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BEIGE BOOK REPORT

# Fed Officials Remain Doubtful About Prospects for Recovery

## 'Beige Book,' Statements Show Skepticism Despite Stronger-Than-Expected Reports

**By GREG IP**
**Staff Reporter of THE WALL STREET JOURNAL**

WASHINGTON -- Recent economic data and the rallying markets suggest the economy may be climbing out of its soft spot, but Federal Reserve officials remain skeptical.

Since the central bank cut its short-term interest rate target to a 41-year low of 1.25% from 1.75% earlier this month, economic reports have been better than expected and stock prices have hit three-month highs.

While this has reassured central bank officials that the economy isn't headed back into recession, it hasn't assured them that the economy has left its soft patch. Though they hope growth will return to its "potential" -- between 3% and 4% -- by the middle of next year, some still struggle to identify where that growth will come from.

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This suggests the Fed will likely keep rates steady when its policy-making committee meets Dec. 10, but it will be tempted to cut again if the economy shows no sign of accelerating early next year. If the economy does improve, as forecast, it still will likely be months before the Fed contemplates raising rates, because inflation pressure is weakening.

The downbeat mood was captured by the Fed's "beige book," an anecdotal survey of business conditions in the central bank's 12 districts prepared for the Dec. 10 meeting. The economy "grew slowly" during late October and early November, according to the Wednesday report. About half the districts reported retail-sales

growth, but the "increases were generally slight." Manufacturing was "soft in most districts," while "business capital spending in all sectors continued to be limited." Inflation was nonexistent and wage pressures "subdued."

That also is the message in most Fed officials' public comments, though they are quick to add the last rate cut should help things turn around.

"The economy continues to grow [though] it is currently not growing at a rate that is satisfactory," Federal Reserve Bank of Philadelphia President Anthony Santomero said in an interview last week. "Consumers continue to spend, incomes continue to grow." But businesses, hamstrung by uncertainty and weak sales growth, "are more reluctant to commit" to new investment, in part because the lack of price increases has held down revenue growth.

Officials' concern for the economy and lack of concern about inflation seem at odds with the statement they released with their Nov. 6 rate cut: risks to the economy were now balanced between rising inflation and faltering growth. At prior Fed meetings, the policy makers had said weak growth posed greater risk. The shift left many analysts scratching their heads.

Indeed, the change exaggerated the confidence central bank policy makers had in the outlook for the economy. But they feared a half-point rate cut and a continued assessment of weakness would leave the impression the Fed thought the outlook was truly grim and panic the markets, triggering a selloff that would weaken the rate cut's impact. By saying risks were now balanced, they hoped to convey the Fed's underlying optimism. It appears to have had the desired effect, with stocks and corporate bonds continuing to rally.

Furthermore, even if risks weren't exactly balanced, officials all agreed that with rates a lot lower, they were at least better balanced.

The shift in the balance of risks served other purposes. It comforted a few officials who thought a half-point rate cut was going too far, and it communicated that the rate cut wasn't one of a series -- without constraining the Fed's ability to move again if needed.

"We view that the risks are balanced, especially because we have moved the funds rate down significantly," Fed Chairman Alan Greenspan told Congress two weeks ago. But that wouldn't inhibit the Fed if "economic events emerge that require us to move it."

Data released Wednesday suggest the economy is growing, but at a weak rate. The Commerce Department said orders for durable goods -- items expected to last at least three years -- rose 2.8% during October after dropping 4.6% during September. An important indicator of business spending, orders for capital goods excluding defense and aircraft rose 5.3%, recouping September's 4.3% drop. However, orders data have been exceptionally volatile, and such positive reports run counter to gloomy anecdotal evidence from businesses themselves.

Fed officials aren't of one mind on the causes of the gloom. Mr. Greenspan has blamed businesses' concerns about a possible war with Iraq, but others blame excess capacity, weak pricing and lack of orders.

The Commerce Department also reported personal consumption rose 0.4% during October, or 0.2% when adjusted for inflation, regaining some of September's sharp drop caused by lower auto purchases. But personal income rose just 0.1%, reflecting stagnant job growth.

A month ago, Fed officials were alarmed that consumer spending, which has sustained the recovery so far,

was faltering under the weight of falling stock prices and weak job markets. The latest evidence suggests consumers are still spending, and even auto sales have picked up from their late-October lows. The job market also appears to have improved: The number of workers making first-time claims for unemployment insurance fell 17,000 last week to 364,000, a 21-month low, though seasonal distortions may overstate the improvement.

Spending continues to get a big lift from mortgage-refinancing activity, which has enabled some families to lower their payments and others to spend some of the equity in their homes. With a lengthy backlog of refinancing applications yet to be processed, Fed officials think the boost to consumers could continue for several months. But there is a concern that by the middle of next year, even if mortgage rates remain stable, the number of homeowners who can profitably refinance will have declined considerably, eroding that source of spending power.

**Write to** Greg Ip at greg.ip@wsj.com[3]

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