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# *Records*

## *Record of Policy Actions of the Board of Governors*

### **Regulation D** Reserve Requirements of Depository Institutions

[Docket No. R-1268]

*On October 18, 2006*, the Board approved amendments to reflect the annual indexing of the low reserve tranche and of the reserve requirement exemption for use in 2007 reserve requirement calculations. The amendments decrease the 3 percent low reserve tranche for net transaction accounts to \$45.8 million (from \$48.3 million in 2006) and increase the reserve requirement exemption to \$8.5 million (from \$7.8 million in 2006).

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Warsh, Kroszner, and Mishkin. Absent and not voting: Governor Bies.

### **Regulation E** Electronic Fund Transfers

[Docket No. R-1247]

*On August 24, 2006*, the Board approved amendments to Regulation E and its official staff commentary to apply the regulation to payroll card accounts established to distribute employee salaries, wages, or other compensation

on a recurring basis. The amendments also provide financial institutions with an alternative to sending periodic statements for payroll card accounts if they make account information available to account holders by certain specified means. The amendments are effective July 1, 2007.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, and Kroszner.

[Docket No. R-1265]

*On November 27, 2006*, the Board approved amendments to Regulation E and its official staff commentary to clarify that the requirement to obtain consumer authorization applies to any person who intends to collect electronically a fee for a check or other item that is returned unpaid. The amendments also provide guidance on the regulation's requirements concerning consumer notice when a returned-item fee is collected electronically or a transaction involves an electronic check conversion. The amendments, which are based substantially on an interim final rule approved on August 24, 2006, are effective January 1, 2007; compliance with certain disclosure requirements for returned-item fees collected in connection with point-of-sale transactions is delayed until January 1, 2008.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, and Kroszner. Absent and not voting: Governor Mishkin.

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NOTE: Full texts of the policy actions are available via the online version of the Annual Report, from the "Reading Rooms" on the Board's FOIA web page, and on request from the Board's Freedom of Information Office.

## **Regulation H**

Membership of  
State Banking Institutions  
in the Federal Reserve System

## **Regulation Y**

Bank Holding Companies  
and Change in Bank Control

[Docket No. R-1087]

*On February 2, 2006*, the Board, acting with the other federal bank regulatory agencies, approved amendments to the agencies' market risk rules to reduce the capital requirement for certain securities-borrowing transactions collateralized with cash. The interagency rule, which makes permanent and expands an interim final rule approved in 2000, is effective February 22, 2006.

Votes for this action: Chairman Bernanke, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn.

## **Regulation K**

International Banking Operations

[Docket No. R-1147]

*On March 15, 2006*, the Board approved amendments requiring Edge Act and agreement corporations and the U.S. branches, agencies, and representative offices of foreign banks supervised by the Board to establish and maintain procedures that ensure and monitor compliance with the Bank Secrecy Act and related regulations. The amendments are effective April 19, 2006.

Votes for this action: Chairman Bernanke and Governors Bies, Olson, Kohn, Warsh, and Kroszner. Absent and not voting: Vice Chairman Ferguson.

## **Regulation O**

Loans to Executive Officers,  
Directors, and Principal  
Shareholders of Member Banks

[Docket No. R-1271]

*On December 6, 2006*, the Board approved an interim final rule, with request for comment, to implement section 601 of the Financial Services Regulatory Relief Act of 2006 by eliminating certain reporting requirements that have not contributed significantly to effective monitoring or prevention of insider lending abuse. The interim final rule is effective December 11, 2006.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, Kroszner, and Mishkin.

## **Regulation Y**

Bank Holding Companies  
and Change in Bank Control

[Docket No. R-1235]

*On February 22, 2006*, the Board approved amendments to expand the applicability of its Small Bank Holding Company Policy Statement and related exemptions from its consolidated capital adequacy guidelines on risk-based and leverage measures by increasing the asset-size limitation specified in the policy statement from \$150 million to \$500 million. The amended policy statement does not apply, however, to bank holding companies with less than \$500 million in assets that engage in significant nonbanking or off-balance-sheet activities or have a material amount of debt or equity securities registered with the Securities and Exchange Commission. The amendments also clarify that subordinated debt related to the issuance of trust preferred securities generally

would be treated as debt under the policy statement, subject to a five-year transition period. The amendments are effective March 30, 2006.

Votes for this action: Chairman Bernanke, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn.

## **Regulation BB** Community Reinvestment

[Docket No. OP-1240]

*On March 1, 2006*, the Board, acting with the other federal bank regulatory agencies, approved guidance intended to aid implementation of recent changes to the agencies' regulations under the Community Reinvestment Act (CRA). The guidance discusses, among other regulatory topics, (1) the criteria for determining if an area is distressed, is underserved, or has suffered a disaster; (2) the period of time that bank activities in those areas are eligible for consideration in a CRA evaluation; and (3) the standards used by CRA examiners to decide if such activities qualify as "community development." The guidance also explains how the new community development test for intermediate small banks (banks with assets between \$250 million and \$1 billion) will be applied. The interagency guidance is effective March 10, 2006.

Votes for this action: Chairman Bernanke, Vice Chairman Ferguson, and Governors Bies, Olson, Kohn, and Warsh.

## **Rules Regarding** Equal Opportunity

[Docket No. OP-1264]

*On August 1, 2006*, the Board approved an interim rule, with request for com-

ment, to extend eligibility for access to confidential supervisory information to certain noncitizen employees. The interim rule is effective August 7, 2006, and also applies to all grants of access made as of that date.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, and Kroszner.

## **Policy Statements** and Other Actions

### Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters

*On January 30, 2006*, the Board, acting with the other federal financial regulatory agencies, approved an advisory to address safety and soundness concerns associated with agreements by financial institutions that limit the liability of their external auditors. The advisory applies to provisions that (1) indemnify an external auditor against claims made by third parties (including punitive damages); (2) hold harmless or release an external auditor from liability for claims or potential claims that might be asserted by the client financial institution; or (3) limit the remedies available to the client financial institution. Provisions that waive the right of financial institutions to seek punitive damages against their external auditors are not considered unsafe and unsound under the advisory. The interagency advisory is effective for engagement letters executed on or after February 9, 2006.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn.

## Federal Reserve Currency Recirculation Policy

[Docket No. OP-1164]

*On March 17, 2006*, the Board revised the Federal Reserve System's cash services policy, with the intention of increasing the recirculation of fit currency by (1) initiating a custodial inventory program to encourage depository institutions to hold \$10 and \$20 notes in their vaults to meet customer demand and (2) charging a fee to depository institutions that deposit fit \$10 or \$20 notes at a Reserve Bank and order the same denominations, above a de minimis amount, during the same business week. The custodial inventory program will begin in July 2006, and fee assessments are expected to begin in July 2007.

Votes for this action: Chairman Bernanke and Governors Olson, Kohn, Warsh, and Kroszner. Absent and not voting: Vice Chairman Ferguson and Governor Bies.

## Nontraditional Mortgage Product Risks

[Docket No. OP-1246]

*On September 27, 2006*, the Board, acting with the other federal financial regulatory agencies, approved interagency guidance on underwriting and managing nontraditional mortgage products (loans that allow borrowers to defer payment of principal and in some cases interest) in a safe and sound manner and on clearly disclosing the potential risks of those products.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, Kroszner, and Mishkin.

## Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices

[Docket No. OP-1248]

*On December 6, 2006*, the Board, acting with the other federal bank regulatory agencies, approved guidance intended to reinforce sound risk-management practices for institutions that have high and increasing concentrations of commercial real estate loans on their balance sheets. The guidance includes supervisory criteria to assist in identifying institutions that have potentially significant concentrations. The interagency guidance is effective December 12, 2006.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, Kroszner, and Mishkin.

## Interagency Statement on Sound Practices concerning Elevated Risk Complex Structured Finance Activities

[Docket No. OP-1254]

*On December 20, 2006*, the Board, acting with the Securities and Exchange Commission and the other federal bank and thrift regulatory agencies, approved a statement that describes internal controls and risk-management procedures to assist financial institutions in identifying, managing, and addressing the heightened legal and reputational risks associated with certain complex structured finance transactions. The interagency statement is effective January 11, 2007.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Kroszner, and Mishkin. Absent and not voting: Governor Warsh.

## Discount Rates in 2006

Under the Federal Reserve Act, boards of directors of the Federal Reserve Banks must establish rates on loans to depository institutions at least every fourteen days, subject to review and determination by the Board of Governors.

### Primary Credit

Primary credit is the Federal Reserve's main lending program. Primary credit is made available with minimal administration for very short terms as a backup source of liquidity to depository institutions that, in the judgment of the lending Federal Reserve Bank, are in generally sound financial condition. Primary credit is extended at a rate above the federal funds rate target set by the Federal Open Market Committee (FOMC).

During 2006, the Board approved four increases in the primary credit rate, bringing the rate from  $5\frac{1}{4}$  percent to  $6\frac{1}{4}$  percent. The Board reached its determinations on the primary credit rate recommendations of the Reserve Bank boards of directors in conjunction with the FOMC's decisions to raise the target federal funds rate from  $4\frac{1}{4}$  percent to  $5\frac{1}{4}$  percent and related economic and financial developments. Rising energy prices coupled with high levels of resource utilization contributed to heightened inflation pressures over the first half of the year. Those pressures receded over the second half of the year as energy prices dropped and weakness in the housing sector weighed on economic activity. In light of these conditions, the Federal Reserve raised the structure of policy rates at a measured pace in the first half of the year and kept those rates unchanged for the remainder of the year. Monetary policy developments are reviewed more fully in other parts of this report (see the section

"Monetary Policy and Economic Developments" and the minutes of FOMC meetings held in 2006).

### Secondary and Seasonal Credit

Secondary credit is available in appropriate circumstances to depository institutions that do not qualify for primary credit. The secondary credit rate is set at a spread above the primary credit rate. In 2006, the spread was set at 50 basis points.

Seasonal credit is available to smaller depository institutions to meet liquidity needs that arise from regular swings in their loans and deposits. The rate on seasonal credit is calculated every two weeks as an average of selected money-market yields, typically resulting in a rate close to the federal funds rate target.

At year-end, the secondary and seasonal credit rates were  $6\frac{3}{4}$  percent and 5.30 percent, respectively.

### Votes on Discount Rate Changes

About every two weeks during 2006, the Board approved proposals by the twelve Reserve Banks to maintain the formulas for computing the secondary and seasonal credit rates. Details on the four actions by the Board to approve changes in the primary credit rate are provided below.

*January 31, 2006.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by  $\frac{1}{4}$  percentage point, to  $5\frac{1}{2}$  percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective February 1, 2006. The

Board also approved an identical action subsequently taken by the directors of the Federal Reserve Bank of Minneapolis, effective February 2, 2006.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn. Votes against this action: None.

*March 28, 2006.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by  $\frac{1}{4}$  percentage point, to  $5\frac{3}{4}$  percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective March 29, 2006. The Board also approved an identical action subsequently taken by the directors of the Federal Reserve Bank of Kansas City, effective March 30, 2006.

Votes for this action: Chairman Bernanke and Governors Bies, Olson, Kohn, Warsh, and Kroszner. Votes against this action: None.

*May 10, 2006.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Dallas, and San Francisco

to raise the rate on discounts and advances under the primary credit program by  $\frac{1}{4}$  percentage point, to 6 percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective May 11, 2006. The Board also approved an identical action subsequently taken by the directors of the Federal Reserve Bank of Kansas City, effective May 11, 2006.

Votes for this action: Chairman Bernanke, Vice Chairman Ferguson, and Governors Bies, Olson, Kohn, Warsh, and Kroszner. Votes against this action: None.

*June 29, 2006.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, and Dallas to raise the rate on discounts and advances under the primary credit program by  $\frac{1}{4}$  percentage point, to  $6\frac{1}{4}$  percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective June 30, 2006. The Board also approved identical actions subsequently taken by the directors of the Federal Reserve Banks of San Francisco, effective June 29, 2006, and Kansas City, effective July 6, 2006.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, and Kroszner. Votes against this action: None. ■

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## *Minutes of Federal Open Market Committee Meetings*

The policy actions of the Federal Open Market Committee, contained in the minutes of its meetings, are presented in the Annual Report of the Board of Governors pursuant to the requirements of section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each policy action, and that it shall include in its annual report to Congress a full account of such actions.

The minutes of the meetings contain the votes on the policy decisions made at those meetings as well as a summary of the information and discussions that led to the decisions. The descriptions of economic and financial conditions are based solely on the information that was available to the Committee at the time of the meetings.

Members of the Committee voting for a particular action may differ among themselves as to the reasons for their votes; in such cases, the range of their views is noted in the minutes. When members dissent from a decision, they are identified in the minutes and a summary of the reasons for their dissent is provided.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System

Open Market Account. In the area of domestic open market operations, the Federal Reserve Bank of New York operates under instructions from the Federal Open Market Committee that take the form of an Authorization for Domestic Open Market Operations and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Federal Reserve Bank of New York operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations. These policy instruments are shown below in the form in which they were in effect at the beginning of 2006. Changes in the instruments during the year are reported in the minutes for the individual meetings.

### **Authorization for Domestic Open Market Operations**

In Effect January 1, 2006

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regu-

lar, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement.

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

(c) To sell U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding. The Federal Reserve Bank of New York shall set a minimum lending fee consistent with the objectives of the program and apply reasonable limitations on the total amount of a specific issue that may be auctioned and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's

ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York and accounts maintained at the Federal Reserve Bank of New York as fiscal agent of the United States pursuant to Section 15 of the Federal Reserve Act, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities in 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and such foreign, international, and fiscal agency accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

## Domestic Policy Directive

In Effect January 1, 2006<sup>1</sup>

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 4¼ percent.

### Authorization for Foreign Currency Operations

In Effect January 1, 2006

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Canadian dollars	Mexican pesos
Danish kroner	Norwegian kroner
Euro	Swedish kronor
Pounds sterling	Swiss francs
Japanese yen	

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement

1. Adopted by the Committee at its meeting on December 13, 2005.

shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding \$25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada .....	2,000
Bank of Mexico .....	3,000

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non-market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account ("Manager"), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

## **Foreign Currency Directive**

In Effect January 1, 2006

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular

currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under IMF Article IV.

## **Procedural Instructions with Respect to Foreign Currency Operations**

In Effect January 1, 2006

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$300 million on any day or \$600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding \$150 million, or \$300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular

currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

## **Meeting Held on January 31, 2006**

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, January 31, 2006 at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman  
Mr. Geithner, Vice Chairman  
Ms. Bies  
Mr. Ferguson  
Mr. Gynn  
Mr. Kohn  
Mr. Lacker  
Mr. Olson  
Ms. Pianalto  
Ms. Yellen

Mses. Cumming and Minehan, Messrs. Moskow, Poole, and Hoenig, Alternate Members of the Federal Open Market Committee

Messrs. Fisher, Stern, and Santomero, Presidents of the Federal Reserve Banks of Dallas, Minneapolis, and Philadelphia, respectively

Mr. Reinhart, Secretary and Economist

Ms. Danker, Deputy Secretary

Ms. Smith, Assistant Secretary

Mr. Skidmore, Assistant Secretary

Mr. Alvarez, General Counsel

Mr. Baxter, Deputy General Counsel

Ms. Johnson, Economist

Mr. Stockton, Economist

Messrs. Connors, Eisenbeis, Judd, Kamin, Madigan, Sniderman, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

Messrs. English and Sheets, Assistant Directors, Division of Monetary Affairs and International Finance, respectively, Board of Governors

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

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Chaboud and Mses. Kusko and Weinbach, Senior Economists, Divisions of International Finance, Research and Statistics, and Monetary Affairs, respectively, Board of Governors

Ms. Roush, Economist, Division of Monetary Affairs, Board of Governors

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

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

Mr. Stone, First Vice President, Federal Reserve Bank of Philadelphia

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Messrs. Evans and Hakkio, Mses. Mester and Perelmuter, and Messrs. Rasche, Rolnick, and Steindel, Senior Vice Presidents, Federal Reserve Banks of Chicago, Kansas City, Philadelphia, New York, St. Louis, Minneapolis, and New York, respectively

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

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for a term beginning January 31, 2006 had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

Timothy F. Geithner, President of the Federal Reserve Bank of New York, with Christine M. Cumming, First Vice President, Federal Reserve Bank of New York as alternate.

Jeffrey M. Lacker, President of the Federal Reserve Bank of Richmond, with Cathy E. Minehan, President of the Federal Reserve Bank of Boston as alternate.

Sandra Pianalto, President of the Federal Reserve Bank of Cleveland, with Michael H. Moskow, President of the Federal Reserve Bank of Chicago as alternate.

Jack Guynn, President of the Federal Reserve Bank of Atlanta, with William Poole, President of the Federal Reserve Bank of St. Louis as alternate.

Janet L. Yellen, President of the Federal Reserve Bank of San Francisco, with Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City as alternate.

By unanimous vote, the following officers of the Federal Open Market Committee were selected to serve until the selection of their successors at the first regularly scheduled meeting of the Committee in 2007, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee:

Alan Greenspan	Chairman <sup>2</sup>
Timothy F. Geithner	Vice Chairman
Vincent R. Reinhart	Secretary and Economist
Deborah J. Danker	Deputy Secretary
David W. Skidmore	Assistant Secretary
Michelle A. Smith	Assistant Secretary
Scott G. Alvarez	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Karen H. Johnson	Economist
David J. Stockton	Economist
Thomas A. Connors, Robert A. Eisenbeis, John P. Judd, Steven B. Kamin, Brian F. Madigan, Mark S. Sniderman, Charles S. Struckmeyer, Joseph S. Tracy, John A. Weinberg, and David W. Wilcox, Associate Economists	

In addition, it was agreed that the Committee would conduct a notation vote upon the swearing in of a new Chairman of the Board of Governors to elect Alan Greenspan's successor as Chairman of the Committee.<sup>3</sup>

By unanimous vote, Deborah J. Danker, or her successor as Deputy Secretary, was elected to serve as Chief

2. Alan Greenspan was elected to serve for the remainder of the day.

3. Secretary's note: By notation vote completed on February 1, 2006 the Committee unanimously approved the election of Ben S. Bernanke as Chairman of the Federal Open Market Committee.

Freedom of Information Act Officer to comply with an Executive Order issued on December 14, 2005 that requires federal agencies to take certain actions relating to FOIA activities.

By unanimous vote, the Committee amended its Program for Security of FOMC Information, primarily to reflect incorporation of the Board's new rules on access to confidential information by non-citizens.

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market.

By unanimous vote, Dino Kos was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.<sup>4</sup>

By unanimous vote, the Authorization for Domestic Open Market Operations was reaffirmed in the form shown below.

### Authorization for Domestic Open Market Operations (Reaffirmed January 31, 2006)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the

4. Secretary's note: Advice subsequently was received that the selection of Mr. Kos as Manager was satisfactory to the board of directors of the Federal Reserve Bank of New York.

System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement;

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

(c) To sell U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding. The Federal Reserve Bank of New York shall set a minimum lending fee consistent with the objectives of the program and apply reasonable limitations on the total amount of a specific issue that may be auctioned and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York and accounts maintained at the Federal Reserve Bank of New York as fiscal agent of the United States pursuant to Section 15 of the Federal Reserve Act, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities in 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and such foreign, international, and fiscal agency accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

With Mr. Lacker dissenting, the Committee approved the Authorization for Foreign Currency Operations with an

amendment to paragraph 5 which clarifies the language about permissible investment activities for the foreign portfolio and brings that language into alignment with that present in the authorization for the domestic portfolio. Accordingly, the Authorization for Foreign Currency Operations was adopted, effective January 31, 2006, as shown below.

**Authorization for Foreign Currency Operations (Amended January 31, 2006)**

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee’s foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Canadian dollars	Mexican pesos
Danish kroner	Norwegian kroner
Euro	Swedish kronor
Pounds sterling	Swiss francs
Japanese yen	

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding \$25.0

billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements (“swap” arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada .....	2,000
Bank of Mexico .....	3,000

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non-market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any

agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). Such investments may include buying or selling outright obligations of, or fully guaranteed as to principal and interest by, a foreign government or agency thereof; buying such securities under agreements for repurchase of such securities; selling such securities under agreements for the resale of such securities; and holding various time and other deposit accounts at foreign institutions. In addition, when appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account ("Manager"), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

With Mr. Lacker dissenting, the Foreign Currency Directive was reaffirmed in the form shown below.

### Foreign Currency Directive (Reaffirmed January 31, 2006)

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under IMF Article IV.

Mr. Lacker dissented in the votes on the Foreign Currency Directive and Authorization for Foreign Currency Operations to indicate his opposition to foreign currency intervention by the Federal Reserve. In his view, such intervention would be ineffective if it did not also signal a shift in domestic monetary policy. And if it did signal such a shift, it could potentially compromise the Federal Reserve's monetary policy independence.

By unanimous vote, the Procedural Instructions with Respect to Foreign Currency Operations were reaffirmed in the form shown below.

### Procedural Instructions with Respect to Foreign Currency Operations (Reaffirmed January 31, 2006)

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Com-

mittee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$300 million on any day or \$600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding \$150 million, or \$300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

Among the organizational matters raised, the Committee indicated that it intended to take up at a future meeting

the relationship between its formal vote and the policy statement issued after each meeting.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that underlying growth in aggregate demand remained solid, even though the expansion of real GDP was estimated to have slowed in the fourth quarter. Household spending rose smartly, outside of autos, and orders and shipments of nondefense capital goods in the business sector were generally quite strong. Housing markets showed some signs of cooling, but starts and sales remained at high levels. Industrial production posted moderate gains, even after excluding hurricane-related rebounds in some production categories, and private payrolls expanded at a firm rate on average. Headline consumer inflation had been held down by falling consumer energy prices; more recently, however, crude oil prices climbed back up to high levels. Meanwhile, core inflation had moved up a bit from low levels seen last summer.

Labor demand expanded further in the fourth quarter, as private nonfarm payrolls showed large gains in November followed by more-modest gains in December. The average increase over those two months represented sturdy job gains, even after accounting for the likely catch-up in employment follow-

ing Hurricanes Katrina and Rita. Several sectors, including manufacturing and several service groups, added vigorously to payrolls in December, but the total for the month was held down by employment declines in a number of sectors, such as retail trade and construction, where seasonal adjustment can be difficult this time of year. Aggregate hours fell slightly in December owing to a decrease in the workweek, but they rose over the fourth quarter as a whole. The unemployment rate edged down to 4.9 percent in part due to the labor force participation rate ticking down.

Industrial production rose notably in November and December, boosted by partial recovery from the effects of the hurricanes. Production in the mining industry, which includes oil and gas extraction, increased sharply. Utilities output also popped up in December as temperatures turned unseasonably cold in the first half of the month. Abstracting from the effects of these special factors, underlying activity in the industrial sector advanced moderately. Modest production increases in most manufacturing categories in December, including high-tech, consumer goods, and business equipment, outweighed production declines in the motor vehicles and parts sector. The capacity utilization rate in manufacturing stood a bit above its level of one year ago and near its long-run average.

Real personal consumption expenditures appeared to have increased only modestly in the fourth quarter, as spending on motor vehicles was restrained following a surge in the summer in response to manufacturers' price incentives. Outside of motor vehicles, consumption was brisk, supported by job growth, increases in personal income, and the decline in energy prices. Consumption was also likely supported by further gains in home values and equity

prices that raised the ratio of household wealth to disposable income relative to that seen earlier in 2005. Consumer sentiment measured by surveys moved up in December and, judging by the preliminary reading of the Michigan Survey, edged up further in January.

Activity in the housing market appeared to continue at high levels, although there were some indications of slowing. Single-family housing starts decreased markedly in December; however, this decline may have been due in part to unusually cold and wet weather in some areas of the country. Multifamily housing starts increased in December. Sales of new and existing homes remained at elevated levels but slowed somewhat toward the end of the year. Moreover, the stock of homes for sale increased to the upper end of ranges seen in recent years. Recent data on mortgage applications and survey measures of homebuying attitudes also pointed to some cooling in the housing market.

Real outlays for equipment and software appeared to have slowed significantly in the fourth quarter, as expenditures for transportation and communications equipment reversed some of their earlier sharp increases. With few exceptions, however, new orders appeared to be quite strong, and order backlogs increased for several goods in the transportation sector. Underlying fundamentals continued to support gains in capital spending as business sector output expanded, firms remained flush with funds, and relative price declines pushed down the user cost of capital equipment. Anecdotal reports and surveys also indicated that businesses were optimistic about near-term capital spending plans. Vacancy rates for nonresidential properties drifted lower as construction expenditures on commercial and manufacturing

structures remained well below recent peaks. However, spending on drilling and mining structures continued to increase strongly. Business investment in real nonfarm inventories increased moderately in the fourth quarter, boosted by a rapid accumulation of motor vehicle inventories. Outside of motor vehicles, stocks continued to rise slowly. The restrained growth in inventories in recent months suggested that firms outside the motor vehicle sector were intentionally keeping stockbuilding low; however, it could also have reflected an unanticipated increase in sales or supply interruptions following the hurricanes last fall. That said, the level of stocks appeared reasonably well aligned with demand in most industries.

After increasing further in October, the U.S. international trade deficit narrowed somewhat in November. The reduction in the deficit reflected a modest increase in exports and a similar-sized decrease in imports that owed importantly to a decline in imports of oil. The firm pace of third-quarter GDP growth in foreign economies generally appeared to continue in the fourth quarter.

Core consumer price inflation remained moderate over the second half of last year. Core prices had posted a string of very low increases last summer, held down in part by falling motor vehicle prices. In recent months, increases in core prices had rebounded. The overall consumer price index edged down further in December in response to substantial declines in its volatile energy price components. However, survey data pointed to large increases in gasoline prices in January, which were due to the backup in crude oil prices. Preliminary survey measures of near-term inflation expectations for January had nonetheless ticked down, continuing the reversal of a sharp increase after the hurricanes last fall, and longer-term

inflation expectations had moved lower as well. Input prices increased somewhat less in December, as upward pressure from previous energy price increases receded somewhat. Indeed, the increase in core intermediate producer prices over the year was estimated to be considerably lower than over the previous year. At its December meeting, the Federal Open Market Committee decided to increase the target level of the federal funds rate 25 basis points, to 4¼ percent. In its accompanying statement, the Committee indicated that, despite elevated energy prices and hurricane-related disruptions, the expansion in economic activity appeared solid. Core inflation had stayed relatively low in recent months, and longer-term inflation expectations had remained contained. Nevertheless, the Committee noted that possible increases in resource utilization as well as elevated energy prices had the potential to add to inflationary pressures. In these circumstances, the Committee believed that some further measured policy firming was likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance.

Investors had largely anticipated the Committee's interest rate decision at the December meeting and a change in the portions of the statement characterizing policy as accommodative. Accordingly, the policy announcement elicited only modest reactions in financial markets. With mixed readings on economic activity and inflation over the intermeeting period, the market's expectations for the path of monetary policy and yields on Treasury coupon securities ended the period little changed, on balance. Yields on investment- and speculative-grade corporate debt moved largely in line with Treasury yields. Major stock price indexes rose modestly, and the trade-

weighted foreign exchange value of the dollar depreciated slightly over the period.

Domestic nonfinancial sector debt appeared to have expanded at a somewhat slower pace in the fourth quarter, down from the rapid increase in the third quarter. Household debt growth likely moderated amid hints of a downshift in mortgage borrowing from its robust third-quarter pace and an outright decline in consumer credit, which owed in part to increased charge-offs from October's spike in bankruptcy filings. Business sector debt slowed somewhat in the fourth quarter, mainly reflecting a runoff of commercial paper by multinational firms that were reported to have repatriated foreign earnings to take advantage of a recently enacted tax provision. M2 expanded at a somewhat faster pace in the fourth quarter than had been predicted from historical relationships with income and opportunity costs. In part, the monetary aggregate was likely boosted by payments to hurricane victims by the federal government and insurance companies.

The staff forecast prepared for this meeting suggested that, after slow growth in the fourth quarter of 2005, real GDP would expand at a fairly robust pace over the first half of this year, boosted in part by spending on recovery activities associated with the hurricanes. Thereafter, real GDP growth was expected to moderate, importantly reflecting a reduced impetus to consumption from house price appreciation and some slowing in residential housing expenditures. Core PCE inflation was expected to be a touch higher this year than in 2005, largely because of the pass-through of higher energy and non-fuel import prices, but, with energy prices leveling out, core inflation was projected to drop back modestly in 2007.

In their discussion of the economic situation and outlook, meeting participants noted the slowing in GDP growth in the fourth quarter of 2005, but believed that it probably owed in large part to transitory factors and that economic growth would bounce back in the current quarter. In that regard, several high frequency indicators of production, labor markets, and private demand suggested greater underlying strength of late than had been reflected in the most recent GDP data. Over the next couple of years, the economy seemed poised to expand at a moderate rate in the neighborhood of its sustainable pace. Most participants expected core inflation to move up slightly in the near term, reflecting some pass-through of increased energy and other commodity prices. Although heightened inflation pressures could also arise from possible increases in resource utilization, the outlook for economic growth and the stability of inflation expectations suggested that core inflation should remain contained over time.

In preparation for the Federal Reserve's semiannual report to the Congress on the economy and monetary policy, the members of the Board of Governors and the presidents of the Federal Reserve Banks submitted individual projections of the growth of GDP, the rate of unemployment, and core consumer price inflation for the years 2006 and 2007. The forecasts of the rate of expansion in real GDP for 2006 were in a range of  $3\frac{1}{4}$  to 4 percent, centered at  $3\frac{1}{2}$  percent, while those for 2007 were in a range of 3 to 4 percent, with a central tendency of 3 to  $3\frac{1}{2}$  percent. These rates of growth were associated with projections of the civilian unemployment rate in a range of  $4\frac{1}{2}$  to 5 percent, with a central tendency of  $4\frac{3}{4}$  to 5 percent, in both the fourth quarter of 2006 and the fourth quarter of

2007. Expectations for the rate of inflation, as measured by the core PCE price index, were in a range of  $1\frac{3}{4}$  to  $2\frac{1}{2}$  percent this year, centered at about 2 percent, and in a range of  $1\frac{3}{4}$  to 2 percent in 2007.

In their discussion of major sectors of the economy, meeting participants noted that consumer spending in the latter months of 2005 had been buffeted by the effects of hurricanes, increased energy prices, and reduced auto sales incentives. However, anecdotal reports contributed to a view that consumer spending had been solid over the holiday season and in recent weeks, while measures of consumer confidence remained high. Nevertheless, signs of slowing in the housing sector had become more evident, and the boost to construction from hurricane-related rebuilding now seemed likely to be spread over the next couple of years rather than being more concentrated in the near term. In some areas, home price appreciation reportedly had slowed noticeably, highlighting the risks to aggregate demand of a pullback in the housing sector. For instance, the effects of a leveling out of housing wealth on the saving rate were difficult to predict, but, in the view of some, potentially sizable. Rising debt service costs, owing in part to the repricing of variable-rate mortgages, were also mentioned as possibly restraining the discretionary spending of consumers. The most likely outlook, however, was for a gradual moderation in house price appreciation and in the growth of consumption, which would continue to be supported by increases in jobs and incomes.

Participants generally anticipated fairly strong growth of capital expenditures. Though firms had been cautious about expanding their plant and equipment, business confidence was high, capacity utilization was tightening, and

companies were continuing to look for investment opportunities that increased productivity. As a result, the outlook was for reasonably robust spending on capital equipment even if economic growth slowed a bit. Anecdotal reports suggested that nonresidential real estate markets were improving in some areas.

The slowdown in government spending in the fourth quarter was generally seen as reflecting shifts in the timing of outlays, rather than a change in the underlying trend. However, fiscal stimulus was expected to diminish somewhat by next year. By contrast, global demand had picked up of late and would provide ongoing support for U.S. exports; indeed, the sharp increases in commodity prices and rallies in world equity markets suggested the possibility of an even stronger path for demand abroad.

Financial market conditions in the United States, as well as those abroad, suggested that investors were optimistic about the economic outlook. The recent strength in equity markets and the low prevailing term premiums and bond spreads perhaps reflected market assessments that economic risks were lower than usual, as well as strong demands for longer-term assets and an ample supply of liquidity. The possibility that term premiums and credit spreads could return to more typical settings represented a downside risk for interest-sensitive components of aggregate demand.

A variety of indicators, along with anecdotal reports, suggested that employment was expanding at a fairly good pace and labor compensation was rising moderately. Some participants remarked on the uncertainties regarding the extent of remaining capacity in labor markets and the outlook for labor costs. In particular, developments affecting the participation rate in the labor force and the

pace of growth in productivity would importantly condition prospects for employment and business cost pressures.

Participants noted that, while the pass-through of higher energy and other commodity prices to prices of core goods and services had remained subdued, there were continuing upside risks to inflation from these sources. Whatever the size of such pass-through effects, however, it was thought that they would probably be temporary in nature and likely diminish as energy prices flattened out, as long as inflation expectations did not move higher. In that regard, participants were encouraged that, despite recent energy price increases, survey measures of inflation expectations had notched down and longer-term inflation compensation in financial markets was little changed. Although high profit margins could imply some existing pricing power, they might also provide a cushion to absorb some future cost increases. Indeed, anecdotal reports suggested that the ability of firms to pass through higher input costs generally remained limited. Nevertheless, the increased prices of energy and other commodities and the possibility of a further rise in resource utilization, which some members viewed as nearly full at present, represented continuing risks, potentially adding to inflation pressures.

In the Committee's discussion of monetary policy for the intermeeting period, all members favored raising the target federal funds rate 25 basis points to 4½ percent at this meeting. Although recent economic data had been uneven, the economy seemed to be expanding at a solid pace. Members were concerned that, even after their action today, possible increases in resource utilization and elevated energy prices had the potential to add to inflation pressures. Although the stance of policy seemed

close to where it needed to be given the current outlook, some further policy firming might be needed to keep inflation pressures contained and the risks to price stability and sustainable economic growth roughly in balance. In the view of some members, the possibility of additional policy moves was reinforced by readings on core inflation and inflation expectations that were somewhat higher than was desirable over the long run. However, all members agreed that the future path for the funds rate would depend increasingly on economic developments and could no longer be prejudged with the previous degree of confidence.

As this meeting marked Alan Greenspan's last as a member of the Committee, meeting participants took the opportunity individually and collectively to pay tribute to his many years of outstanding service to the Federal Reserve and to the nation. They expressed their appreciation for his collegial and successful leadership of the Committee and of the Federal Reserve System and emphasized the privilege and honor they felt in having served with him.

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 4½ percent.

The vote encompassed approval of the paragraph below for inclusion in the

statement to be released shortly after the meeting:

The Committee judges that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. In any event, the Committee will respond to changes in economic prospects as needed to foster these objectives.

Votes for this action: Messrs. Greenspan and Geithner, Ms. Bies, Messrs. Ferguson, Gynn, Kohn, Lacker, and Olson, Ms. Pianalto and Yellen. Votes against this action: None.

The confirmation of the date of the next meeting of the Committee was postponed, pending the election of a successor Chairman.

The meeting adjourned at 12:25 p.m.

#### Notation Vote

By notation vote completed on December 30, 2005, the Committee unanimously approved the minutes of the Federal Open Market Committee meeting held on December 13, 2005.

Vincent R. Reinhart  
Secretary

#### Meeting Held on March 27–28, 2006

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Monday, March 27, 2006 at 3:00 p.m. and continued on Tuesday, March 28, 2006 at 9:00 a.m.

#### *Present:*

Mr. Bernanke, Chairman  
Mr. Geithner, Vice Chairman  
Ms. Bies  
Mr. Gynn  
Mr. Kohn  
Mr. Kroszner  
Mr. Lacker

Mr. Olson  
Ms. Pianalto  
Mr. Warsh  
Ms. Yellen

Mses. Cumming and Minehan, Messrs. Moskow, Poole, and Hoenig, Alternate Members of the Federal Open Market Committee

Messrs. Fisher and Stern, Presidents of the Federal Reserve Banks of Dallas and Minneapolis, respectively

Mr. Stone, First Vice President, Federal Reserve Bank of Philadelphia

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

Messrs. Connors, Eisenbeis, Kamin, Madigan, Sniderman, Struckmeyer, Tracy, Weinberg, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Hambley,<sup>5</sup> Assistant to the Board, Office of Board Members, Board of Governors

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

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

Mr. English, Assistant Director, Division of Monetary Affairs, Board of Governors

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

Mr. Orphanides, Adviser, Division of Monetary Affairs, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors.

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

Mr. Perli, Senior Economist, Division of Monetary Affairs, Board of Governors

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

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

Mr. Connolly, First Vice President, Federal Reserve Bank of Boston

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Messrs. Evans and Hakkio, Ms. Mester, and Messrs. Rasche, Rolnick, and Rudebusch, Senior Vice Presidents, Federal Reserve Banks of Chicago, Kansas City, Philadelphia, St. Louis, Minneapolis, and San Francisco, respectively

Ms. Mosser, Vice President, Federal Reserve Bank of New York

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that economic activity was expanding strongly in the first quarter. Consumer spending was on track to rise at a robust pace, and busi-

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5. Attended Monday's session only.

ness purchases of equipment and software picked up appreciably. Warm weather boosted housing construction in January and February, although sales of new homes dropped back and house prices decelerated slightly. Private payrolls advanced solidly in the first two months of the year. Headline consumer price inflation jumped in January but moderated in February as energy prices moved down. Core inflation remained contained.

Labor demand continued to increase in the first two months of 2006, as private nonfarm payroll employment showed large gains in both January and February. With favorable weather conditions, employment growth was especially brisk in the construction sector. Financial activities, business services, and nonbusiness services also posted solid payroll gains. Although the average workweek edged down in February, the level of aggregate hours for production and nonsupervisory workers was above its average for the fourth quarter of 2005. The unemployment rate continued to decline and averaged 4¾ percent over the first two months of the year. Several other labor market indicators also signaled a further tightening of labor market conditions.

Industrial production picked up in February after a modest decline in January. That pattern was attributable to swings in utilities output, as temperatures were historically warm early in the year before reverting to near seasonal norms in February. Excluding utilities, industrial production posted a sizable gain in January before flattening out in February, pointing to a solid rise in the first quarter. Mining output—which includes oil and natural gas extraction—slipped in February after registering robust gains in each of the previous three months. Manufacturing output was unchanged in February after a significant

increase in January. The rate of capacity utilization in the manufacturing sector stood a bit above its long-run average.

Consumer spending appeared to have rebounded strongly in the first quarter. Motor vehicle purchases bounced back in late 2005 and early 2006 from the sluggish pace that followed the end of the past summer's "employee pricing" programs. Excluding motor vehicles, consumption spending was robust, supported by continuing improvement in the labor market and advances in wage and salary income. The annual raise in the pay of federal employees, cost-of-living adjustments to Social Security benefits and other transfer programs, and the initiation of the Medicare Prescription Drug Plan boosted the level of personal disposable income in January. Consumption was likely supported also by ongoing increases in home prices and gains in the stock market. Consumer confidence as measured by surveys remained consistent with moderate increases in consumer spending.

Housing activity had moderated somewhat from the robust pace of the past summer. Although the level of single-family housing starts was unusually high in January and February, much of this strength was likely the result of mild winter weather; new permit issuance extended the downward trajectory that began in October. After an unusual spike in January, multifamily housing starts dropped back in February to a rate well within their historical range. Sales of new homes fell in the first two months of the year, while sales of existing homes turned up in February for the first time since last August; both measures were well below their peaks of mid-2005. The stock of homes for sale was elevated compared with its range of the last several years. Mortgage applications continued to decline in February, and survey measures of homebuying at-

titudes also maintained their recent downward trend. Housing demand was likely damped by rising mortgage rates, which moved up further in late 2005 and early 2006. House price appreciation appeared to have slowed from the rapid pace of the summer, but price increases for both new and existing homes remained well within the elevated range that has prevailed in recent years.

Real outlays for equipment and software decelerated in the fourth quarter of 2005 but appeared to have gained strength in early 2006. This pattern reflected sizable swings in outlays for transportation equipment. The fundamentals underlying capital spending continued to be supportive, as business sector output expanded briskly, firms remained flush with funds, and relative price declines for high-tech equipment continued to push down its user cost. Although vacancy rates for nonresidential properties were well below the peaks reached in the first quarter of 2004, real spending on new construction had yet to gain traction. In contrast, outlays for drilling and mining structures continued to rise rapidly and appeared poised to increase further in the near term.

The book value of manufacturing and trade inventories excluding motor vehicles rose at a moderate pace in the fourth quarter of 2005, and inventories appeared to have continued to build in January. Much of the increase reflected rising prices of goods held, and real inventory accumulation was subdued. The inventory-sales ratio declined slightly in January, extending its long-run downward trend. Inventory stocks appeared to be well aligned with demand in most industries.

The U.S. international trade deficit rose in the fourth quarter and widened further in January, as gains in exports of goods and services were outweighed by a substantially larger rise in imports.

Exports of industrial supplies, capital goods, and agricultural products picked up robustly in January, while the increase in imports was widespread across most product categories. Real GDP growth in foreign industrial economies was mixed in the fourth quarter, as economic activity slowed in the euro area and in Canada while the Japanese economy expanded briskly and growth in the United Kingdom firmed. Recent indicators of economic activity in developing economies were generally quite positive.

Readings on core consumer price inflation were favorable in recent months. Nonetheless, the overall consumer price index edged up in February after registering a large increase in January that was driven mostly by a spike in energy prices. While prices of food and core items recorded only modest increases in February, energy prices fell back amid increases in oil inventories and unseasonably mild temperatures since the latter part of December. Weekly data for March, however, indicated that gasoline prices rose sharply. Prices of capital equipment inched up in February after a more substantial gain in January. Nevertheless, prices of capital equipment decelerated over the past twelve months. Higher energy prices still seemed to be passing through to the prices of a number of core intermediate materials, although such increases were more moderate than those observed in the immediate aftermath of the hurricanes last autumn. The increase in the employment cost index in the fourth quarter of 2005 was relatively modest. Compensation per hour in the nonfarm business sector, after having increased substantially in the third quarter, was estimated to have risen somewhat less in the fourth quarter. Preliminary survey measures of short-term inflation expectations in

March edged up, but longer-term measures remained steady.

At its January meeting, the Federal Open Market Committee decided to raise the target level of the federal funds rate 25 basis points, to 4½ percent. In its accompanying statement, the Committee indicated that, although recent economic data had been uneven, the expansion in economic activity appeared solid. Core inflation had stayed relatively low in recent months, and longer-term inflation expectations had remained contained. Nevertheless, the Committee noted that possible increases in resource utilization as well as elevated energy prices had the potential to add to inflation pressures. In these circumstances, the Committee judged that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance but reiterated that it would respond to changes in economic prospects as needed to foster its objectives.

Investors had largely anticipated both the Committee's interest rate decision at the January meeting and the text of the accompanying statement. Consequently, the policy announcement elicited little market reaction. Policy expectations and yields on Treasury coupon securities subsequently firmed, on net, over the intermeeting period, as incoming data indicated robust economic growth in the United States and strengthening expansion abroad. Yields on investment-grade corporate debt rose roughly in line with those on comparable-maturity Treasury securities, while yields on speculative-grade corporate debt were little changed. Broad stock market indexes were modestly higher amid favorable economic news and lower oil prices, and the trade-weighted foreign exchange value of the dollar appreciated slightly over the period.

Growth of domestic nonfinancial sector debt appeared to have moderated only a bit in the first quarter from its robust pace in the fourth quarter of 2005. Net issuance of corporate bonds and expansion of business loans at commercial banks had abated in February and early March after robust growth in January; commercial paper outstanding was about flat in the first quarter. Household mortgage borrowing was thought to have slowed somewhat in the first quarter in response to increased mortgage interest rates. Consumer credit rebounded some in January after contracting in the fourth quarter because of elevated charge-offs related to the spike in bankruptcy filings. Based on monthly Treasury statements, federal debt seemed likely to have accelerated in the first quarter. On average, M2 grew briskly in January and February. While liquid deposits expanded moderately, small time deposits and retail money funds advanced strongly, supported by further increases in offering rates.

The staff forecast prepared for this meeting showed real GDP expanding briskly in the current quarter. Economic growth was expected to moderate later this year. The level of output in the current quarter was estimated to be close to the economy's potential and was anticipated to remain so over the projection period. Core PCE inflation was expected to move slightly higher in 2006 because of cost pressures induced by high energy and import prices and to step back down in 2007 as these cost pressures were anticipated to abate.

In their discussion of the economic situation and outlook, meeting participants saw the economy as having rebounded strongly from the slowdown in the fourth quarter of last year, with aggregate spending and employment expanding briskly in the current quarter. Growth was expected to moderate to a

more sustainable pace later this year. The ongoing cooling in the housing market would act to restrain residential construction and growth in consumption, but business and household confidence and supportive financial conditions would help to foster growth in employment and incomes, keeping consumption and investment on a solid upward track. Several meeting participants observed that, although the economy's sustainable potential output could not be observed directly or estimated with precision, historical patterns and recent data suggested that current levels of labor and product market resource utilization were in a zone consistent with little or no remaining economic slack. The recent behavior of core consumer prices seemed to indicate that any pass-through of higher energy and other commodity prices had been limited. In addition, productivity growth, moderate increases in compensation, contained inflation expectations, and international competition were helping to restrain unit labor costs and price pressures. Nonetheless, meeting participants generally remained concerned about the risk that possible increases in resource utilization, in combination with the elevated prices of energy and other commodities, could add to inflation pressures.

Regarding the major sectors of the economy, meeting participants noted that consumer spending appeared to be growing at a solid pace, notwithstanding earlier rises in energy prices. Contacts in the retail sector reported strong demand, and lending to households seemed to be robust. However, some automobile dealers reported subdued demand for domestic name-plate products. In coming quarters, consumer outlays were expected to be supported by continued employment gains, household income growth, and relatively low long-term interest rates, even if gains in housing wealth abated.

Meeting participants discussed at some length signs of cooling in the residential real estate market. Published data on housing starts showed little evidence of a significant weakening in construction activity. However, anecdotal reports from several markets, surveys of home-buyer attitudes, and data on inventories, home sales, and new home cancellation rates all pointed to a moderation in housing activity. It was noted that the relatively robust data on construction activity could owe in part to unseasonably warm weather. Going forward, participants expected a deceleration in house prices to contribute to an increase in the household saving rate and to weigh on consumption growth. Aggregate demand was also expected to be restrained directly by a softening in the pace of home building. Moreover, rebuilding following last year's major hurricanes appeared to be proceeding at a slow pace, and so would provide only limited offset to the implications of more fundamental developments in this market.

Generally, however, the economic expansion appeared to be broad-based. Contacts indicated that certain sectors, such as energy and semiconductor production, were particularly strong. Against this backdrop, robust growth in business spending was seen as likely, even as household spending growth moderated somewhat. Business capital expenditures, especially on equipment and software, appeared to have considerable momentum, supported by strong corporate profits, exceptionally liquid balance sheets, and greater business optimism. Some participants indicated that nonresidential construction was in the process of picking up and commercial vacancy rates were declining in some regions.

Financial market conditions remained supportive of growth, with long-term rates relatively low, risk spreads in cor-

porate debt markets narrow, and banks seeking lending opportunities. Merger and acquisition activity was strong and infusions of private equity continued at a rapid pace, but the domestic market for initial public offerings was reported to be quite weak. Although rates on fixed-rate mortgages remained historically low, some ratcheting up of rates on adjustable-rate mortgages was seen as a factor weighing to some degree on the housing market. More generally, the effects on spending of the substantial increase in short- and intermediate-term rates since June 2004 had probably not yet been fully felt.

There were reports of increased construction by state and local governments, which were benefiting from strong tax collections. Federal defense expenditures had leveled out. Foreign economic growth appeared to have strengthened of late, prompting some firming of monetary policy by several foreign central banks. Nonetheless, increases in imports were expected to continue to outpace increases in exports in coming quarters, trimming the rate of expansion of domestic output.

Meeting participants saw both upside and downside risks to their outlook for expansion around the rate of growth of the economy's potential. In the housing market, for instance, some downshift from the rapid price increases and strong activity of recent years seemed to be underway, but the magnitude of the adjustment and its effects on household spending were hard to predict. Some participants cited stronger growth abroad and robust nonresidential investment spending as potentially contributing more to activity than expected. It was also noted that an abrupt rise in long-term interest rates, reflecting, for example, a reversion of currently low term premiums to more typical levels,

could weigh on both household and business spending.

Several participants noted that the labor market had continued to strengthen, with payrolls increasing at a solid pace. The labor market was now showing some signs of tightness, consistent with a relatively low jobless rate. There were anecdotal reports of shortages of skilled labor in a few sectors, such as health care, technology, and finance. Still, participants expressed uncertainty about how much slack remained. Pressures on unit labor costs appeared contained, despite rising health-care costs, amid continued robust productivity growth and still-moderate increases in several comprehensive measures of compensation growth.

In their discussion of prices, participants indicated that data over the intermeeting period, including measures of inflation expectations, suggested that underlying inflation was not in the process of moving higher. Crude oil prices, though volatile, had not risen appreciably in recent months on balance, and a flattening in energy prices was beginning to damp headline inflation. In addition, core consumer inflation was flat or even a bit lower by some measures. Some meeting participants expressed surprise at how little of the previous rise in energy prices appeared to have passed through into core inflation measures. However, with energy prices remaining high, and prices of some other commodities continuing to rise, the risk of at least a temporary impact on core inflation remained a concern.

Participants noted that there were as yet few signs that any tightness in product and labor markets was adding to inflation pressures. To date, unit labor costs were not placing pressure on inflation, and high profit margins left firms a considerable buffer to absorb cost increases. Moreover, actual and potential

competition from abroad could be restraining cost and price pressures, though participants exchanged views on the extent to which conditions in foreign markets might be constraining prices domestically. However, participants observed that there was a risk that continuing increases in resource utilization could add to inflationary pressures. Some participants held that core inflation and inflation expectations were already toward the upper end of the range that they viewed as consistent with price stability, making them particularly vigilant about upside risks to inflation, especially given how costly it might be to bring inflation expectations back down if they were to rise.

In the Committee's discussion of monetary policy for the intermeeting period, all members favored raising the target federal funds rate 25 basis points to 4¾ percent at this meeting. The economy seemed to be on track to grow near a sustainable pace with core inflation remaining close to recent readings against a backdrop of financial conditions embodying an expectation of some tightening. Since the available indicators showed that the economy could well be producing in the neighborhood of its sustainable potential and that aggregate demand remained strong, keeping rates unchanged would run an unacceptable risk of rising inflation. Most members thought that the end of the tightening process was likely to be near, and some expressed concerns about the dangers of tightening too much, given the lags in the effects of policy. However, members also recognized that in current circumstances, checking upside risks to inflation was important to sustaining good economic performance. The need for further policy firming would be determined by the implications of incoming information for future activity and inflation.

With regard to the Committee's announcement to be released after the meeting, members expressed some difference in views about the appropriate level of detail to include in the statement. In the end, they concurred that the statement should note that economic growth had rebounded in the current quarter but that it appeared likely to moderate to a more sustainable pace in coming quarters. Policymakers agreed that the announcement should also highlight the favorable outlook for inflation and summarize their reasons for that assessment, but that it should reiterate that possible increases in resource utilization, along with elevated levels of commodity and energy prices, had the potential to add to inflation pressures. Changes in the sentence on the balance of risks to the Committee's objectives were discussed. Several members were concerned that market participants might not fully appreciate the extent to which future policy action will depend on incoming economic data, especially when an end to the tightening process seems likely to be near. Some members expressed concern that retention of the phrase "some further policy firming may be needed to keep the risks... roughly in balance" could be misconstrued as suggesting that the Committee thought that several further tightening steps were likely to be necessary. Nonetheless, all concurred that the current risk assessment could be retained at this meeting.

The Committee also discussed its experience with the two-day meeting. Participants agreed that the additional time had facilitated their discussion of the economy, policy, and the wording of the announcement. It was agreed that, because of scheduling conflicts, the next meeting of the Committee would be held on one day, Wednesday, May 10, 2006. After experience with that and perhaps

the subsequent meeting that is already scheduled for two days, a decision would be taken about the general format of future meetings.

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around  $4\frac{3}{4}$  percent.

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

The Committee judges that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. In any event, the Committee will respond to changes in economic prospects as needed to foster these objectives.

Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Guynn, Kohn, Kroszner, Lacker, and Olson, Ms. Pianalto, Mr. Warsh, and Ms. Yellen. Vote against this action: None.

The meeting adjourned at 12:15 p.m.

### Notation Vote

By notation vote completed on February 1, 2006, the Committee unanimously approved the election of Ben S. Bernanke as Chairman of the Federal Open Market Committee.

By notation vote completed on February 17, 2006, the Committee unani-

mously approved the minutes of the Federal Open Market Committee meeting held on January 31, 2006.

Vincent R. Reinhart  
Secretary

### Meeting Held on May 10, 2006

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, May 10, 2006 at 8:30 a.m.

#### *Present:*

Mr. Bernanke, Chairman  
Mr. Geithner, Vice Chairman  
Ms. Bies  
Mr. Guynn  
Mr. Kohn  
Mr. Kroszner  
Mr. Lacker  
Mr. Olson  
Ms. Pianalto  
Mr. Warsh  
Ms. Yellen

Mr. Hoenig, Ms. Minehan, and Messrs. Moskow and Poole, Alternate Members of the Federal Open Market Committee

Messrs. Fisher and Stern, Presidents of the Federal Reserve Banks of Dallas and Minneapolis, respectively

Mr. Stone, First Vice President, Federal Reserve Bank of Philadelphia

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

Messrs. Connors, Eisenbeis, Judd, Kamin, Madigan, Sniderman, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

- Messrs. Oliner and Slifman, Associate Directors, Division of Research and Statistics, Board of Governors
- Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors
- Mr. Orphanides, Adviser, Division of Monetary Affairs, Board of Governors
- Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors
- Mr. Wright, Section Chief, Division of Monetary Affairs, Board of Governors
- Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors
- Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors
- Mr. Werkema, First Vice President, Federal Reserve Bank of Chicago
- Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively
- Messrs. Evans and Hakkio, Ms. Mester, and Mr. Rasche, Senior Vice Presidents, Federal Reserve Banks of Chicago, Kansas City, Philadelphia, and St. Louis, respectively
- Mr. Hilton, Vice President, Federal Reserve Bank of New York
- Mr. Potter, Assistant Vice President, Federal Reserve Bank of New York
- Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis
- Mr. Hetzel, Senior Economist, Federal Reserve Bank of Richmond

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the

System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

With Mr. Lacker dissenting, the Committee voted to extend for one year beginning in mid-December 2006 the reciprocal currency ("swap") arrangements with the Bank of Canada and the Banco de Mexico. The arrangement with the Bank of Canada is in the amount of \$2 billion equivalent, and that with the Banco de Mexico is in the amount of \$3 billion equivalent. Both arrangements are associated with the Federal Reserve's participation in the North American Framework Agreement of 1994. The vote to renew the System's participation in the swap arrangements maturing in December was taken at this meeting because of the provision that each party must provide six months prior notice of an intention to terminate its participation. Mr. Lacker dissented because of his opposition, as indicated at the January meeting, to foreign exchange market intervention by the Federal Reserve, which such swap arrangements facilitate, and because of his opposition to direct lending to foreign central banks.

By unanimous vote, the Committee delegated the authority to review and determine appeals of a denial of access to Committee records under FOIA and other rules to the Board members designated as the primary and alternate Administrative Governors for Freedom of Information and Privacy Act Matters. Also by unanimous vote, the Committee established a FOIA Requester Service Center and designated Carol R. Low to fulfill the associated responsibilities.

The information reviewed at this meeting suggested that economic activity expanded strongly in the first quarter and that gains were widespread across most categories of final sales. Consumer spending posted a sizable increase, driven by January's bounceback in motor vehicle purchases and an acceleration in spending on other goods at the turn of the year. In addition, favorable weather boosted housing construction early in the quarter. Later in the quarter, however, the pace of consumer spending moderated, and housing starts retraced their earlier run-up. Business investment spending strengthened in the first quarter, in part because of a surge in the purchases of transportation and high-tech equipment and a step-up in nonresidential construction. Manufacturing production also posted solid gains in the first quarter and payroll growth moderated a bit in April after robust gains in employment in the first quarter. Overall consumer prices jumped in March because of higher energy prices, while core prices rose a bit more rapidly than in earlier months.

Nonfarm payrolls increased by 138,000 jobs in April following robust growth in March. The gains in April were widespread: Manufacturing and related industries registered significant increases, mining activity and employment were boosted by rising energy prices, construction hiring posted a moderate gain, and a range of services-producing industries strengthened, with the important exception of retail trade, which more than reversed its March gains. Average hours of production or nonsupervisory workers on private nonfarm payrolls edged up in April. The increases in the workweek and employment in April led to notable growth in aggregate hours of production or nonsupervisory workers. The unemployment

rate edged down to 4.7 percent in March and remained at that level in April.

Industrial production in March expanded at about the same strong pace as it did in February, with gains posted across all major components of the index. Manufacturing activity picked up in March after a lull in February. While manufacturing growth for the first quarter as a whole slowed from the rapid pace of the fourth quarter, it exceeded that of the previous year. Manufacturing capacity utilization during the quarter was a bit above its long-run average. Mining output—which includes oil and natural gas extraction—strengthened in the first quarter as a whole. Within the quarter, however, the boost from hurricane-related recovery seemed to ebb. While utility output surged in February and moved up a bit more in March, these increases only partly reversed the weather-related plunge in January.

Growth of consumer spending appeared to moderate after posting sizable gains around the turn of the year. Excluding motor vehicles, real outlays rose temperately in March, boosted by the continued rise in spending on services. Spending on goods excluding motor vehicles posted a second-straight monthly decline after robust gains over the previous four months. Sales of light vehicles held steady in March and picked up a bit in April, bringing the average pace for the year well above that of the fourth quarter but about even with the rate of last year. Although continued improvements in the labor market had been generating considerable gains in nominal wage and salary income, rising gasoline prices held down the increase in real disposable personal income in March and were expected to damp it in April as well. Ongoing increases in home prices and additional gains in the stock market,

however, further boosted household wealth during the first quarter. Measures of consumer confidence remained consistent with moderate increases in consumer spending.

The underlying pace of residential activity seemed to moderate in the first quarter. After unseasonably warm weather allowed a high level of single-family housing starts in January and February, starts fell in March to their lowest level in a year. New permit issuance for single-family homes also fell in March, continuing its downward trend. Multifamily starts recovered a bit in March from their low rate in February but remained well within their historical range. Home sales also declined, on net, in recent months. Although sales of existing single-family homes edged up in February and March, the level of sales for the first quarter as a whole was notably below the record high in the second quarter of last year. Sales of new homes also moved up in March, but their average in the first quarter was down substantially from the peak in the third quarter of last year. House price appreciation appeared to have slowed from the elevated rates seen over the past summer. Growth in the average sales price of existing homes in March, versus a year earlier, decelerated sharply, and the average price for new homes in March fell compared to a year earlier. In addition, other indicators, such as months' supply of both new and existing homes for sale and the index of pending home sales, supported the view that housing markets had cooled in recent months.

Real outlays for equipment and software surged in the first quarter after a relatively subdued performance in the fourth quarter of last year. Much of the growth reflected a sharp jump in business purchases of transportation equipment, such as airplanes and motor vehi-

cles. Spending on high-tech equipment and software also improved as exceptionally strong growth in expenditures for communications equipment more than compensated for fairly soft spending on computers and peripherals and on software. Conditions in the nonresidential construction sector improved noticeably. Although spending on nonresidential building construction remained well short of the robust levels seen in late 2000, growth of expenditures in this sector was at its fastest pace in the first quarter in nearly six years. Outlays on drilling and mining structures continued to climb in the first quarter, and available data pointed to ongoing growth.

Real nonfarm inventories stepped down in the first quarter, largely reflecting a decline in investment in motor vehicle inventories. Excluding motor vehicles, inventories increased at a pace well above that in the fourth quarter. Over the past twelve months, inventories relative to shipments and sales had moved down moderately on balance, extending the long-run downward trend.

The U.S. international trade deficit narrowed in February as a sharp decrease in imports more than offset a modest fall in exports. The declines in both categories were generally widespread across sectors with the exception of oil imports, which were flat, and imported services, which rose. Incoming data for foreign industrial economies were generally favorable and pointed to continued expansion. Available data showed continued growth in GDP in the United Kingdom in the first quarter, continuing strong domestic demand in Canada through February, ongoing recovery in Japan, and a first-quarter rebound in euro-area economic performance.

Headline inflation turned up in March. Although the price of natural gas

had fallen because of continued plentiful inventories, retail gasoline prices surged, leading to a jump in overall energy prices for the month. Prices of core goods and services also rose more quickly in March, largely because of a spike in the apparel component that unwound a decline in February and a one-time step-up in medical prices related to changes in Medicare reimbursement rules. During the twelve months ending in March, overall inflation rose at a slightly faster pace than that in the preceding twelve-month period, while core prices for the same period increased a bit more slowly than in the previous year. Producer price inflation also moved up in March, driven largely by higher food and energy prices. Readings on the growth in the cost of labor were mixed. Over the three months ending in March, the employment cost index for hourly compensation of private industry workers rose at its slowest pace in several years. Data on compensation per hour in the nonfarm business sector, however, pointed toward notably faster growth in the first quarter. Some financial-market and survey indicators suggested that inflation expectations, both for the upcoming year and for the longer term, had moved up since the March meeting.

At its March meeting, the Federal Open Market Committee decided to raise its target for the federal funds rate 25 basis points, to  $4\frac{3}{4}$  percent. In its accompanying statement, the Committee indicated that the slowing of the growth of real GDP in the fourth quarter of 2005 seemed largely to have reflected temporary or special factors. Economic growth had rebounded strongly in the first quarter but seemed likely to moderate to a more sustainable pace. As yet, the run-up in the prices of energy and other commodities appeared to have had only a modest effect on core inflation,

ongoing productivity gains had helped to hold the growth of unit labor costs in check, and inflation expectations had remained contained. Still, the Committee noted that possible increases in resource utilization, in combination with the elevated prices of energy and other commodities, had the potential to add to inflation pressures. In these circumstances, the Committee judged that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance, but reiterated that in any event the Committee would respond to changes in economic prospects as needed to foster these objectives.

Investors anticipated the FOMC's decision at its March meeting to raise the target federal funds rate 25 basis points, but the Committee's post-meeting statement evidently led them to mark up somewhat their expected path for the federal funds rate. Subsequently, the path was pushed up further by data releases that were, on balance, stronger than market participants had expected. Speeches by Federal Reserve officials, the minutes of the March meeting, and Congressional testimony by the Chairman combined to restrain policy expectations some. On net, the anticipated path of the federal funds rate over the next two years nonetheless rotated upward. Yields on inflation-indexed Treasury securities moved up over the intermeeting period, but yields on nominal Treasury issues rose more. Spreads of yields on investment-grade bonds over those on comparable-maturity Treasury securities were about unchanged, while those on speculative-grade bonds declined. Major stock price indexes were up a bit over the intermeeting period, as positive first-quarter earnings reports more than offset the nega-

tive effects of higher energy prices and rising interest rates.

The trade-weighted exchange value of the dollar against major foreign currencies fell since the March meeting. Increased focus in public debate on the risks posed by the large U.S. external imbalance appeared to erode investor support for the dollar.

Domestic nonfinancial sector debt was estimated to have grown at a robust pace in the first quarter, down only slightly from the brisk pace of 2005. Business sector debt appeared to have expanded strongly, supported by significant net issuance of U.S. corporate bonds and double-digit growth of business loans at commercial banks. In the household sector, consumer credit continued to rise slowly, and the growth of household mortgage debt was thought, based on limited data, to have moderated somewhat in the first quarter against a backdrop of higher mortgage interest rates and some signs of a deceleration in house prices. M2 advanced at a pace somewhat below that of nominal GDP in the first quarter and was estimated to have expanded moderately in April.

The staff forecast prepared for this meeting showed real GDP growth moderating somewhat from the average pace of the previous several quarters. The projected deceleration of real GDP reflected the lagged effects of the tightening of monetary policy, the waning impetus from increases in household wealth, and reduced stimulus from fiscal policy. While higher energy prices were expected to boost inflation in the near term, structural productivity was strong, and the influence of higher energy and material costs was thought likely to moderate. Thus, consumer prices, after increasing at a faster rate in the first half of the year, were expected to decelerate later this year and next year.

In their discussion of the economic situation and outlook, meeting participants saw the economy as having rebounded strongly so far this year after the slowing of growth in the fourth quarter. The advance in output had been vigorous in the first quarter of this year, with real GDP increasing at around a 5 percent annual rate. Although the expansion appeared likely to moderate, it evidently remained solid. Inflation pressures appeared to be somewhat greater than the Committee had anticipated at the time of its March meeting. Consumer prices recently had risen at a pace noticeably above the average rise over the previous twelve months. Also, prices of energy and many other commodities had climbed sharply of late, and inflation expectations appeared to have risen slightly. If economic growth continued to moderate over coming quarters, as anticipated, pressures on productive resources would most likely continue to be limited. Most participants expected that, after allowing for some possible near-term volatility related to the recent jump in energy and other commodity prices, core inflation would probably remain around the levels experienced on average over the past year. However, recent developments suggested that upside risks to inflation had risen somewhat since the time of the March meeting.

In their discussion of major sectors of the economy, some participants noted that growth of household spending was likely to slow over the remainder of the year. Anecdotal information pointed to some cooling of housing markets. That cooling was especially noticeable for high-end homes and for houses in markets that previously had experienced the steepest appreciation. Data on home sales, permits, and starts on the whole likewise suggested that activity was gradually diminishing. Some reports

indicated that speculative building of homes had dropped off considerably, but inventories of unsold homes still seemed to be expanding. Although fresh comprehensive data were not available, home prices on average appeared still to be rising, but at a slower pace than over the past few years. Going forward, growth in consumption spending was likely to be supported by gains in employment and personal income. But slower appreciation of home prices and the effects of the increases in energy prices and interest rates that had already occurred would likely act to restrain consumption spending somewhat. Certain features of recently popular nontraditional mortgage products had the potential to cause financial difficulties for some households and erode mortgage loan performance for some lenders. Nonetheless, the household sector seemed likely to remain in sound financial condition overall. On balance, consumption spending was viewed as most likely to expand at a moderate pace in coming quarters.

Several participants remarked that business investment spending was robust. Nonresidential construction was accelerating notably, in the process absorbing some of the resources that were being diverted from housing. Office vacancy rates were declining, spurring construction of new office buildings. Drilling and mining activity was said to be particularly strong, propelled by the high levels of energy prices. Investment in equipment and software appeared to be expanding at a solid rate. Capital formation was likely to continue to be supported by rising output, strong balance sheets in the business sector, and ready availability of financing on attractive terms.

Some participants commented on the recent surge in federal tax revenues, a development that was being mirrored at

the state level. While the precise reasons for the increase in federal receipts were not entirely clear, robust income growth was probably an important factor. In any case, the effect was to trim the current federal budget deficit noticeably. Nonetheless, the longer-run federal fiscal imbalance remained a serious concern.

Data on economic growth outside the United States indicated that the global expansion was firming, a sense amplified by reports from international contacts. The apparent strengthening of global growth was likely to support U.S. exports and economic activity and would also tend to maintain upward pressures on energy and commodity prices.

Meeting participants expressed some concern about recent price developments and their implications for inflation prospects. Core consumer inflation lately had been a little higher than expected. Moreover, energy prices had risen steeply in the period since the March meeting, and, although pass-through apparently had been limited to date, the most recent increases might be reflected to a greater degree in core inflation in coming months. Participants noted that prices of non-energy commodities, such as industrial metals and building supplies, also had been climbing. The recent decline in the dollar was another factor that could add to inflation pressures, although the effect of prior changes in the foreign exchange value of the dollar on core consumer prices had apparently been limited. Business contacts had reported continued shortages of certain types of skilled labor and related wage pressures in some occupations, which would tend to boost costs.

However, participants also cited some factors that could be expected to restrain inflation. Although alternative measures of labor compensation provided divergent readings, growth of total compen-

sation on balance appeared to remain moderate. And, even if nominal wages should accelerate somewhat, relatively wide profit margins could buffer the effect on prices of final goods and services. While firms would seek to maintain those margins, recent experience suggested that this might be accomplished in part through further productivity gains, which had remained fairly strong on balance in recent quarters, rather than through more rapid price hikes.

Participants discussed in some detail inflation expectations—a potentially important factor influencing future inflation trends. Some surveys suggested that inflation expectations had risen in recent weeks, but others implied that expectations were little changed. Measures of inflation compensation based on the difference between yields on nominal Treasury securities and inflation-indexed issues had edged higher. It was possible, though, that investors' uncertainty regarding inflation prospects, not just inflation expectations themselves, had risen. On balance, participants judged that inflation expectations had risen somewhat—a development that would have to be taken into account in policy-making and warranted close monitoring—but remained contained.

Although the Committee discussed policy approaches ranging from leaving the stance of policy unchanged at this meeting to increasing the federal funds rate 50 basis points, all members believed that an additional 25 basis point firming of policy was appropriate today to keep inflation from rising and promote sustainable economic expansion. Recent price developments argued for another firming step at today's meeting. Core inflation recently had been a bit higher than had been expected, and several members remarked that core inflation was now around the upper end of

what they viewed as an acceptable range. Moreover, a number of factors were augmenting the upside risks to inflation: the surge in energy and commodity prices, some recent weakness in the foreign exchange value of the dollar, and the possibility that the apparent increase in inflation expectations could, if it persisted, impart momentum to inflation. In addition, the economy appeared to be operating at a relatively high level of resource utilization and had been growing quite strongly, and whether economic growth would moderate to a sustainable pace was not yet clear. At the same time, members also saw downside risks to economic activity. For example, the cumulative effect of past monetary policy actions and the recent rise in longer-term interest rates on housing activity and prices could turn out to be larger than expected. Still, it seemed most likely that, with modest further policy action, including a 25 basis point firming today, growth in activity would moderate gradually over coming quarters, pressures on resources would remain limited, and core inflation would stay close to levels experienced over the past year.

Given the risks to growth and inflation, Committee members were uncertain about how much, if any, further tightening would be needed after today's action. In view of the risk that the outlook for inflation could worsen, the Committee decided to repeat the indication in the policy statement released after the March meeting that some further policy firming could be required. However, the Committee agreed to emphasize that “the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information.” Members debated the appropriate characterization of inflation expectations in the statement. Low and stable

inflation expectations were key to the attainment of the Committee's dual objectives of price stability and maximum sustainable economic growth. However, the apparent pickup in longer-term expectations, while worrisome, was relatively small. They remained within the range seen over the past couple of years, and the increase could well reverse before long. Accordingly, it appeared appropriate to characterize inflation expectations again as "contained."

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 5 percent.

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

The Committee judges that some further policy firming may yet be needed to address inflation risks but emphasizes that the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information. In any event, the Committee will respond to changes in economic prospects as needed to support the attainment of its objectives.

Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Guynn, Kohn, Kroszner, Lacker, and Olson, Ms. Pianalto, Mr. Warsh, and Ms. Yellen. Votes against this action: None.

During the interval between the March and May meetings, Chairman

Bernanke had appointed a subcommittee on communications issues to be chaired by Governor Kohn and including Presidents Stern and Yellen. At today's meeting, Governor Kohn indicated that the objective of the subcommittee was to help the Committee frame and organize discussion of a broad range of such issues over coming meetings.

The meeting adjourned at 1:10 p.m.

### Notation Vote

By notation vote completed on April 17, 2006, the Committee unanimously approved the minutes of the Federal Open Market Committee meeting held on March 27–28, 2006.

Vincent R. Reinhart  
Secretary

### Meeting Held on June 28–29, 2006

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, June 28, 2006 at 2:00 p.m. and continued on Thursday, June 29, 2006 at 9:00 a.m.

#### *Present:*

Mr. Bernanke, Chairman  
Mr. Geithner, Vice Chairman  
Ms. Bies  
Mr. Guynn  
Mr. Kohn  
Mr. Kroszner  
Mr. Lacker  
Ms. Pianalto  
Mr. Warsh  
Ms. Yellen

Ms. Minehan, Messrs. Moskow, Poole, and Hoenig, Alternate Members of the Federal Open Market Committee

Messrs. Fisher and Stern, Presidents of the Federal Reserve Banks of Dallas and Minneapolis, respectively

Mr. Stone, First Vice President, Federal Reserve Bank of Philadelphia

Mr. Reinhart, Secretary and Economist

Ms. Danker, Deputy Secretary

Ms. Smith, Assistant Secretary

Mr. Skidmore, Assistant Secretary

Mr. Baxter, Deputy General Counsel

Ms. Johnson, Economist

Mr. Stockton, Economist

Messrs. Connors, Eisenbeis, Judd, Kamin, Madigan, Sniderman, Struckmeyer, Tracy, Weinberg, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

Ms. Zickler, Deputy Associate Director, Division of Research and Statistics, Board of Governors

Mr. English, Assistant Director, Division of Monetary Affairs, Board of Governors

Messrs. Dale<sup>6</sup> and Simpson, Senior Advisers, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

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

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

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

Mr. Perli, Senior Economist, Division of Monetary Affairs, Board of Governor

Mr. Doyle and Ms. Judson, Economists, Divisions of International Finance and Monetary Affairs, respectively, Board of Governors

Mr. Luecke, Senior Financial Analyst,

Division of Monetary Affairs, Board of Governors

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

Mr. Moore, First Vice President, Federal Reserve Bank of Cleveland

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Mr. Evans, Ms. Mester, and Messrs. Rasche, Rolnick, and Sellon, Senior Vice Presidents, Federal Reserve Banks of Chicago, Philadelphia, St. Louis, Minneapolis, and Kansas City, respectively

Ms. Mucciolo, Vice President, Federal Reserve Bank of New York

By unanimous vote, the Committee approved a "Report and Plan of the Federal Open Market Committee to Improve FOIA Operations" and approved a delegation of authority to the Chairman (or his designee) to take actions required under the Freedom of Information Act.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at the June meeting suggested that the growth of economic activity in the second quarter slowed substantially from its rapid first-quarter pace. The expansion of consumer spending softened, and activity in

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6. Attended Thursday's session only.

the housing market continued to cool. In contrast, the underlying rate of business spending remained strong and was well supported by fundamentals. The demand for labor appeared to moderate as hiring stepped down in recent months. Consumer price inflation remained elevated in April and May, reflecting sharp rises in energy prices and more rapid increases in core prices.

Gains in nonfarm private payrolls averaged 112,000 over the three months ending in May, a pace considerably below the average of about 170,000 jobs per month for the prior three-month period. The slowing in hiring was most pronounced in retail trade but was also evident in construction and information services. Establishments in professional and business services, nonbusiness services, and wholesale trade continued to add jobs at roughly the same pace as earlier in the year. Average hours of production or nonsupervisory workers on private nonfarm payrolls edged up in April but reversed these gains in May. The unemployment rate was 4.6 percent in May, near its average for the year so far.

Industrial production edged down in May after strong growth in April, largely reflecting the patterns of manufacturing output. For the year to date, manufacturing production advanced at a rate significantly below its rapid fourth-quarter growth rate but only a bit below its average pace of expansion since mid-2003. The mining sector, which includes oil and natural gas extraction, expanded solidly in April before falling back in May. Utilities output also grew strongly in April but retreated in May as temperatures returned to normal after having been unseasonably warm in April. Capacity utilization in manufacturing remained somewhat above its long-run average in both April and May.

Real consumer spending appeared to be on track to decelerate noticeably in the current quarter after posting robust growth in the first quarter. The slowing reflected both a marked reduction in the growth in real outlays for motor vehicles from an elevated first-quarter pace and a moderation in the advance of real expenditures for other goods in recent months. Underlying this slowing in the expansion of consumer expenditures was a moderation in the fundamental determinants of spending. The level of nominal wages and salaries beginning in the fourth quarter of 2005 was revised down considerably, and rising consumer prices held down the gains in real disposable income. Higher interest rates also likely restrained spending. Nonetheless, despite recent declines in equity prices, the wealth-to-income ratio remained well above its historical average, and consumer sentiment, which dipped in May, rebounded some in early June.

Residential construction activity moderated over the past few months but remained at a historically high level. Single-family starts posted a sizable drop in May for the third consecutive month. Although a substantial portion of May's decline seemed to be a partial payback for the elevated level of starts early in the year, when weather conditions had been favorable, the underlying pace of single-family housing construction appeared to have slowed. In the multifamily sector, starts in May were well within the typical range seen since 1995. Sales of both new and existing single-family homes in April and May were significantly below their peaks of the summer of 2005, though new home sales continued to regain some ground after having fallen in February. The most reliable measures of house prices indicated modest growth following the rapid increases seen last year.

After a first-quarter surge, real spending on equipment and software appeared on track for a much smaller gain in the second quarter. Incoming data for the current quarter suggested that spending on transportation equipment reversed the run-up that occurred in the first quarter. Spending on high-tech equipment and software advanced at a slower pace in the second quarter as a flattening out of spending on communications equipment after a huge increase in the first quarter offset some pickup in business-sector demand for computers and software. The construction of nonresidential buildings picked up noticeably so far this year, although activity remained well short of its previous peak in mid-2000. Outlays on drilling and mining structures continued to climb in response to high projected energy prices.

The book value of manufacturing and trade inventories excluding motor vehicles stepped up in April. The ratio of book-value inventories to sales held steady for the year so far after having fallen considerably last year. In general, inventories appeared to be well aligned with demand, and business surveys suggested that firms were comfortable with the level of inventories.

The U.S. international trade deficit widened in April, reflecting a large increase in imports coupled with a slight decline in exports. Import growth was led by sharp rises in the value of imported oil and natural gas and increased imports of automotive products and capital goods. Exports were restrained in part by a decline in aircraft exports. Expansion of economic activity in the foreign industrial countries was solid in the first quarter, but indications for the second quarter were more mixed. Incoming data pointed to a possible slowing in Canada, but signs of further expansion in the euro area and of continued growth in Japan were evident, not-

withstanding sharp declines in equity indexes in these countries.

Headline inflation picked up in April and May, driven partly by sharp increases in the prices of petroleum-based products. In contrast, natural gas prices continued to decline in response to excess supply, fully reversing last autumn's rises. Higher oil prices showed through to producer prices for a variety of energy-intensive intermediate goods. Consumer food prices decelerated markedly since January, reflecting slower price increases for food away from home and declines, on balance, in the prices of fruits and vegetables. Core price inflation rose less than headline inflation in April and May but above its pace earlier in the year. Core prices were boosted in part by an acceleration in shelter costs, especially those imputed for owner-occupied residences. Readings on the growth of labor costs were revised down for the fourth quarter of 2005 and first quarter of 2006, but recent data suggested a pickup in the second quarter. A number of indicators of inflation expectations largely reversed increases recorded in the spring.

At its May meeting, the Federal Open Market Committee (FOMC) decided to raise its target for the federal funds rate 25 basis points, to 5 percent. The Committee's accompanying statement indicated that economic growth had been quite strong so far this year. The Committee saw growth as likely to moderate to a more sustainable pace, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices. At that time, the run-up in the prices of energy and other commodities appeared to have had only a modest effect on core inflation. Ongoing productivity gains had helped to hold the growth of unit labor costs in check, and inflation expectations remained con-

tained. Still, possible increases in resource utilization and the elevated prices of energy and other commodities had the potential to add to inflation pressures. In these circumstances, the Committee foresaw the possibility of a need for some further policy firming to address inflation risks but emphasized that the extent and timing of any such firming would depend importantly on the evolution of the economic outlook as implied by incoming information.

Investors anticipated the FOMC's decision at its May meeting to raise the federal funds rate target 25 basis points, but near-term policy expectations edged up, apparently in response to the accompanying statement. Subsequent data releases reporting higher-than-expected inflation, the release of the FOMC minutes, and speeches by Federal Reserve policymakers all led investors to push up their expectations for the future path of the federal funds rate. Yields on near-term nominal Treasury securities rose in line with policy expectations over the intermeeting period, but those on longer-dated securities moved up by smaller amounts. Yields on inflation-indexed Treasury securities increased by more than those on nominal securities, and the resulting decline in inflation compensation retraced a substantial share of the rise that had occurred over the preceding intermeeting period. Major stock price indexes fell sharply over the period. Spreads of yields on corporate bonds over those on comparable-maturity Treasury securities widened somewhat, while those on speculative-grade issues rose by more.

After changing little on balance during much of May, the dollar's foreign exchange value against other major currencies moved up in June and showed a modest increase, on net, over the intermeeting period. The dollar appreciated after comments by FOMC policymakers

that were interpreted by market participants as suggesting a higher likelihood of policy tightening at the June FOMC meeting. Prices of precious and industrial metals, which had risen sharply since early March, particularly in May, reversed those gains later in the intermeeting period.

Debt of the domestic nonfinancial sectors was estimated to have decelerated in the second quarter after a robust first-quarter increase. Business sector debt advanced more slowly in the second quarter, although the expansion of business loans remained brisk and net issuance of corporate bonds was solid. In the household sector, mortgage borrowing slowed in response to more subdued housing activity and moderating house-price appreciation. M2 growth in the second quarter was tepid, as the growth of nominal income had apparently softened and rising opportunity cost continued to dampen demand for money.

The staff forecast prepared for this meeting indicated that, after the significant deceleration of real GDP in the current quarter from the first quarter of 2006, growth would proceed through the end of 2007 at a pace a bit below the rate of growth of the economy's potential. The outlook for modest growth of real GDP reflected a slowdown in the housing market, the effects of past policy tightening, and a diminished boost to consumer spending from increases in household wealth. Core consumer price inflation was projected to have stepped up in the second quarter from its average pace over the preceding several quarters but to then drop back somewhat, albeit to a level higher than previously forecasted, as energy and import prices flatten out and some slack emerges in labor and product markets.

In their discussion of the economic situation and outlook, meeting partici-

pants saw economic growth as having moderated in the second quarter from its robust pace in the first quarter, reflecting a cooling of the housing market and the lagged effects of increases in interest rates and energy prices. Most participants expected output to advance over the next year and a half at a pace close to that which the economy can sustain over time. All participants found the elevated readings on core inflation of recent months to be of concern and, if sustained, inconsistent with the maintenance of price stability. However, contained inflation expectations, the abatement of upward pressure from past increases in energy and other commodity prices, and the slowing in the growth of economic activity that was under way were expected to contribute to a moderation in core inflation in coming quarters. Nonetheless, participants noted a risk that the drop-back in inflation could be slower or more limited than the Committee would find desirable since resource utilization was currently tight and the pickup in price increases had been broadly based rather than being limited to a few specific sectors that could be linked to energy costs.

In preparation for the Federal Reserve's semiannual report to the Congress on monetary policy, the members of the Board of Governors and the presidents of the Reserve Banks submitted individual projections of the growth of GDP, the rate of unemployment, and core consumer price inflation for 2006 and 2007, conditioned on the participants' views of the appropriate path for monetary policy. The forecasts of the rate of fourth-quarter to fourth-quarter expansion in real GDP for 2006 were in a range of 3 to 3¾ percent, with a central tendency of 3¼ to 3½ percent, and those for 2007 were in a range of 2½ to 3¼ percent, with a central tendency of 3 to 3¼ percent. These rates of

growth were associated with a civilian unemployment rate in a range of 4½ to 5 percent in the fourth quarter of this year and 4¼ to 5¼ percent in the fourth quarter of 2007, with a central tendency at both horizons of 4¾ to 5 percent. Forecasts of the rate of inflation, as measured by the change in the average fourth-quarter core PCE price index from a year earlier, ranged from 2¼ to 3 percent for this year, with a central tendency of 2¼ to 2½ percent, and the range and central tendency were 2 to 2¼ percent for next year.

In their discussion of the major sectors of the economy, participants observed that housing construction activity had declined notably in recent months as indicated by lower housing starts and permits; moreover, higher inventories of unsold homes, a sharp rise in cancellations of new home sales, and reports from construction companies suggested that the weakness was likely to be extended. Several participants pointed out that the decline was broadly in line with expectations in light of the tightening in monetary policy and the rapid run-up in home prices and residential construction in recent years. Participants also observed that the evidence to date indicated that the slowdown was orderly but were mindful of the possibility of a sharper downturn in the sector.

The growth of consumer spending had dropped off significantly in the second quarter from a robust pace earlier in the year. The slowdown was attributed in part to higher energy prices and also to a likely downshift in home price appreciation and higher interest rates. A reduction in the attractiveness of home equity borrowing was mentioned as possibly contributing to the slowdown. Some retailers, especially those catering to lower- and middle-income customers, reported weaker growth in sales. Consumer spending was expected to ad-

vance modestly in coming quarters as the effects of more moderate gains in home prices and a gradual rebound in the household saving rate from recent historically low levels were offset by further gains in employment and growth in labor income. A few participants noted that the surge in federal tax receipts this year and a similar advance in revenue at the state level could be a sign of vigorous gains in income, indicating that household spending may expand more rapidly than many were anticipating.

Participants interpreted the incoming data on orders and shipments of durable goods, positive readings on business sentiment, and continued high levels of corporate profitability as suggesting that business investment would remain a source of strength going forward. In a shift from the pattern observed in the past few years, some contacts suggested that businesses were now directing their capital expenditures toward expanding capacity rather than increasing efficiency, a signal of the anticipation of continued solid growth in demand. Business expenditures on nonresidential structures also were seen to be advancing robustly in a number of markets, possibly providing some offset to reduced residential construction activity. Several participants observed that the continued ready availability of credit would support business expenditures. Others, however, noted that the pullback from risk-taking that had been observed in some financial markets over the preceding few months could intensify, raising the cost of funds.

Participants observed that many foreign central banks had tightened monetary policy over the intermeeting period in response to strengthening activity and indications of inflation pressures. Greater uncertainty about inflation pressures and the needed policy response

had perhaps contributed to a reassessment of risks by investors globally. Despite the tighter policy, however, economic growth in the United States' major trading partners appeared likely to remain solid, supporting U.S. exports. Participants also discussed the role of global capacity utilization in the inflation process.

All meeting participants expressed concern about recent elevated readings on core inflation. A key issue was the extent to which this spring's increase in inflation reflected transitory or persistent influences. Many noted that a number of factors were temporarily boosting inflation. The pass-through of the substantial rise in energy prices could account for a considerable part of the step-up in core inflation in recent quarters. In addition, rising rents had been boosting the cost of shelter and so contributing to the increase in core inflation. However, energy prices were expected to level out, and rents, while difficult to forecast, were viewed by some participants as likely to decelerate in coming quarters. The moderation in the economic expansion was expected to prevent pressures on resource utilization from intensifying. In sum, with inflation expectations contained and unit labor costs held down by ongoing gains in productivity and modest advances in compensation, inflation was seen by most participants as likely to edge down.

Nevertheless, several factors were cited as potentially sustaining upward pressure on inflation, and the range of participants' forecasts for core inflation in 2007 rose by  $\frac{1}{4}$  percentage point relative to the range of forecasts made in February. Some participants noted that businesses in their Districts were experiencing difficulty hiring certain types of skilled workers, suggesting that increased wage pressures might emerge. In addition, some business contacts indi-

cated a greater ability to pass higher costs on to customers, although other businesses continued to report that their pricing power remained limited. The relatively taut resource markets and the lagged effects of the increase in energy prices raised the possibility that inflation could continue at somewhat elevated levels for some time. Higher levels of inflation, should they persist, could become embedded in inflation expectations. In that vein, several participants noted that inflation expectations had been sensitive to incoming data and to communications regarding monetary policy over the intermeeting period.

All Committee members agreed that raising the target for the federal funds rate 25 basis points, to 5¼ percent, at this meeting was appropriate given the recent readings on inflation and the associated deterioration in the inflation outlook. Such an action would also help preserve the decline in inflation expectations that had occurred over the intermeeting period and which appeared to be conditioned on an outlook for a policy firming. Characterizing the resulting stance of policy was quite difficult in the view of most members; those who did venture a judgment saw the stance as ranging from modestly restrictive to somewhat accommodative. Many members noted that significant uncertainty accompanied the appropriate setting of policy going forward, and one indicated that the decision to raise the target federal funds rate at this meeting was a close call.

In their discussion of the wording of the statement to be released after the meeting, members expressed a wide range of views. Some members favored a shorter statement that focused on the Committee's desire to see core inflation decline from its recent elevated levels, while others were inclined to provide more information about the forces that

would likely influence the future path of policy. In light of the possibility that the lessening of inflation pressures could be more limited than consistent with sustained good performance of the economy, members agreed to indicate that "[a]lthough the moderation in the growth of aggregate demand should help to limit inflation pressures over time . . . some inflation risks remain." Nevertheless, with the economy slowing and some of the effects of past tightening still in the pipeline, members recognized the value of accumulating more information for determining what, if any, additional policy action would be needed following the tightening adopted at the current meeting. To indicate that policy action at future meetings was not foreordained and would depend on the forecasts for inflation and activity in the medium term, the Committee agreed to state that "[t]he extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information."

After consulting with the participants, the communications subcommittee recommended that the Committee begin its discussions of communications issues at the FOMC meeting in August and that the FOMC meetings scheduled for later this year be lengthened to allow a fuller initial discussion of some of these issues. The Committee also discussed briefly the schedule for FOMC meetings next year and tentatively agreed to increase the number of two-day meetings to four.

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 5¼ percent.

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

Although the moderation in the growth of aggregate demand should help to limit inflation pressures over time, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information. In any event, the Committee will respond to changes in economic prospects as needed to support the attainment of its objectives.

Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Guynn, Kohn, Kroszner, and Lacker, Ms. Pianalto, Mr. Warsh, and Ms. Yellen. Votes against this action: None.

The meeting adjourned at 11:10 a.m.

### Notation Vote

By notation vote completed on May 30, 2006, the Committee unanimously approved the minutes of the Federal Open Market Committee meeting held on May 10, 2006.

Vincent R. Reinhart  
Secretary

### Meeting Held on August 8, 2006

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal

Reserve System in Washington, D.C., on Tuesday, August 8, 2006 at 8:30 a.m.

#### *Present:*

Mr. Bernanke, Chairman  
Mr. Geithner, Vice Chairman  
Ms. Bies  
Mr. Guynn  
Mr. Kohn  
Mr. Kroszner  
Mr. Lacker  
Ms. Pianalto  
Mr. Warsh  
Ms. Yellen

Mr. Hoenig, Ms. Minehan, Messrs. Moskow and Poole, Alternate Members of the Federal Open Market Committee

Messrs. Fisher, Plosser, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis, respectively

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

Messrs. Connors, Eisenbeis, Kamin, Madigan, Sniderman, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. English and Ms. Liang, Associate Directors, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

Mr. Reifschneider, Deputy Associate Director, Division of Research and Statistics, Board of Governors

Messrs. Dale and Orphanides, Senior Advisers, Division of Monetary Affairs, Board of Governors

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

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

- Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors
- Ms. Beechey, Economist, Division of Monetary Affairs, Board of Governors
- Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors
- Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta
- Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively
- Mr. Hakkio, Ms. Mester, Messrs. Rasche and Williams, Senior Vice Presidents, Federal Reserve Banks of Kansas City, Philadelphia, St. Louis, and San Francisco, respectively
- Messrs. Peach and Krane, and Ms. Weir, Vice Presidents, Federal Reserve Banks of New York, Chicago, and New York, respectively
- Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis
- Mr. Hetzel, Senior Economist, Federal Reserve Bank of Richmond

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at the meeting suggested that the growth of economic activity in the second quarter

slowed from its rapid pace in the first quarter. Residential investment contracted as activity in the housing market continued to cool. Consumer spending and business investment decelerated after posting substantial increases in the first quarter. The demand for labor moderated, with hiring in recent months below the pace of earlier this year. Consumer price inflation remained elevated in July, reflecting further increases in energy prices and shelter costs.

Nonfarm payrolls increased in June and July, but more slowly than in the first quarter. The moderation in hiring was most pronounced in retail trade but was also evident in construction and non-business services. Establishments in professional and business services continued to add jobs at roughly the same pace as that of earlier in the year. Average hours of production or nonsupervisory workers on private nonfarm payrolls edged up. The unemployment rate rose to 4.8 percent in July, above its average over the first half of the year.

Industrial production picked up in June. For the second quarter as a whole, it grew at a robust rate that was faster than its first-quarter pace. Gains in manufacturing production were widespread across industries. The mining sector, which includes oil and natural gas extraction, expanded solidly in June, although average growth in the second quarter was below that of the first quarter, in part because the recovery from the disruptions caused by last year's hurricanes neared completion. Utilities output grew strongly in the second quarter. The rate of capacity utilization in the manufacturing sector stepped up in June and remained above its long-run average.

The growth of consumer spending slowed considerably in the second quarter after the surge in purchases around the turn of the year. Spending on goods

excluding motor vehicles posted a modest increase in June after remaining flat, on average, over the previous four months. Although nominal wages and salaries rose briskly in the first half of the year, gains in real disposable income were held down by rising consumer prices. While past gains in household wealth, particularly from home prices, supported consumer spending, higher interest rates and energy prices were likely a restraining influence. Indicators of consumer sentiment for July were mixed.

Residential construction activity contracted in the second quarter. Single-family starts declined in June to a level well below the average of the previous twelve months. Construction in the multifamily sector remained steady, with starts in June well within the typical range seen since 1995. Sales of both new and existing single-family homes slowed in June and were significantly below their peaks of the summer of 2005. Available measures of house prices indicated that price increases had moderated over the past four quarters.

After surging in the first quarter, real spending on equipment and software edged down in the second quarter. The decline was accounted for primarily by a drop in expenditures on communications and transportation equipment. Spending on high-tech equipment and software declined as well. The construction of nonresidential buildings moved up at a solid pace over the first half of the year, although activity remained well short of its previous peak in mid-2000. Outlays on drilling and mining structures continued to climb in response to high energy prices, and spending on office construction edged up as vacancy rates continued to trend down. Overall, economic fundamentals and business sentiment continued to support increased investment.

The book value of manufacturing and trade inventories excluding motor vehicles rose in May, and real nonfarm inventories excluding motor vehicles appeared to be slightly higher in the second quarter than earlier in the year. The ratio of book-value inventories to sales edged down in May in both the trade and manufacturing sectors after having remained relatively steady over the previous three months. In the manufacturing sector, however, inventories ticked up again in June. In general, inventories appeared to be well aligned with demand, and business surveys suggested that firms were comfortable with the level of inventories.

The U.S. international trade deficit widened in May, reflecting a sharp increase in imports that more than offset a sizable gain in exports. Import growth was heavily concentrated in oil, reflecting both higher prices and quantities; other categories of imports fell on balance. Exports rose across almost all major product categories; the largest gains were in consumer goods and capital goods, especially aircraft. Expansion of economic activity in the advanced foreign economies appeared to continue in the second quarter at a pace roughly comparable to that of the first quarter, on net. Incoming data for the second quarter pointed to a pickup in economic growth in the euro area and Japan but indicated that growth slowed somewhat in Canada. Recent economic indicators from the developing economies were mixed but, in general, suggested some moderation in growth from the rapid first-quarter pace.

Headline inflation continued to move up, on balance, in recent months, and consumer prices increased at a faster pace in the second quarter than over the previous twelve months. Consumer energy prices, while declining slightly in June, surged during the second quar-

ter, on net. Core consumer prices also continued to rise, boosted by an acceleration in shelter costs, particularly those for owner-occupied residences, and some pass-through of energy cost increases. Higher oil prices showed through in producer prices for a variety of energy-intensive intermediate goods. Rising import prices, higher domestic rates of capacity utilization, and strong global demand for materials were factors underlying an acceleration in core prices for intermediate materials. The price of crude oil increased further over the intermeeting period, and strong weather-related demand caused the price of natural gas to rise considerably. The employment cost index rose somewhat faster in the second quarter than over the preceding three months, but the twelve-month change was less than that of a year ago. Survey measures of households' inflation expectations in June and July reversed their increases in April and May.

At its June meeting, the Federal Open Market Committee (FOMC) decided to raise its target for the federal funds rate 25 basis points, to 5¼ percent. The Committee's accompanying statement indicated that economic growth had been moderating from its quite strong pace earlier in the year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices. Readings on core inflation had been elevated in recent months, but ongoing productivity gains had held down the rise in unit labor costs, and inflation expectations remained contained. However, high levels of resource utilization and the high prices for energy and other commodities had the potential to sustain inflation pressures. Although the moderation in the growth of aggregate demand would help limit inflation pressures over time, the Committee judged

that some inflation risks remained. The extent and timing of any additional firming would depend on the evolution of the economic outlook as implied by incoming information.

Investors anticipated the FOMC's decision at its June meeting to raise the federal funds rate 25 basis points, but near-term policy expectations edged lower, apparently in response to the accompanying statement. Subsequently, data releases on real activity that were weaker than expected, the Chairman's testimony on the semiannual Monetary Policy Report, and the release of the June FOMC minutes all led investors to revise down their expectations for the future path of the federal funds rate. Yields on nominal Treasury securities fell in line with policy expectations over the intermeeting period. Yields on inflation-indexed Treasury securities declined a bit more than those on comparable nominal Treasury securities, leaving inflation compensation up slightly, albeit within recent ranges. Spreads of yields on corporate bonds over those on comparable-maturity Treasury securities were about unchanged, while those on speculative-grade bonds widened. Major stock price indexes rose modestly. The foreign exchange value of the dollar against other major currencies fell, on net, over the intermeeting period.

Debt of the domestic nonfinancial sectors was estimated to have decelerated in the second quarter after a robust first-quarter increase. Business-sector debt increased briskly, as the expansion of business loans remained robust. In the household sector, mortgage debt decelerated from the first quarter's rapid pace in response to higher mortgage rates and slower house-price appreciation. M2 growth dropped in the second quarter and remained modest in July, consistent with moderating growth of

nominal income and rising opportunity cost.

The staff forecast prepared for this meeting indicated that real GDP growth would slow in the second half of 2006 and 2007, and to a lower rate than had been anticipated in the prior forecast. The marking down of the outlook was largely attributable to the annual revision of the national income and product accounts, which involved downward revisions to actual GDP growth in prior years and prompted reductions in the staff's estimate of potential output. The slowdown in the housing market, the effects of higher energy prices on household purchasing power, the waning impetus of household wealth effects on consumer spending, and the effects of past policy tightening were expected to hold economic growth below potential over the next six quarters. Core consumer price inflation was projected to drop back somewhat later this year and next, mainly as the effects of higher energy and import prices abated.

In their discussion of the economic situation and outlook, meeting participants noted that the slowing of GDP growth in the second quarter was generally in line with expectations, reflecting the continued cooling of the housing market, the restraining influence on demand of higher energy prices, and the lagged effects of past increases in interest rates. Going forward, output was expected to advance at a pace at or slightly below the economy's potential rate of growth, but several participants noted that the annual revision to the national income and product accounts suggested this growth rate likely was lower than previously believed. Incoming information with regard to inflation had not been encouraging. Still, most participants thought that, with energy prices possibly leveling out, aggregate demand moderating, and long-term in-

flation expectations contained, core PCE inflation likely would decline gradually from its recent elevated level, though the upside risks to inflation were significant.

In their discussion of the major sectors of the economy, participants noted that residential construction activity had continued to recede over the past few months and cited the housing sector as a downside risk to the outlook for growth. The rate of new home sale cancellations, which was identified as an important leading indicator by some contacts in the construction industry, had spiked higher. Single-family housing starts and permits continued to fall, and inventories of unsold housing appeared to have risen significantly, pointing to continued slowing in this sector. Some participants observed that the slowing seemed to be orderly thus far, but it was also noted that in some areas of the country housing construction had experienced a relatively sharp fall. In general, participants expressed considerable uncertainty regarding prospects for the housing sector.

Meeting participants noted that the continued increases in energy prices and borrowing costs appeared to have restrained consumer spending growth in recent months. Contacts in the retail sector generally reported a continued slowing of growth in sales, although the situation differed somewhat by region and type of good or service. Reliable, comprehensive data were not yet available on recent house price movements, but the rate of appreciation appeared to be moderating and was likely to slow further in coming months. The slower pace of increase in housing wealth would restrain consumption growth, though by how much was uncertain. However, the financial condition of households, as judged by indicators such as bankruptcy filings and loan delin-

quencies, appeared to remain solid. Overall, consumption spending seemed likely to expand at a moderate pace in coming quarters.

Although business fixed investment in the second quarter was a little lower than had been expected, participants noted that this development appeared mainly to reflect the timing of purchases, particularly of transportation equipment, and not weakness in the underlying trend. Some participants noted that nonresidential construction had continued to strengthen, offsetting some of the contraction in residential construction. Looking forward, strong business balance sheets and high profitability were seen as supporting continued growth in expenditures on software and equipment. However, it was noted that if the reported slowing of increases in retail sales continued, businesses might trim capital spending plans.

With regard to the federal sector, spending related to last year's hurricanes appeared likely to abate, and federal expenditures overall would probably be providing less impetus to aggregate demand going forward. Federal receipts had been increasing rapidly, a development that reflected continued strong growth in labor and non-labor income.

Some participants noted that global demand remained strong, potentially adding to worldwide pressures on resources. Increased geopolitical risks, particularly related to developments in the Middle East, continued to put pressure on energy prices, and the prices of many other commodities also had firmed over the intermeeting period. Central banks had been raising interest rates globally, however, and this was viewed as a factor that should help to restrain global inflation pressures. But it was also noted that the recent decline in the foreign exchange value of the dollar

could lead to a weakening of import competition in the form of increases in the prices of tradable goods in the United States.

As at the June meeting, all participants expressed concern about continued elevated readings on core inflation and inflation risks going forward. Several participants took note of the revisions to historical data that painted a more worrisome picture of cost trends; measures of unit labor costs had been marked up, reflecting upward revisions to labor compensation and downward revisions to labor productivity. Core PCE inflation now appeared to have been running at or above a 2 percent annual rate for more than two years, with prices accelerating over the first half of 2006. Many participants noted that the extent to which the increase in core inflation so far this year reflected transitory or persistent influences remained unclear. The recent pickup in price increases appeared to be broad-based, and a number of business contacts reported greater ability to pass through higher costs. However, some types of price pressures were not likely to continue to increase. The recent acceleration in shelter costs, which contributed substantially to the increase in core inflation this year, could prove short-lived. Moreover, while energy prices had risen further in the intermeeting period, energy prices could well level out in coming quarters. Also, the anticipated moderation in aggregate demand implied that pressures on resource utilization likely would not increase and could abate to a degree going forward. Finally, inflation expectations appeared to have remained contained despite adverse news about prices. In light of these factors, most participants expressed the view that core inflation was likely to decline gradually over the next several

quarters, although appreciable upside risks remained.

In the Committee's discussion of monetary policy for the intermeeting period, nearly all members favored keeping the target federal funds rate at 5¼ percent at this meeting. In view of the elevated readings on costs and prices, many members thought that the decision to keep policy unchanged at this meeting was a close call and noted that additional firming could well be needed. But with economic growth having moderated some, most members anticipated that inflation pressures quite possibly would ease gradually over coming quarters and the current stance of policy could well prove to be consistent with satisfactory economic performance. Under these circumstances, keeping policy unchanged at this meeting would allow the Committee to accumulate more information before judging whether additional firming would be necessary to foster the attainment of price stability over time. The full effect of previous increases in interest rates on activity and prices probably had not yet been felt, and a pause was viewed as appropriate to limit the risks of tightening too much. Following seventeen consecutive policy firming actions, members generally saw limited risk in deferring further policy tightening that might prove necessary, as long as inflation expectations remained contained.

All members agreed that the statement to be released after the meeting should convey that inflation risks remained dominant and that consequently keeping policy unchanged at this meeting did not necessarily mark the end of the tightening cycle. They concurred that an indication that economic growth had moderated was appropriate, and a consensus favored citing the same reasons for that moderation as in the June statement. Members also

agreed that the statement should both mention factors contributing to the likely moderation of inflation pressures over time and reiterate the forces that were seen as having the potential to sustain inflation pressures.

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5¼ percent.

The vote encompassed approval of the text below for inclusion in the statement to be released at 2:15 p.m.:

The Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Guynn, Kohn, Kroszner, Ms. Pianalto, Mr. Warsh, and Ms. Yellen. Votes against this action: Mr. Lacker.

Mr. Lacker dissented because he believed that further tightening was needed to bring inflation down more rapidly than would be the case if the policy rate were kept unchanged. The inflation outlook had deteriorated in the intermeeting period; the recent surge in core inflation had persisted and appeared to be broad-based, while the revision of the national income and product accounts indicated a recent upswing in compensation and unit labor costs. Although real

growth was likely to be somewhat lower in coming quarters, in his view it was unlikely to moderate by enough to bring core inflation down. He noted, moreover, that real short-term interest rates had fallen in the intermeeting period and were still low relative to rates typically associated with sustained expansions.

The Committee then turned to a discussion of the goals and principles that should guide the review of its approaches to policy communications that it had recently undertaken. Participants agreed that communication was important for democratic accountability and could promote the effectiveness of policy. Although considerable strides had been made in FOMC communications over the past ten years or so, participants generally thought that further advances were possible. In that regard, consideration of how the Committee expressed both its economic objectives and its assessments of expected progress toward those objectives was likely to be particularly important. Conveying the degree of uncertainty and conditionality about Committee expectations of future developments was seen as a major challenge. It was recognized that communications should support appropriate decisionmaking, including respect for the diversity of views that contributed to good decisions. Participants agreed to continue the Committee's review of communications issues at the FOMC meeting in October.

The meeting adjourned at 3:05 p.m.

### Notation Vote

By notation vote completed on July 19, 2006, the Committee unanimously approved the minutes of the FOMC meeting held on June 28–29, 2006.

Vincent R. Reinhart  
Secretary

### Meeting Held on September 20, 2006

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 20, 2006 at 8:30 a.m.

#### *Present:*

Mr. Bernanke, Chairman  
Mr. Geithner, Vice Chairman  
Ms. Bies  
Mr. Gwynn  
Mr. Kohn  
Mr. Kroszner  
Mr. Lacker  
Mr. Mishkin  
Ms. Pianalto  
Mr. Warsh  
Ms. Yellen

Ms. Cumming, Mr. Hoenig, Ms. Minehan, and Messrs. Moskow and Poole, Alternate Members of the Federal Open Market Committee

Messrs. Fisher, Plosser, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis, respectively

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

Messrs. Connors, Eisenbeis, Kamin, Madigan, Sniderman, Struckmeyer, Tracy, Weinberg, and Wilcox, Associate Economists  
Mr. Kos, Manager, System Open Market Account

Messrs. English and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

Mr. Reifschneider, Deputy Associate Director, Division of Research and Statistics, Board of Governors

- Mr. Oliner, Senior Adviser, Division of Research and Statistics, Board of Governors
- Mr. Gross, Special Assistant to the Board, Office of Board Members, Board of Governors
- Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors
- Mr. Durham, Section Chief, Division of Monetary Affairs, Board of Governors
- Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors
- Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors
- Mr. Lyon, First Vice President, Federal Reserve Bank of Minneapolis
- Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively
- Mr. Evans, Ms. Mester, Messrs. Rasche, Rolnick, Rudebusch, and Sellon, Senior Vice Presidents, Federal Reserve Banks of Chicago, Philadelphia, St. Louis, Minneapolis, San Francisco, and Kansas City, respectively
- Ms. Mosser, Vice President, Federal Reserve Bank of New York

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at the meeting suggested that economic activity continued to decelerate in recent months. Consumer and business spending held up well, and payroll employment continued to rise moderately in July and August. However, a contraction in homebuilding was damping the economic expansion. Core consumer price inflation eased somewhat but nonetheless remained higher than it was in 2005. Total consumer price inflation moderated in August, reflecting a substantial slowing of the increase in energy prices.

Nonfarm payrolls rose in August at a pace similar to that recorded over the previous four months. Employment gains were widespread in the service sector, and the construction industry also added jobs, particularly in nonresidential building. However, employment in retail trade and manufacturing fell again in August. Average hours of production or nonsupervisory workers edged lower. The unemployment rate ticked back down to 4.7 percent in August, but it remained within the narrow band that prevailed since the beginning of the year.

Industrial production rose in July but edged down in August. Manufacturing output was unchanged in August, as a small increase in the production of motor vehicles and parts was offset by a slight net decline in other sectors. Output of construction supplies, for example, dropped a little. In the high-technology sector, the production of computers rose tepidly through the summer, while output of communications equipment turned down in August after increasing markedly during the first half of the year. Semiconductor production remained sluggish through August.

Consumer spending appeared to be rising at a moderate pace in recent months. Spending on cars and light

trucks increased somewhat in July after a lackluster pace in the second quarter but apparently weakened in August. Consumer spending on goods excluding motor vehicles increased modestly during the four months ending in July. Despite the sharp net increase in energy prices, real disposable income rose further, with solid gains in June and July. Increases in household wealth earlier in the year continued to boost consumer spending. However, consumer borrowing costs had risen since the beginning of the year with the increase in short-term interest rates. Recent readings on consumer sentiment were mixed. The personal saving rate fell further in July.

Residential construction activity continued to contract in recent months. Single-family starts fell further in July and August to a level well below the peak in the third quarter of 2005. Construction in the multifamily sector also fell back. Sales of both new and existing single-family homes fell in July and were significantly below the peaks of last summer. A range of indicators suggested that housing market activity was likely to slow further in the near term. Pending home sales dropped noticeably in July, and mortgage rates had increased since the beginning of the year. Available measures suggested that prices of existing homes increased through the second quarter at a much lower rate than the one observed during the same period last year.

After strong increases in the first half of 2006, real spending on equipment and software remained robust into the summer against a backdrop of rising business output, plentiful corporate cash reserves, positive sentiment among executives, and falling relative prices for high-tech equipment. Orders and shipments of communications equipment leveled off in recent months after climbing earlier this year. Real computer

spending remained sluggish in July. Business purchases of light vehicles picked up in August after a weak performance in July, and sales of medium and heavy trucks remained brisk. Available data indicated that aircraft purchases remained flat. Real spending on equipment outside the high-tech and transportation sectors appeared to be increasing moderately in the current quarter.

Book-value data for the manufacturing and trade sectors suggested that inventory accumulation slowed only modestly in July from a brisk pace in the second quarter. Outside the motor vehicle sector, inventories appeared to be well aligned with demand, and surveys indicated that firms continued to be generally comfortable with their level of inventories.

Both imports and exports increased in the second quarter, but imports increased and exports decreased in July, widening the U.S. trade deficit. The growth of imports was heavily concentrated in oil, reflecting higher petroleum prices, and in non-oil industrial supplies and capital goods. Imports of services fell slightly. Exports of capital goods and industrial supplies declined after considerable gains in June, but exports of telecommunications equipment and automotive products were strong. Exports of services were unchanged in July.

Economic activity in the advanced foreign economies decelerated in the second quarter but remained strong. A fall in net exports held back expansion in Japan and Canada, while strong domestic demand boosted growth in the United Kingdom and the euro area. Incoming data suggested that overall GDP growth in these countries for the current quarter was dropping a bit from the second-quarter pace. Recent economic indicators from the emerging-market economies generally pointed to robust, but moderating, growth.

The overall price index for personal consumption expenditures rose relatively steeply in July and was estimated to have increased further in August, bringing the advance over the twelve-month period above the year-earlier rise. After July, though, crude oil and gasoline prices dropped back significantly, and with inventories of natural gas remaining near seasonal highs, natural gas prices fell from their spike earlier this summer. Core consumer prices increased at a somewhat more subdued pace over July and August, but despite the recent moderation, the twelve-month change in core prices remained above the increase over the comparable period twelve months earlier. The producer price index for core intermediate materials rose significantly in July and August. Substantial upward revisions to wages and salaries boosted compensation per hour in the first quarter. The increase likely owed in part to the exercise of stock options and cash bonuses; other data that did not include such forms of compensation pointed to more moderate increases. Hourly compensation rose further in the second quarter and recorded an increase of about  $7\frac{3}{4}$  percent from four quarters earlier. After more favorable readings in June and July, survey measures of households' inflation expectations turned back up in August, but preliminary September readings suggested a decline.

At its August meeting, the Federal Open Market Committee (FOMC) decided to maintain its target for the federal funds rate at  $5\frac{1}{4}$  percent. The Committee's accompanying statement indicated that economic growth had moderated from its quite strong pace earlier in the year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices. Readings on core inflation had been elevated

in recent months, and the high levels of resource utilization and of the prices of energy and other commodities had the potential to sustain inflation pressures. However, inflation pressures seemed likely to moderate over time, reflecting contained inflation expectations and the cumulative effects of monetary policy actions, as well as reduced impetus from higher energy and materials costs. Nonetheless, the Committee judged that some inflation risks remained. The extent and timing of any additional firming that may be needed to address these risks would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Investors had largely anticipated the FOMC's decision at its August meeting to maintain the federal funds rate at its current level, and short-term rates dropped only a bit in response. Subsequently, data on inflation that were weaker than expected, substantial declines in oil prices, and the release of the minutes of the August FOMC meeting led investors to revise down their expectations for the future path of the federal funds rate. Over the intermeeting period, yields on short- and intermediate-term nominal Treasury securities fell, while yields on inflation-indexed Treasury securities of comparable maturity increased somewhat, pushing inflation compensation considerably lower at those horizons. Nominal forward rates further out the yield curve fell about the same amount as real forward rates, implying little change in far-forward inflation compensation. Spreads of yields on investment- and speculative-grade corporate bonds over those on Treasury securities were about unchanged. Major stock price indexes posted solid gains. The foreign exchange value of the dollar against other major currencies was little

changed, on net, over the intermeeting period.

Debt of the domestic nonfinancial sectors in the third quarter was estimated to be rising at about the same pace as in second quarter. Business-sector debt was increasing briskly, as the expansion of business loans remained robust. In the household sector, debt expanded in the second quarter at a rate slightly below that in the first quarter, as mortgage debt decelerated somewhat. M2 growth remained modest in August, consistent with moderating growth of nominal income and lagged increases in opportunity cost.

The staff forecast prepared for this meeting indicated that real GDP growth would continue to slow into the second half of 2006 before strengthening gradually thereafter. By 2008, output was projected to be expanding at a pace about equal to the staff's forecast of potential output growth. The staff, however, had again reduced its projection for potential GDP growth, and the projected slow pace of growth over the next several quarters was thus consistent with an opening of only a small gap in resource utilization. In the near term, the cooling of the housing market and lower motor vehicle production were expected to hold growth back. At the same time, though, significantly lower energy prices, sustained increases in labor income, and favorable labor market conditions were anticipated to support expansion through the end of the year. Further ahead, the lagged effects of the previous tightening of monetary policy and waning stimulus from household wealth and fiscal policy were anticipated to restrain growth, but the drag from the downturn in residential construction was expected to abate. Core consumer price inflation was projected to drop back somewhat later this year and next, reflecting the emergence of

slack in the economy and lower energy costs.

In their discussion of the economic situation and outlook, meeting participants noted that the pace of the expansion appeared to be continuing to moderate in the third quarter. In particular, activity in the housing market seemed to be cooling considerably, which would contribute to relatively subdued growth over the balance of the year. Growth was likely to strengthen next year as the housing correction abated, with activity also encouraged by the recent decline in energy prices and still-supportive financial conditions. In the view of many participants, economic expansion would probably track close to the rate of growth of the economy's potential next year and in 2008. Many participants also noted that core inflation had been running at an undesirably high rate. Although most participants expected core inflation to decline gradually, substantial uncertainty attended this outlook.

In their discussion of major sectors of the economy, meeting participants focused especially on developments in the housing market. Although the situation varied somewhat across the nation, housing activity was continuing to contract in most regions. Home sales had slowed considerably, and anecdotal reports suggested that more buyers were canceling contracts for purchases. Participants noted that inventories of unsold homes had climbed sharply in many areas and that builders were taking a number of measures to reduce inventories. Both permits for new construction and housing starts had declined significantly. Available measures of home prices suggested that appreciation had slowed considerably but prices in most areas were not falling, although some sellers were reported to be providing

various inducements to potential purchasers that reduced effective prices.

Thus far, the drop in housing market activity appeared not to have spilled over significantly to other sectors of the economy. Indeed, consumer expenditures appeared to have been expanding moderately over the previous few months, buoyed by increases in employment, personal income, and household wealth. Contacts in some Districts reported that retail sales had picked up a little most recently. Meeting participants noted that consumer spending going forward would be supported by the higher levels of personal income indicated by recent revisions to the national income and product accounts, by further gains in employment, and by the decline in consumer energy prices over recent months. However, considerable uncertainty was expressed regarding the ultimate extent of the downturn in the housing sector and the degree to which the slowing in housing activity and the deceleration in home prices would affect consumption and other expenditures going forward.

Business investment spending generally was seen as expanding at a reasonably good pace. Meeting participants noted broad strength in manufacturing of capital goods. Nonresidential construction activity continued to strengthen, and in the process was absorbing some of the resources that were no longer employed in homebuilding. Although some survey evidence suggested that some firms were trimming capital spending plans, participants reported that their business contacts generally were quite positive about the economic outlook and the strength of demand for their products. In this environment, investment spending would likely continue to be supported by expansion of overall output, strong balance sheets and profits, and the ready

availability of funding from financial markets and institutions.

Participants noted that the financial condition of federal and state governments continued to improve. Inflows of tax revenues remained strong, consistent with expanding personal incomes, sales, and business profits.

Economic activity abroad appeared to be slowing a little from the unusually rapid rate of the first half of the year, but still expanding at a reasonably good pace overall. Foreign economic growth was expected to continue, albeit perhaps at a somewhat slower pace than expected by some outside forecasters, contributing to increases in U.S. exports.

Participants took note of the jump in labor compensation in the first half of the year, but commented that the increase likely reflected in part the exercise of stock options. Nonetheless, some participants viewed the recent increase in overall compensation as pointing to upside risks to inflation. Participants reported steady gains in employment in various regions, roughly in line with expansion of the labor force. Many business contacts continued to experience shortages of labor and accelerating wages, particularly for certain types of professionals and skilled workers and, in some areas, unskilled workers.

One participant highlighted that, in the staff forecast, labor force growth would begin to slow over the next few years as more members of the baby-boom generation retired. Even if resource utilization rates were unchanged, slower growth of the labor force would mean that increases in employment would be significantly lower, on average, than those registered in recent years. In that case, the slower growth of the labor force and employment implied that the expansion of potential GDP could be somewhat lower than it had been earlier this decade.

Some participants commented, however, that they viewed potential output growth, as well as expansion of actual output, as likely to remain solid over the next several years.

Many meeting participants emphasized that they continued to be quite concerned about the outlook for inflation. Recent rates of core inflation, if they persisted, were seen as higher than consistent with price stability, and participants underscored the importance of ensuring a moderation in inflation. To be sure, very recent data on inflation suggested some improvement from the situation in the late spring, partly reflecting slower increases in owners' equivalent rent. Also, the considerably lower level of energy prices of recent weeks, if sustained, would help reduce overall inflation and damp increases in core prices. Moreover, businesses would meet more resistance to attempts to pass through cost increases in the less robust economic circumstances that were likely to prevail at least for a time. However, energy prices remained quite sensitive to a wide range of forces, including geopolitical developments, and might well rebound. To date, the available evidence indicated that inflation expectations remained contained—indeed, expectations of price increases for the next few years had fallen some as energy prices declined. Nonetheless, several participants worried that inflation expectations could rise and the Federal Reserve's willingness to carry through on its intention to seek price stability could be called into question if cost and price pressures mounted or even if there was no moderation in core inflation. Looking forward, most participants thought that the most likely outcome was a reduction in inflation pressures, but the anticipated decline was only gradual and the uncertainties around that forecast

were skewed toward higher rather than lower inflation rates.

In the Committee's discussion of monetary policy for the intermeeting period, nearly all members favored keeping the target federal funds rate at 5¼ percent at this meeting. Members generally expected economic activity to expand at a pace below the rate of growth of potential output in the near term before strengthening some over time. Moreover, given the uncertainties in forecasting, significantly more sluggish performance than anticipated could not be entirely ruled out. Although the uncertainties were substantial, core inflation seemed most likely to ebb gradually from its elevated level, in part owing to the waning effects of past increases in energy prices. The anticipated expansion of economic activity at a pace slightly below the rate of growth of the economy's potential would likely also play a role by easing pressures on resources. Members noted that certain developments of late—appreciable declines in energy prices, some softer indicators of economic activity, and slightly lower readings on core inflation—pointed to a modestly better inflation outlook and hence made the policy decision today somewhat less difficult than it was in August, when it was seen as a particularly close call.

In view of the most recent information on the economy, members agreed that it was appropriate for the post-meeting statement to characterize economic growth as apparently continuing to moderate. However, in view of still-high energy and other commodity prices and elevated rates of resource utilization as well as recent indications of a possible acceleration in labor costs, members continued to see a substantial risk that inflation would not decline as anticipated by the Committee. Consequently, the Committee agreed that the

statement should again cite such risks to inflation and explicitly reference the possibility of additional policy firming.

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5¼ percent.

The vote encompassed approval of the text below for inclusion in the statement to be released at 2:15 p.m.:

Nonetheless, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Guynn, Kohn, Kroszner, and Mishkin, Ms. Pianalto, Mr. Warsh, and Ms. Yellen.  
Votes against this action: Mr. Lacker.

Mr. Lacker dissented because he believed that further tightening was needed to bring inflation down more rapidly than would be the case if the policy rate were kept unchanged. Recent data indicated that inflation remained above levels consistent with price stability. Moreover, the upswing in compensation and unit labor costs in the first half of the year indicated that inflation risks were tilted to the upside. Although real growth was likely to be moderate in coming quarters, in his view it was unlikely to be slow enough to bring core inflation down.

The meeting adjourned at 1:20 p.m.

### Notation Vote

By notation vote completed on August 28, 2006, the Committee unanimously approved the minutes of the FOMC meeting held on August 8, 2006.

Vincent R. Reinhart  
Secretary

### Meeting Held on October 24–25, 2006

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, October 24, 2006 at 2:00 p.m. and continued on Wednesday, October 25, 2006 at 9:00 a.m.

#### *Present:*

Mr. Bernanke, Chairman  
Mr. Geithner, Vice Chairman  
Ms. Bies  
Mr. Kohn  
Mr. Kroszner  
Mr. Lacker  
Mr. Mishkin  
Ms. Pianalto  
Mr. Warsh  
Ms. Yellen

Mr. Hoenig, Ms. Minehan, and Messrs. Moskow and Poole, Alternate Members of the Federal Open Market Committee

Messrs. Fisher, Plosser, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis, respectively

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

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

Messrs. Connors, Eisenbeis, Judd, Kamin, Madigan, Sniderman, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. English and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

Messrs. Gagnon and Wascher, Deputy Associate Directors, Divisions of International Finance and Research and Statistics, respectively, Board of Governors

Messrs. Dale and Oliner, Senior Advisers, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

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

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors.

Ms. Weinbach, Senior Economist, Division of Monetary Affairs, Board of Governors

Messrs. Kumasaka<sup>7</sup> and Luecke,<sup>8</sup> Senior Financial Analysts, Division of Monetary Affairs, Board of Governors

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

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Mr. Evans, Ms. Mester, and Messrs. Rasche and Sellon, Senior Vice Presidents, Federal Reserve Banks of Chicago, Philadelphia, St. Louis, and Kansas City, respectively

Ms. Mucciolo and Mr. Todd, Vice Presidents, Federal Reserve Banks of New York and Minneapolis, respectively

Ms. McConnell, Assistant Vice President, Federal Reserve Bank of New York

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

The manager of the System Open Market Account (SOMA) reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The Manager also discussed with the Committee the results of a recent review of the management of the domestic security holdings of the SOMA. The Manager noted that in 2000, in response to reduced issuance of Treasury securities, limits were adopted on the SOMA's holdings of individual Treasury bonds, notes, and bills that ranged between 15 percent and 35 percent of amounts outstanding. In recent years, those limits had created occasional operational complications for the Trading Desk. Meanwhile, circumstances in the Treasury securities market had changed considerably, and the Manager noted that he intended to revert to the previous practice of applying a single 35 percent limit across all issues.

The Chairman noted that the President had recently signed the Financial Services Regulatory Relief Act of 2006, which among its provisions gave the

7. Attended Tuesday's session only.

8. Attended Wednesday's session only.

Federal Reserve discretion, beginning October 2011, both to pay interest on reserve balances and to reduce further or eliminate reserve requirements. The Act potentially has important implications for many aspects of the Federal Reserve's operations and the Chairman asked Vincent Reinhart, Director of the Division of Monetary Affairs, to form a committee of Federal Reserve System staff to consider these issues.

The information reviewed at the October meeting suggested that economic activity increased at a slow pace in the third quarter. The contraction in home construction remained a significant drag on economic activity, and steep reductions in motor vehicle assemblies further weighed on growth in the third quarter. Nonetheless, consumer spending and business investment continued to hold up well. Payroll employment extended its moderate expansion, on average, through September. Sharp declines in energy prices reduced total consumer price inflation in September, but the twelve-month change in core prices remained elevated relative to year-earlier readings.

Nonfarm payrolls rose modestly in September after a larger increase in August, with some of the variation apparently a result of seasonal factors. In September, job increases in the service-producing sectors were fairly widespread and were again led by the health-care industry. The construction sector also added jobs; the lift came from gains associated with nonresidential building that more than offset further losses in the residential sector. Job cutbacks in the retail trade and manufacturing sectors continued. Aggregate hours of private production or nonsupervisory workers again edged lower. The unemployment rate ticked down to 4.6 percent in August.

After having been flat in August, industrial production declined in September, reflecting a sizable weather-related decrease in the output of utilities and a fairly broad-based reduction in manufacturing output. These declines were partially offset by a rise in output in the mining sector that was led by gains in crude oil extraction and in mined construction supplies, such as stone, sand, and gravel. The output of motor vehicles and parts fell in September, as automakers continued to trim production of light trucks in response to bloated inventories. Output growth in the high-technology sector softened a bit in September relative to the summer months, reflecting a smaller rise in the production of semiconductors. Computer production continued to increase at a tepid rate, while output of communications equipment turned up noticeably after a decline in August. For the third quarter as a whole, growth in industrial production moderated a bit relative to the first half of the year; stronger output in the high-technology sector and a pickup in the production of business equipment partially offset a steep contraction in the output of motor vehicles and parts and a slowdown in mining output.

Real consumer spending appeared to regain some steam in September after a lackluster August. Although nominal retail sales fell noticeably in September, the steep drop in gasoline prices more than accounted for the decline. Excluding sales at gasoline stations, the step-up in consumer spending was the result of faster sales of motor vehicles and broad-based strength in outlays for other categories of goods, particularly apparel. Real disposable income rose moderately in both July and August; the pace was somewhat above its second-quarter average. Consumer spending continued to draw support from the lagged effects

of the increases in household wealth over the past two years. But interest rates on some types of household loans, both short- and long-term, had risen this year, on balance. The latest readings on consumer sentiment had been positive, perhaps reflecting the recent declines in oil prices. The personal saving rate edged up in August after a dip in July.

Residential construction activity remained weak. Single-family starts ticked up in September, but new permit issuance slid further to its lowest level in nearly five years. Construction in the multifamily sector continued to fluctuate within the range that has prevailed for several years. Sales of new single-family homes edged up in August, while sales of existing homes held steady. Pending home sales, which rose somewhat in August after a noticeable drop in July, and the decline in mortgage rates since July likely indicated some support for housing demand in the near term. Still, the overhang of unsold homes remained historically high, and price appreciation of existing homes continued to slow through the second quarter.

Real spending on equipment and software increased at a solid pace during the summer as the fundamental influences on such spending remained favorable for the most part. In particular, although business output had recently been rising at a slower rate, corporate financial reserves remained plentiful and the cost of high-tech capital goods continued to fall. In the high-tech sector, real outlays on communications equipment likely stabilized in August after having surged earlier this year, and the available data suggested that real computer spending picked up in the third quarter. In the transportation sector, business purchases of motor vehicles were brisk of late; the Environmental Protection Agency's regulations on truck emissions that are

scheduled to take effect in 2007 likely pulled forward some spending on medium and heavy trucks. Outlays on aircraft appeared to have risen somewhat in the third quarter from their extremely low second-quarter level. Real spending on equipment other than high-tech and transportation items seemed to have retained considerable momentum in the third quarter. Activity in the nonresidential construction sector continued to strengthen in August.

Book-value data on manufacturing and trade inventories, which were available through August, suggested that the rate of stockbuilding remained substantial in the third quarter. A major exception was the motor vehicle sector, where the cutbacks in assemblies probably began to reduce the inventory overhang in that sector. Outside of the motor vehicle sector, inventories generally appeared to be well aligned with demand. Although survey data in September showed a noticeable rise in the share of firms that viewed their inventories as being too high, a large majority remained comfortable with their level.

The U.S. international trade deficit widened to another record in August, reflecting a surge in imports that more than offset a sizable jump in exports. The sharp increase in imports was driven importantly by oil and natural gas, but imports of capital goods and non-oil industrial supplies, particularly metals, also exhibited large gains. Imports of services fell back slightly. The increase in exports was led by capital goods, with aircraft, computers, semiconductors, and other machinery all climbing briskly. Exports of industrial supplies and consumer goods also rose strongly, while exports of services expanded modestly.

Economic activity in the foreign industrial economies continued to expand at a relatively solid pace in the

third quarter. Investment spending boosted the expansion in Japan. In the euro area, data on industrial production and retail sales were consistent with robust growth in real activity. Mixed indicators in Canada and the United Kingdom suggested that output growth in those countries remained around recent rates. Incoming data across the emerging-market economies continued to point to moderating, but solid, growth in economic activity in the third quarter.

Core prices for personal consumption expenditures were expected to have risen in September at the same pace as in July and August, leaving the change over the twelve months ending in September a bit higher than the year-earlier period. Increases in shelter costs, which accounted for a significant proportion of the pickup in core inflation over the past year, had slowed considerably in recent months but remained well above the rates that prevailed from 2003 to 2005. The price index for total personal consumption expenditures was estimated to have fallen markedly in September because of the steep decline in gasoline prices, bringing its twelve-month increase to a two-and-one-half-year low. Retail gasoline prices fell especially rapidly in September as crude oil prices declined and as the historically high level of gasoline inventories likely led to a sharp narrowing of margins between retail gasoline prices and crude oil prices. The producer price index for core intermediate materials rose only slightly in September; the increase was well below its average monthly advance over the preceding twelve months, reflecting a drop in prices of some chemicals that have a high energy content. Average hourly earnings increased moderately in both August and September after a larger gain in July. Survey measures of households' year-ahead inflation expectations eased substantially in early Octo-

ber with the sharp drop in energy prices. Respondents' longer-term inflation expectations changed little, remaining well within the narrow range reported over the past year.

At its September meeting, the Federal Open Market Committee (FOMC) decided to maintain its target for the federal funds rate at 5¼ percent. The Committee's accompanying statement indicated that the moderation in economic growth had appeared to be continuing, partly reflecting a cooling of the housing market. Readings on core inflation had been elevated, and the high levels of resource utilization and of the prices of energy and other commodities had the potential to sustain inflation pressures. However, inflation pressures seemed likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand. Nonetheless, the Committee judged that some inflation risks remained. The extent and timing of any additional firming that may be needed to address these risks would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

The FOMC's decision at its September meeting to leave the target federal funds rate unchanged had been largely anticipated by investors, and policy expectations for mid-2007 and beyond rose only slightly. Investors subsequently revised down their expectations for the future path of the federal funds rate in light of some data releases that indicated weaker-than-expected economic activity. However, those declines were then rolled back in the wake of speeches by FOMC members, the release of the minutes of the September FOMC meeting, and stronger-than-expected economic data. Over the inter-

meeting period, yields on nominal and inflation-indexed Treasury coupon securities rose somewhat, on net. Inflation compensation for 2007 declined modestly, perhaps reflecting the further drop in spot energy prices, but was largely unchanged at longer maturities. Spreads of investment-grade corporate bond yields over those on comparable-maturity Treasury securities held steady, while those on speculative-grade corporate bonds narrowed a little. Broad equity indexes rose noticeably. The trade-weighted index of the foreign exchange value of the dollar versus major currencies rose somewhat on balance, and the gains were spread evenly against most currencies.

Debt of the domestic nonfinancial sectors in the third quarter was estimated to be expanding at around its second-quarter pace. Business debt rose more moderately as bank lending to businesses slowed. In particular, bank lending to finance commercial real estate activity waned in August and September, while commercial and industrial loans, which had been expanding briskly for many months, slowed sharply in September. In the household sector, the further slowing of the rate of increase of house prices appeared to have continued to weigh on the expansion of mortgage debt in the third quarter. M2 grew slowly in the third quarter, exhibiting the lagged effects of earlier increases in opportunity costs and the slow rise in nominal spending.

The staff forecast prepared for this meeting indicated that growth of real GDP had slowed further in the third quarter, reflecting both a significant drag from the continuing contraction in residential construction and a steep decline in motor vehicle assemblies. Looking ahead, a gradual reduction in the restraining effects of the contraction in residential investment and further solid

gains in consumer and business spending were expected to lead to a pickup in GDP growth through 2007 and into 2008. These gains in spending were likely to be supported by past declines in energy prices and continued gains in payroll employment and labor income. Real GDP was expected to rise at a somewhat slower rate over the next two years than in 2006 in part as a result of less impetus from household wealth, interest rates, and fiscal policy. The projected increase in real output over the next year or so was a little below the staff's estimate of potential output growth, leading to a lessening in pressures on resource utilization. Core inflation was anticipated to edge down in 2007 and 2008 relative to the second half of this year because of the diminishing impetus from the prices of energy and other commodities and because of the modest easing in resource utilization.

In their discussion of the economic situation and outlook, meeting participants noted that incoming data over the relatively brief intermeeting period had come in broadly as anticipated. The most recent indicators suggested that economic growth had probably slowed more sharply in the third quarter than had been expected at the time of the September meeting, but that appeared to largely reflect the impact of temporary influences. Participants continued to expect the economy to expand at a rate close to or a little below the economy's long-run sustainable pace over coming quarters. The ongoing adjustment in the housing market was likely to depress real activity in the near term, but this effect was expected to wane gradually; private final domestic purchases had held up well in recent months and looked set to expand at a reasonably good pace. Although recent monthly inflation readings indicated some slowing

of core inflation from the very rapid rates of spring and early summer, many participants noted that current rates of core inflation remained undesirably high. Most participants expected core inflation to moderate gradually, but they were quite uncertain as to the likely pace and extent of that moderation.

In their discussion of the major sectors of the economy, participants noted that housing activity was likely to remain a substantial drag on economic growth over the next few quarters. Many participants drew some comfort from the most recent data, which suggested that the correction in the housing market was likely to be no more severe than they had previously expected and that the risk of an even larger contraction in this sector had ebbed. But further adjustment in the housing market appeared likely. Single-family housing permits continued to fall and inventories of unsold homes remained at historically high levels. Contacts in the building sector suggested that construction firms were attempting to reduce their backlogs of unsold homes, both by cutting back sharply on new construction and by offering substantial price incentives. Several meeting participants noted the considerable strain on some small- and medium-sized residential construction firms.

To date, weakness in the housing market and the associated downshift in house price appreciation did not seem to be spilling over into consumer spending, which appeared to have grown at a steady pace in recent months. Retail activity in most Districts had been relatively robust and contacts in the retail sector were generally upbeat about the outlook. Several participants noted, however, that contacts within the transportation sector had reported that activity in anticipation of the holiday shopping season appeared to be softer than in

previous years. Meeting participants judged that consumer expenditures going forward were likely to expand at a steady pace a little below the growth in disposable income, supported by favorable financial conditions, continued increases in employment and income, and the recent decline in energy prices. Nonetheless, many participants expressed concern that ongoing developments in the housing market could have a more pronounced impact on consumer and other spending, especially if house prices declined significantly.

Investment spending also appeared to be holding up well. Meeting participants reported that their business contacts were generally optimistic and perceived the economic outlook as relatively favorable. Several participants noted that growth in nonresidential construction remained robust and was absorbing some of the resources displaced from the residential sector. The strength of corporate balance sheets and profits was seen as likely to help maintain a solid profile for investment spending over the next year or so, despite some restraint from the slower growth in final sales. However, one participant observed that the uncertainty concerning the possible severity of the current slowing in economic growth could lead some businesses to delay investment plans.

In contrast to the steady expansion of consumer and business investment spending in recent months, several other components of output and demand appeared to have been somewhat weaker than expected. In particular, apparently uncomfortably high levels of inventories within the auto sector had prompted a sharp reduction in light vehicle production in the third quarter. Federal expenditures had been held down by surprisingly weak defense outlays. And strong growth in imports in July and August, driven in part by a surge in oil imports,

suggested that net exports probably posed an arithmetic drag on economic growth in the third quarter. However, participants judged that the recent weakness in these components largely reflected temporary influences and was not likely to depress the pace of economic expansion going forward. That said, one participant did note the possibility that the recent decline in oil prices may in part stem from weakness in global demand.

Both data and reports from businesses indicated that the labor market remained tight. Employment had continued to rise at a steady pace, and participants reported that many of their contacts were increasingly concerned about the difficulty of recruiting suitably qualified workers. Shortages were most pronounced for certain types of professional and skilled workers. These reports of shortages and the associated wage pressures had not unambiguously shown through in the aggregate compensation data, which were giving contradictory signals about whether compensation increases were picking up. However, the possibility that the tightness of the labor market could lead to a sustained increase in wage pressure was viewed by participants as an upside risk to costs and their expectations of a gradual decline in inflation. It was noted, though, that continuing high profit margins provided some scope for increased labor costs to be absorbed without necessarily leading to elevated price pressures.

All meeting participants expressed concern about the outlook for inflation. Most participants expected core inflation to edge lower, in part as the effects of the run-up in energy prices in recent years waned. And shelter costs were not expected to add materially to inflation going forward. Moreover, moderate growth in aggregate demand and the

associated modest easing of pressures on resource utilization should also contribute slightly to the slowing in core inflation. Recent changes in core prices had declined slightly from earlier in the year. Nonetheless, nearly all participants viewed the current rates of core inflation as uncomfortably high and stressed the importance of further moderation. The available measures suggested that medium- and long-term inflation expectations remained around the levels seen for the past several years, although in the view of some participants these expectations were probably higher than would be consistent with their assessment of long-run price stability. Participants were concerned that inflation expectations could begin to drift upwards if core inflation remained elevated for a protracted period. Any such rise in inflation expectations and associated upward pressure on inflation itself would likely prove costly to reverse. Although some participants noted that the recent slowing in core inflation had helped to allay their fears of a further sustained increase in inflation, all participants emphasized that the risks around the desired downward path to inflation remained to the upside.

In the Committee's discussion of monetary policy for the intermeeting period, nearly all members favored keeping the target federal funds rate at 5¼ percent at this meeting. The Committee's view of the outlook for economic growth and inflation had changed little since the previous meeting. Nearly all members expected that the economy would expand close to or a little below its potential growth rate and that inflation would ebb gradually from its elevated levels. Although substantial uncertainty continued to attend that outlook, most members judged that the downside risks to economic activity had diminished a little, and likewise, some

members felt that the upside risks to inflation had declined, albeit only slightly. All members agreed that the risks to achieving the anticipated reduction in inflation remained of greatest concern. Members noted that a significant amount of data would be published before the next Committee meeting in December, giving the Committee ample scope to refine its assessment of the economic outlook before judging whether any additional firming was needed to address those risks.

Members agreed that the statement to be released after the meeting should continue to convey that inflation risks remained the dominant concern and that additional policy firming was possible. The Committee concurred that the statement should mention both that economic growth had slowed over the course of the year and that, going forward, the economy seemed likely to expand at a moderate pace. With energy prices well off the highs reached earlier in the year, members felt that it was no longer appropriate to note that the high level of energy prices had the potential to sustain inflation pressures.

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5¼ percent.

The vote encompassed approval of the text below for inclusion in the statement to be released at 2:15 p.m.:

Nonetheless, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Kohn, Kroszner, and Mishkin, Ms. Pianalto, Messrs. Poole and Warsh, and Ms. Yellen. Votes against this action: Mr. Lacker

Mr. Lacker dissented because he believed that further tightening was needed to help ensure that core inflation declines to an acceptable rate in coming quarters.

The Committee then continued its discussion of communication issues and considered the advantages and disadvantages of quantifying an inflation objective. Participants stressed that any such step had to be consistent with the statutory objectives for monetary policy. In that regard, it was noted that over time price stability is a prerequisite for maximum employment and moderate long-term interest rates. However, the possible specification of a numerical price objective raised a number of complex and interrelated issues that required considerable further discussion. The Committee reached no decisions on these issues at this meeting, and participants agreed to continue the Committee's review of communication issues at its meeting in January 2007.

The meeting adjourned at 1:30 p.m.

### Notation Vote

By notation vote completed on October 10, 2006, the Committee unanimously approved the minutes of the FOMC meeting held on September 20, 2006.

Vincent R. Reinhart  
Secretary

## Meeting Held on December 12, 2006

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 12, 2006 at 8:30 a.m.

### *Present:*

- Mr. Bernanke, Chairman
- Mr. Geithner, Vice Chairman
- Ms. Bies
- Mr. Kohn
- Mr. Kroszner
- Mr. Lacker
- Mr. Mishkin
- Ms. Pianalto
- Mr. Warsh
- Ms. Yellen
  
- Ms. Cumming, Mr. Hoenig, Ms. Minehan, and Messrs. Moskow and Poole, Alternate Members of the Federal Open Market Committee
  
- Messrs. Fisher, Plosser, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis, respectively
  
- Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta
  
- Mr. Reinhart, Secretary and Economist
  
- Ms. Danker, Deputy Secretary
  
- Ms. Smith, Assistant Secretary
  
- Mr. Skidmore, Assistant Secretary
  
- Mr. Alvarez, General Counsel
  
- Mr. Baxter, Deputy General Counsel
  
- Ms. Johnson, Economist
  
- Mr. Stockton, Economist
  
- Messrs. Connors, Eisenbeis, Kamin, Madigan, Sniderman, Struckmeyer, Weinberg, and Wilcox, Associate Economists
  
- Mr. Kos, Manager, System Open Market Account
  
- Messrs. Clouse and English, Associate Directors, Division of Monetary Affairs, Board of Governors
  
- Ms. Liang and Mr. Slifman, Associate Directors, Division of Research and Statistics, Board of Governors
  
- Messrs. Gagnon and Wascher, Deputy Associate Directors, Divisions of International Finance and Research and Statistics, respectively, Board of Governors
  
- Mr. Dale, Senior Adviser, Division of Monetary Affairs, Board of Governors
  
- Mr. Gross, Special Assistant to the Board, Office of Board Members, Board of Governors
  
- Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors
  
- Mr. Driscoll, Economist, Division of Monetary Affairs, Board of Governors
  
- Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors
  
- Mr. Rasdall, First Vice President, Federal Reserve Bank of Kansas City
  
- Mr. Rosenblum, Executive Vice President, Federal Reserve Bank of Dallas
  
- Mr. Hakkio, Mses. Mester and Perelmuter, and Messrs. Rasche, Rolnick, and Williams, Senior Vice Presidents, Federal Reserve Banks of Kansas City, Philadelphia, New York, St. Louis, Minneapolis, and San Francisco, respectively
  
- Messrs. Kahn and Sullivan, Vice Presidents, Federal Reserve Banks of New York and Chicago, respectively
  
- Mr. Olivei, Senior Economist, Federal Reserve Bank of Boston

The Manager of the System Open Market Account (SOMA) reported on recent developments in foreign ex-

change markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at the December meeting suggested that economic activity was increasing at a subdued rate during the second half of the year. The contraction in homebuilding was continuing to restrain overall activity, and a step-down in motor vehicle output held down industrial production. In contrast, consumer spending and business investment were increasing at a moderate rate, and payroll employment expanded solidly through November. Additional sharp declines in energy prices reduced total consumer price inflation in October, but the twelve-month change in core prices remained above its year-earlier level.

Indicators from the labor market were generally strong through November. Nonfarm payrolls increased at a solid pace, while revisions to previous estimates showed a larger gain, on balance, over the preceding two months. Employment in manufacturing and construction industries fell in November, but hiring continued to be brisk in the professional and nonbusiness service industries. Aggregate weekly hours of private production or nonsupervisory workers edged up. The unemployment rate had fallen to 4.4 percent in October but ticked back up to 4.5 percent in November, remaining below the average of 4.7 percent during the first three quarters of the year.

Industrial production (IP) declined in September but rose slightly in October. In October, total industrial production was boosted by a weather-related rebound in electricity generation, while output in the mining sector posted a sizable gain as crude oil extraction in Alaska returned to full production following pipeline repairs. Manufacturing output fell in both months, partly because of cutbacks in motor vehicle production as vehicle makers pared elevated inventories in light trucks. Although less pronounced than in the motor vehicle sector, the recent softness in factory output was also apparent in a number of other sectors. A notable exception was production in high-tech industries, which posted another solid increase in October, reflecting a pickup in computer output and a rise in semiconductor production attributable to the rollout of a new generation of microprocessors.

The National Income and Product Accounts for the third quarter incorporated an estimate by the Bureau of Economic Analysis (BEA) that gross output of new motor vehicles increased at a rapid pace in the third quarter, a sharp contrast to a drop in the IP index for motor vehicles (including parts production) for that same period. Much of that difference could be attributed to the BEA's method of inferring motor vehicle output from separate data on sales, net international trade, and changes in inventories rather than measuring output directly using data on production. In addition, a large drop in the producer price index for light trucks in the third quarter resulted in a jump in the BEA's implied unit values of light trucks in inventory. In the staff's view, these measurement issues likely caused an overstatement of the rate of increase in real GDP in the third quarter, and the gradual unwinding of those effects would prob-

ably lead to an understatement of real GDP growth over the next several quarters.

Real consumer spending increased strongly in October after a more modest gain in September. Although purchases of motor vehicles weakened in October, outlays on a broad range of other categories of goods, including gasoline, food, and apparel, rose briskly. Spurred by sharp declines in consumer energy prices, real disposable income also increased rapidly in September and October. Despite the further deceleration in house prices, the ratio of household wealth to disposable income remained well above its historical average, buoyed by robust gains in the stock market. Readings on consumer sentiment edged down in November and early December but stayed above levels seen in the summer.

Residential construction activity continued to be very weak. Single-family housing starts dropped substantially in October after a slight increase in September, while new permit issuance fell to nearly its lowest level in the past ten years. Construction in the much-smaller multifamily sector continued to fluctuate within a range that had prevailed for the past several years. Inventories of unsold homes remained high in October but were a bit lower than those in preceding months. Sales of new and existing homes showed tentative signs of stabilizing, although at levels well below their mid-2005 peaks. Price appreciation of existing homes continued to slow in the third quarter, and some price measures showed outright declines.

Real spending on equipment and software continued to increase at a solid pace in the third quarter, supported by strong corporate cash positions and a low cost of capital. Early indicators for the fourth quarter, including survey measures of business conditions, sug-

gested a slowdown in spending, in part reflecting the deceleration in business output. Business purchases of motor vehicles were likely to continue to be boosted by an increase in spending in advance of the upcoming change in regulations on truck engines from the Environmental Protection Agency. Although spending on high-tech capital goods and software expanded at a robust pace in the third quarter, data on new orders and shipments in October pointed to more moderate growth in the fourth quarter. Growth of nonresidential construction spending appeared to have slowed from a rapid rate earlier in the year, responding in part to still-high vacancy rates in the office and industrial categories. The number of natural gas and petroleum drilling rigs in operation had moved down, on balance, since September in response to the moderation in energy prices.

Unit stocks of light motor vehicles dropped in the third quarter. Outside the motor vehicle sector, real nonfarm inventories edged up, and the ratio of book-value inventories to sales for both the manufacturing and trade sectors rose in September to levels last seen in mid-2005. Inventory imbalances appeared more widespread than a few months earlier, although business surveys through November indicated that a large majority of firms perceived that their customers' inventories remained at comfortable levels.

The U.S. international trade deficit declined in September from a record level in August. The narrowing primarily reflected a sharp falloff in the value of imported oil, although non-oil imports, including industrial supplies, capital goods, and automotive products, also declined. Export growth in September was led by aircraft and industrial supplies, while exports of automotive products, consumer goods, and semiconduc-

tors fell. The trade deficit shrank a bit further in October.

Economic activity in the advanced foreign economies rose at a moderate rate in the third quarter. The expansion in real activity in the euro area, although slower than the staff had expected, was supported by strong domestic demand. Canada's real GDP growth was dragged down by weakness in inventories and government spending, while slumping private consumption weighed on growth in Japan. The U.K. economy, buoyed by strong investment, continued to expand solidly. Recent economic indicators for the developing economies were somewhat mixed but suggested generally brisk growth in the third quarter.

The overall price index for personal consumption expenditures fell in September and October, reflecting sharp declines in energy prices in both months; the declines left the change in that index over the twelve months ending in October substantially lower than over the preceding twelve-month period. In contrast, the change in the core price index for personal consumption expenditures over the twelve months ending in October was still somewhat higher than it was a year earlier, largely reflecting an acceleration in shelter costs over that period. The producer price index for core intermediate materials was flat in October. Increases in average hourly earnings had been moderate in recent months, and compensation per hour in the nonfarm business sector appeared to have risen at a subdued rate in the third quarter. The estimated increase in hourly compensation for the second quarter had been revised down substantially; hourly compensation was now estimated to have declined in the second quarter following the sharp gain recorded in the first quarter. This uneven pattern suggested that the surge in hourly compensation in the first quarter had largely

been driven by transitory factors. Hourly compensation of private industry workers, as measured by the employment cost index, increased at a somewhat faster rate in the three months ending in September than it had in preceding quarters.

At its October meeting, the Federal Open Market Committee (FOMC) decided to maintain its target for the federal funds rate at 5¼ percent. The Committee's accompanying statement indicated that economic growth had slowed over the course of the year, partly reflecting a cooling of the housing market. Going forward, the economy seemed likely to expand at a moderate pace. Readings on core inflation had been elevated, and the high level of resource utilization had the potential to sustain inflation pressures. However, inflation pressures seemed likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand. Nonetheless, the Committee judged that some inflation risks remained. The extent and timing of any additional firming that might be needed to address these risks would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Investors had largely anticipated the FOMC's decision at its October meeting to leave the target federal funds rate unchanged and to make only modest changes in the accompanying policy statement. As a result, the announcement of the decision elicited little market reaction, as did the subsequent publication of the minutes of the meeting. However, somewhat weaker-than-anticipated economic data over the intermeeting period apparently led to some softening of investors' perception of the

economic outlook. As a result, the likely pace and extent of policy easing expected by investors increased, and yields on nominal and inflation-indexed Treasury coupon securities fell. Inflation compensation measures were little changed. Spreads of investment-grade corporate bond yields over those of comparable-maturity Treasury securities remained about unchanged, while those on speculative-grade corporate bonds rose a bit. Broad equity indexes showed solid gains. The foreign exchange value of the dollar against other major currencies fell, on net, over the intermeeting period, with pronounced declines against the euro and sterling.

Debt of the domestic nonfinancial sectors in the third quarter expanded at around its second-quarter pace. Business debt rose slightly more slowly than in the second quarter, in part reflecting reduced borrowing in the bond and commercial paper markets. In the household sector, mortgage debt increased at its lowest pace since the late 1990s, reflecting the continued deceleration in house prices. M2 rose more strongly in October and November than it had in preceding months.

The staff forecast prepared for this meeting indicated that growth in economic activity had slowed to a pace below that of the economy's long-run potential in the second half of 2006, partly as a result of the ongoing adjustment of the housing sector. The rate of increase in real GDP was expected to pick up gradually as the drag from the contraction in residential construction diminished, returning towards the end of 2007 to a rate close to the staff's estimate of potential output growth. Core inflation was anticipated to edge down in 2007 and 2008 in response to a waning of the effects of higher energy and import prices, a step-down in rent

increases, and the emergence of a small amount of slack in the economy.

In their discussion of the economic situation and outlook, meeting participants noted that their assessments of the medium-term prospects for economic growth and inflation were little changed from the previous meeting. Incoming indicators of near-term activity had been mixed, with some spending and production data pointing to a more subdued picture than that suggested by the still-solid labor market data. Many participants judged that economic activity in the second half of this year was probably a touch softer than had been expected at the time of the October meeting. But looking over the next year or so, participants continued to expect the economy to expand at a rate close to or a little below the economy's long-run sustainable pace. The ongoing adjustment of the housing market was likely to damp economic growth in the near term, but this effect was expected to dissipate, and spending in other categories looked set to expand at a reasonably good pace. Although readings on core inflation had improved modestly since the spring, price pressures were not yet viewed as convincingly on a downward trend. Most participants expected core inflation to moderate slowly over time, but stressed that the risks to the inflation outlook remained to the upside.

In their discussion of the major sectors of the economy, participants noted that developments in the housing market continued to weigh heavily on economic activity. Housing starts and permits for new construction had dropped sharply in October, and contacts in the building sector reported that construction firms were continuing to cancel options on land purchases. However, there were some indications that home sales might be starting to stabilize, aided by a marked slowing in the rate of increase

of house prices and a decline in mortgage rates in recent months. Several participants also noted that a range of non-price incentives and concessions were being offered by construction firms to bolster sales. But even if home purchases had begun to level off, residential investment was likely to fall further in coming quarters as homebuilders sought to reduce their backlogs of unsold homes.

Thus far, the adjustment of activity and prices in the housing market did not appear to have spilled over significantly to consumer spending, which had expanded at a steady pace in recent months, buoyed by continued gains in employment and by a decline in energy prices. Retailers in most Districts expected good sales over the holiday season, although some contacts at package delivery and trucking firms reported that activity was less busy than usual for this time of year. Participants noted the downward revision to the BEA's estimate of personal income in the second quarter of this year, but nonetheless continued to anticipate consumer expenditures to expand at a steady pace going forward. Growth in consumer spending was expected to be supported by favorable financial conditions and solid gains in income from employment, outweighing any damping effect of sluggish increases in housing wealth. Still, considerable uncertainty regarding the ultimate extent of the housing market correction meant that spillovers to consumption could become more evident, especially if house prices were to decline significantly.

Business investment appeared to have decelerated recently, and surveys and orders data pointed to a relatively slow rise in equipment and software spending over the next few quarters. Incoming data on construction activity and employment also suggested that, following

very rapid growth earlier in the year, increases in nonresidential construction spending could be moderating considerably. However, the weaker cast of some of these data contrasted with the sense of optimism among business contacts. Moreover, several participants noted that contacts within the construction sector had reported that commercial real estate activity remained robust, encouraged by lower vacancy rates, some firming in rents, and accommodative financial conditions. Looking further ahead, meeting participants expected investment to expand at a solid pace, supported by strong corporate balance sheets and profits and by the ready availability of funding from financial markets and institutions, factors that were expected to be offset only partially by restraint from slower growth in final sales.

Recent data suggested that aggregate demand in the rest of the world was likely to continue to expand at a somewhat faster rate than in the United States. Participants noted that the strength of global demand and the recent decline in the foreign exchange value of the dollar should help to support increases in U.S. exports.

The slowing in the pace of economic expansion in recent quarters evidenced by the business spending data was also apparent in measures of industrial production. Much of the slowing in production had been concentrated in the motor vehicle sector—as producers had cut assemblies in order to reduce high inventory levels—and in construction-related sectors. But, more recently, inventories had increased in a number of other sectors, and manufacturing production had been trimmed in response. Further adjustments remained possible, suggesting an additional source of downside risk to economic growth in the near term. In contrast, indicators of activity in the ser-

vices sector implied continued brisk growth.

Participants noted that recent indicators provided mixed signals about the strength of near-term activity. Solid gains in employment over recent quarters stood in contrast to the softer pace of economic expansion suggested by the spending and production data. That difference most likely reflected lags between movements in activity and employment, implying that growth in employment would probably slow over the next quarter or so. Participants suggested that other forces might be at work as well. The growth of structural labor productivity could be weaker than currently thought, helping to reconcile the steady growth in employment with more subdued advances in spending and output. Moreover, the recent pace of activity may have been stronger than that indicated by the spending and production data. With regard to this possibility, it was noted that gross domestic income had grown substantially more quickly than measured GDP over the past year.

Incoming data and reports from businesses suggested that the labor market remained tight. The unemployment rate had moved slightly lower on balance over recent months, and many business contacts reported difficulties in recruiting suitably qualified workers, especially for certain types of professional and skilled positions. The downward revision to the estimated increases in labor compensation and unit labor costs earlier in the year had eased some participants' concerns about the extent of the pressures on labor resources. Nonetheless, the possibility that the tightness of the labor market could lead to sustained upward pressure on nominal labor costs was viewed as an upside risk to the expected moderation in inflation.

All meeting participants remained concerned about the outlook for infla-

tion. Although readings on core inflation had improved modestly since the spring, nearly all participants viewed core inflation as uncomfortably high and stressed the importance of further moderation. Participants expected core inflation to edge lower over time, in part as the pass-through of higher prices for energy and other commodities ran its course and as the moderate growth in aggregate demand likely led to a modest easing of pressures on resources. Some participants also highlighted the impact that movements in the prices of individual components of the price index, such as owners' equivalent rent and medical costs, could have on near-term readings on core inflation. More generally, participants stressed there was considerable uncertainty as to the probable pace and extent of the moderation in core inflation and that the risks around this desired downward path remained to the upside. Moreover, participants expressed concern that a failure of inflation to moderate as expected could entail significant costs if an upward drift in inflation expectations ensued.

In the Committee's discussion of monetary policy for the intermeeting period, nearly all members favored keeping the target federal funds rate at 5¼ percent at this meeting. The outlook for economic growth and inflation was thought to have changed relatively little since the previous meeting. Nearly all members felt that maintaining the current target for now was most likely to foster moderate economic growth and a gradual ebbing of core inflation from its elevated levels. Several members judged that the subdued tone of some incoming indicators meant that the downside risks to economic growth in the near term had increased a little and become a bit more broadly based than previously thought. Nonetheless, all members agreed that the risk that inflation would fail to mod-

erate as desired remained the predominant concern.

In light of the data received over the intermeeting period, members felt that the statement should characterize the cooling in the housing market as substantial and should note that recent indicators had been mixed. The Committee thought that the statement should reiterate that the economy seemed likely to expand at a moderate pace, while also recognizing the possibility that measured GDP growth could be somewhat uneven in coming quarters. Members agreed that the statement should continue to convey that inflation risks remained of greatest concern and that additional policy firming was possible. One member did not favor language that referenced only the possibility of additional policy firming and believed that, although the risks to inflation remained the predominant concern, the statement should emphasize that policy could be adjusted in either direction depending on the evolution of the outlook for inflation and economic growth.

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5¼ percent.

The vote encompassed approval of the text below for inclusion in the statement to be released at 2:15 p.m.:

Nonetheless, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Kohn, Kroszner, and Mishkin, Ms. Pianalto, Messrs. Poole and Warsh, and Ms. Yellen. Votes against this action: Mr. Lacker

Mr. Lacker dissented because he believed that further tightening was needed to help ensure that core inflation declines to an acceptable rate in coming quarters.

Meeting participants briefly reviewed some issues regarding communications and the next steps in their continuing discussion of the topic. At the next FOMC meeting, confirmed for January 30–31, 2007, the Committee intended to consider the role that economic projections and forecasts can play in communicating information.

The meeting adjourned at 1:35 p.m.

#### Notation Vote

By notation vote completed on November 14, 2006, the Committee unanimously approved the minutes of the FOMC meeting held on October 24–25, 2006.

Vincent R. Reinhart  
Secretary

## Litigation

During 2006, the Board of Governors was a party in two lawsuits or appeals filed that year and was a party in five other cases pending from previous years, for a total of seven cases; in 2005, the Board had been a party in a total of thirteen cases. As of December 31, 2006, five cases were pending.

*Price v. Bernanke*, No. 06-1569 (D.D.C., filed September 8, 2006), is an employment discrimination action.

*Texas State Bank v. United States*, No. 05-1168 (U.S. Supreme Court, filed March 10, 2006), was an appeal of a decision of the Court of Appeals for the Federal Circuit dismissing an action challenging on constitutional grounds the failure to pay interest on reserve accounts held at Federal Reserve Banks. On June 19, 2006, the Supreme Court denied *certiorari*. 126 S. Ct. 2889.

*Inner City Press/Community on the Move v. Board of Governors*, No. 05-6162 (Second Circuit, filed November 21, 2005), is an appeal of the district court's order (No. 04-CV-8337, 380 F. Supp. 2d 211 (S.D.N.Y. 2005)) granting in part and denying in part the Board's motion for summary judgment in a Freedom of Information Act case. On Sep-

tember 11, 2006, the court of appeals affirmed in part and reversed in part the ruling of the district court, and remanded the case. 463 F.3d 239.

*Price v. Bernanke*, No. 05-5361 (D.C. Circuit, filed September 29, 2005), was an appeal of an order of the district court (No. 04-CV-0973, 374 F. Supp. 2d 177) dismissing an employment discrimination action. On December 15, 2006, the court of appeals affirmed the district court's dismissal. 470 F.3d 384.

*Barnes v. Greenspan*, No. 04-CV-1989 (CKK) (D.D.C., filed November 15, 2004), is a case under the Age Discrimination in Employment Act.

*Jones v. Greenspan*, No. 04-CV-1696 (RMU) (D.D.C., filed October 4, 2004), is an employment discrimination action. On December 13, 2005, the district court granted in part and denied in part the Board's motion to dismiss and for summary judgment. 402 F. Supp. 2d 294.

*Artis v. Greenspan*, No. 01-0400 (D.D.C., filed February 22, 2001), is an employment discrimination action. An identical action, No. 99-2073 (EGS) (D.D.C., filed August 3, 1999), was consolidated with this action on August 15, 2001. ■