up in goods exports occurred mostly in motor vehicles and aircraft, while the gain in exports of services was spread across travel and other private services. The decline in imports was concentrated in consumer and capital goods, royalties, and license fees. The very limited available information on economic activity abroad in the third quarter suggested continued sluggish expansion in the euro area and Japan, moderate growth in the United Kingdom, further brisk recovery in Canada, and ongoing recovery in emerging Asia. Conditions in South America remained fragile: Economic activity was still very weak in Argentina and Venezuela, and the Brazilian economy had been adversely affected by the turbulence in financial markets, though those markets had stabilized recently. By contrast, Mexico experienced brisk growth in the second quarter.

Despite a slight pickup in consumer price inflation in August, the increase in consumer prices (measured by either the consumer price index or the chain-indexed personal consumption expenditure index) for the year ending in August was considerably smaller than that for the previous twelve-month period. Much of the drop in inflation reflected developments in the food and energy sectors, but core inflation also declined noticeably. Producer prices for core finished goods likewise signaled a drop in inflation over the last year. With regard to labor costs, average hourly earnings of production or nonsupervisory workers decelerated sharply over the twelve months ended in August, reflecting the effects of both the rise in unemployment and the drop in consumer price inflation.

At its meeting on August 13, 2002, the Committee retained a directive that called for maintaining conditions in reserve markets consistent with keeping the intended level of the federal funds rate at 1-3/4 percent, but it shifted from a statement of a neutral balance of risks to one that was tilted toward economic weakness in the foreseeable future. Market participants read the tilt and the wording of the announcement as indicating that economic activity in the coming months likely would be weaker than had been expected, and some short-term interest rates eased slightly while broad indexes of equity prices moved lower. The following day's deadline for the recertification of corporate financial statements passed uneventfully and equity markets rallied. Subsequently, however, a weaker tone to incoming data on production and employment, a gloomier outlook for business profits, and heightening tensions over Iraq seemed to lead investors to revise down their outlook for the economy. Over the intermeeting period, intermediate- and longer-term Treasury security yields and broad equity indexes fell considerably on balance.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies appreciated slightly on balance over the intermeeting period as projections for growth of foreign industrial countries, particularly Germany and Japan, were marked down more than those for the United States. The dollar moved within narrow ranges against most major currencies but rose somewhat against the yen and the currencies of other important trading partners.

M2 growth remained elevated in August, though somewhat below July's rapid pace. Much of the strength of the aggregate's liquid components likely was associated with the continuing historically low opportunity costs of holding such deposits, the recent surge in mortgage refinancing activity, and the safe haven provided from volatile equity prices. Borrowing by domestic nonfinancial businesses remained weak, likely reflecting reduced requirements for funds to finance capital spending projects and perhaps the improved tone in the corporate bond market and a modest increase in the issuance of corporate debt.

The staff forecast prepared for this meeting suggested that, in light of weaker-than-expected incoming economic data, the expansion of economic activity would pick up more gradually but would still reach a relatively brisk pace late next year. The considerable monetary ease and fiscal stimulus already in place, continuing gains in structural productivity, and improving business confidence would provide significant impetus for spending. Inventory overhangs appeared to have been largely eliminated, and business capital stocks appeared to have moved closer to desired levels. As a consequence, a gradually improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to boost business investment spending. However, a less robust pickup in final sales was now expected over the forecast period, which would put somewhat less pressure on resource margins than had been anticipated previously, and the level of activity would remain below that of the economy's potential for a longer time. The persistence of underutilized resources was expected to foster some moderation in core price inflation.

In the Committee's discussion of current and prospective economic conditions, members commented that economic growth appeared to have picked up in the third quarter but that the most recent information had been mixed, raising questions about whether the pace of the expansion going forward would be strong enough to erode margins of underutilized labor and capital resources. For now, a high degree of business caution in the context of substantial uncertainties, exacerbated recently by apparently increased concerns about the geopolitical outlook, continued to restrain business investment and hiring. Even so, the economy appeared to be well positioned for solid gains over time in light of the progress that had been made in bringing inventories and capital stocks into better alignment with sales, the stimulus provided by accommodative fiscal and monetary policies, and the implications of the strong uptrend in productivity for profitable investment opportunities and growth in consumer incomes. With the growth of economic activity nonetheless expected to remain below the economy's potential for some time, pressures on labor and other resources would be limited and in turn wage and price increases likely would continue to edge lower.

In their review of developments in and prospects for key sectors of the economy, members commented that household spending had continued to be well maintained. Buttressed by exceptional strength in sales of motor vehicles, consumer spending had displayed solid growth during the summer months. While survey indicators of consumer confidence had declined this year, the high levels of consumer spending on homes, motor vehicles, and other big-ticket items were, in the view of at least some members, perhaps a better gauge of consumer confidence. The value of homes had continued to rise in most areas, and unusually low interest rates were inducing people to refinance mortgages and in the process to extract and spend some of the embedded equity gains. Increasing home equity values probably were also providing some counterweight to the impact on consumer spending of the negative wealth effects associated with the declines in stock market prices since the spring of 2000. Other positive factors cited as helping to undergird the persisting strength in consumer spending included reductions in federal income tax rates; the availability of financing for consumer durable goods at relatively attractive interest rates, including zero interest rates for selected motor vehicles; and the cumulative effects of productivity gains on current and expected real consumer incomes. Looking ahead, sales of motor vehicles likely would moderate to some extent over coming months from their currently unsustainable levels, and some members referred to indications of slower growth in retail sales in late summer and somewhat downbeat forecasts for coming months reported by a number of retailer contacts. Moreover, the absence of significant growth in employment, should it persist, could at some point have significant adverse repercussions on consumer spending. On balance, consumer spending was seen as likely to remain a positive but possibly a more limited source of support for the expansion over the next several quarters.

In the context of sustained growth in incomes, low mortgage interest rates, by facilitating the extraction of homeowners' equity, had played a key role in inducing a high level of spending on residential structures and home improvement expenditures. Tending to confirm currently available data on housing activity, members cited persisting anecdotal reports of robust home sales and residential construction in many regions, though indications of softening were noted in some areas and market segments, particularly in the high-price sector of the housing market. Some members questioned whether generally rising housing prices and elevated levels of refinancings would persist. However, given the anticipated continuation of accommodative conditions in mortgage markets and forecasts of rising incomes, the overall outlook for housing remained favorable.

Business fixed investment remained a significant question mark in the outlook for economic expansion. Recent readings on business spending for equipment and software pointed to gradual improvement, but nonresidential construction activity continued to be severely depressed in many areas. It was unclear whether the recent strength in orders and shipments signaled a significant acceleration in capital outlays, and in this regard the new information that would become available in the next few weeks might provide important evidence on the outlook for capital spending and thus for the performance of the economy more generally. At least for now, however, anecdotal reports suggested that a high degree of caution continued to characterize business investment decisions in the face of an elevated level of uncertainty. Much of the current spending for equipment and software reportedly represented replacement demand largely associated with the short useful lives of various types of equipment, and there appeared to be little spending that would entail capital deepening. At the same time, several positive factors in the outlook for capital spending could be cited including the greater productivity of new capital equipment, the temporary accelerated expensing tax incentives, generally strong business cash positions, and the relatively rapid depreciation of existing capital equipment. For the present, however, business contacts widely reported that because of prevailing uncertainties they were deferring major investment initiatives until they saw clear evidence of an increased need for capital to meet growing demand.

Business firms appeared to be in the process of moving from inventory liquidation to accumulation, and the available evidence suggested that inventory positions were getting tighter. Accordingly, prospective growth in final demand would have to be met through increased production. And as demand rose over the next several quarters, businesses were expected to accumulate inventories to maintain desired inventory-sales ratios, adding in the process some limited impetus to the growth of GDP.

The growth of economic activity in most major foreign countries appeared to be falling below expectations earlier in the year, with adverse implications for U.S. exports. Among those nations, only Canada had experienced a robust economic recovery thus far this year. Current forecasts continued to anticipate strengthening activity abroad, but as in the case of the U.S. economy substantial uncertainties surrounded the timing and pace of the improvement.

In the context of limited demand pressures on labor and other resources, current forecasts continued to point to quite low and perhaps declining inflation over the next several quarters, although there appeared to be significant crosscurrents in the outlook for prices.

Rapid increases in healthcare and other insurance costs and the lagged passthrough of large increases in oil prices would tend to maintain upward pressure on prices. Tending to oppose those forces, though, were the effects on resource use of an extended period of economic activity below the economy's potential as well as the effects of robust productivity gains on costs, apparently declining inflation expectations, and the persistent absence of pricing power in highly competitive markets. Indeed, the members did not rule out the emergence of appreciably lower inflation. In this regard, some observed that a significant decline in inflation from current levels could imply an unwelcome tightening of monetary policy in real terms. In addition, further sizable disinflation that resulted in a nominal inflation rate near zero could create problems for the implementation of monetary policy through conventional means in the event of an adverse shock to the economy that called for negative real policy interest rates.

In the Committee's discussion of policy for the intermeeting period ahead, all but two of the members endorsed a proposal to maintain an unchanged policy stance. In the view of all the members, current forecasts clearly were subject to the risk that economic growth would not be sufficient to reduce excess capacity in labor and capital markets. However, the members who favored a steady policy course noted that the recent data on household and business spending had been a bit stronger than expected and that a number of factors pointed to solid growth over time. In these circumstances, they believed that in the context of prevailing uncertainties more evidence of subpar expansion was desirable before policy was eased further. It was noted in this regard that the information that would become available over the next several weeks should provide an improved basis for assessing the recent anecdotal reports from around the nation that pointed to a possibly slowing expansion. Several members indicated that if compelling evidence of a weak economy were to materialize they would be prepared to ease promptly. Two members preferred an immediate easing action because they were persuaded by what they viewed as already strong evidence of a persisting unsatisfactory, and perhaps weakening, economic performance. While the current stance of policy was already accommodative, they felt that greater stimulus was now called for to foster an acceptable pace of economic expansion.

All the members agreed that the risks to the economy remained tilted toward weakness and that such an assessment needed to be incorporated in the statement to be released shortly after today's meeting. The members also accepted a proposal to add a reference in the statement regarding what they viewed as recently heightened geopolitical risks that appeared to constitute a major source of the uncertainty currently prevailing in the economy. The addition was not intended to signal that any particular policy response would be forthcoming in the event of a crisis. Rather, consistent with its usual practice, the Committee would assess the implications of any such development for the domestic economy before deciding on an action. Indeed, if the geopolitical uncertainties were to ease significantly along with what already were apparently diminishing concerns about corporate governance issues, the resulting improvement in business and consumer sentiment could generate a more robust economic expansion.

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

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To

> further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1-3/4 percent.

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

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

> **Votes for this action:** Messrs. Greenspan, McDonough, Bernanke, Ms. Bies, Messrs. Ferguson, Jordan, Kohn, Olson, Santomero, and Stern.

> **Votes against this action:** Messrs. Gramlich and McTeer.

Messrs. Gramlich and McTeer dissented because they preferred to ease monetary policy at this meeting. The economic expansion, which resumed almost a year ago, had recently lost momentum, and job growth had been minimal over the past year. With inflation already low and likely to decline further in the face of economic slack and rapid productivity growth, the potential cost of additional stimulus seemed low compared with the risk of further weakness.

It was agreed that the next meeting of the Committee would be held on Wednesday, November 6, 2002.

The meeting adjourned at 1:30 p.m.

Notation Vote

By notation vote completed on September 30, 2002, the Committee authorized Vice Chairman McDonough to accept the “Decoration of Merit” honor to be awarded by the government of Argentina.

> **Votes for this action:** Messrs. Greenspan, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, Kohn, McTeer, Olson, Santomero, and Stern.

> **Votes against this action:** None.

> **Abstention:** Mr. McDonough.

Vincent R. Reinhart
Secretary

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