



Fed Decision Making— Why New Appointments to the Fed Don't Really Matter

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According to media reports, President Obama is poised to name economist Janet Yellen to be Vice Chair of the Federal Reserve Board. Yellen is the President of the San Francisco Federal Reserve Board (since 2004) and Professor Emeritus at the Haas School of Business at the University of California, Berkeley.¹ She is an intellectual heavyweight and had the respect of Alan Greenspan and the Fed staff when she was on the Board from 1994 to 1997. She also served as Chair of the President's Council of Economic Advisers during the Clinton Administration. She is an expert in unemployment; as her Fed bio puts it: *"Dr. Yellen has written on a wide variety of macroeconomic issues, while specializing in the causes, mechanisms and implications of unemployment."*

Obama is also considering filling the two other vacancies on the Fed Board with lawyer Sarah Raskin, commissioner of financial regulation for the state of Maryland, and MIT economics professor Peter Diamond, an expert on Social Security. As always, the Senate would need to confirm these nominations.

With the economic outlook still uncertain and the jobless rate so high, Obama is expected to appoint people to the Fed who would favour keeping interest rates as low as possible for as long as possible. Wall Street refers to these people as inflation doves and considers Yellen a dove. Much is made of this, but my experience as an economist at the Federal Reserve Board in Washington (1977-82) belies that view. From what I saw and what others still there tell me, Fed Governors have less influence on Fed policy than most people think, particularly when the Chairman is as qualified and expert as the past three have been.

The Chairman of the Federal Reserve Board (the Board) dominates all policy decisions owing to historical precedent, culture and institutional structure. One might even argue that the second most powerful in determining policy is the Board staff comprised of hundreds of economists, lawyers and supervisory and regulatory experts. The President of the Federal Reserve Bank (FRB) of New York, who serves as Vice Chair of the FOMC and is a permanent voting member, is also quite influential followed by the six Governors of the Board, and then the voting and nonvoting presidents of the Federal Reserve Banks.

¹ She is married to George Akerlof, a Nobel prize-winning economist and Professor Emeritus at the University of California, Berkeley.

Fed outsiders have a tendency to overestimate the influence of new Governor appointees. As well, speeches by any FOMC member other than the Chairman and the Vice Chair of the Board are not a reliable indicator of future policy decisions. The Fed would never use an FRB president's or Governor's speech to signal a policy change. But when the Chair or the Vice Chair speaks, Wall Street listens. The Vice Chair never contradicts or disagrees with the Chair in public, so when the Vice Chair signals a change, he or she is speaking on behalf of the Chairman. Don Kohn has been a particularly powerful board Vice Chair because of his 40 years of Fed experience, much of it as leader of the Monetary Affairs Division of the Board (staff), a very close advisor to the Chairman.²

The closest advisor to the top on economic policy issues for at least the past 30 years has been the Director of the Monetary Affairs Division. That person serves as Secretary to the FOMC. Most people have never heard his name, as he keeps a very low external profile. Don's successor in the role is his former deputy, Brian Madigan.

Former Fed Governor, Larry Meyer, writes that one of the first things he learned upon joining the Board is that "the Chairman owns the room".³ The Chairman expresses his opinion regarding the appropriate policy stance and the rest of the Board of Governors as well as the FRB President of NY vote accordingly, so that each time the twelve-member Federal Open Market Committee (*FOMC*) meets, the Chair enters the room (through his own private door, no less) knowing he has at least eight votes in his pocket and the assurance that there will be at least two more each time.⁴ It has happened periodically that an individual Governor sees the economy's functioning in a fundamentally different way than the Chair. Nevertheless, there has been only one occasion in more than 30 years when a Fed Governor voted against the Chair at an FOMC meeting, and that was in September 2005. Following

² Don Kohn received his Ph.D. in economics in 1971 from the University of Michigan, started his Fed career as a financial economist at the Kansas City Fed and then moved to the Division of Research and Statistics at the Board in Washington, D.C. When I joined the staff in 1978, Don was senior economist in the Government Finance Section, a specialist in Treasury markets and operations. He subsequently became my boss, as head of the Capital Markets Section. A brilliant economist, Don moved over to the Monetary Affairs Division to work side-by-side with Steve Axelrod—then the closest advisor to Paul Volcker on monetary policy. When Axelrod left the Board to pursue a job on Wall Street, Don became Director of the division and stewarded its expansion. He was Chairman Greenspan's closest policy advisor for many years before President Bush appointed him to the Board in May 2006. Clearly, Don's retirement from the Board leaves a huge hole in terms of expertise and experience.

³ "Is Janet Yellen Really a Dove?" via Economist's View by Mark Thoma on 3/12/10. <http://economistsview.typepad.com/economistsview/2010/03/is-janet-yellen-really-a-dove.html>.

⁴ This is not literally true, in that Board members and the NY FRB President have dissented, mostly in the long-ago past, but their frequency of dissention over very long periods is extremely low—far lower than for the other four members of the Committee who are FRB Presidents (and only once during Greenspan's nearly 18-year tenure; so far, never in Bernanke's tenure). Board members who share a building with and are briefed by the same staff as the Chairman have dissented less frequently on average and have been less hawkish in their dissents than have the regional banks presidents. For the period 1968-2004, see http://www.oenb.at/de/img/documenting_fomc_voting_patterns_tcm14-39080.pdf.

Hurricane Katrina, Governor Mark Olson voted against the Committee's decision to hike rates 25 basis points. Indeed, it is rare for a Governor to vote against the Chairman.

No question, however, that outside of the FOMC meeting, Governors sometimes butt heads with the Chairman. Two examples of this come to mind: Paul Volcker in the late-1980s, a diehard supporter of the Glass-Steagall Act, often crossed swords in private with Wayne Angell and Manuel Johnson who supported the deregulation of the industry. This was a regulatory issue, but it never resulted in Volcker losing a vote.

Another example was Alan Greenspan's relationship with Alan Blinder in the mid-1990s. Greenspan, the libertarian, clashed with Blinder's liberal predilections, but Blinder always voted with the Chair at FOMC meetings. Maybe that is why Blinder resigned when his partial term expired, serving only about 18 months.

G. William Miller, Chairman briefly from March 1978 to August 1979, came as close to losing a vote as any Chair in recent history. Appointed by Jimmy Carter, Miller was formerly CEO of Textron and had no financial or economic expertise. Moreover, he was uncomfortable with the Fed staff's ponderous technical reports and required they be shortened and begin with a one-page summary. For the first time, staff recommendations on very complex issues had to be boiled down to a single page, with reams of data omitted. Miller, certainly not a data-junky like his predecessors, preferred charts to tables. The staff privately doubted that the Chair read beyond the first page. The scuttlebutt has it that before the staff could intervene, Miller lost a discount rate vote⁵, as most of his Governors dwarfed his understanding of the economy. Evidently, the next day, they reversed the vote. Chairman Miller was by far the exception as other Fed Chairs had extensive knowledge and experience in financial economics and banking-related issues.

Historically and culturally, the Fed Chair rules by his intellectual gravitas (aided by the resources of the large and very talented Fed staff at his fingertips) and by his ability to set the agenda. A good Chair is aware of the views of the other members of the Committee (usually by having a staff person interview them), and will pose his position statements and the wording of the FOMC press release in a way that appeases most dissenters, and therefore, builds consensus.

A former senior staffer⁶ told me that he could not recall a time when there were more than two dissenters at an FOMC meeting. Roughly two-thirds of the time, the Committee decision is unanimous. There are often different opinions going into the meeting, but most succumb to the Chairman's influence by the end of the meeting. Dissenting votes by regional presidents (other than NY) occur periodically, especially near turning points in policy. Regional presidents are

⁵ Discount rate changes are made by the Board alone, not the FOMC.

⁶ He served under William McChesney Martin, Jr. (1951-1970), Arthur F. Burns (1970-1978), G. William Miller (1978-1979), Paul A. Volcker (1979-1987) and Alan Greenspan (1987-2006).

expected to represent the business and banking interests of their districts, which are sometimes at odds with the interests of the nation as a whole. Also, in recent decades, most FRB presidents have had Ph.D.s in economics, and the profession is known for its diverse schools of thought. For example, the St. Louis Fed has long favoured a monetarist approach to policy.

According to one study completed in preparation for the formation of the European Central Bank, dissenting votes represented only 6.5% of all votes taken at the 282 FOMC meetings from 1968 until 2004.⁷ We looked at the voting patterns under Chairman Bernanke's tenure (38 meetings or teleconferences since March 2006) and found that only 5.2% of all FOMC votes over the period were dissenting votes, which reflected dissention at 39% (15) of the meetings. Most of those (13 of the 15) had only one dissenter.

Historically, there are always some FRB districts that dissent more often than others. For example, since Bernanke became Chairman, the dissenting votes have been from only five of the eleven FRB districts (excluding New York, which always votes with the Chairman). Tied for first with five dissenting votes each are Presidents Lacker from Richmond and Fisher from Dallas; all were hawkish dissents. Next were three hawkish dissents by Hoenig, President of the Kansas City Fed, two of which were lone dissenting votes at the past two meetings (January and March this year) on the grounds of potential financial imbalances and rising inflation pressures.⁸ President Poole of the St. Louis Fed dissented once on monetarist grounds and the sole dovish dissent was by President Rosengren of Boston who wanted a 50 basis point cut in the fed funds rate at the December 11, 2007 meeting, rather than a 25 bp cut. He got his way very soon thereafter when the FOMC called an intermeeting session on January 22 to announce an additional 75 bp cut in both the fed funds rate and the discount rate.

Fed Independence: Institutional Structure

The 'independence' of the Fed has been hotly debated of late in the Congress, as the Fed has been one of the whipping boys for the financial crisis.⁹ However, **the Act of**

⁷ There would be roughly twelve votes at each meeting. "The European Integration Process: A Changing Environment for National Central Banks," October 21, 2005, by Ellen E. Meade and D. Nathan Sheets, Proceedings of OeNB Workshops.

http://www.oenb.at/de/img/eesti_pank_in_the_european_integration_process_tcm14-39122.pdf

⁸ The January 27-28 Minutes said, "Mr. Hoenig believed that it would be more appropriate for the Committee to express an expectation that the federal funds rate would be low for some time--rather than exceptionally low for an extended period. Such a change in communication would provide the Committee flexibility to begin raising rates modestly. He further believed that moving to a modestly higher federal funds rate soon would lower the risks of longer-run imbalances and an increase in long-run inflation expectations, while continuing to provide needed support to the economic recovery".

⁹ A major opponent of Fed independence has been Ron Paul, Republican Congressman from Texas and former candidate for the 2008 Republican nomination. He sets forth his views in his 2009 book, *End the Fed*, in which he argues that the Fed is corrupt and unconstitutional, positions that have virtually no support among mainstream economists. He is an uber-inflation hawk and states that the Fed is inflating the U.S. dollar today at nearly a Weimar or Zimbabwe level, which Paul asserts threatens to put the U.S. into an inflationary depression "where \$100 bills are worthless".

Congress creating the Fed in 1913 was very clear that independence must be maintained, reflecting the conviction that the people who control the country's money supply should be independent of the people who frame the government's spending decisions. Although the Fed is accountable to the Congress and the law sets its goals of low inflation and full employment, its conduct of monetary policy is insulated from day-to-day political pressures.

The Fed's independence derives from a number of factors: first, the appointments are *usually* staggered to reduce the chance that a single president could "load" the Board with appointees (although, as of June of this year, owing to unusual circumstances, there will be three vacancies on the current Board, including the Vice Chair); and second, their terms of office are 14 years—much longer than the terms of elected officials.

The FOMC has twelve voting members: the seven members of the Federal Reserve Board and five of the twelve Federal Reserve Bank presidents, with the FRB President of New York a permanent voting member. So the other four seats rotate among the remaining eleven Bank presidents, who serve one-year terms beginning in January of each year.¹⁰ However, all of the Reserve Bank presidents, even those who are not voting members, attend Committee meetings, participate in discussions, and contribute to the Committee's assessment of the economy and policy options. The Committee meets eight times a year, or roughly every six weeks or so.

Each Reserve Bank president is appointed to a five-year term by that Bank's Board of Directors¹¹, subject to final approval by the Board of Governors. This procedure adds to independence because the Directors of each Reserve Bank are not chosen by politicians but are selected to provide a cross-section of interests within the region, including those of depository institutions, nonfinancial businesses, labour, and the public.

In addition, the Fed is independent of congressional decisions about appropriations. The Fed is self-sufficient in the sense that it meets its operating expenses primarily from the interest earnings on its portfolio of securities. The FOMC is therefore a blend of a national board and regional input of private and public interests.

It doesn't take very long before a Board member, including the Chairman, loses allegiance to the President that appointed him and embraces the independent culture of the Fed. Chairman Arthur Burns (1970-1978) appears to be a notable exception as he was

¹⁰ The rotating seats are filled from the following four groups of banks, one bank president from each group: Boston, Philadelphia, and Richmond; Cleveland and Chicago; Atlanta, St. Louis, and Dallas; and Minneapolis, Kansas City, and San Francisco.

¹¹ The Boards of Directors of the Reserve Banks have nine members, six of whom are selected by the member commercial banks in the respective districts and the remaining three are selected by the Board of Governors.

notorious for his disastrous policy support of President Nixon's re-election bid, conducting excessively easy monetary policy that fueled the escalation in prices and the devaluation of the U.S. dollar and ultimately triggered stagflation and the end of the Bretton Woods system. Even Burns finally broke away from the political line to tighten policy aggressively thereafter, although with hindsight, certainly not aggressively enough. Most long-serving Chairmen, however—such as Martin, Volcker, Greenspan and Bernanke—were appointed by both Parties, as the Administration and Congress realize that continuity and bipartisanship are necessary for Fed credibility.

An FOMC Meeting

Like any other long-standing decision-making process, the FOMC meeting follows a well-practiced protocol, maintaining the integrity of the process, but also limiting the ability of any one person (other than, possibly, the Chairman, and even that is in question) to derail it. Whether that is a good thing or not, depends on your point of view. Most market participants and economists think it is.

The FOMC meeting has always been shrouded in secrecy, for obvious reasons, but increasingly over time, the policy-making procedure has become more transparent. Fed now releases a policy statement at 2:15 PM on the final day of every meeting and statements today are somewhat less oblique than in the past. Prior to February 1994, the Fed didn't issue a statement following meetings. After making several post-meeting statements in 1994, the Committee formally announced in February 1995 that it would communicate all *changes* in the stance of monetary policy. If there were no change in policy, there would be no post-meeting statement. In January 2000, the Committee announced that it would issue a statement following each regularly scheduled meeting, regardless of whether there had been a change in monetary policy.

Also adding to transparency since December 2004 is the more timely release of the minutes, three weeks after the date of the policy decision.¹² However, the minutes are not a transcript. They are a summary of the discussions and reports that do not give attribution to comments or points of view, except the tabulation of the vote. It is a guessing game to figure out who said what. No names are given; the minutes refer to attendees as a member of the Committee, member of the Board or as staff.

We have a better understanding of the format of the meeting as well from first-person accounts. Larry Meyer presented a detailed description of the meeting in an April 1998

¹² From their emergence in their present form in February 1993 until December 2004, the minutes were published approximately three days after the Committee's subsequent meeting. In December 2004, the Committee decided to expedite the release of its minutes. Since then, the minutes have been made available to the public three weeks after the date of the policy decision, thus reducing the lag in their release by an average of about three weeks.

speech and others have followed.¹³ Clearly, **all discussions take place in an environment of overwhelming consensus and even the most rebellious members of the Committee are not very rebellious.** Mutiny is just not part of the culture. For example, today's lone dissenter, President Hoenig, only wanted to change the wording of the policy statement to "low for *some* time"—rather than "*exceptionally* low for an *extended period*", hardly a radical change. There really isn't much difference between the views of the hawks and the doves.

Tradition has scripted the meetings to a tee, right down to the order of the seating around the large board table at the Washington Fed building on Constitution Avenue (with the entrance on C Street). Everything about the building and the boardroom is impressive (think marble and mahogany and 30-foot ceilings). The Chairman calls the meetings to order. The first substantive item on the agenda of most meetings is the report from the Manager of the System Open Market Account in New York, currently Brian Sack, who presents developments in financial and foreign exchange markets and the Fed's balance sheet. The Chairman then opens the floor for questions.

The Chairman sets the agenda, determining what, if any, special issues he would like discussed. This gives him an opportunity to highlight some aspect of policy determination, which is a powerful way to get the Committee to see the issues he thinks are important. At the January meeting, the staff presented their analysis of the tools and strategies for an eventual withdrawal of policy accommodation. They summarized the linkages between these options and alternative frameworks for implementing monetary policy in the longer run.

Following any discussion, they move on to the economic outlook. David Stockton, Director of the Division of Research and Statistics, (and sometimes Nathan Sheets, Director of the Division of International Finance) briefs the Committee on the current economic and financial situation and how it has changed since the prior meeting; following this, he presents the Board staff's forecast. Currently, the Board staff expects a moderate recovery with continued high unemployment and very little inflation.

Meeting participants, including the twelve voting members of the FOMC and the five non-voting members, then have an opportunity to question the staff. According to Larry Meyer,

¹³ Remarks by Governor Laurence H. Meyer, The Gillis Lecture, Willamette University, Salem, Oregon, April 2, 1998, "Come With Me to the FOMC".

<http://www.federalreserve.gov/BoardDocs/Speeches/1998/199804022.htm> . Meyer also wrote a book, *A Term at the Fed, An Insider's View*, HarperCollins, June 2004.

Another insider account is Remarks by Governor Mark W. Olson at the 26th Conference of the American Council on Gift Annuities, Orlando, Florida, May 5, 2004, "The Federal Open Market Committee and the Formation of Monetary Policy".

<http://www.federalreserve.gov/BoardDocs/Speeches/2004/20040505/default.htm> .

most of the questions come from the Reserve Bank presidents, because the Board has ample opportunity to question the staff at weekly briefings, the most recent one, and usually the longest, is on the day before the FOMC meeting.¹⁴

Next there is the first of two go-arounds where each member expresses his or her views on current conditions and the economic outlook.

The most recent FOMC meeting (for which we have minutes) was a two-day meeting in late January in preparation for the upcoming semiannual Monetary Policy Report to the Congress. Prior to 2006, two-day meetings occurred in roughly February and July each year.¹⁵ According to the most recent minutes, "all meeting participants—the five members of the Board of Governors and the presidents of the twelve Federal Reserve Banks—provided projections for economic growth, the unemployment rate, and consumer price inflation for each year from 2010 through 2012 and over a longer horizon. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge over time under appropriate monetary policy and in the absence of further shocks."

Since 2006, the Fed has had more frequent two-day meetings, presumably to give them more time to discuss important issues.¹⁶

Accounts of these participant presentations suggest that there is little interchange between the members of the Committee. They each make their statements, some from written texts (prepared by the economists at their regional FRB) and some more extemporaneously, and then move on to the next one. How the Chairman participates in the go-around has changed over time and depends on the preferences of the individual

¹⁴ Senior staffs of the Research, International, and Monetary Affairs Divisions brief the Board every Monday morning on the economic, financial and international situation. After each briefing, the Chairman and members of the Board in turn ask questions. Keeping in mind that most of the Board members are also economists, the questions are often quite detailed and technical. Economists who are specialists in important sectors also attend these meetings because occasionally, if the briefer is stumped, they will answer the questions. Having participated in this process, I can tell you that the Chairman and the Governors are very tough interrogators.

¹⁵ Two-day meetings begin at 2:30 PM and go to 5:30 or 6:00 PM on the first day and conclude with a meeting from about 9:00 AM until roughly noon on the second day. Each member submits forecasts for GDP growth, the unemployment rate, PCE inflation and core PCE inflation for the current year 2010, and two subsequent years, 2011 and 2012, as well as a forecast range for the longer run. The Report publishes the central tendency and the range of each of these forecasts and compares it to the forecasts in the prior report, 6-months earlier. On the first day of the meeting, Committee member and staff discuss the economy and the outlook in greater detail and length than at one-day meetings.

¹⁶ In 2007, there were four two-day FOMC meetings and there were five of them in 2008. In 2009, every Committee meeting was a two-day meeting as the financial crisis clearly warranted a more fulsome discussion of many very difficult issues. This year, four of the nine scheduled meetings are for two days.

incumbent. According to Larry Meyer, Alan Greenspan did not participate in the outlook go-around. This ends part one of the meeting and the members break for coffee.¹⁷

Following the break, the policy part of the meeting begins with a presentation by the Secretary of the FOMC, Brian Madigan, Director of the Division of Monetary Affairs and close advisor to the Chairman. Madigan provides the Committee with an outline of policy issues and options. The Chairman offers the members the opportunity to ask questions and then the policy go-around begins. This is when the Chairman has enormous influence. Greenspan would go first and Bernanke probably does the same as it sets the stage for further discussion. The Chair weaves the elements of the outlook, and addresses some of the member's comments, into a policy framework. No doubt Bernanke currently highlights the continued weakness in the labour market and muted inflation outlook. Following the Chairman's comments, each member, in no particular order, provides his or her own perspectives. Sometimes there is little discussion other than to agree with the Chair, and other times, particularly at turning points, there is extensive dialogue.

The Chairman never loses the policy vote and the Committee works towards a consensus on the policy decision. When the policy discussion winds down, the Chairman summarizes his view of the consensus. The Assistant Secretary then polls the Committee for its vote. According to Meyer, the Chairman votes first, the Vice Chair second, and then other voting members vote in alphabetical order. The Committee and staff carefully craft the policy statement, knowing that the markets scrutinize every word and nuance to predict future Fed actions. These subtleties move markets at 2:15 PM when the Fed releases the statement.

Bottom Line: Dissenting votes, rather than signaling a fundamental difference in the direction of policy, generally reflect a difference in the timing or magnitude of the consensus decision. New appointees to the Board (or the FRBs) have surprisingly little influence on the stance of monetary policy. The Chairman's role is highly respected by the Committee and the staff, and therefore has a disproportionate share of the decision-making power. While other members of the Committee might influence the Chair's views, the Fed staff usually has a 'louder' voice in that regard.

Outsiders often question just how independent the staff of economists can be when they serve a strong Chairman who is himself an economist. The Chairman doesn't have the time to analyze fully the incoming data and the enormous volume of often-conflicting inputs to the staff forecast. Staff specialists carefully follow every meaningful contributor to the economic outlook. There are economists who do nothing but analyze consumer savings patterns, or the mortgage market, or auto sales, and so on. Several would cover

¹⁷ Or, in the case of a two-day meeting, the session is closed and reconvenes at 9 AM the next morning.

fiscal issues, some at the federal level and some at the state level. The Fed has the resources move economists around and to research in depth new issues and events as they arise. An entire division of economists follow international developments. The culture supports analysis that is independent of the predilections or preconceived notions of the Chairman. Economists are encouraged to look for risks to the outlook and arguments against conventional thinking. While many economists at the Fed do current analysis, many others do pure research, which sets the stage for new methodologies and analyses.

As well, the Board regularly and formally summons independent views from Wall Street (daily phone conferences with the NY Fed), the banking community (the Federal Advisory Council) and the nonfinancial business community (regular discussion at the FRB level). Regional FRB staffs survey businesses and consumers within their regions in preparation of the Beige Book¹⁸ distributed during the week before each FOMC meeting. And the Board supplements their knowledge with ad hoc surveys on particular subjects of interest.

The Fed also confers with private sector economists (at Fed-sponsored meetings such as the annual Jackson Hole Conference) and with other central banks at regularly scheduled meetings (such as the G-20 meetings of Finance Ministers and Central Bank Governors, and meetings in Basel, Switzerland of the Bank for International Settlements).

It is political theatre in Congress to criticize the Fed. Periodically, they threaten to reduce its independence, but it is highly unlikely that they would actually do so. The Fed is not only the lender of last resort to American banks, but as we have seen in the recent financial crisis, in an emergency, the Fed takes on the responsibility of financial stability for all market participants regardless of sector or geography. The House (and Senate) Finance Committee, throughout the Fed's history, has regularly debated and threatened the Fed's independence, usually when the Fed does unpopular things or when bad things happen in the markets. Demonstrators burned Volcker's body in effigy on the lawn outside the Chairman's office when interest rates were over 14% and Congress echoed the populist complaints. The independence of the Fed is good for elected officials because it allows them to blame someone else when their constituents complain.

¹⁸ The Beige Book, a summary of regional developments, is named for the colour of its cover. Similarly, the Board's staff prepares the Greenbook, which is a review of the economy and financial markets and the Bluebook, which presents the staff forecast under different policy assumptions. The Greenbook and Bluebook are restricted to FOMC and internal staff use only. Indeed, very few staffers would see the Bluebook.

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