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What the Transcripts Reveal About the FOMC's Pre-Emptive Easing in July 1995

Kevin L. Kliesen

September 26, 2024

ABSTRACT
At their September 2024 meeting, the FOMC began reducing the federal funds target rate and indicating the likelihood of additional reductions by the end of the year and into 2025. The FOMC took this action because of favorable inflation trends and some developing weakness in labor markets. A similar dynamic was at work from 1994 to early 1996. During this period, the FOMC undertook, first, a pre-emptive tightening in policy to combat emerging price pressures and then, second, a pre-emptive easing of monetary policy to counter the expectations of slower real GDP growth or outright recession. One key difference between the two episodes was the marked acceleration in inflation rate in 2021-2022 compared to 1994-95. Nevertheless, the end result of the 1994-96 episode was that the US economy avoided a recession and inflation by the end of 1997 was effectively at a level that is now deemed price stability. The purpose of this article is to outline the key arguments that Chairman Greenspan and the other FOMC participants deployed during the 1995-96 pre-emptive easing episode.

JEL Classification: E3, E4, E5, N1

Key Words: Federal Open Market Committee, monetary policy, macroeconomy, inflation, recession

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The 1994-95 monetary policy tightening episode was a classic application of risk management.[1] In that episode, the FOMC raised the nominal federal funds target rate (FFTR) by 300 basis points from February 1994 to February 1995 in anticipation of developing price pressures. Increasing the FFTR in an *anticipation* of an increase in inflation rather than an actual acceleration in inflation is known as pre-emptive monetary policy. Pre-emptive policymaking, which is an application of the risk management framework, can be difficult in practice because many key economic data are backward looking and/or subject to revision. To compensate for these challenges, forecasts often play an important role in the monetary policymaking process. But forecasting models are fallible, particularly when subject to large macroeconomic shocks.

By contrast, the FOMC's 2022-2023 tightening episode would not be considered a pre-emptive tightening of monetary policy, because inflation was well in excess of the 2% target when the FOMC began to raise its FFTR rate in March 2022. Nevertheless, the FOMC became a conventional inflation fighter and took aggressive actions to return inflation to the target rate. With the target rate in sight, though, the FOMC in September 2022 implemented what could be characterized as a pre-emptive easing with an aggressive 50 basis point reduction in the FFTR. The FOMC then signaled, through its Summary of Economic Projections, that additional reductions in the FFTR were likely (i.e., under optimal policy) over the remainder of 2024 and into 2025. The pre-emptive nature of this easing stems from the fact that although real GDP growth has been above conventional estimates of potential real GDP growth for seven of the eight quarters up through the second quarter of 2024, there were signs that of developing labor market softness.

[1] See Kliesen (forthcoming, Federal Reserve Bank of St. Louis *Review*) for an analysis of the 1994-95 FOMC tightening episode.

A similar dynamic was at work in 1995-96. Shortly after the 1994-95 tightening episode ended, the FOMC implemented three 25 basis point reductions in the FFTR from July 1995 to January 1996 to help prevent a sharp slowing, or outright decline, in the pace of aggregate economic activity, despite inflation exceeding the FOMC's desire rate. Ultimately, no recession ensued, and the unemployment rate and the inflation rate would trend lower over the next few years.

The first section of this article will outline key macroeconomic developments leading up to the FOMC's decision in July 1995 to reverse some of 300 basis point increase in the FFTR that occurred from February 1994 to February 1995. This section will also briefly discuss parallels between this period and the macroeconomy leading up to the FOMC's decision at the September 18, 2024, meeting to begin recalibrating the stance of monetary policy from a level that was "appropriately restrictive" to a level that is "more neutral."[2] The second part of the article will outline Chairman Greenspan's views at the July 1995 meeting, when he convinced the FOMC that it was time to loosen the stance of monetary policy. This section will also include discussion points from the "Blue Book" presentation to the FOMC, which outlined policy options for the Committee. The third section will discuss the views of the remaining FOMC participants. This section will rely heavily on the FOMC transcripts. The fourth section will briefly discuss key developments following the July 1995 meeting that spurred the FOMC reducing the FFTR by 25 basis points at the December 1995 and January 1996 meetings. The final section concludes.

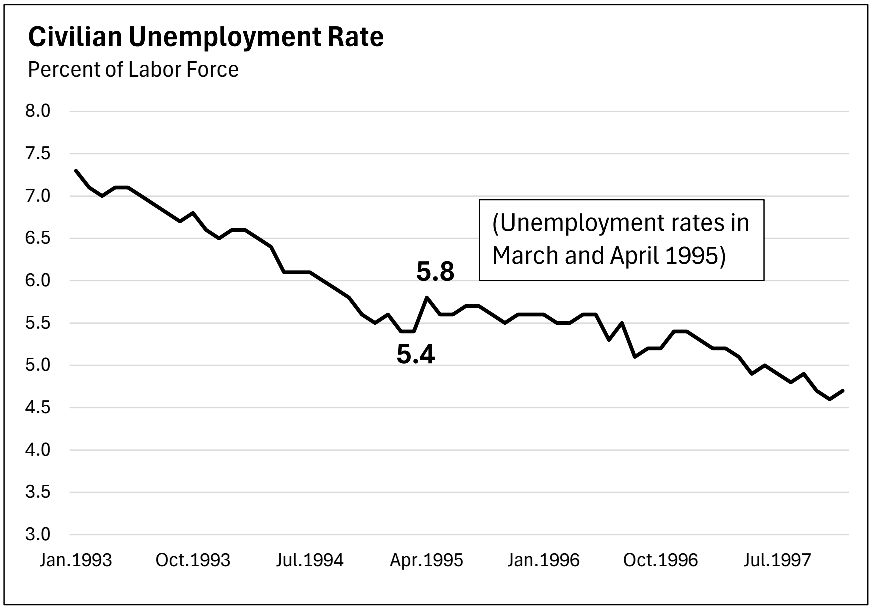
1. MACROECONOMIC DEVELOPMENTS LEADING UP TO THE JULY 1995 FOMC MEETING

[2] Chair Powell's Press Conference, September 18, 2024. https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20240918.pdf.

The shift to a less restrictive policy stance at the July 1995 FOMC meeting was perhaps surprising because headline and core inflation rates remained above the level consistent with Greenspan's preference of price stability (zero inflation, properly measured). Parenthetically, it should be noted that Greenspan's definition of price stability was different from the median FOMC participant, as a subsequent discussion about the appropriate rate of inflation to target revealed.[3] Moreover, pre-emptive easing occurred against the backdrop of a relatively healthy labor market. In January and February 1994, the unemployment rate measured 6.6%. By February 1995, the unemployment rate was 1.2 percentage points lower than a year earlier. The unemployment rate would steadily decline, on net, thereafter, falling to less than 5% by the third quarter of 1997. However, as seen in Figure 1 below, the unemployment rose by 0.4% points between March and April 1995. As will be discussed below, this development, along with a steady markdown in the forecasts of real GDP growth in the second and third quarters of 1995, contributed to the Committee's conclusion that the economy was slowing—and perhaps potentially, headed towards a recession—thus necessitating the adjustment of policy to a less restrictive stance.

[3] This debate was spawned by a planned debate between then Federal Reserve Governor Janet Yellen and Richmond Fed President Al Broaddus on the merits of inflation targeting during the July 2-3, 1996, FOMC meeting.

Figure 1



On the inflation front, the Board staff admitted that the data was coming in better than expected in 1995. However, both headline and core CPI inflation was trending modestly higher through the first four months of the year. Thereafter, as seen in Figure 2, both inflation rates would moderate some over the remainder of the year—and headline more so than the core. But this positive development was partially offset in the staff's view by higher levels of resource utilization—at least until their view changed in late spring (as will be discussed below). Thus, with expectations of a soft landing in sight, the FOMC voted to maintain the FFTR at 6% at the March 28 and May 23 FOMC meetings. In fact, the FOMC maintained a restrictive policy rate throughout 1995, as measured by the Taylor rule.[4] See Figure 3 below.

[4] See Kliesen (forthcoming) for details.

Figure 2

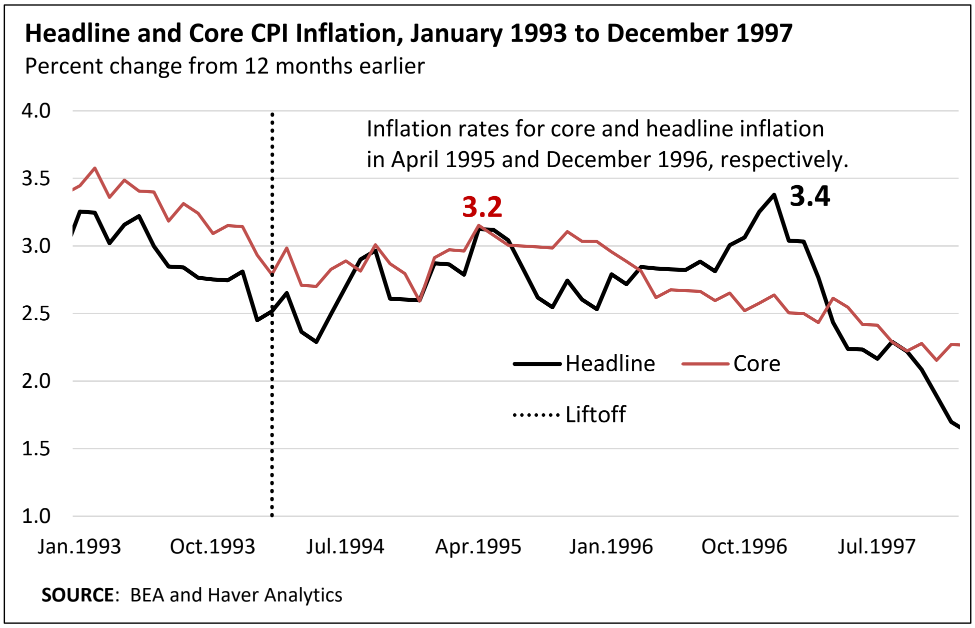
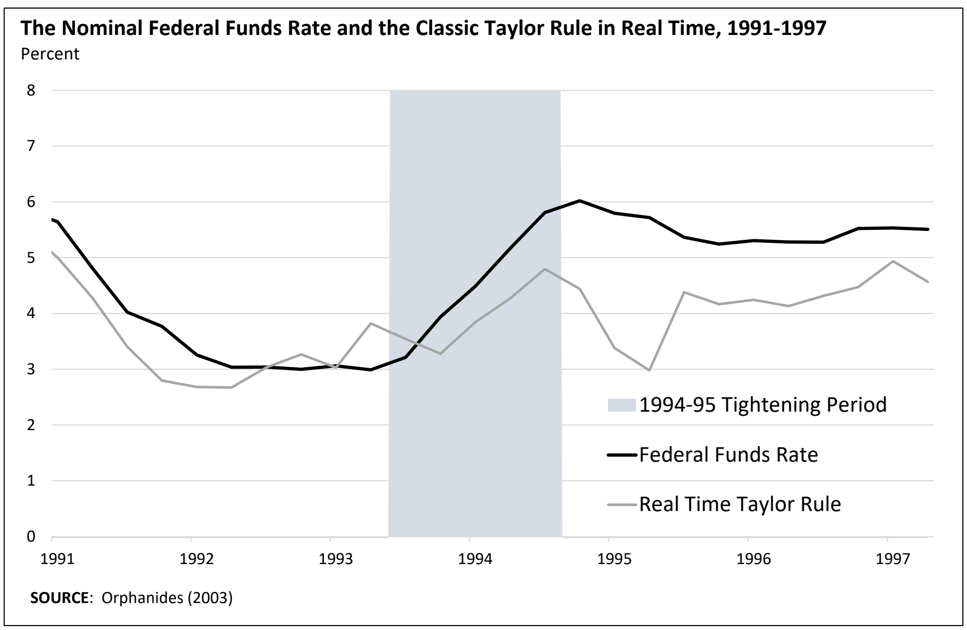


Figure 3



There is no agreed upon measure of a soft-landing after an FOMC tightening episode, but a steady decline in the unemployment rate and continued positive growth in real GDP in the absence of an acceleration in inflation or inflation expectations suggests that the FOMC achieved its soft-landing by the spring of 1995—or so the Committee believed.[5] However, by July, the FOMC was pivoting to an easing posture, as policy was deemed too restrictive to achieve its policy goals by Chairman Greenspan and a majority of the FOMC.

Two subsequent developments affirmed (in the staff and the Committee's view) that further disinflationary pressures were likely to prevail, thus leading to the FOMC's decision to begin implementing a less restrictive policy in July 1995. First, the Greenbook forecasts of real GDP growth for the second and third quarters of 1995 were steadily marked down over the first half of the year. When the FOMC convened for the July 1995 FOMC meeting, many participants concluded that the economy was slowing sharply. This sentiment was probably heavily influenced by the Greenbook forecast prepared for this meeting: The Board staff forecast negative real GDP growth in the second quarter (-0.5%) and below-trend growth (1.1%) in the third quarter. However, as noted above, the unemployment rate was steadily declining over this period—except for the hiccup in April 1995—despite the FOMC's 300 basis point increase in the FFTR from February 1994 to February 1995. In the Greenbook prepared for the July 1995 FOMC meeting, the Board staff thus noted a "less robust labor market," as reflected in the unexpected jump in the unemployment rate in April (Figure 1). In the January 1995 Greenbook, the staff forecast that the unemployment rate would not exceed 5.5% in 1995 and 1996. But in the July Greenbook, with a below-trend growth forecast in hand, the staff now forecast that the unemployment rate would increase from 5.5% in the first quarter of 1995 to 6.1% by the end of 1996.

Second, the risk of inflation reaccelerating was deemed low by Board staff, as reflected in the Greenbook forecast. This assessment largely reflected the Phillips curve structure embedded

[5] Romer and Romer (forthcoming, *Journal of Monetary Economics*, 2024) discuss lessons from successful disinflations in the US post-WWII period up through 1989.

in the FRB/US model, and thus the view that the wage-price causality was mostly from wages to prices. In the July Greenbook, the staff noted that:

> Owing to the current weakness of the economy, inflationary pressures are likely to be more subdued than previously projected. Falling capacity utilization has already led to a softening in some materials prices, and the concerns of workers and managers regarding the outlook for business activity are probably helping to put a damper on wage gains. As in recent Greenbooks, we expect that price increases will slow in the second half of this year, but—in contrast to earlier projections—we are now looking for core CPI inflation to edge back below 3 percent in 1996, as the unemployment rate runs just above 6 percent.

Ultimately, the FOMC would subsequently cite favorable inflation developments in the statements that announced rate cuts in July and December 1995 and in January 1996.

Parallels with 2024

The 1995-96 easing episode is interesting because it parallels in some ways developments in the macro economy from 2022 to 2024. First, prior to the July 1995 easing, the FOMC had increased by FFTR by 300 basis points from February 1994 to February 1995. Between March 2022 and July 2023, the FOMC increased the policy rate by 525 basis points. The FOMC's action was taken to combat a CPI inflation rate (all items, or headline) that reached 9.1% in June 2022; the 12-month percent change in the headline personal consumption expenditures price index (PCEPI) peaked at 7.1% in June 2022. A second characteristic common to both episodes was the resilience of real GDP growth and labor markets in the aftermath of the sharp increase in the nominal and real FFTR. Although the unemployment rate increased from its expansion low of 3.4% in January 2023 and April 2023 to 4.2% in August 2024, real GDP has increased at a robust 2.9% annual rate from the second quarter of 2022 to the second quarter of 2024.[6] In the September Summary of Economic Projections, the median FOMC participant pegged the longer-

[6] Chair Powell noted that labor market softness also reflected the BLS' preliminary annual benchmark revision released in August 2024, which showed that the level of nonfarm payrolls in March 2024 was 818,000 less than the current estimate.

run values for the unemployment rate at 4.2% and real GDP growth of 1.8%. Despite above-trend real GDP growth, most monetary policymakers wanted to avoid a further weakening in the labor market by recalibrating the FFTR to a less restrictive stance, eventually returning the FFTR to a level deemed neutral.

Given the similarities between today's developments and the 1994-96 episode, it might be useful to examine the transcripts from the July 1995 FOMC meeting to see the arguments that those FOMC participants used that led them to enact the first of three rate cuts so soon after a considerable tightening in monetary policy. Of course, historical parallels are just that. They are not a blueprint for future policy decisions by the current FOMC. What follows immediately below are the arguments advanced by Chairman Greenspan in the policy go-round. Comments from Don Kohn's staff presentation on policy options from the Blue Book will also be summarized, since he listed several points for the FOMC to consider in their decision-making process.

2. Chairman Greenspan's Arguments

The Chairman's comments throughout the 1994-95 tightening episode and the start of the pre-emptive easing episode that began in July 1995 showed that he closely monitored inventory adjustments as an important barometer for gauging the strength of final demand for goods and services over the near term. Nevertheless, Chairman Greenspan concluded that recession risks appeared to be moving lower, but they remained relatively high.

> I might indicate that I was somewhat surprised yesterday by the degree of convergence on the outlook [NOTE: in the economic go-round on the previous day]. As I saw it, virtually all of us were concerned about asymmetric risks on the downside, but no one thought the probability of a recession was better than 50/50. Indeed, all your forecasts imply that the economy will work its way through this period. . . In my judgment, the crucial issue is whether the inventory adjustment will reach a critical mass that will weaken incomes sufficiently to upend final demand. Such a development would in turn set in motion a typical recession driven by inventories in a vicious circle downward until it exhausts itself. At this stage that does not appear to be the likely outcome, and indeed time is on the side

> of emerging stability. All we really need is sluggish final demand that persists until the inventory adjustment finally dissipates. Three or so weeks ago I must say that I interpreted the risks as still increasing, because all the evidence that I could see suggested that the economy was moving to the downside. . . But the data of the last few weeks clearly are moving in the direction that, while the downside risks are still there, we at least seem to have reached the maximum risk potential and probably are now somewhat on the other side. But by no means have we reached the point where we can very readily presume that the major threat to the recovery is over at this stage.

Greenspan concluded that because of their tightening actions over the past year, the Committee has "defused to a significant degree the inflationary pressures that were building through the early weeks of this year. . . In this regard we have quite encouraging evidence that the cyclical peak in inflation may be close at hand."[7] He further contended that the FOMC's fight for price stability was being assisted by developments in the rest of the world. Greenspan then turned to the key aspects of the discussion, which first included a presentation about policy options from the Blue Book. Don Kohn's presentation on the implications of short-run policy options facing the FOMC teed up the discussion that centered on two key policy questions.[8] First, is the current FFTR level too high relative to the short-term real federal funds rate (R*)? Second, what would be the financial market's response if the FOMC voted to (i) maintain the FFTR at 6%, (ii) to decrease the FFTR by 25 basis points, or (iii) to decrease the FFTR by 50 basis points?

In his presentation, Kohn said that "policy may well be positioned a bit to the restrictive side at this point." He further elaborated that this judgement was based on the expectation of slower inflation, the level of the real FFTR relative to its historical averages, and in the "read

[7] A little less than two years later, Greenspan acknowledged in the February 1997 Humphrey-Hawkins testimony before the House of Representatives, that some were critical of the pre-emptive tightening of policy in 1994-94:

> I find it ironic that our actions in 1994-95 were criticized by some because inflation did not turn upward. That outcome, of course, was the intent of the tightening, and I am satisfied that our actions then were both necessary and effective, and helped to foster the continued economic expansion.

See: https://www.federalreserve.gov/boarddocs/hh/1997/february/testimony.htm.

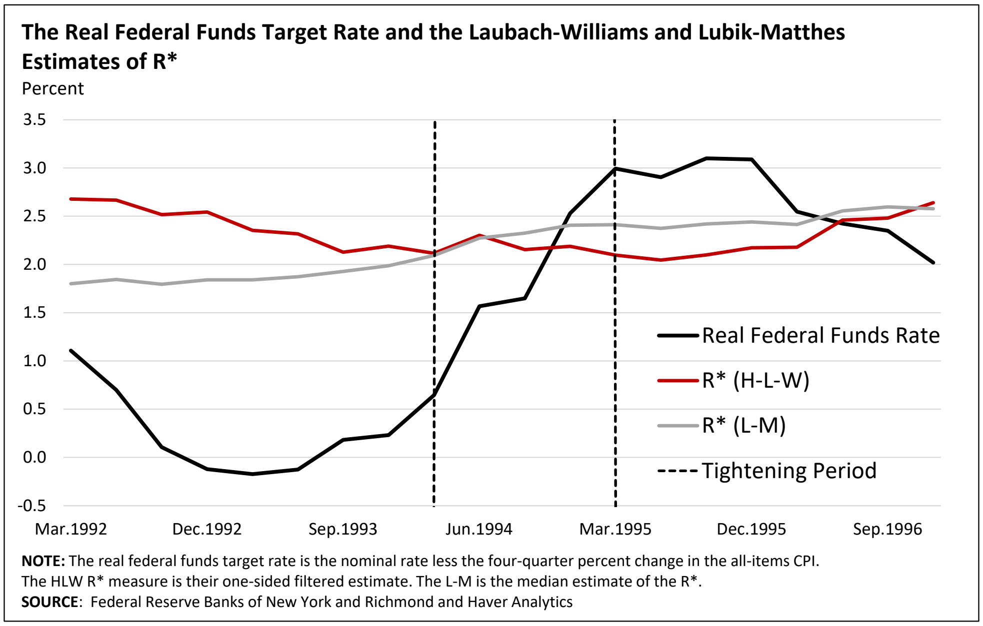
[8] At the time, Kohn was director of the Division of Monetary Affairs and secretary of the Federal Open Market Committee.

outs" from various policy rules. As noted in Figure 3 above, a 1993 Taylor rule using real time data indicated that the nominal FFTR was 158 basis points above the calibrated policy rule rate in the second quarter of 1995; by the third quarter, the gap was 242 basis points. Thus, the Taylor rule indicated that the FFTR was too high and moving in the wrong direction relative to the prescribed rate from the rule. Kohn further noted that the staff's assessment was that the current FFTR was only about 50 to 75 basis points above the natural rate. Figure 4 below, which is copied from Kliesen (forthcoming), indicates that the real federal funds rate in the second quarter of 1995 was 86 basis points above the R* measure of Laubach-Williams (LW) and 53 basis points above the R* measure of Lubik-Matthes (LM).[9] In the third quarter of 1995 (which includes the July reduction in the nominal FFTR of 25 basis points), the real FFTR was 100 basis points above the LW estimate and 68 basis points above the LM estimate. The gap between the real FFTR and the R* estimates would subsequently close rapidly beginning in 1996 following the FOMC's easing actions. Regarding the second discussion point (how much to ease), Kohn noted that the failure to ratify the market's expectation of a reduction in the FFTR would likely lead to a reversal in the decline in longer-term rates that had occurred since last winter. However, Kohn also noted one benefit of maintaining the policy rate at the July meeting:

> Keeping the funds rate unchanged at this time increases the odds on some disinflation and would send another signal to markets that the Federal Reserve takes seriously its stated goal of making progress toward price stability over time.

[9] See discussions and references in Kliesen (forthcoming, 2025).

Figure 4



Nevertheless, in Kohn's and the staff's judgement, inflation would likely continue to slow under the expectation of a lower expected path of the FFTR. But he also cautioned that reducing the FFTR would also increase the probability of a policy reversal under the assumptions that, first, policy was not "fundamentally too high" and, second, incoming data that was stronger than expected might "unnecessarily confuse markets. But Kohn also assured them that even if a policy reversal were to occur, an increase in the FFTR would "seem entirely appropriate" and "readily explainable in the contest of that new information."

In terms of the pace and magnitude of a reduction in the FFTR, Kohn made three points. First, markets would see a reduction in the FFTR as the first of a "relatively long sequence" of rate reductions. Second, a 50 basis point reduction in the FFTR would be interpreted by markets as the FOMC signaling "significant risks to economic expansion and current short-term rates as appreciably above appropriate levels." Third, a 25 basis point reduction would prompt speculation almost immediately when the next reduction will occur. In a forthcoming article in the *Journal of Monetary Economics*, Kohn argues that many members favored a policy that came to be known as "opportunistic disinflation."[10] Under this strategy, said Kohn:

> once inflation had fallen to a fairly low level, the FOMC would not try to engineer economic slack to bring it all the way down but would resist any increases and take advantage of favorable supply shocks or negative demand shocks that inadvertently opened up output gaps to get all the way to stability. Thus 1994-5 is another example, along with 1982, 1984, and 1988-89 of policymakers backing off disinflationary policy before they saw the way clear to price stability.[11]

In elaborating on his policy preferences, Greenspan said that he agreed with Kohn that the real FFTR was above "some notion" of the equilibrium or natural real rate. (which I have called R*). But the question in Greenspan's mind was "whether we need a 3 percent real federal funds rate to continue the secular disinflation that we have been involved with for a number of years." He concluded that "the real federal funds rate consistent with achieving price stability is "something under 3 percent—not for certain but with some degree of reasonableness." As seen in Figure 4, Greenspan's estimates were consistent with Laubach-Williams and Lubik-Matthes estimates of R*. Greenspan then said that he was initially inclined to reduce the FFTR by 50 basis points at this meeting "as a mid-course correction." But he said that he has since concluded that the risks "are beginning to ease slightly," so that there is no longer any urgency to move 50 basis points.[12] In summing up his position for the FOMC policy go-round discussion, Greenspan said:

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[10] "Comments on 'Lessons from History for Successful Disinflation' by Christina D. Romer and David H. Romer," *Journal of Monetary Economics*, 2024, forthcoming. Kohn compared and contrasted the deliberate disinflation approach with the opportunistic disinflation approach at the December 1995 FOMC meeting. This presentation is available at: https://www.federalreserve.gov/monetarypolicy/files/FOMC19951219material.pdf.

[11] *Ibid*

[12] Greenspan had earlier hinted at the possibility of easier policy at some point in the near future in his Humphrey-Hawkins testimony on February 22, 1995:

> [T]here may come a time when we hold our policy stance unchanged, or even ease, despite adverse price data, should we see signs that underlying forces are acting ultimately to reduce inflation pressures. Events will rarely unfold exactly as we foresee them, and we need to be flexible--to be willing to adjust our stance as the weight of new information suggests it is no longer appropriate That flexibility, Mr. Chairman, applies to the particular stance of policy--not its objectives.

> I have concluded that probably the best thing to do is to move the funds rate downward by 25 basis points, which I must say likely will be a big deal because we would be changing the direction of policy. I am concerned about going further than that in part because I am really concerned about spooking the markets, especially the foreign exchange markets in this context. And I don't think a larger reduction now is necessary. We could readily, if we so chose, add another 25 basis points in August or later. In that sense, I think what we would do is probably create an expectation in the marketplace that indeed we will move again since everyone says "well, the Fed never moves only once." I am not sure that is all bad because it probably would mean that we would support gradually declining long-term rates, including mortgage rates, which would create support within the economic system. I find it very difficult to envisage inflationary pressures emerging at any point in the near term. If we were to lower rates by 50 basis points, I am fearful the markets would ask "when is the next 50?" I would be uncomfortable with that because it is very difficult to dissuade the markets from that point of view, and I think we would drive the federal funds futures rate down to a considerable extent.

3. VIEWS OF THE OTHER FOMC PARTICIPANTS

Chairman Greenspan's recommendation of a 25 basis point reduction in the FFTR was approved by the Committee with only one dissent. Kansas City Fed President Tom Hoenig dissented in favor of no change in policy. As will be noted below, Hoenig—along with a few other nonvoting participants—was more concerned about the longer-term inflation outlook and what a reduction in the FFTR with inflation still too high would send to the markets about the Fed's commitment to price stability. This was one of the options cited by Kohn for maintaining the existing FFTR for that reason.

Despite the near unanimity in the policy decision, the Committee discussion was wide-ranging, and there was some nervousness about the Chair's policy recommendation. In this vein, I have summarized the discussion points on the following three issues. [NOTE: The APPENDIX provides a transcript summary of each participant's notables comments spoken at the July 1995 FOMC Meeting in the policy go-round portion of the two-day meeting.]

See https://fraser.stlouisfed.org/files/docs/historical/greenspan/Greenspan_19950222.pdf?utm_source=direct_download.

Policy Adjustments as a Form of Insurance

In the Bluebook prepared for this meeting, Board staff wrote that "a reduction in the federal funds rate, perhaps of the 1/2 percentage point size embodied in alternative A, could be favored as a form of insurance against the downside risks in the economic outlook." Seven participants commented on the insurance aspect of a reduction in the FFTR in the policy go-round, which occurred on the second-day of the FOMC meeting. Federal Reserve Bank Presidents Robert Forrestal (Atlanta) and Robert Parry (San Francisco), and Governors Alan Blinder, Susan Phillips, and Janet Yellen, all favored a reduction in the FFTR to insure against the possibility of a recession or slower growth. Moreover, Governor Yellen, amplifying a comment made by Chairman Greenspan, noted that a FFTR reduction would simply be a mid-course correction. By contrast, Kansas City Fed President Tom Hoenig warned that taking out an insurance policy against the possibility of weaker growth was not costless. In a similar fashion, Cleveland Fed President Jerry Jordan made two points. First, he argued against a rate cut as insurance (against a contraction in economic activity) because in his view "the economy tends to expand in the absence of adverse shocks or perverse policy." Second, he argued that the 50 basis point increase in the FFTR in February 1995 was an insurance policy against higher inflation. Thus, he asked if it is prudent "to cancel all of that insurance or only half of it."

The Degree of Policy Restrictiveness

In his comments that presaged the policy go-round, Chairman Greenspan posed "the crucial question" facing the FOMC: "At this point we have to ask ourselves whether a 6 percent nominal federal funds rate, or a 3 percent real federal funds rate, is the appropriate level we wish to be at in the next 6 to 12 months?" He then challenged the Committee further, asking: "If the argument essentially is that the 3 percent real rate is indeed appropriate for the future, I would ask how do we know that 4 percent real or 6 percent real is not more appropriate?" Greenspan's follow-up question hinted at the inherent uncertainty in gauging the appropriate stance of monetary policy through the lens of the real FFTR relative to a measure of the equilibrium real rate or long-term real interest rate.

Some FOMC participants believed that a real FFTR less than 3% was appropriate, and most of those individuals came into the meeting planning to press for a 50 basis point reduction in the nominal target rate; however, they ultimately did not dissent for various reasons. In Governor Blinder's view:

> "the case for easing now starts with the presumption, or the guesstimate, that the 3 percent real funds rate is too high for the long or intermediate run." He further argued that "the economy looks highly vulnerable to a negative shock right now." He then said that if the FOMC failed to ease, "the very things that we are expecting to support the economy and prevent a recession will evaporate right before our eyes, if we don't act. . . It starts with the belief that the ultimate need is going to be more than 50 basis points. . .The second part of the argument is, as I said before, that I think we are already behind the curve and it is useful at this point to give a signal to bolster confidence that the Fed is watching and not asleep at the wheel."

In his assessment, only cutting by 25 basis points would be "read as a fairly timid action suggesting a very tentative Federal Reserve not quite sure about what should be done."

Two other Fed Governors aligned themselves with Governor Blinder. Governor Lindsey argued that "ultimately we are going to need more than a 50 basis point reduction. If I were betting I would say that a year from now we will be 100 basis points under where we are now, and we still may be chasing where we want to be." That assessment turned out to be modestly too pessimistic, as the FOMC would ultimately only decrease the FFTR by 75 basis points during this easing episode. President McTeer (Dallas) said that "it now looks like we may have gone one bridge too far," stressing that a 25 basis point reduction in the FFTR fed funds would not be "much of an easing of policy." The essence of McTeer's argument was that the final 50 basis point increase in the FFTR in February 1995 was excessive, and that a mid-course correction was necessary.

Governor Yellen also favored a 50 basis point cut "to cement in place the existing financial conditions that are already working to provide the critical cushion against the downside risks. So, I would like to see a cut to prevent a further backup in long-term interest rates, namely, to ratify the expectations implicit in the current structure of longer-term yields." Ultimately, though, Governor Yellen did not dissent, because she recognized the "possible impact on financial markets" from a 50 basis point decrease. Using language similar to Chair Powell years later at the Kansas City Fed's 2024 Jackson Hole Economic Symposium, Vice Chair William McDonough said "the time is now" to cut. But he agreed with Greenspan (and Yellen) that a 50 basis point decrease in the FFTR could destabilize financial markets and signal that the FOMC feared the worst for the US economy. Thus, Chairman Greenspan's contention that a 50 basis point decrease in the FFTR would spook the financial markets was decisive in the views of some key participants.

Fed Presidents Boehne (Philadelphia), Broaddus (Richmond), and Moskow (Chicago) all urged the Committee to adopt a cautious or gradualist approach to easing. Boehne argued that "a cautious move toward less restraint, therefore, would help shore up demand and lessen downside risks." More importantly, building on a comment made by Blinder, it would demonstrate that the Fed is awake at the switch and wants to avoid a recession." In a different vein, President Moskow was attuned to the fiscal outlook, noting "I believe the real federal funds rate should be below 3 percent, especially given the fiscal policy assumptions."[13] As will be noted below, the Administration and the Congress were haggling over a fiscal package that fall to assuage the concerns of some in the markets (including Greenspan) about the outlook for the federal budget deficit. President Parry countered that while a rate cut was necessary, the FOMC "should be prepared to reverse course and raise rates if circumstances change and growth looks as though it will exceed the growth rate of potential output. In fact, I don't think we should cut rates now unless we are prepared to raise them again fairly soon, should that become necessary." Parry's policy reversal argument dovetailed with Kohn's discussion about the potential necessity of reversing course if the data demanded it.

Some participants did not believe conditions warranted a rate cut. Fed President Melzer said that:

> "I don't believe the current economic outlook warrants a change in the stance of monetary policy. Easing policy at the first sign of economic weakness after a period of what I think we would all agree is unsustainable real growth undermines our credibility and could adversely affect the bond and foreign exchange markets. In effect, we would be engaging in short-run fine-tuning under conditions of great uncertainty with respect to the economic outlook. Accordingly, my preference would be to maintain the current restrictive policy to ensure that the acceleration in inflation that began last year is capped and to bring trend inflation to a level significantly below 3 percent."

Similarly, President Hoenig argued that "the real funds rate may be where it should be at this stage. There is no strong evidence that it is not."

Risks to the Forecast

Most of the FOMC participants agreed that the economy had slowed along the lines suggested by Chairman Greenspan and the staff forecast. However, there was some disagreement about the near-term outlook beyond the July 1995 meeting. For example,

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[13] The fiscal outlook and the implications for policy would play a larger role in the discussion at the following FOMC meeting in August. For example, Chairman Greenspan noted that "Our forecasts are going to be tested by the fiscal crunch we are all talking about." The issue at hand was the pending debt limit extension. Eventually, the federal government would incur a partial shutdown for a total of 23 days from November 14, 1995, to January 5, 1996.

Governor Blinder said that the FOMC was “already somewhat behind the curve,” while President McTeer (Dallas) said that “we probably have one negative quarter in the bag and we may have a second in the bag.” Governor Yellen said that she was “concerned about downside risks and the possibility of destabilizing feedbacks that could weaken the economy more than the Greenbook envisions.” However, Yellen was comforted that inflation would trend lower given the projected policy path and “the greater slack already in evidence in both product and labor markets.”

Some participants commented that uncertainty seemed higher than normal. President Parry said that if he was “certain of our forecast and that in the Greenbook, I would probably favor leaving policy unchanged at present. However, as we all know, forecasts are often wrong and they often underpredict the size of cyclical swings in the economy.” Governor Phillips mentioned that she was uncertain about the forecasted inventory correction discussed by Chairman Greenspan, while President Mike Moskow (Chicago) said that although there has been “two or three months of bad numbers, there is still a lot of uncertainty about the economy's underlying strength.” Several participants mentioned that lags in the transmission process meant that the FOMC should not focus on developments today, but developments in the future. For example, Governor Lindsey said that “we cannot think of ourselves as reacting to the current slowdown because there is nothing we can do about the current slowdown.” Likewise, Minneapolis Fed President Gary Stern said that “there is not much we can do about the economy at this point.”

Other participants were more optimistic that the economy would recover from its current bout of slowing growth, and that, accordingly, risks to the longer-term inflation outlook should remain front and center. St. Louis Fed President Tom Melzer said that in his judgment, “the current slowing in the expansion will be followed by a rebound of growth at a rate near the economy's long-term potential. . . So, at this time my principal concern is really with the long-run inflation trend." Melzer's forecast for real GDP growth turned out to prescient, as real GDP would increase at a 4% annual rate from the third quarter of 1995 to the fourth quarter of 1996.[14] Similarly, Boston Fed President Cathy Minehan said that, while "risks have changed over the last few months from being on the upside. . . to being fairly evenly balanced, now they seem to be much more on the downside. However, I think these risks are wholly in the context of a pause in economic growth and not a recession." Likewise, Governor Kelley said that "I see the likelihood of a moderate and sustainable noninflationary growth period ahead of us coupled with a cyclically plateauing inflation rate that is still in a secular downward trend. I find all of that rather attractive."

Some of the participants' optimism stemmed from recent financial market developments due to "lower intermediate- and long-term interest rates [that] have in effect put a floor under the housing and auto markets" (Melzer). Similarly, President Minehan was reassured that "there is a powerful offset to all of this in the drop in interest rates, the health of the banking system, and the health of financial markets in general. In my view, those financial factors will pull the economy out in fine measure by year-end." Like Melzer, Minehan's forecast was also prescient. Philadelphia Fed President Edward Boehne expressed concerns about fueling an unsustainable increase in financial asset values; he worried that too large a cut in the FFTR would "avoid feeding another big run-up in asset values versus."

There was concern among some participants about the longer-run inflation outlook. President Hoenig, who dissented at this meeting, agreed with President Melzer, warning that "when we vote for monetary stimulus, we are also increasing the risk of further inflation." In a similar vein, Richmond Fed President Al Broaddus reminded the

[14] This growth rate is based on current-vintage data using chain weights.

Committee to keep a longer term perspective about the inflation outlook: "It was less than a year and a half ago that we ended an extended period of substantial monetary ease. While the risk of further inflation in this cycle is smaller than it was, I don't think it is zero and we need to keep that in mind." Still, Governor Yellen countered that "all our forecasts, with or without a cut in the funds rate of the size we are envisioning here, show a decline in inflationary pressures as we go forward."

Figures 5 and 6 below plot Greenbook forecasts of real GDP growth and headline CPI inflation for 1995 and 1996 (Q4/Q4). Real GDP growth for 1995 was steadily marked lower over the first half of the year, but then marked higher over the second half of 1995. This episode provided two examples why the FOMC should not place too much faith in the current forecasts. First, the Greenbook forecasts for real GDP growth in the second and third quarters of 1995 turned out to be too pessimistic—a point made by some participants (e.g., Melzer and Minehan). Forecasts of real GDP growth for 1996 changed modestly through 1995, but on net were unchanged by the December 1995 Greenbook. The second example occurred because of the results of the 1996 comprehensive revisions of the national income and product accounts in January 1996. The sharp decline in 1995 and 1996 real GDP growth rates (the final data points in the chart) reflected the Bureau of Economic Analysis' switch from fixed weights to chain weights at the end of 1995.[15] The switch to chain weights lowered the annualized quarterly growth of real GDP in the first and second quarters to 0.6% and 0.5% respectively, from 2.7% and 1.3%. It's possible, though no means certain, that if the FOMC would have been aware of state of the economy as measured by the chain-weighted growth of real GDP over the first half of 1995, they might not have increased the FFTR by 50 basis points in February 1995. Regardless, the development illustrates the difficulty of making policy in real time.

[15] See US Department of Commerce (1996).

Figure 5

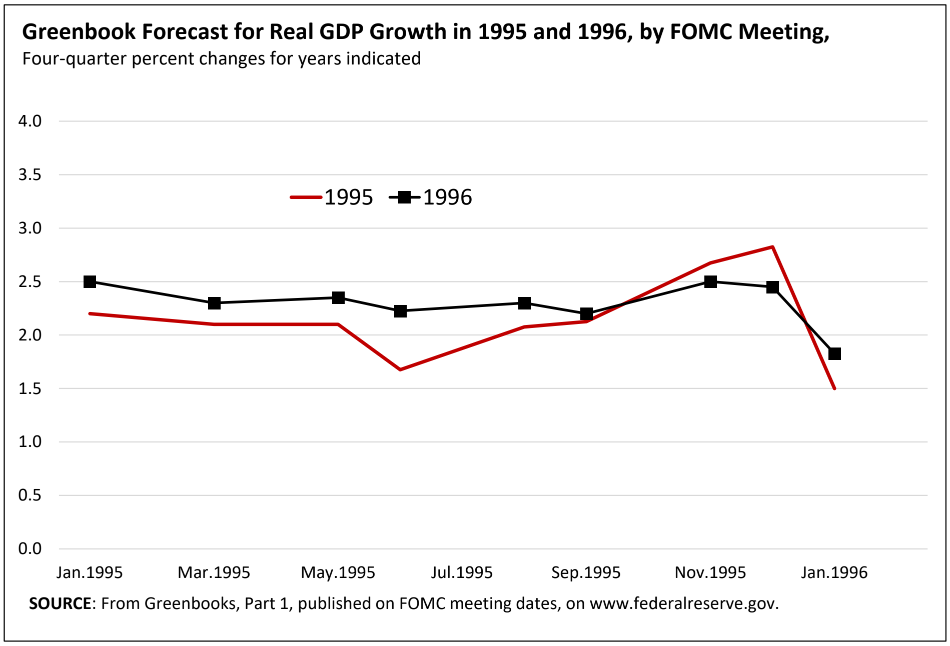
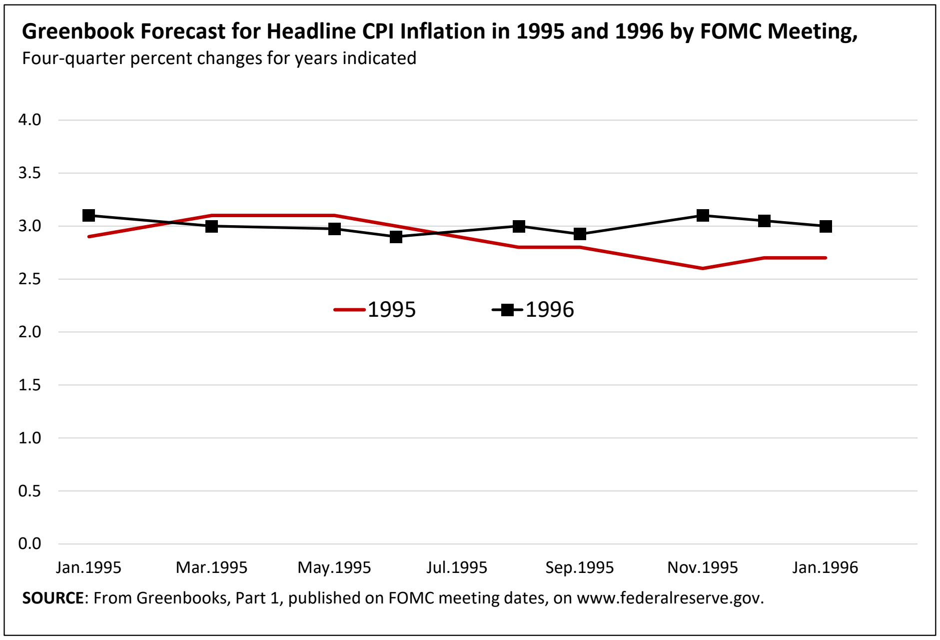


Figure 6



The Policy Decision

At the conclusion of the July 6, 1995, meeting the FOMC issued a Press Release and noted that “inflationary pressures have receded enough to accommodate a modest adjustment in monetary conditions.[16] The Minutes of the July meeting that were published prior to the August meeting noted the preferences of those who wanted an unchanged policy stance and those who "preferred somewhat greater easing." Nevertheless, the decision to reduce the FFTR by 25 basis points was based on what would become a modus operandi of the Greenspan FOMC: A policy of moving gradually to avoid the potential for increasing financial instability.[17] In that vein, the Minutes noted:

> The members agreed that under present economic conditions a slight easing of the stance of policy would incur little risk of stimulating increased inflation and would be entirely consistent with their commitment to continued progress toward price stability over time. Several members also observed that any move toward less restraint should be cautious at this point because easing would represent a change in the direction of policy and its repercussions on financial markets, including the foreign exchange markets, could be relatively pronounced.[18]

4. A SUMMARY OF SUBSEQUENT DEVELOPMENTS AFTER JULY 1995

Following a 25 basis point decrease at the July 1995 meeting, the FOMC would maintain the FFTR at 5.75% at the August 22, September 26, and November 15, 1995, meetings. At the August and September meetings, Greenspan mentioned the evolving fiscal outlook, believing it to be "unwise" to move because of the budget discussions between the Administration and Congress that were occurring at the time. However, he also warned the Committee that they should be "careful not to allow monetary policy to be frozen in place by a process that could go on for months and months" (Sept. 26 transcript). This sentiment would also be expressed by the Chairman at the November meeting. In this regard, there was also concern by some participants that FOMC policy actions should not be tied too closely to actions taken by the fiscal authorities.

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[16] https://www.federalreserve.gov/fomc/19950706default.htm.
[17] In this vein, see Blinder and Reis (2005).
[18] https://www.federalreserve.gov/fomc/MINUTES/1995/19950706min.htm.

As seen in Figure 5, the Board staff outlook for real GDP growth in 1995 improved over the second half of 1994, from 1.7% at the July meeting to 2.8% at the December 1995 meeting. Over the same period, the forecast for real GDP growth in 1996 was lifted from 2.2% to 2.5%. In contrast, the Greenbook forecast for CPI inflation in 1995 was lowered from 3.1% in July to 2.7% in December, but the inflation forecast for 1996 was raised from 2.9% to 3.1%. Thus, with some improvement in the near-term inflation outlook and with economy having skirted a recession, the FOMC decided to take out more insurance against a possible reversal in the real economy by reducing the FFTR by 25 basis points at the December 19 meeting and by an additional 25 basis points at the January 30-31, 1996, meeting. At both meetings, Greenspan said that he was more pessimistic about the near-term output growth forecast than the Greenbook, but that he was more optimistic about the longer-term inflation forecast because of improvements on the supply side stemming from the computer microchip and its applications.[19]

In all, the FOMC reduced the FFTR by 75 basis points to 5.25% during this easing episode. The target rate would remain at that level until March 1997, when the FOMC raised the FFTR rate by 25 basis points. This would be an unusual one-time increase, since the next move was another series of three 25 basis point cuts in the FFTR in September, October, and November 1997 in response to the Russian debt default and Asian financial crisis. Like the 1995-96 preemptive easing episode, this policy response also helped to avoid a sharp slowing in real GDP growth and/or recession. The next recession would not occur until March 2001. Headline and core CPI inflation would continue to slow until 1998-99, as Greenspan predicted. Thereafter, inflation rebounded in response to a sharp increase in energy prices between December 1998 and November 1999, only to retreat during the relatively short and shallow 2001 recession.

[19] On the latter point, see Anderson and Kliesen (2012).

CONCLUSION

The 1995-96 preemptive easing of policy occurred largely for four reasons. First, Chairman Greenspan and many of the other FOMC participants believed that they had defused the buildup of inflation pressures that motivated the pre-emptive tightening of policy from February 1994 to February 1995. Second, these participants believed that monetary policy had turned too restrictive—that is, the real federal funds target rate was too high, whether viewed through the lens of a Taylor rule, or the level of the real FFTR relative to a measure of R*. Thus, while restrictive monetary policy was believed to be tamping down inflationary pressures, Greenspan and many participants believed it was also slowing down the pace of real economic activity unnecessarily and raising the probability of a recession. Third, many participants sought to ratify the decline in market interest rates that had occurred prior to the July meeting, believing that this would also help support the pace of economic activity. Finally, Greenspan convinced the FOMC to ease on the conviction that a restrictive policy stance of policy would eventually lower inflation—even though the staff's inflation forecasts did not agree with that view—while avoiding pushing the economy into a recession.

Ultimately, the policy should be judged by its outcome. The pre-emptive tightening of monetary policy in 1994-95, followed shortly thereafter by the pre-emptive easing in 1995-96 achieved its intended result: The US economy avoided a recession and inflation by the end of 1997 was at a rate consistent with what is now termed price stability. Years later, Greenspan wrote that "the soft landing of 1995 was one of the Fed's proudest accomplishments during my tenure."[20]

[20] Alan Greenspan (2007), p. 156.

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APPENDIX ON THE FOLLOWING PAGE

MR. FORRESTAL. In terms of policy I think it is wise and prudent for us to take this action at this time--as an insurance policy in a sense. When I came into the meeting, I must say I was thinking more in terms of a 50 basis point drop because I thought that 25 basis points would only compel the market to keep asking when the next move is going to take place. But hearing your rationale for 25 basis points, I would be prepared to support that.

MR. BLINDER. I strongly feel we should be easing today. Indeed, it seems to me that we are already somewhat behind the curve, which is something we rightly feared greatly on the upside. . . The case for easing now starts with the presumption, or the guesstimate, that the 3 percent real funds rate is too high for the long or intermediate run. Were it not for that belief, I think we would have a much weaker case for easing now. . . the economy looks highly vulnerable to a negative shock right now. As Bob Forrestal just said, that means we ought to be taking out some insurance against recession. It would have been nice if we had taken this insurance out some months ago, but we didn't have that kind of foresight. . . given what the markets have done, if the Fed does not ratify it with some easing--and it doesn't have to be today, but soon--the bond market is likely to back up. I might add that I would expect the stock market to crack as well. So, the very things that we are expecting to support the economy and prevent a recession will evaporate right before our eyes, if we don't act. . . Let me very briefly give you the reasons why I think doing 50 basis points would be preferable today. It starts with the belief that the ultimate need is going to be more than 50 basis points. If you don't believe that, doing 50 basis points today would not be a smart action. The second part of the argument is, as I said before, that I think we are already behind the curve and it is useful at this point to give a signal to bolster confidence that the Fed is watching and not asleep at the wheel. In addition to that, doing 25 basis points will be read as a fairly timid action suggesting a very tentative Federal Reserve not quite sure about what should be done.

MR. PARRY. Mr. Chairman, I basically agree with many of the comments that Bob Forrestal made. If I were certain of our forecast and that in the Greenbook, I would probably favor leaving policy unchanged at present. However, as we all know, forecasts are often wrong and they often underpredict the size of cyclical swings in the economy. Therefore, I support a 25 or a 50 basis point cut in the funds rate. I would have some preference for the latter with symmetric language as insurance against a more prolonged decline in real GDP than I think is most likely. I want to emphasize, however, that we should be prepared to reverse course and raise rates if circumstances change and growth looks as though it will exceed the growth rate of potential output. In fact, I don't think we should cut rates now unless we are prepared to raise them again fairly soon, should that become necessary.

MR. MELZER. In my judgment, and I expressed some of this yesterday, the current slowing in the expansion will be followed by a rebound of growth at a rate near the economy's long-term potential. In fact, I think the recent evidence suggests, and you mentioned this in your comments, that lower intermediate- and long-term interest rates have in effect put a floor under the housing and auto markets. So, at this time my principal concern is really with the long-run inflation trend. Trend CPI inflation of 3 percent or higher is reflected in the forecasts, including the Greenbook forecast, and in long-term interest rates. In my view trend inflation of 3 percent just isn't good enough. With CPI inflation during the first half of 1995 running about 3-1/2 percent at an annual rate and the economy expected to continue to expand at or near its potential, I don't believe the current economic outlook warrants a change in the stance of monetary policy. Easing policy at the first sign of economic weakness after a period of what I think we would all agree is unsustainable real growth undermines our credibility and could adversely affect the bond and foreign exchange markets. In effect, we would be engaging in short-run fine-tuning under conditions of great uncertainty with respect to the economic outlook. Accordingly, my preference would be to maintain the current restrictive policy to ensure that the acceleration in inflation that began last year is capped and to bring trend inflation to a level significantly below 3 percent.

MR. LINDSEY. When we look down the road 6 to 12 months, we are looking at the first half of 1996 when our action will have its impact. Therefore, I agree with the point that was just made that we cannot think of ourselves as reacting to the current slowdown because there is nothing we can do about the current slowdown. What we can do is affect what we think is going to be the economy in early 1996. I agree, therefore, with Governor Blinder that ultimately we are going to need more than a 50 basis point reduction. If I were betting I would say that a year from now we will be 100 basis points under where we are now, and we still may be chasing where we want to be.

MR. MCTEER. We probably have one negative quarter in the bag and we may have a second in the bag. If we do, that will be embarrassing. It will be called a recession; and if we have a recession in the second and third quarters, looking back on it in the future, we will be a lot happier if we had eased today. If we barely escape a negative third quarter and barely escape the recession label, the economy is still likely to be weak and an easing will still look to have been appropriate at this time. Only if we have a booming third quarter will we look back on a decision to cut the fed funds target now as something of an embarrassment. If the economy last February had looked like it does now, I don't believe we would have gone that last 50 basis points. It now looks like we may have gone one bridge too far. I don't regard a 25 basis point reduction in the fed funds target as much of an easing of policy, but even if we call it an easing, it is consistent with our long-term goal of fighting inflation for much the same reason that a race car has brakes. [NOTE: Like Forrestal, He came into the meeting wanting to go 50.]

MS. MINEHAN. I think I view the risks to the forecast pretty much the same as everybody else here sees them. I think those risks have changed over the last few months from being on the upside--that is, that growth would be faster and inflation more of a problem--to being fairly evenly balanced; and now they seem to be much more on the downside--that is, in the direction of slower growth than the forecast suggests. However, I think these risks are wholly in the context of a pause in economic growth and not a recession. . . I do think there is a powerful offset to all of this in the drop in interest rates, the health of the banking system, and the health of financial markets in general. In my view, those financial factors will pull the economy out in fine measure by year-end. Normally, I would not be sympathetic to a wait-and-see attitude, but I really have these concerns about what would happen if we are wrong on the up side by the end of the year and what we would have to do in 1996 to rein in that excess demand. So, I came into the meeting wanting to vote for a no-change, although asymmetric, directive. I am not going to dissent over 25 basis points.

MR. BOEHNE. I think a quarter-point drop in the funds rate is the right amount at the right time, along with an asymmetric directive. The current level of monetary restraint has helped cause more of a correction and associated downside risks than we preferred. A cautious move toward less restraint, therefore, would help shore up demand and lessen downside risks. More importantly, it would demonstrate that the Fed is awake at the switch and wants to avoid a recession. I think we would be seen as forward-looking both when the economy is overheating and when it is underachieving. As the central bank our primary contribution to prosperity over time is price stability. Within the longer-run context of moving toward price stability, however, there is some room and indeed an obligation to take into account shorter-run fluctuations in demand. Now is one of those times to act promptly. To wait is to risk having to ease more and faster later on, with a greater probability of boom/bust in 1996 or 1997. A quarter-point drop in the funds rate would be a prudent magnitude for financial markets as well. It would in my judgment balance the need to try to avoid feeding another big run-up in asset values versus the risk of setting off a major correction.

MR. HOENIG. Mr. Chairman, after listening to the Committee's discussion yesterday and today, one of the things that strikes me--it feeds a little bit off the Bluebook--is that if we take the outcome in the baseline forecast as reasonable and desirable, then we might go with a no-change policy. In our own Bank's view and in my view that outcome is reasonable, and in their comments around this table a lot of people said that they found such an outlook reasonable. This suggests to me that the real funds rate may be where it should be at this stage.

There is no strong evidence that it is not. When we look at the risks, yes, there are downside risks. But as others have pointed out, the strong financial markets, the favorable banking conditions, and our own Bank's projection point to upside inflation risks, and that leaves me inclined to leave policy unchanged. There is a statement in the Bluebook to the effect that if we want to insure against a possible further slowdown, we might want to ease. But I am concerned that that insurance comes with its own price. When we vote for monetary stimulus, we are also increasing the risk of further inflation. In addition, some members want to ease in anticipation of prospective shocks that have not yet materialized. The odds of such occurrences are unknown and that, too, leaves me uneasy about moving at this time.

MR. JORDAN. I think the appropriate criterion for choosing a stance of monetary policy is whether we feel it is a move toward the objective of stabilizing the purchasing power of the dollar. An inappropriate criterion would be either somebody's idea about what the impact of fiscal multipliers was going to be, assuming we knew how to measure fiscal policy appropriately, or some idea about a cumulative process of decline in the economy in the absence of some pump-priming to prop it up. . . The way I think about policy now is in terms of how much insurance we need against future inflation. I would not want to be taking out insurance against a contraction because I think the economy tends to expand in the absence of adverse shocks or perverse policy. So, it is a question of whether we should cancel all the insurance now and whether that would be appropriately interpreted, or in the alternative that we have a growing confidence that we are back on track with regard to the future value of the dollar and so we are going to cancel half the insurance now.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, policy changes should not be based on reaction to present data, but rather on our views of the economy and prices about 18 months from now. I say that because if we were dealing only with a response to recent data I would want to keep policy unchanged because I don't like the price numbers that we have seen thus far this year. But based on a view toward the future, I do think that the real federal funds rate is too high. It is higher than it either should be or needs to be and thus we should ease. The question therefore becomes when and how much. Especially because of my very great concern about possible shocks from weakness abroad, I think the time is now. . . I believe that the likely total easing requirement is 50 basis points. I think a single 50 basis point move now would be very likely to destabilize financial markets and lead to a concern that we know much more than we really do, or fear more than we really should, about a likely recession.

MR. MOSKOW. Mr. Chairman, I believe that we should be forward-looking in setting our monetary policy. While we had two or three months of bad numbers, there is still a lot of uncertainty about the economy's underlying strength. As you mentioned, some of the more recent data that we have seen on housing and orders for durable goods suggest that the economy is stabilizing at a sustainable level of real activity. I think it is important that we be careful not to give the perception that we are tying monetary policy too closely to the fluctuations in short-run output. That would damage the credibility of our commitment to reducing inflation. Clearly, if inflationary pressures are moderating, we should be prepared to reduce the federal funds rate gradually. I believe the real federal funds rate should be below 3 percent, especially given the fiscal policy assumptions.

MR. STERN. I will make only a couple of points. I think the decision does not hinge--some people have made this point already--on the current weakness in the economy or even prospective weakness, at least of the type we have been talking about. In part that is because of the well-recognized lags in policy; there is not much we can do about the economy at this point. In part also, as people have commented, the reaction that has already occurred in the bond and stock markets and the anticipation that the inventory adjustment will be rather brief and rather shallow--those, of course, are not independent events--do not suggest to me that a decision today hinges on the immediate outlook. What I think is important at this juncture is that the markets have essentially priced in an easing of policy. We do not in my view want to peg the federal funds rate at any particular level. Interest rates typically fluctuate pro-cyclically.

MR. BROADDUS. If I were a voting member, I would support your recommendation, Mr. Chairman, although I must say with a considerable degree of nervousness. That kind of nervousness has been underscored by Tom Hoenig and some others. There seems to be a feeling--calling it a consensus may be too strong a characterization--that we can be fairly confident that inflation has reached a cyclical peak. The probability of that is certainly higher than I would have expected a while back, but I think we need to keep a longer-term perspective here. It was less than a year and a half ago that we ended an extended period of substantial monetary ease. While the risk of further inflation in this cycle is smaller than it was, I don't think it is zero and we need to keep that in mind. I think a cautious approach involving a quarter-point reduction in the funds rate is the appropriate degree of easing now. I would oppose a half-point reduction. One other comment: As Mike Moskow and others have said, it is important in communicating this action to the public to make clear that it is done in the context of a continuing longer-term commitment to price stability.

MR. KELLEY. I think that we have the flexibility here to move for positive and affirmative reasons as opposed to negative and defensive ones. Based on my reading of the likely outlook, I don't see us as driven primarily by the specter of a collapsing economy, although I would certainly concur that the downside risks are still there. Rather, I see the likelihood of a moderate and sustainable noninflationary growth period ahead of us coupled with a cyclically plateauing inflation rate that is still in a secular downward trend. I find all of that rather attractive. It gives the Committee room to move within the context of maintaining its posture relative to a steady focus on attaining price stability.

MS. PHILLIPS. I also think that the baseline projection is probably the most reasonable, but I would support a 25 basis point move as insurance in the sense of not being 100 percent sure about how our forecast of the inventory correction is going to work out.

MS. YELLEN. Mr. Chairman, I support your recommendation to lower the funds rate today. As I already emphasized, I am concerned about downside risks and the possibility of destabilizing feedbacks that could weaken the economy more than the Greenbook envisions. On the inflation side, I think a funds rate cut is consistent with our longer-term objective of gradually attaining price stability, given the greater slack already in evidence in both product and labor markets. Moreover, all our forecasts, with or without a cut in the funds rate of the size we are envisioning here, show a decline in inflationary pressures as we go forward. To me, one of the major rationales for such a cut, as Governor Blinder and others have emphasized, is that we need to cement in place the existing financial conditions that are already working to provide the critical cushion against the downside risks. So, I would like to see a cut to prevent a further backup in long-term interest rates, namely, to ratify the expectations implicit in the current structure of longer-term yields. I certainly am not arguing that we should be setting monetary policy by following the fed funds futures, but I think we should recognize situations when the market has gotten things right and act accordingly. . . Our task at this point is to be careful to avoid a pitfall that is well recognized in the literature on monetary policy. It is that interest rate targeting has the potential to thwart the operation of that natural adjustment mechanism, thereby exacerbating economic volatility. So, I see a cut in the funds rate now as essentially giving the green light for this market mechanism, which is already working, to continue its work. . . In my view this is a mid-course correction and it is designed to do a little sooner as an insurance policy what I would envision our having to do anyhow in the not-too-distant future. . . I guess my inclination would be if I had my druthers to choose a 50 basis point move today because I think it is needed, if not now then in the near future, to move to a more neutral policy stance. In a way, it would be psychologically stabilizing for households and firms to be able to rest a bit more secure in the knowledge that the Federal Reserve wants to take actions to keep the economy growing. But I also recognize the arguments against such a move today that the Chairman and others among you have articulated on the basis of the possible impact on financial markets. So, I can certainly support the proposal for a 25 basis point cut today.