Meeting of the Federal Open Market Committee
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., starting at 8:30 a.m. on Wednesday, May 10, 2006. Those present were the following:

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

Transcript of the Federal Open Market Committee Meeting of May 10, 2006

CHAIRMAN BERNANKE. Good morning, everyone. Let me just remind you that we're going to try to fit our slightly modified format into a one-day setting today. We still plan to have two full rounds of discussion, the first round on the economy and the outlook, and I hope we can complete that before the coffee break. Then we will have the second round on policy and the statement. So to allow time for discussion, I hope that people will try to keep their remarks reasonably concise. At the end of the meeting, we'll have a brief report from Governor Kohn on his communications subcommittee, and we'll talk a bit about procedures for thinking about the question of a one-day versus a two-day meeting. So first on the agenda—Dino.

MR. KOS.[1] Thank you, Mr. Chairman. We all know that asset prices can be volatile, sometimes too volatile. Well, the last few months have *not* had that quality. Volatility in all asset classes, with the exception of commodities, continues to be low. And yet, despite that low volatility, over the past six months investors, traders, and strategists have already been through three very different phases. Late last year, market participants were confident that monetary policy in the United States was at or near neutrality and that once neutrality was achieved—at 4 or 4¼ percent—the Committee would stop tightening. Then the market temporarily got worked up that monetary policy was getting too tight and that the inevitable slowdown would cause the Committee to be easing later this year. Now we are in a new phase, in which worries about nascent inflation have supplanted the earlier fears of a slowdown and the discussion about neutrality has all but evaporated. Markets haven't been volatile, but sentiment has.

On page 1, the top two panels graph the three-month deposit rate for dollar, euro, and yen deposits and three-, six-, and nine-month forward rates for each. U.S. dollar forward rates are trading on top of each other, anticipating either the end of the tightening cycle or a lengthy pause starting sometime soon. The minutes of the Committee's March meeting made public in mid-April and the Chairman's JEC testimony were both taken as signals that a pause was on the horizon, despite the qualified language in both and despite other data that were generally strong and that contributed to the rise in long-term yields, which I'll talk about later.

In the euro area, forward rates continued their steady upward climb as growth forecasts increased, business confidence improved, and the European Central Bank signaled that more tightening was likely. Markets anticipate roughly 25 basis points of tightening per quarter through year-end. The list of central banks that have tightened recently includes Canada,

[1] The materials used by Mr. Kos are appended to this transcript (appendix 1).

Switzerland, Australia, Norway, Thailand, and Malaysia. The People's Bank of China raised the minimum lending rate that financial institutions can charge 27 basis points, to 5.85 percent, though I'm not sure that qualifies as a tightening for an economy with real growth in double digits.

The Bank of Japan is working to slowly bring down the current account balances. From about ¥30 trillion, balances have now been reduced to about half that level. The BOJ will continue to bring them down over the next month and then will likely maintain a buffer above required reserves for a period to give banks more time to adjust to the interest rate targeting framework that will follow. As the middle panel shows, yen forward rates have continued to rise, and markets now presume that the BOJ will bring the overnight call rate to 25 basis points sometime this autumn—but rumors circulated overnight that the first increase could come as early as July. Those rumors fueled a rise of 9 basis points in two-year Japanese government bond yields and Euroyen futures.

The bottom panel graphs the two- and ten-year Treasury yields and the target fed funds rate. Since the last meeting, the ten-year yield has risen 34 basis points, and the curve has steepened. This is consistent with the ebbing of worries about a policy-induced slowdown. The curve steepening was given a push by news, particularly the release of the minutes, of a possible pause in the cycle.

Page 2 breaks down the increase in ten-year yields. The top left panel graphs the real ten-year yield. Real yields have risen about 40 basis points since early March and 14 basis points since the last FOMC meeting. The top right panel graphs the ten-year breakeven rate (the blue line) and five-year breakeven rate five years forward (the green line). Both have risen since early April with the five-year forward rate rising somewhat more. On a technical note, these are straight breakeven rates without adjustments for carry. The picture of rising real and rising breakeven rates is also visible internationally—at least for those countries with inflation-linked bonds. The middle left panel graphs the change in the real yield this year for France, the United Kingdom, and Japan. Real yields have risen in all three by varying degrees. The middle right panel graphs the change in their breakeven rates. All three have moved about 20 basis points so far this year—somewhat less than the 36 basis point increase for the United States.

Fueling the sentiment about inflation expectations has been the rise in commodity prices. The bottom left panel graphs selected metal prices indexed from January 1. Some of these are at record highs or, in the case of gold, multidecade highs. The right panel graphs the movement of energy prices so far this year. The one outlier is natural gas, which rose sharply after Katrina but fell back when consumption did not meet forecasts because of an unseasonably warm winter.

Let us turn to page 3 and the other element that has garnered substantial attention: the recent weakness of the dollar. After being stuck in a narrow \$1.18 to \$1.22 range, the euro appreciated out of that range in mid-April as sentiment turned against the dollar, as shown in the top left panel. This morning it was trading just below \$1.28. Meanwhile, the yen appreciated from ¥118 to the dollar in early April to about ¥110.60 this morning. It's tempting to conclude that the current account deficit is finally exerting itself on the exchange rate. Call me skeptical, but I find it hard to believe that markets awoke to the scale of the imbalances only when reading the now-famous annex in the G7 communiqué. And yet that there was a shift in sentiment can be felt if not visibly observed. One place this shift in sentiment can be felt is in options markets. The middle left panel graphs one-month risk reversals, where dollar puts are bid relative to dollar calls, especially against the yen, and suggests that market participants are more concerned about further downside for the dollar. Another view into this phenomenon is through interest rate differentials. The middle right panel graphs the euro–dollar exchange rate and the differential between December 2006 Eurodollar and Euribor futures. The two tracked pretty closely in 2005 and most of this year but started to diverge in mid-April, suggesting that the effect of interest rate differentials on the exchange rate had lessened and, hence, that something else was exerting greater force.

So what are some possible explanations for the shift in sentiment? At the macro level, most forecasts have the United States slowing down in the second half while Japan and Europe do not slow, even if in level terms the United States is still growing faster. Second, the strong growth of the global economy is being interpreted by some in the leveraged community as increasing the odds that emerging Asian countries in particular will allow a rise in their currencies—and hence less dollar accumulation—in the period ahead. Some countries are apparently struggling with sterilization of accumulated reserves. A third explanation is the continued nagging fear that central banks will diversify their dollar holdings. During much of April there were rumors that a large central bank—presumed to be from the Middle East—was selling dollars. Whether that’s true or not, I don’t know. However, it is true that a central bank from Europe—the Swedish Riksbank—was in the midst of lowering its dollar holdings, eliminating its yen holdings, and increasing holdings of European and other currencies. The Swedes made their changes public on April 21. Whether other central banks will follow is an open question; but analysts have noted the prisoner’s dilemma that the large holders of dollars face on this question of diversification, and it is one the markets focus on intensely and are acutely sensitive to. Finally, the markets noted the Treasury’s report on foreign holdings of U.S. securities for the year through June 2005 and the unfavorable revisions it contained. This report corrects the estimations in the monthly TIC data. Whereas the TIC data reported that private investors were the large buyers in that twelve-month span, it now turns out that private demand was minimal and that most of the buying was by official accounts.

The bottom panel charts the appreciation against the dollar by a range of currencies in the intermeeting period. Several of these are commodity based, but many are not. And even some of the currencies I talked about last time that had been caught in the liquidation of carry trades made strong comebacks. Yes, even the Icelandic krona, which fell another 10 percent after your last meeting, has reversed course and, on balance, has risen slightly since March 28. I should note that the Canadian dollar is at its strongest level against the U.S. dollar since 1977. Besides the positive terms-of-trade shock, the Canadians have both strong growth and low inflation and something we don’t have: a current account surplus and an ongoing budget surplus that is being used to pay down debt.

Changing pace a bit, if you turn to page 4, the top panel graphs the evolution of required operating balances since 2001 and the target fed funds rate. Required operating balances (ROBs) have fallen sharply as the opportunity cost of holding demand deposits has risen. From a peak of about $23 billion, required balances have fallen to about $15 billion. Significant changes in the level of ROBs have been associated with changes in fed funds rate volatility because lower levels of such balances give banks less scope for absorbing daily shocks to their reserve holdings at the Fed. Meanwhile, a lower level of ROBs provides the Desk with less scope to manage the funds rate by adjusting the daily reserves supplied without forcing banks either to borrow at the discount window or to accumulate unwanted excess reserves. So far the effect of the decline in required operating balances has been muted, and we do have some experience in operating in such an environment from the last time that required balances were at such levels in the late 1990s and the early part of this decade.

Finally, I want to inform the Committee that the Desk has just finished implementing a new electronic trading system that we call FedTrade and through which we conduct open market operations with the primary dealers. This system replaces a legacy mainframe system that was inflexible and no longer suited our needs. The bottom panel lists some of FedTrade's main features.

Mr. Chairman, there were no foreign operations. I will need approval of domestic operations.

CHAIRMAN BERNANKE. Thank you. On the rise in inflation breakevens since our last meeting, do you have a sense about the breakdown between carry effects, expectations, and risk premiums?

MR. KOS. Well, as somebody said in another setting just the other day, risk premiums are something we don't know a lot about, and they are difficult to disentangle. I haven't done the exercise, but with energy prices rising, I don't know that the carry effects have been huge.

MR. REINHART. The carry effects are going to matter only for the first part of it. And as we noted in the Bluebook, at the time we had an increase in inflation compensation of about 15 basis points. Most of it was related to energy prices. If you think about the term structure of energy futures, they actually tilt down at the far end, and so that would go the wrong way. So everything in terms of the rise in the five-year-ahead five-year forward rate would be inflation compensation. If you go to our multifactor models of the term structure, we would attribute something like half to term premiums, and half then would be inflation expectations.

CHAIRMAN BERNANKE. My other question relates to a regulatory relief bill in the Congress, which is very likely to pass, that would allow us to pay interest on reserves and to have more flexibility in setting required reserves. Would you like to comment on the potential operational implications of that?

MR. KOS. We would welcome that. It would make our life a bit easier.

CHAIRMAN BERNANKE. Do you see any operational issues in just getting to the point where we can manage that?

MR. KOS. I don’t think so. Spence?

MR. HILTON. No, I think that adapting to that environment would not be a problem for us. It would probably be very easy to do.

MR. REINHART. Mr. Chairman, I would note that the first place I could find mention of the Federal Reserve’s asking about paying interest on reserves was in 1965. But there are some operational implications, including in the STAR (Statistics and Reserves) process, of actually figuring out a way of paying interest on reserves. It came close about four years ago, I guess, and we had put modifications into STAR in order to be able to pay interest on reserves. There might be some bumps along the way.

MR. KOS. But those are transitional, operational hurdles.

MR. KOHN. In fact, the point of asking for this authority was to make sure that the Desk didn’t run into issues in the future of the sort that Dino was outlining. We can put the interest on balances at the Federal Reserve at such a level that banks can arbitrage these balances and we won’t have trouble hitting our target.

CHAIRMAN BERNANKE. No, I understand it’s a good thing for us.

MR. REINHART. As for the longer-run implications, once we're assured that there's a stable demand for reserves, we can simplify reserve requirements, which are quite antiquated and kind of embarrassing.

MR. KOHN. Including simplifying them at zero. [Laughter]

MR. REINHART. Yes.

VICE CHAIRMAN GEITHNER. What's the probability that this is going to pass?

CHAIRMAN BERNANKE. It appears to be very high.

MR. KOHN. It's in both the House and the Senate bills, but the House bill is a very different bill. It has controversial things in it.

MS. MINEHAN. Haven't we been there before?

MR. KOHN. No. We haven't gotten quite this far before.

CHAIRMAN BERNANKE. They eliminated a number of controversial items so that this could go through. Other questions? President Lacker.

MR. LACKER. My sense is that the broad conventional way of thinking about how we would implement interest on reserves is to pay a rate of interest somewhat below the federal funds target rate. My sense is that the conventional view emerged at a time when we were less transparent about our targeting of the funds rate. The Chairman asked you whether it would be an operational problem for you. The natural thing, if you're pegging the funds rate, is to use the rate of interest on deposits to do it, so you don't have to estimate where the demand curve for funds lies every day. Have you folks thought about whether paying interest on reserves at the target rate would be a feasible mechanism?

MR. KOS. I can speak only for myself. I have worked on the presumption that we would set it, as you started out, below the funds rate, so we would in effect be creating something of a corridor with the primary credit rate on top and a deposit facility at the bottom. Now, whether that would be 1 percent below, ½ percent, or some other number would be up to others to decide. But I think that's the way that I viewed it rather than paying it at the target.

MR. HILTON. We have thought of different ways that the ability to pay interest on reserves could be used, and you're making a distinction between a rate that might be paid on excess and a rate that might be paid on required. Maybe they'd be the same; maybe they would be different. Depending on which you chose, you could have a very different framework for implementing policy on a day-to-day basis. Operationally, from the Desk's perspective, they could both be executed in a fairly straightforward fashion.

CHAIRMAN BERNANKE. Other questions? President Hoenig.

MR. HOENIG. May I just ask about the breakeven rate in TIPS—we looked at it and saw perhaps some seasonality to it. Is that just nonsense, or have you looked at it or thought about it?

MR. KOS. I've spoken about that in the past actually. There has been some seasonality. It has happened before—that some seasonal moves upward have occurred in the first part of the year.

MR. HOENIG. Usually this part of the year.

MR. KOS. Yes, usually in this part of the year. That relationship has not been stable, but one has noticed that there has been that tendency.

MR. HOENIG. But you haven't actually systematically looked at it?

MR. KOS. We looked at it a couple of years ago, and we noted it, but I think it was just too unstable.

MR. HOENIG. Thank you.

CHAIRMAN BERNANKE. President Fisher.

MR. FISHER. Having nothing to do with the subject we're currently discussing, but going back to your chart of metals prices, is there a way to get a judgment from the staff as to how much of this is speculative and how much of it is real demand and what the volume expansion has been on the different exchanges? We probably already have that, Vince, but it would be helpful. We keep discussing this with regard to oil prices, for example. In terms of the big integrated companies, nobody knows the answer, that I can determine, but clearly a good deal of this is speculative activity as opposed to real demand. The question is, Could somebody send around a memo that gives us a breakdown, if possible?

MR. KOS. We could look into it.

MR. FISHER. Including the volume expansions?

MR. KOS. Yes. The volume expansions are something we can probably get data on. I’m not sure that doing so will answer the question that you would like answered, which is how much of the price movement is linked to certain classes of participants.

MR. FISHER. For example, Exxon will tell you that, in terms of futures trading just on oil, West Texas crude was 6 billion in 1999; this year it’s running at a 120 billion rate. That tells you something—we just don’t know what. But it would be helpful for us to get a breakdown. At least it would be helpful to me.

CHAIRMAN BERNANKE. Hearing no other questions, we need a vote to ratify domestic operations. Do we have a motion?

VICE CHAIRMAN GEITHNER. So moved.

CHAIRMAN BERNANKE. Any objection? Thank you. Yes? Dino.

MR. KOS. Very briefly, I circulated a memo that comes around at this time every year asking you to vote to approve renewal of the swap lines to Canada and Mexico.

CHAIRMAN BERNANKE. Do I have a motion?

VICE CHAIRMAN GEITHNER. So moved.

CHAIRMAN BERNANKE. Discussion? President Lacker.

MR. LACKER. I intend to vote "no" on this motion for the reasons related to those I gave in January for voting against the foreign exchange authorization: a general sense of opposition to our central bank's being involved in foreign exchange operations, much less lending to foreign central banks.

CHAIRMAN BERNANKE. Other comments? I'll ask for a show of hands. All in favor? Opposed? Thank you.

We have an issue related to FOIA. A memorandum was distributed proposing to delegate certain FOIA responsibilities as described in the May 1 note to the Committee from Scott Alvarez and Kit Wheatley. Scott is here, I assume? Yes, there he is. Are there any questions for Scott? These are just technical changes. Do I have a motion?

MS. BIES. So moved.

CHAIRMAN BERNANKE. So moved. Thank you. Any objection? All right. Thank you very much. Okay. Our next item on the agenda is the economic situation.

MR. STOCKTON. Thank you, Mr. Chairman. I am told that counselors are taught to begin by acknowledging the validity of the fears and anxieties of those whom they are counseling. The strategy then is to deconstruct and examine in greater detail the specific sources of heightened anxiety in order to gain better perspective on the problems at hand. Being a naturally anxious person, I have had moments in the past six weeks when I felt the need to engage in a little "self help" therapy by employing this strategy on myself. So this morning, I thought that I would report the results of my efforts to identify and analyze some of the developments over the intermeeting period that could have made one more uneasy about the outlook for activity and inflation.

I'll admit that there have been a few reasons to be concerned. The growth in real GDP in the first quarter was very strong—even stronger than we had expected in the March Greenbook. And most components of spending surprised us to the upside. Moreover, hard evidence of the anticipated second-quarter slowdown is still sparse. Meanwhile, inflation concerns have been mounting. Oil prices are up another $10 per barrel, and the prices of non-oil commodities are soaring amid signs that the global economy is strengthening. The dollar seems to be sinking on good news and bad. The incoming data on core consumer prices have exceeded our expectations a bit. And measures of expected inflation have moved higher. Clearly, there is plenty to keep one up at night.

At other times, I have awoken with the fear that recent developments could provoke us into a familiar trap of overshooting on policy. If policy were to lean against strength in activity and inflation pressure that was largely seen in the rear-view mirror, the risk of tightening too much and for too long would be amplified. In that regard, the evidence has continued to accumulate that housing markets are softening, and last Friday's employment report at least hinted at some slowing in labor demand. Tightening significantly further when the economy already may have begun to decelerate risks an unwelcome cyclical downturn in the economy. Given our poor track record in predicting recessions, one should not take lightly the risk of overshooting the mark.

I'm not embarrassed to admit that I've harbored both fears—that of falling behind the curve and that of overshooting—often on the same day and sometimes even in the same conversation with my colleagues. [Laughter] But in the end, I have come to the view that, while you are almost certainly somewhat behind or somewhat ahead of the curve, there are some good reasons to think that you are not too far from the curve.

So just how strong is the economy at present, and will it maintain that strength going forward? As you know, we had been expecting a big bump-up in the growth of output in the first quarter, in part as activity rebounded from hurricane-depressed levels. And we surely got it. We are now estimating that the growth of real GDP in the first quarter was 5¼ percent, about ½ percentage point faster than projected in the March Greenbook. That said, it is important not to exaggerate the extent to which that surprise signals greater underlying momentum in the economy.

About half of our miss in the first quarter reflected higher-than-expected federal spending. While I'll admit that "higher-than-expected federal spending" might seem to be an oxymoron, we view the first-quarter miss as largely one of timing, related in part to FEMA outlays. We are expecting the level of federal spending to drop back in the current quarter. Inventory investment outside the motor vehicle sector, after being very subdued in the second half of last year, also has surprised us to the upside of late. Although it is presently providing a lift to activity, we would not expect inventory investment to be a source of ongoing impetus to production.

Of course, these were not our only surprises. Household and business spending, too, have come in above our expectations, and we read domestic demand as having somewhat greater momentum than we had earlier thought. As a consequence, we revised up our projection for second-quarter growth in real GDP to 3¾ percent—similar to the above-trend pace that we experienced over the past year. Had everything else remained as it was in March, this greater strength in near-term activity would have led us to mark up our forecast for the remainder of the year as well. But there have been some powerful countervailing forces with which we have had to contend.

The steep rise in the price of crude oil has continued to siphon purchasing power from the household sector. The bill for imported oil is now expected to be about $50 billion per year higher than in our March projection. Moreover, gasoline prices have increased even more than oil prices, reflecting a tight inventory situation that has resulted from some refinery shutdowns and from the higher costs associated with the switch in blends of reformulated gasoline. Because the spending propensities of oil company shareholders are likely lower than those of gasoline consumers, the transfer of income between these two groups also is likely to subtract some from consumer spending. In the very near term, we have households dipping into saving to meet their higher energy bills, but we think that some adjustment to overall spending plans probably is under way and that more will be required in coming quarters.

Besides the restraining effects of higher oil prices, the recent increase in long-term interest rates is expected to weigh on activity over the remainder of the projection period. To be sure, some of that increase reflects higher expected inflation. But real long-term rates have increased as well, in part as term premiums have widened a bit. Mortgage rates and corporate bond rates are expected to run about 20 to 30 basis points above the levels that in our previous projection we had assumed would prevail. Obviously, those increases have been too recent to have yet affected demand; but we expect that, by the second half of the year, higher rates will be leaving an imprint on housing activity and business investment. As you know from reading the Greenbook, the stronger underlying momentum in the economy is eventually more than offset by the greater drag from higher energy prices and interest rates, leaving the level of output a touch weaker by the end of 2007 than forecast in March.

What about inflation concerns? There can be little doubt that price pressures have intensified somewhat over the intermeeting period. As I noted earlier, crude oil prices have risen about $10 per barrel, and participants in futures markets expect those higher prices to persist. Other commodity prices have been soaring as well, especially prices for industrial metals. These increases can be expected to add a bit to core inflation in coming months. Another troubling development in the inflation picture has been the increase in most measures of inflation compensation and inflation expectations. TIPS measures of inflation compensation have increased between 15 and 20 basis points over the intermeeting period. At the same time, the Michigan survey measure of median year-ahead inflation expectations increased to 3.3 percent, and the median measure of inflation expectations five to ten years ahead edged up to 3.1 percent; both are about ¼ percentage point higher than in March.

Still, these developments should be placed in perspective. None of these measures has breached the range that has been maintained over the past few years. And there have been several episodes during that period when expectations moved up as much as or more than they have in the past six weeks, only to reverse course on softer news about the economy or inflation. So for now, it is difficult to gauge the extent to which there has been any meaningful deterioration in inflation expectations. Moreover, we have scant evidence that higher price inflation or higher inflation expectations have become embedded in labor costs. As you know, the employment cost index (ECI) rose at an annual rate of just 2½ percent in the first three months of the year, more than 1½ percentage points less than we had projected. In contrast, we currently estimate that compensation per hour in the nonfarm business sector increased at a 5¾ percent annual rate in the first quarter, about 1½ percentage points more than we had projected. Nonetheless, despite their divergent movements last quarter, both measures actually decelerated over the past year. To be sure, because labor compensation tends to lag prices in the overall inflation process, this observation should provide only limited solace. But I do think the incoming information on labor costs makes it more difficult to argue that you have fallen far behind the curve.

We continue to expect the growth of hourly labor compensation to pick up going forward in response to tight labor markets, the increases in labor productivity that have occurred in recent years, and the lagged effects of higher price inflation. Nevertheless, with price markups at very high levels, the projected acceleration in hourly labor compensation is expected to result chiefly in some narrowing of profit margins rather than in an increase in price inflation.

What about the price data themselves? Both the core consumer price index (CPI) and core personal consumption expenditure (PCE) prices rose 0.3 percent in March, exceeding our expectations. Some of the surprise in both measures was attributable to higher-than-expected increases in apparel prices that may have more to do with imperfectly anticipated seasonal patterns than underlying trends and to a step-up in medical prices related to increased Medicare reimbursements. As a consequence, we attach only a small signal to this upside surprise. All told, the developments over the past six weeks—another jump in oil prices, some deterioration of inflation expectations, and a slightly higher reading on core inflation—led us to mark up our projection of core consumer price inflation, but just by 0.1 percent in both 2006 and 2007. The pattern of projected inflation remains the same. As higher prices for oil and other commodities are passed through into the prices of final goods and services, core PCE inflation is projected to move up to a 2¼ percent pace this year. With those prices expected to flatten out next year and with the pass-through of the earlier run-ups largely complete, we expect core PCE inflation to ease back down to a 2 percent pace in 2007.

Finally, what about the concern that we could be in the process of overshooting the mark on policy tightening? Because policy operates with a lag and because we are so poor at predicting turning points, this risk seems especially relevant after a period of substantial tightening. But given the strength that appears evident in both domestic and foreign economies, my guess is that the expansion is not so fragile that some modest overshoot on policy would result in a cyclical downturn in activity. Moreover, if our baseline assessment of the economy is close to the mark, a higher path for the funds rate might not even be deemed an overshooting. As we noted in a simulation in the Bluebook, greater policy tightening than is built into the baseline might be desired if your objective is to achieve a more rapid and pronounced decline in core price inflation.

So, in the end, while we could see a heap of worries in a variety of different directions, we interpreted recent developments as warranting only small changes in our forecast. That forecast remains one in which activity slows to a more sustainable pace and inflation fluctuates around recent levels. Still, I don’t want to be seen as offering false reassurances. Much could happen to change the outlook. My own concerns about potential outcomes that could take us far from the staff baseline projection are centered mainly on asset markets. Asset markets are impressive information-processing machines that, for the most part, deliver very efficient outcomes. But those markets are also subject, from time to time, to abrupt shifts in confidence and psychology that are difficult for forecasters to predict and difficult for policymakers to influence.

I see risks on both sides of the ledger here. One of the risks associated with overshooting is that, at some point, higher interest rates could trigger a sharp contraction in house prices and real estate activity. Given the long lags with which we receive reliable information on house prices, such developments might take some time to recognize and thus might prove harder to counteract than implied by our alternative scenarios. Of course, undershooting on policy also presents risks for asset markets. If policy were to trigger a substantial fall in the dollar, inflation pressures and your efforts to deal with those pressures could create some significant challenges for monetary policy and for the economy. Karen will have more to say on the prospects for the dollar in her presentation.

MS. JOHNSON. On the international side, two major developments during the intermeeting period merit some further discussion this morning: the rapid and sizable run-up in global prices for crude oil and the significant depreciation of the exchange value of the dollar in the second half of the period. Those developments occurred against a background of continued strong global growth, with some economic indicators again surprising us on the positive side for some countries. As a result, we are still expecting moderately strong foreign real GDP growth at an annual rate of 3½ percent over the forecast period, with inflation projected to remain contained although upside risks are a concern.

When we finalized the March Greenbook forecast, the spot price of WTI was just over $60 per barrel. Last week, as we completed the forecast for this meeting, that price reached about $75 per barrel before partially retracing. The intervening seven weeks had witnessed almost daily tales of woe of higher prices, with the supply problems in Nigeria proving more persistent and serious than earlier thought and tensions over the nuclear program of Iran adding to heightened pressures on energy prices. In addition, outages of U.S. crude production as a result of the hurricanes continue, as do issues regarding supply from Iraq and Venezuela. Events in Bolivia have also rattled the energy market. As a result, and consistent with the shift in futures prices for the rest of this year and next, we raised the projected path of the U.S. oil import price about $10 per barrel. As in March, that path rises slightly through the end of this year and then is about flat in 2007.

One significant and direct consequence of the higher oil prices is an increase in the U.S. oil import bill from that forecast in March. In the baseline forecast, the value of oil imports has been revised up $34 billion for this year and $48 billion for next. As a consequence, of the approximately $150 billion widening of the U.S. nominal trade balance that we now project from the fourth quarter of last year to the final quarter of 2007, just about one-third is accounted for by the enlarged oil bill. The overall trade deficit is now expected to be about 6½ percent of GDP at the end of next year.

A second consequence of higher global oil prices is that the revenues to the world’s oil exporters have significantly increased. This positive change to the external revenue of these countries has raised a number of questions about their propensities to import and from whom and their decisions about how to hold the funds that they have received and have not as yet spent on goods and services. Data on the portfolio allocation of oil revenues by many exporting countries are sparse; in many cases, the funds are held by national oil companies or in special stabilization funds, neither of which are likely to be included in reports of foreign official reserves. Moreover, officials in some of these countries tend not to reveal detailed information about their holdings. A case can be made that increased revenue flows to these countries over recent years likely added to overall global net saving and contributed to low long-term interest rates globally. It is still uncertain whether their behavior has had or will in the future have a systematic influence on exchange rates.

From U.S. TIC data, we have some limited information about some categories of dollar holdings that are current through March of this year. As was reported in Part 2 of the Greenbook, inflows of foreign official assets in the United States held by OPEC countries were quite strong in the fourth quarter of last year and in January. However, in February and March those inflows dropped sharply, as did aggregate official inflows from other non-G-10 countries. For total portfolio inflows to the United States that combine public and private investors, funds from oil exporters (including the Middle East, Mexico, Russia, and Norway) were more than $25 billion in the first quarter—a pace comparable with that in 2005. The $25 billion inflow compares with estimates of the net oil revenues of the oil exporters of about $200 billion in the first quarter. Again, the monthly data show a sizable step-down in the size of inflows after January. Among the oil exporters, there is some variation across countries in their inflows into the United States. After showing positive inflows in the previous two years, net outflows were recorded for both Russia and Venezuela in the first quarter. In contrast, inflows from Middle East oil exporters, Mexico, and Norway were strong. All told, although total inflows for oil exporters remained near rates in 2005, there are some hints of possible diversification away from assets held in the United States by some oil-exporting countries, especially in more recent months. I should note that these countries may hold dollar assets outside the United States; changes in such holdings are not captured by the TIC data and may give rise to entries for countries such as the United Kingdom that are the location of major global financial intermediaries.

We have only extremely partial data for U.S. financial inflows in April, so it is not possible to relate the recent sharp depreciation of the dollar to any pattern in such data. The exchange value of the dollar fell significantly against all the currencies of our index of major industrial country trading partners as well as against the currencies of Brazil, Korea, Chile, and most other Asian emerging-market economies. This broad-based decline reflects a significant change in preferences on the margin among at least some global investors and may alter expectations of some of those holding large amounts of dollar assets. Over the intermeeting period, U.S. long-term nominal interest rates moved up nearly 40 basis points. But rates rose 20 or more basis points in most foreign industrial countries. Real long-term interest rates taken from inflation-indexed, sovereign securities in Japan and the euro area also rose about 20 basis points, comparable to the change in U.S. inflation-indexed rates. A significant decrease in the market value of the dollar with no evident change in relative real rates of return on comparable fixed-income securities could indicate an increase in the risk premium attached to holding dollars, or it could signal a change in perceptions of the long-run real exchange value of the dollar.

Even given lags in the underlying relationships, the weaker projected path of the dollar does show through in our forecast. For real exports of core goods, the drop in the level of the dollar to date and the slightly faster pace we now project for real dollar depreciation imply that relative prices will boost growth of these exports about 1 percentage point more over the remainder of the forecast period than we thought in March, based on our model. For real exports of services, the story is similar. For core import prices, our equations imply a positive effect, concentrated in this year. However, when incoming data and other factors are taken into account, our projection for import price inflation is only a little above that in the previous Greenbook, and so the net effect on real imports is negligible. For real imports of services, a negative effect from higher relative prices is evident in the baseline projection.

For the nominal measures at the end of the forecast period, total exports are revised up, but total imports are up more. The enlarged oil bill accounts for virtually all of the upward revision to nominal total imports. As a consequence, the trade deficit has been revised to a somewhat larger figure. That change is significantly offset by the effects of the lower dollar on projected investment income. The lower dollar is positive for investment income as it translates earnings abroad of U.S. firms into more dollars. In addition, in our forecast those earnings are directly boosted by higher oil prices. All told, our outlook for the current account deficit is for more-rapid deterioration this year than we previously thought but a deficit at the end of 2007 that is only slightly larger than we had been expecting in March. David and I would be happy to answer any questions.

CHAIRMAN BERNANKE. Questions for our colleagues? President Lacker.

MR. LACKER. David, I noted an alternative scenario in the Greenbook in which inflation expectations are unanchored, and the description of the scenario says that inflation expectations end up ½ percentage point higher than in the baseline. I looked around for the baseline time series for inflation expectations, but I couldn’t find it. What are they?

MR. STOCKTON. Well, that’s a good question. The reason we don’t publish an inflation expectations series is that we’re using a lot of different measures of inflation expectations to gauge where underlying inflation is. We’re using a lot of different models for that matter, too. Some are purely backward-looking models, in which inflation expectations and underlying inflation are basically proxied by lagged inflation. In other models, there are explicit measures. For example, in FRB/US we use the Philadelphia Fed Survey of Professional Forecasters as a long-run anchor on inflation expectations, and then we allow that to move over time as people are assumed to learn about the Fed’s inflation objective. So in constructing the scenario, we actually had a variable in FRB/US that we could add-factor up ½ percentage point from what it was.

Now, I think the deeper question you're asking is, what do we think underlying inflation is currently in the economy, and what lies under the staff's inflation projection? We think there has probably already been, roughly speaking, something like ½ percentage point deterioration in underlying inflation from where it was in 2003, when actual inflation was running just a little above 1 percent. We thought that was unusually low, and our estimate of underlying inflation was about 1½ percent.

What fits into this forecast now is that there probably has been some upward creep roughly on the order of ½ percentage point to something like 2 percent. The scenario that we were showing you in this Greenbook had some further deterioration over and above that. Until recently, there wasn't a lot, other than the pickup in actual core inflation itself, that we could point to for a deterioration in inflation expectations. I think we're still nervous about making that call in this forecast. It could very well be that inflation expectations have remained well anchored, and we have been showing some scenarios in the Greenbook that take that possibility into account. As I noted in my briefing, although one could use what's happened to inflation expectations and inflation compensation over the intermeeting period as being supportive or consistent with what underlies the forecast, we still think it's too early to make the call that a determination has definitively occurred. So, our basic view is that there has probably been some pickup. It's been limited. But obviously, there are risks on both sides of that. One side is that inflation expectations could have stayed better anchored. On the other, there may be the risk that inflation expectations are at the front edge of a process of increasing and that they will continue to deteriorate.

MR. LACKER. I appreciate your answer. Let me tell you what motivated my question. First was the broad concern about inflation. But, second, in looking at the Greenbook and thinking through the outlook, I see that inflation expectations held by market participants are a key conceptual anchor for us. I note that you tell us quantitatively about other sorts of latent variables—for example, the NAIRU and potential output. I thought perhaps inflation expectations deserved the same explicit quantitative treatment in the Greenbook.

MR. STOCKTON. If I could respond to that for just a second—I'd be happy to write a number down on the back of an envelope. [Laughter] If we were to write a number down, I'd caution you not to take it too seriously. I think you ought to be looking at survey measures of inflation expectations. You ought to be looking at market-based measures of inflation expectations. And in some sense, I think you still need to take seriously models that have adaptive expectations as well, because they could be reflecting how people are learning or how they might be influenced by past inflation. We show some of those things. We could show a lagged inflation term, or as I say, we could certainly create a variable that we would call inflation expectations for purposes of the staff forecast. But I'd be nervous about giving it prominence over and above these other measures that I think you should be taking on board as well.

MR. LACKER. I can appreciate that, but it comes up in our deliberations. Last fall, we were talking about the reaction to Katrina, and you were showing us a scenario in which core inflation rose and then fell in the first half of this year. I asked you what happened to inflation expectations along that path, and they rose and then smoothly fell. For us to get a handle on whether that's a reasonable scenario, it helps to think through what would bring about a fall in inflation expectations like that and whether they can vary at high frequency as they seem to have over the last month or two. But I don't want you guys penciling down numbers just to pencil down numbers. I appreciate the difficulties involved.

CHAIRMAN BERNANKE. President Poole.

MR. POOLE. Thank you, Mr. Chairman. I have several questions that I will ask quickly here. First of all, I do want to commend the Board staff and the staff of the Reserve Banks on the special survey. I thought the information on nonresidential construction was very useful.

Here are my questions. First, is there a way we can reconcile the ECI and the compensation data? They seem to be further apart than typical. I don’t know technically whether doing so is possible or the extent to which it’s possible. Second, you note in the Greenbook, but without any real explanation, that federal tax revenues are coming in extraordinarily strong—stronger than anticipated. What do we know about why that might be the case? I would also ask about your expected narrowing of profit margins. My question is, why? There are lots and lots of economic incentives for corporate managers to keep those margins high and to expand them if they can. A lot of people have compensation linked to profits, the stock market, and so forth. So it seems to me that the economics would say that there’s no reason particularly to expect a reversion. I gather that your explanation was that it’s sort of outside what we have typically observed and, in a time series sense, you expect it to go back. But I’m worried about the economics underlying that view. I think it’s quite important for the inflation outlook because, even if wages are well contained, it could well be that companies will just take price increases whenever they can and enjoy the benefits of the profits. So I’ll let you deal with those in any way you want. [Laughter]

MR. STOCKTON. About the issue of reconciling the ECI with the compensation per hour figures, the previous Chairman tortured us [laughter]—and the Bureau of Labor Statistics—for a number of years precisely on this issue on the thought that we ought to be able somehow to resolve the difference in these measures. That came to no avail. [Laughter]

The BLS for a while was publishing a measure for wages of nonsupervisory workers just to see whether or not it was tracking, and it actually roughly tracked what was happening in the average hourly earnings taken from the establishment survey, but not very closely. Now, if you look at the history of the series, there are some very significant gaps in the past, and the one that we're currently witnessing actually doesn't even necessarily stand out relative to the historical changes. One of the major factors in explaining some of those past deviations was that the exercise of stock options is included in nonfarm business compensation but not in the ECI. We just don't know at this point whether that could be explaining last quarter. I think I'd make the bigger point that, over the past year, both those measures have actually slowed somewhat so that, in terms of their second difference, they are not telling substantially different stories. It's a significant frustration for us, as I'm assuming it is for you, that we're unable to have a better answer to reconcile them.

As for taxes being stronger—they have been significantly stronger. Obviously, at this point, we don't really know the reasons that they have been stronger than they were projected. It could be a shift in income distribution toward higher-income individuals. It could be signaling greater strength in underlying income than is currently being measured. In the past, we have not had any success in using those revenue surprises to predict ultimate revisions in aggregate income. While I think it's a plausible hypothesis, it doesn't have a lot of empirical support.

MR. WILCOX. For us, anyway, most of the surprise has been on the nonwithheld side, on the final payments, and that implicates maybe something like capital gains rather than the sort of more directly payroll-tied sources of income.

MR. STOCKTON. And small upward surprises on the withheld portion. As David notes, most of it is in the nonwithheld portion.

On the economics behind the forecast for the profit margins to revert just a bit toward mean, there is empirical and historical support for that kind of movement, and I think there are some good economic reasons for it as well. Obviously, income shares in the United States have been remarkably stable over long periods of time, and it has been quite typical, after periods when profit margins have widened as much as they have in the past few years, for them to narrow. The mechanism through which that occurs is that there is both pressure coming through tighter labor markets to push up overall wages and competitive pressure in product markets to compete down those profit margins over time through lower prices.

So you’re absolutely right. Obviously, no business will willingly give up profits. But we have a good reason to think that, faced with significant competitive pressures, profit margins ought, over time, to revert back to historical norms. We haven’t been terribly aggressive in pushing this particular feature of the forecast, meaning that we don’t have them coming down a whole lot. We basically have them leveling off and just inching down further on. But we think there are some good economic reasons why that happened in the past and why it could happen going forward. If we are experiencing right now some permanent shift in income distribution away from labor toward capital, then using history as a guide here could throw you off. But I guess that I wouldn’t start with that presumption.

CHAIRMAN BERNANKE. Thank you. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. I, too, wanted to ask about the alternative simulation that President Lacker talked about, the greater pass-through with unanchored expectations. It seems to give the impression that inflation is pretty controllable, and I have a bit more concern than that. You said in the scenario at the end that, beyond 2007, policy would yield a noticeable rise in the real federal funds rate. I guess that the action is all after ’07 the way you have phased in this gradual increase in inflation expectations of 50 basis points. So I guess I’ll start with the question, how does it play out in ’08 and ’09? What would be the cost in terms of output and price stability? Then, of course, expectations could rise more quickly. The increase wouldn’t necessarily have to be gradual over this year and a half. What happens if inflation expectations rise more quickly, and what would the implications be for beyond 2006 and 2007?

MR. STOCKTON. Starting with that last point, an increase in inflation expectations leads almost one for one into actual inflation, and in relatively short order. If some significant shift occurred in inflation expectations, you could expect that it would show up as higher inflation immediately. Now, in the model, inflation is a very inertial variable, and that has two implications. One is that it takes time for inflation to get out of your control, but it also means that it's extremely costly to bring back down again. So if one looked beyond the 2007 horizon, if you wanted inflation at 2 or 1½, you'd have a lot of work left to be done in terms of generating a cumulative output gap. You have the sacrifice ratio; we think it is something like 4. That would mean that, if you were at 2½ and wanted to go to 1½, you'd have to have four point-years of unemployment above the NAIRU to get inflation back down to that 1½ level. So the news is both good and bad regarding the slow response of inflation. It's slow to move up, but then it's also costly to bring back down again.

MR. REINHART. You see exactly that point, President Moskow, in the alternative simulation in the Bluebook in which we asked what it would take over the extended Greenbook period to achieve an inflation target of 1½ percent—which effectively means to work out ½ percentage point worth of inflation. You have to keep the real five-year interest rate almost ¾ percentage point higher until the end of the decade to do that. You also see the importance, as President Lacker noted, of the behavior of inflation expectations because in one simulation we assume that inflation expectations evolve as they have historically—that is, only gradually adjusting. In the other simulation we ask, what happens if that adjustment is quicker? The answer is that monetary policy is a lot easier when inflation expectations are better anchored at a lower level.

MR. MOSKOW. I found that Bluebook alternative simulation very helpful. I thought it was tied together with the ones in the Greenbook. I found them together to be very helpful. It's this inertia that concerns me. Earlier in my career I was involved in fighting inflation, and once it gets out of control it is very, very difficult to bring back under control.

MR. REINHART. Again, as the property of the model that Dave mentioned, it's a very flat Phillips curve. It takes a lot of unemployment years to work that back.

CHAIRMAN BERNANKE. President Lacker has a two-handed intervention.

MR. LACKER. Yes. Just very briefly, I wanted to get a bit more of the benefit of your expertise about how inflation expectations evolve. As you noted, they evolved slowly in the historical data. But there are episodes, like the last couple of weeks, when I get the sense that they can move fairly rapidly.

MR. REINHART. I'm not sure I have that expertise. Perhaps the evolution of inflation expectations is asymmetric, as President Moskow suggested. Perhaps it's also what we look at at a high frequency. Inflation compensation doesn't exactly map into inflation expectations—it includes an inflation risk premium. We think that some of the rise in inflation compensation is due to an unwinding of something we couldn't explain—that is, a term premium that was very low by historical standards. To the extent that it's the term premium rising, it could get packed into that measure of inflation compensation. I would also note that, as Dave said, in the Michigan survey of households, longer-term inflation expectations ticked up. In the Blue Chip consensus forecast that's released today, longer-term inflation expectations are actually unchanged over the last month, and that covers the span of the rise in energy prices and the whiff of inflation jitters that we saw in financial markets.

MR. LACKER. Does the baseline Greenbook forecast treat inflation expectations as evolving relatively sluggishly, or are they capable of jumping?

MR. STOCKTON. They're capable of jumping. We could make the underlying assumption that inflation expectations have shifted, and I think we would be looking at the things that I noted earlier in trying to make that determination. In what we're assuming is currently happening and what has happened over the past couple of years, inflation expectations are an evolving process, not a jump process.

CHAIRMAN BERNANKE. President Fisher.

MR. FISHER. Thank you, Mr. Chairman. I'd like to turn to the international side and first thank Karen for the good work that's in the book and your briefing. More in the book than in the briefing, there is the note that continued expansion is taking place among our significant trading partners and around the globe.

I wonder if you have a sense, since we always use the term "resource utilization," of what global resource utilization is occurring. I raise this issue because we assume, for example, that the supply of labor in China is infinite. If you read the recent data, you will see that in the Pearl River Valley price pressure on labor is up. Wages are 800 yuan—$100 a month, up from $60 a month. Is it possible for us, as we look at the rest of the world, to place a little more emphasis not just on our net import or net export position, not just on the pressures that come from imported goods in terms of oil prices, and not just on the growth factor, but also on developing a better sense of the kind of resource utilization we're beginning to see?

The second question I have is, since goods have to get from point A to point B, do you have a sense of what's happening with worldwide port capacity and congestion?

MS. JOHNSON. Well, as to the first question, we have not really done a lot to address this issue, which you have raised with us before, but we are trying to give it some thought. One thing struck me over the weekend, when Governor Kohn and I went to the BIS Governors meeting. Certainly the sense of strong global growth was pervasive and more forceful among that group than I can remember for a very long time. So, if I had the Greenbook to do over again, I might push people to raise global growth a little based on what I heard the others saying at those meetings.

What we are observing in China is to some degree the result of deliberate policy actions that Chinese authorities have taken partly to respond to the pressures they are under internationally. They are seeking ways, ways perhaps not based on the exchange rate, to raise domestic demand in China. Among their concerns about how to make that happen and deal with their own perceived domestic problems is the issue of migration from the rural areas into the urban areas and the source of domestic demand arising from the huge amount of population that remains in the rural areas. So they are looking to keep people at home on the farms, so to speak, because it is attractive to be home on the farms, and they are looking to get the people home on the farms doing more consuming as a share of the total of China.

To some degree they have succeeded. Through various tax and subsidy changes and other administrative means they have raised rural incomes. One thing we have observed is very responsive behavior on the part of the Chinese population so that, if the attractiveness of being in one manufacturing urban area changes relative to being in another, you see labor moving in response. Now that you see something of a change, in general, between the manufacturing urban areas versus the rural areas, you're also seeing people willing to go back home or to stay home in the rural areas. That is a good sign that the labor force allocation in China seems to be quite responsive to what we think of as the normal economic incentives that a market economy kicks up. That said, it does suggest that the notion of a perfectly elastic horizontal supply curve of manufactured goods out of China is a distortion and that the curve has some slope to it. But, of course, that is what we want, so we shouldn't lament that outcome.

Over the weekend there was some interest in talking about how strong the global economy was and how much inflation might be around the corner, not just here, but everywhere. Nonetheless, reported inflation in China is down, and most of the variability in China's inflation, as best one can tell, has been in food prices. So what made Chinese inflation appear to go up was a food-price event, and what has made Chinese inflation appear to come down is a food-price event. I'm not sensing that as yet there is a consequence of, say, this wage behavior or this relative-incomes pattern within China, in terms of a very big effect on the price at which the rest of the world can buy Chinese goods or on the availability of those goods. But it certainly has the potential to have such an effect, and it is something for which we should try to develop more sources of information.

MR. FISHER. May I just interrupt you here to ask a question? In terms of your BIS readings and what you came back feeling: Do you have a sense that global resource utilization is tightening and that there is a greater inflationary impulse deriving from global resource utilization?

MS. JOHNSON. Well, it is certainly true that resource utilization in certain industrial countries—Japan, for example—is moving in that direction. Even Europe to some degree is moving in that direction. For the major emerging-market economies of India, China, and so forth, where we have seen the big increase in the global labor force that has been thought to lie behind some of the downward pressure on wages everywhere and some of the flatness in finished goods prices, I am not so sure I did get a sense that we are reaching some kind of capacity constraint.

If anything, China surprised everybody in Q1. The numbers that they released are on a sort of Q4-to-Q4 basis. We translate those internally and, therefore imperfectly, into quarter-on-quarter changes, and so we have Chinese Q1 growth that is a 12, 13 percent rate. I do not see any sign that China is slowing. The whole debate about a hard landing in China is just gone. So in that sense, I do not really see that we are hitting global constraints where it most matters.

We probably do have a permanent terms-of-trade change—or at least an extended, persistent terms-of-trade change—in terms of raw materials as a result of a change in the composition of global growth, and I do not think the composition of global growth has to go back to being almost all industrial countries with most emerging market countries barely growing. I do not see that happening. The countries that have enjoyed terms-of-trade gains because they have commodity resources are probably going to continue to enjoy them; and what they do with those resources, how they choose to consume them, or what they do with domestic investment will become, I think, an important factor in this notion of global capacity.

I do not have any real new news on port capacity, bottlenecks, or shipping rates; but since nobody has been talking about these subjects for quite some time, I take no news to be good news, and I do not think bottlenecks in that area have contributed much to what we have been seeing lately.

CHAIRMAN BERNANKE. Thank you. I think we are ready now to move on to our economic go-round. Let me remind you of our convention. Raise one hand to be put into the queue to speak, and raise two hands if you would like to make an immediate intervention or ask a question pertaining to one of your colleague's comments. President Yellen.

MS. YELLEN. Thank you, Mr. Chairman. Incoming data on the pace of economic activity surprised me slightly to the upside, although the indications are that housing is continuing to cool. Such an upside surprise is of concern, given that we are probably in the neighborhood of full employment and inflation is already on the high side of a range I consider consistent with price stability. I have also been slightly surprised, and unpleasantly so, by incoming data on core inflation.

Beginning on the real side, recent data might signal greater underlying momentum in aggregate demand, portending more of the same going forward. But other developments during the intermeeting period portend slower growth this year. In particular, energy prices and longer-term interest rates have risen surprisingly and substantially. Taking all these factors into account, we have marked down our forecast for real GDP growth a bit for the latter half of 2006 and for 2007. We see growth coming in slightly below trend starting in the second half of this year and the unemployment rate moving up toward 5 percent. This forecast assumes that policy is tightened at this meeting and once more over the next several meetings.

One development on which I would like to comment briefly is the rise in long-term interest rates. Since the beginning of this year, the nominal ten-year Treasury rate is up about 75 basis points. About 50 basis points of this increase is accounted for by a rise in the real component, at least as measured by TIPS rates. It seems natural to assume that this increase in real long rates will restrain future growth, but the outcome for economic activity is not unambiguous: It depends on what caused real rates to rise in the first place, and the causation is far from obvious.

For example, higher long-term rates could reflect rational market expectations of a significantly stronger domestic economy over the next few years. But such an explanation does not strike me as particularly plausible because, although recent data are slightly on the strong side, they are not dramatically strong. Moreover, the uptick in real rates appears to be especially pronounced in implied yields at the long end of the curve—in the distant future, in periods well beyond a plausible forecast horizon.

A second possibility is that higher U.S. interest rates reflect a shift in global capital flows away from the United States, perhaps due to the unwinding of the carry trade or growing concern about the U.S. current account deficit. Such a shift might account for the sharp drop in the dollar over the same period. In simple models, such a shift in portfolio preferences has ambiguous effects on domestic demand because the depreciation in the dollar could stimulate aggregate demand by more than higher yields depress it. It’s not my intention to overemphasize the risk that growth will not slow. My point is simply that, although the rise in bond rates seems likely to help slow the economy, we should not take it for granted.

Turning briefly to inflation, I'm uncertain whether the recent bulge reflects various special factors, as David mentioned, some pass-through of energy and commodity prices, or pressures from resource utilization. Parsing the CPI report, I found it difficult to discern evidence that the uptick does reflect pass-through of energy and commodity prices into core inflation. I would be quite concerned if the uptick reflects pressures from resource utilization and turns out to be persistent. However, half a dozen measures of slack that we monitor suggest no noticeable change in slack since late March. These measures also suggest that we are in the vicinity of full employment and not noticeably beyond it. Data on both productivity and labor compensation are largely reassuring.

My final comment concerns the rise in inflation compensation since our last meeting. While the possibility of some loss of Fed credibility certainly can't be dismissed, I believe we should not overreact. First, the rise we've seen is not out of line with the typical volatility in this series. Second, we must remember that inflation compensation includes not only expected inflation but also an inflation risk premium. Of course, both of these elements could be higher because of a lessening of credibility. But the inflation risk premium could also be higher because the world now strikes market participants as a riskier place, perhaps because of geopolitical concerns that have nothing to do with credibility. Indeed, a growing perception that the world is riskier could explain both the uptick in inflation compensation due to a rise in the inflation risk premium and some of the rise in TIPS yields due to higher real interest rate risk. Factor analysis performed by our staff suggests a strong correlation with the common factor for the term premium and longer-horizon, but not shorter-horizon, breakeven inflation rates and TIPS yields.

My point is that determining what has caused inflation compensation to go up is not an easy matter, and concluding that it's due to a lessening of credibility may be premature. So overall, while we have revised our core inflation forecast up slightly, we continue to be fairly optimistic that inflation will remain reasonably well contained going forward. Inflation in the core PCE price index of around 2 percent over the next year or so seems like the most likely outcome to us.

CHAIRMAN BERNANKE. Do you or your staff have a view on the breakdown between the term premium and future expected rates in terms of the far forward increase in interest rates?

MS. YELLEN. We’ve not tried to estimate an actual breakdown between those two things. We do look at models that estimate the term premium, but we’ve done some empirical work that suggests simply that movements in inflation compensation, the inflation risk premium, and longer-term TIPS yields tend to be correlated at long horizons. But I don’t have an estimate of that precise breakdown.

CHAIRMAN BERNANKE. Thank you. President Lacker.

MR. LACKER. Thank you, Mr. Chairman. Our readings on the Fifth District’s economy very much parallel those for the nation as a whole. I’ll be brief. Surveys show a marked pickup in manufacturing shipments and orders in March and April and ongoing growth in services activities. Retail sales indicators edged higher in April. The real estate market showed signs that residential activity is softening and commercial activity is firming.

Our measures of District price pressures have stepped up significantly in recent weeks. In the service sector, we ask about current price trends, and we get these quantitative measures and rates of increase. In the service sector, the current inflation measure is back up to its post-Katrina peak and is higher than at any time since 2003. We ask about expected six-month inflation. For the service sector, that has drifted up since Katrina and is now at 3.2 percent, higher than at any point since our survey began in the early ’90s. In the manufacturing sector, prices received rose 2.4 percent, also a record high, and prices paid also surged in April. The vast majority of our contacts who have commented on this believe that higher energy prices will persist throughout 2006, and about three-quarters of them say that they will raise their prices in response.

Turning to the national economy, on the real side the recent indicators have been generally upbeat and point to continued healthy growth. I won't enumerate them. Unfortunately, I think the inflation picture has become substantially more troubling to me over the intermeeting period. The March numbers, as others have noted, were certainly eye-catching. The core price index was up at an annual rate of 3.9 percent, even restricting attention to the market-based components that Governor Kohn prefers. [Laughter]

Of course, month-to-month numbers are noisy, as David indicated, but the core PCE index was up at a rate of 2.5 percent over the past three months and 2.4 percent since August. In addition, the outlook for inflation going forward has deteriorated as well, and we have had a fairly thorough discussion in the Q&A, so I'll skip my planned recitation of the indicators. My sense is that inflation expectations have deteriorated markedly.

I don't want to be too alarmist. Inflation spreads are still a bit below where they were two years ago, so I think it is possible to characterize inflation expectations as contained, although the size of the requisite container keeps getting bigger and bigger as time goes on. [Laughter] Right now it's bigger than I'd like to see. My concern is less about the current level of expected inflation than it is about how those expectations have responded to incoming data. We saw an adverse move in inflation expectations last fall after Katrina, accompanied by conjectures that we might pause. Inflation expectations seemed to subside as retail gasoline prices fell, but I think it helped substantially that we stuck with our rate increases and communicated pretty forcefully in the fall about our concerns about inflation.

This time around, rising energy prices have led to upward revisions in market participants' expectations about our policy path, along with upward revisions to their expectations regarding inflation. I would have been far happier, however, had they marked up their expected policy path by more and marked up their inflation expectations by less, especially at longer horizons. I'm particularly distressed by instances in the past several weeks in which the two moved in opposite directions. That is to say, inflation expectations rose simultaneous with our expected policy path falling. President Yellen talked about overreacting. Certainly no one wants to overreact, but I think in situations like this a distinct reaction is warranted. Thank you.

CHAIRMAN BERNANKE. President Lacker, one issue I have with these surveys is that, when they ask about price changes, they don’t distinguish between intermediate goods and final goods. Of course, the final goods are what we care about. Have you tried to make that distinction in your surveys?

MR. LACKER. Yes, we do on the manufacturing side: We have prices paid and prices received. In the service sector, we don’t distinguish; we just ask. And we have separate retail and nonretail service sectors. On the manufacturing side, they are always pessimistic, so prices received never seem as though they’re going up as fast as prices paid, especially in the last couple of years. But over time, if you look at their movements from month to month, you can get a distinct sense. They really moved up markedly in the fall, tapered off a little and softened in the winter, and now have moved up markedly again and are at or above where they were before.

CHAIRMAN BERNANKE. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. Most of my business contacts indicated that overall economic activity remains on a solid footing and that resource utilization has tightened further. Both of the major temporary-help firms headquartered in our District said that hiring remains strong nationwide. They continued to say that skilled workers are in short supply. This topic was also on the minds of our contacts in manufacturing and construction. As I’ve noted previously, we’ve heard a few reports from manufacturers that labor shortages were causing delays in supplier deliveries. Strengthened labor demand, however, has not yet spread to lower-skilled workers. So while wages for skilled individuals continue to increase briskly, pay rates for other workers are up only modestly.

We're also seeing signs of pressure on nonlabor resources. Some of our contacts have run into problems with the costs and availability of trucking and rail shipping capacity, and a manufacturer of drilling equipment reported supply disruptions because its vendors were heavily backlogged. Several contacts noted that price pressures have intensified for many commodities, as we've discussed before. Of course, everyone was talking about the surge in energy costs. Some retailers noted that sales had slowed, and they attributed the softness to higher energy prices. Others were concerned about the impact of energy going forward. In contrast, our manufacturing contacts reported that they generally have no plans to scale back production in response to the recent increases.

There is not much new to report on the Delphi negotiations. The period for Delphi workers to sign up for early retirement is just starting. Delphi, General Motors, and the UAW hope that many will accept the buyout. This would leave fewer union workers vulnerable to being laid off as Delphi downsizes, which would make the negotiations easier for all the parties involved.

On a final note, several of my directors continue to be concerned about the amount of liquidity in financial markets. They say prices and terms for more and more deals are bordering on speculative.

Turning to the outlook, we've had quite a bit of news since our last meeting. Much of it suggests increased risks on the inflation front. Of course, the March reading on core inflation was just one month, but the twelve-month change in core PCE inflation is now back up to 2 percent. And as President Lacker said, the six-month change is now up to 2.4 percent. Moreover, energy prices have jumped again. The dollar has weakened a bit more, and inflation expectations have risen.

In response to the latest data, the forecasts from our indicator models of inflation have moved up some. Currently, these project 2007 core PCE inflation between 2 percent and 2.4 percent. To be sure, things are far from getting out of hand: Resource utilization measures currently are only modestly on the tight side, and we are all well aware of the uncertainty surrounding those measures. Furthermore, the recent ECI data suggest that wage pressures remain muted. That said, other measures of wage growth have been rising.

Looking at the markup of prices over labor costs, one would think that there's plenty of room for profit margins to absorb higher wages. But as Bill Poole suggested in the issue we discussed before, the business people I talked to haven't gotten that message. Their attempts to maintain margins in the face of increasing costs represent an upside risk to the inflation outlook. So I agree with the upward nudge to the Greenbook inflation forecast, but I'd go a bit further. Given the Greenbook path for the funds rate, I think core inflation of 2¼ percent is a more reasonable point forecast for 2007.

In terms of growth, the expansion still appears solid. The softening in housing that we have been anticipating is more obvious now. There's a possibility that moderation might turn to something bigger, but I don't see this as a large risk. Of course, $3-a-gallon gasoline should restrain demand somewhat, and we'll need to keep a close eye on how consumers respond to yet another hit to their purchasing power. But employment continues to rise at a good pace, generating healthy increases in income, which should support household demand. Businesses are supporting spending on capital goods, and growth prospects abroad continue to suggest some optimism on export demand. So I think growth will average around potential over the course of the projection period.

CHAIRMAN BERNANKE. President Fisher.

MR. FISHER. Mr. Chairman, at the last meeting, I reported the comments of a CEO of a big box retailer who said the economy was "amazing." I suppose the best summary of what I'm about to report to you in terms of my readings in the field—this time I assiduously talked to twenty-five CEOs and COOs, and I'll give you that list separately so I won't bore you with the details—the economy is even more amazing than it was before. That is, we see a shift taking place from consumption-driven to business-investment-driven growth, but also, unfortunately, we see evidence that inflation is raising its ugly head and that inflation expectations are higher as we go through time.

Let me give you some specifics. According to reports from shippers that I’ve talked to, the shipping market for bulk and containers is stronger in the second quarter than it was in the first quarter. Karen, there is a report, which is why I would like to see a more definitive version, of fleet utilization running well over 90 percent and waiting time in ports increasing significantly. My rail contacts report that rail traffic as of April 22 is up 4½ percent for the year. They expect higher growth in the second quarter than in the first quarter. UPS is planning for “some moderation in volume” but “hasn’t seen any sign yet of a slowdown, discounting for the late Easter.” An airline with 80 million passengers reports very strong advance bookings through July in every region of the country.

Some pressure from gas going over $3 at the pump has been reported, particularly in the past two weeks, by the retailers at every price point; and yet there’s an interesting shift taking place. For example, JCPenney now runs a billion dollars worth of sales through the Internet. That growth rate is increasing; it’s 23 percent. This way of presenting their products to the market helps to offset the oil price effect.

In the IT sector, the book-to-bill ratio of the large semiconductors is still greater than 1. Companies like EDS and other “productivity enhancers” are seeing increased demand for their products, which they interpret as a vote of confidence. We’re also seeing increased demand for storage capacity, which many would interpret as a vote of confidence going forward in the business picture.

From the largest bank in our District, the report is that volume is “so good you’re able to eat it.” They report, by the way—I don’t want to give offense to any sector of our economy—that the only people having credit problems are personal injury lawyers in Texas because of the reform that has taken place there. But other than that, the credits, as reported by banks, look to be in very, very good shape.

In terms of the housing market, you may recall my last report from a large house builder who built 400,000 homes thus far. I've expanded that to another builder of similar size. The cancellation rate now, David, is up to 40 percent—a key indicator. However, it has shifted around the country, and in our state they report that you'd have to be a princess on a pea to feel any discomfort with the Texas housing market. It is booming, unlike the Florida market—which, as you know, is cascading.

As far as cost-cutting capital expansion, it continues. Fluor reports a remarkable first-time-in-history statistic, which is that every single sector that they deal with, and every one of their product lines, is on the uptick. I want to report one particular project in summary that just puts things in perspective. Texas Utilities is about to announce a $10 billion coal-processing plant. This is conversion from coal to electricity. It will generate 40,000 jobs in our state to construct and 21,000 permanent jobs. But here's the interesting statistic. It'll take 12 million manhours and womanhours to construct. The CEO reports that ten years ago all those jobs would have been American jobs. Only 4 million of the manhours and womanhours to construct this project will be American jobs; the rest of the construction will be done in China or in Germany. Five years ago, it would have taken six years to build. According to the CEO, they'll build it in three years, and to go to President Moskow's point, yesterday the CEO of a large—as we used to say—"underwriting house" in New York offered to assume all the financing. They will finance at 100 percent nonrecourse. There's a lot of liquidity in the system.

We are concerned about prices. We see pricing power creeping upward in the reports we're getting from the CEOs. As you know, our compass in Dallas is the trimmed mean PCE. It's running at a rate of about 2.3 percent. At some point in the future, Mr. Chairman, I would like to provide a memo on that particular measure of inflation, which we consider to be a more reliable indicator of future inflation. But the point is that, in all of our soundings among these operators of businesses, they are feeling increasing price pressure, both at the intermediate level and at the consumer level.

There are two little indicators that I found interesting. One is that Texas Instruments, which usually has 200 or 300 jobs maximum outstanding and looks for highly trained engineers, is now trying to fill 1,000 of those jobs and having trouble filling them. Second, at the other end of the range, 7-Eleven reports that in Florida, the Great Lakes District, and the Chesapeake Bay area, they cannot find $7- to $8-an-hour sales clerks. They are having to raise their prices.

In short, we view this economy to be something like a 2006 BMW Z4 Roadster—Bluetooth-enabled, by the way. It's complex, it's highly integrated, it's a technically advanced machine that apparently cannot help itself from exceeding the speed limit. [Laughter] Thank you.

MS. BIES. My husband will attest to that. [Laughter]

CHAIRMAN BERNANKE. President Fisher, you don't see any drag from high interest rates or energy prices on this overall strength?

MR. FISHER. The two house builders together built 700,000 homes; as you know, that industry is consolidating. I asked them point blank whether the rates are killing them. Now, you have to take this with some skepticism, but they said no. The real issue here is that this highly speculative medium is becoming incredibly liquid. There is obviously a self-feeding mechanism, and the statistic that probably illustrates it best is Palm Beach, Florida. Last year, 6,000 homes were listed for sale. This year, as of last week, 17,000 homes are listed for sale. So what you have is a secondary market that is being speculated with, and advance liquidity provided by the financing mechanisms, and a lot of turmoil in that portfolio. This type of entrepreneur almost always sees things as better than they actually are, and I do pay very close attention to the kind of data that we're seeing. But interest rates don't seem to be the key issue, though obviously they kick in because of the way mortgages are priced.

As far as the consumer is concerned—and Bill and I both talk to Wal-Mart in depth—they are obviously more worried about gas prices than they are about interest rates. So I have a bit of schizophrenia like David. David, schizophrenia beats dining alone. [Laughter] We can always talk to ourselves, when we can't talk to anybody else. The net feeling is that growth is stronger than we're forecasting, and inflation—I agree with President Lacker and the others—is making me feel uncomfortable.

CHAIRMAN BERNANKE. I'm still trying to understand that comment about the schizophrenia. [Laughter] President Poole.

MR. POOLE. Thank you, Mr. Chairman. I'm not going to try to help you on that one. [Laughter] I'm going to try to be very brief here because I want to reserve more of my fair share of the time to the policy discussion.

One of the problems with the anecdotal reports, of course, is the unsystematic way in which we do them. I'm well aware that some of the answers you get depend on the way you phrase the questions. Some of my contacts say that the economy is doing fine, no real problems. One of my contacts from the trucking industry said that the economy looks pretty stable—"boringly normal" is the way he put it. I don't have any contacts, though, who say that they see any sign of weakness. They're not complaining about signs of weakness, and some of the contacts are saying that things are pretty doggone strong. So that's my attempt to filter the observation.

Now, let me just give you a couple of particularly interesting anecdotes. My Wal-Mart contact talked about construction costs. He said even in Indiana, which is not known as one of the great growth states in this country—

MR. MOSKOW. Wait a minute. I have to make a two-handed intervention on that one. [Laughter]

MR. POOLE. Okay. Anyway, he said that their construction costs—for a store, I guess—have come in 27 percent above expectations. Their construction costs are even higher in the Gulf Coast area.

He also said that Wal-Mart is in the process of raising starting wages in about 700 stores. This is the first time in eight years of talking with him that I've heard any comment like that. He said that some of the raises are part of the Wal-Mart, I'll call it "social/political," agenda because of all the controversy about Wal-Mart. But he said about 125 of these were market driven, that they have plenty of labor in rural areas and in urban areas, but they are developing a labor supply problem for their stores in suburban areas. Suburban areas are strong.

I have received some unsolicited e-mail messages—well, I guess to be fair they're sort of solicited. [Laughter] These are from two directors: "Heavy construction industry is really hot. In the past month, I have received reports of a second round of capital cost increases of 25 to 40 percent in the refining industry, and the same for construction of large power plants. These estimates follow similar increases last summer." Another message discussed pressures on the cost of construction materials. I won't read the whole thing. It says, "We believe we are now on the front side of a real surge in prices that will mainly affect highly volatile commodity building products—steel, copper, aluminum, and zinc. However, if it is sustained, it will ripple across a broad range of more-manufactured products."

Now, very briefly, I've made a list of what I think are classic inflation warning signs, and I'll just rattle these off very quickly. Inflation expectations—we've talked about that. Dollar depreciation. Commodity prices are really breaking out of a trading range that has prevailed for about fifteen years—if you look at the chart in the Greenbook Part 2, you'll see that. The surge in construction costs—I think there is a building boom indicating business confidence, and, of course, a direct source of aggregate demand. Relatively low risk spreads, making it easy for firms to raise capital. Strong stock market. Strong corporate profits. From our anecdotal information, some increase in pricing power. And a worldwide boom. There is growth in almost every region of the world, and, of course, that translates to some extent into price pressures everywhere, including goods that we import and goods that we export, at least eventually. I’ll stop there. Thank you.

CHAIRMAN BERNANKE. President Poole, did your contacts have anything to say about the issue of whether the strength in retail sales was a seasonal factor or something else?

MR. POOLE. Wal-Mart, of course, follows those numbers very closely. My contact said that it’s very difficult to sort out what happens when Easter moves the way it does, particularly this time. He said he would just take March and April together. Those two months together came in at 3.8 percent, same-store comparison year over year, and they had 3.9 in their plan—3.8 versus 3.9. That came in just about exactly as they had anticipated. He did say that they are observing a clear response to the gasoline price increases. They are seeing fewer trips to the store, a decline or less growth in the number of sales tickets, and an increased number of sales on each sales ticket, which is a logical thing for consumers to do.

CHAIRMAN BERNANKE. Thank you. President Minehan.

MS. MINEHAN. Thank you very much, Mr. Chairman. Current economic conditions are fair to good in New England. Consumers report rising confidence, at least in the current situation. Manufacturers report solid domestic and international demand. Business confidence is also good relative to the current situation. Unemployment claims and online job postings suggest continuing positive employment momentum. Northern-tier tourism was hurt by lackluster winter weather, but reportedly tourism in Boston has been quite strong. And even with the poor winter season, tax revenues have grown considerably above budget in all but Rhode Island.

On the not-so-hot side, residential real estate markets apparently have slowed, particularly at the high end, with rising inventories of unsold expensive homes. Reportedly, however, more moderately priced homes continue to sell, though transaction volumes for the region as a whole are trailing off.

Average selling prices for single-family homes continue to increase according to conventional home price indexes, the last ones of which we had for the final quarter of last year. More-recent anecdotes also suggest that they have been increasing. However, the rates of increase are down to single digits. To some contacts, the market, though slower, seems healthier and more realistic.

From a wide range of contacts I have spoken with since the last meeting, I want to highlight three concerns. First, rising costs for energy, transportation, and raw materials are pushing price increases. These are more likely to be tolerated by customers than in the recent past. And firms that say they are unable to pass on such increases report that they expect considerable bottom-line deterioration as a result. Second, skilled labor across a wide range of industries is harder to find and expensive, though planned overall wage increases do not seem to be larger than a year ago. So there is some issue here of skilled labor versus unskilled labor differentials. Finally, there is a general worry, despite pretty good current economic conditions, that energy and energy-related costs will eat into consumer demand and, combined with the flattening in housing markets, will affect growth prospects.

Now, on the national scene, our forecast is just about the same as the Greenbook's. Growth slows for the rest of this year to next and in '07 is slightly below potential. Unemployment rises slightly, even with continued pretty good job growth. Inflation first rises and then falls. It's the same general forecast we've had for a while. But the question is where the risks to this forecast are. To me they seem to have risen, perhaps on both sides, but I'd say they're a bit tilted to higher price growth. Q1 growth was clearly above expectations. Some of this was frontloaded into January. April employment was on the slow side; there is some evidence of slowing in housing markets, though prices continue to rise; and household wealth, including stock market wealth, is rising as well.

The longer end of the yield curve has turned up, tightening financial conditions somewhat, though corporate profits remain strong and credit spreads remain narrow. It's possible we're seeing consumer spending slow, but business spending has strengthened. Thus, while the best guess is that the trajectory for growth is downward, how much and how fast remains uncertain and is a part more of the forecast than of the current picture.

On the other hand, although incoming core inflation data have tracked only a bit above what we had expected, I'm not comfortable with what might be called the inflation atmosphere. With inflation compensation and inflation expectations rising, the dollar falling, and gasoline prices around $3 a gallon, it seems to me that inflation risks really have tilted somewhat. I know that each of these may turn out to be transitory. It's also true that, as yet, indications of wage pressures have been mixed, and while productivity growth has been trending lower, it remains quite healthy. The global competition that characterized much of the past ten years remains healthy, and profit margins are wide enough on average to absorb the rising input costs related to a growing world.

Still, anticipating core PCE price growth at 2½ percent, as the Greenbook does for this quarter, makes me at least pause. Given the six-month and the three-month rates of growth in core PCE, a slowing in rates of price growth, while expected, still is only part of the forecast.

In sum, although the forecast is rosy—perhaps a bit too rosy—risks to the realization of that forecast appear to have risen. Some of these may be on the downside, but we are also at a point where estimating the economy's remaining capacity is difficult, and the atmosphere of the inflation picture has changed. So though I don't want to overreact or be accused of doing so, I am less sure than I was at our last meeting about both where we are and where we need to be.

CHAIRMAN BERNANKE. Thank you. President Pianalto.

MS. PIANALTO. Thank you, Mr. Chairman. Based on the reports from my directors and my business contacts in the Fourth District, the relatively broad-based growth of the first quarter appears to have carried over into April. However, their comments about the balance of the year are consistent with the moderating trend of the Greenbook baseline projection.

To put it in terms used by the Conference Board's consumer sentiment measures, the current condition index is high, but the expectations index is falling. I was reminded by my staff as we were preparing for this meeting that real-time data on real economic growth are difficult to assess. At the end of our rate-increase cycle in 2000, the GDP figures were providing unreliable signals about the underlying strength of the economy. We had a second quarter that had real growth of more than 6 percent. We were forecasting, and even saw in the advance figures a very strong third quarter, and yet we had negative growth in that quarter.

Comments I hear about price pressures contain some mixed messages. I don't hear many complaints about price pressures except for the obvious ones about the energy-related costs and material shortages in construction-related businesses. However, I am hearing concerns about the persistence of these costs and the possibility that they may have negative consequences for both inflation and overall business conditions.

The consequences of the energy shocks for prices are already apparent. At our November meeting, I agreed with the Board staff projection that we would, at about this time, find ourselves facing some pass-through in our core inflation measures from some of the previous energy-price increases. At that time, however, it also appeared that headline inflation would be coming down at this point. Obviously, the current Greenbook suggests that recent oil shocks have taken that scenario away from us, at least for the immediate future, and the tick-up in expected core inflation is now even further away from my comfort zone than before.

That said, based on what I'm hearing from my directors and business contacts, the Greenbook's assessment of current conditions and baseline projections going forward seem about right to me. But I sense rather significant perceived risks both that economic growth might turn out weaker than I expect and that inflationary pressures might be larger or even more persistent than I expect. If we can take any encouragement from this, it would be that similar sentiments were expressed during the run-up in oil and gas prices last fall, and those sentiments did abate fairly quickly when the energy market situation stabilized. Unlike many of my colleagues who have spoken ahead of me, I do think that the risks are weighted against both of our objectives, and, obviously, that's not a comfortable place for a monetary policymaker to be in. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. First Vice President Stone.

MR. STONE. Thank you, Mr. Chairman. Economic activity in the Third District continues to advance at a solid pace. Growth in our region has been steadier than in the nation over the past two quarters. Payroll employment grew in each of the three states through March, and the three-state unemployment rate is now 4½ percent. Our business contacts in the region report increased difficulty in filling open positions. In addition, our employment diffusion index in the business outlook survey rose sharply in April. Regional manufacturing activity continues to expand at a moderate pace. In response to a special survey question in April, the majority of participants said that underlying demand for their products was increasing.

On the retail side, performance looks solid. Some of that is seasonal. On the auto side, sales have picked up slightly, but we see some small dealerships actually going out of business. Our retailers have expressed less concern than I've heard around the table about the impact of gasoline prices on their sales going forward.

While initial reports of nonresidential construction contracts in our region have declined in recent months, demand for office and industrial space in the District continues to strengthen. The office market absorption rate is rising in the Philadelphia metropolitan area, and vacancy rates are declining in both the city and the suburbs. Results of the special survey conducted by the Reserve Bank suggest that commercial construction activity is somewhat softer in our District than in the nation as a whole. Nonetheless, our contacts do see a stronger picture this year than they did last year. In the residential sector, home sales have slowed since the winter. Inventories and time on the market have increased. Demand has fallen particularly for higher-priced homes, more so than for lower-priced homes, and house-price appreciation is slowing in our region.

Prices for industrial goods are rising, and construction firms are reporting some shortages of structural materials. Some area builders are starting to stockpile copper, aluminum, and steel for upcoming projects. Employers in a number of industries in our region report that they have paid higher salaries for workers this year compared with hires in similar positions last year. At this time of the year, we usually are traveling around the District and conferring with bankers and other businesses as we're doing our annual field meetings. Over the past week, we were in the typically most depressed areas of our District—the far western part of our District—and for the first time in many years I was hearing optimism about the future and reports of an actual substantial decline in the unemployment rates in those areas.

Turning to the national conditions, our economic outlook is broadly consistent with the Greenbook baseline. However, we see somewhat more economic strength and somewhat higher inflation going forward. We also note that many forecasters have also revised up their forecasts of the second quarter based on the strength of incoming data. Business spending and manufacturing continue to show strength. Notwithstanding the April unemployment report, which came in lower than expected, employment remains strong. Monthly gains have accelerated to an average of 173,000 jobs this year, compared with 165,000 last year. Employment growth will support consumer spending even as house-price appreciation slows. The rising gasoline prices will have a damping effect but probably not a dramatic one. There are no signs of a sharp retrenchment in housing. So far, the slowing has been orderly. With the economy expected to remain at full employment and with labor markets tight, we expect hourly compensation growth to accelerate over the forecast period, but not dramatically so.

I recognize that higher oil prices and higher long-term interest rates pose a downside risk to growth and that the downturn in housing and the monetary policy tightening already in the pipeline could prove to be a bigger drag than anticipated. But in my view, given the underlying strength of the economy, the risks to growth are roughly balanced or perhaps even tilted modestly to the upside.

I have somewhat more concern about inflation over the intermeeting period. It's true that we haven't seen an acceleration in core inflation measured year over year. But at shorter horizons, as has been previously mentioned, we've seen a marked uptick in core inflation. In addition, inflation forecasts have been revised up, reflecting the recent higher-than-expected inflation data and the view that higher oil prices might add to inflationary pressures. Longer-run inflation expectations, as measured by the TIPS and the Michigan survey, as reported earlier, are apparently up somewhat, which is troubling to me. Higher productivity growth will help to keep inflation in check. With inflation running at the top of the range that I consider consistent with price stability and with the economy operating at high levels of resource utilization, there's a risk that stronger inflation pressures could emerge. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. Let me start with our District. Evidence from the District continues to show strong growth. While consumer spending has shown some modest slowing, retailers remain very optimistic in our surveys about future sales, and this despite some of the recent increases in energy prices. Manufacturing activity continues to grow solidly, and energy activity remains, of course, very strong in our area, with continued reports of shortages of both labor and equipment.

Housing markets in the District are cooling, as you've heard described elsewhere, and illustrate I think a potential downside risk overall. Though it's still high by historical standards, residential construction continues to edge downward. Home sales were still growing modestly in most areas but not fast enough to absorb the supply of homes being brought on the market. As a result, first-quarter inventories in the largest District markets have grown markedly relative to a year ago. In addition, foreclosures also point to some weakening in the housing market. I guess the most notable is a 31 percent increase in March over the previous month that pushed Colorado to the highest foreclosure rate in the nation—as reported anyway. One factor behind the increase is the unusually widespread use of interest-only mortgages in that state. However, nonresidential construction in Colorado and elsewhere in the District appears to be taking up some of the slack from the housing side.

Let me turn to the nation and try to be brief. The contours of the outlook that we have are similar to what I reported at our last meeting and not unlike that from the Greenbook. Several factors suggest that the economy will slow over the forecast period. First, as I've suggested before, the removal of policy accommodation continues to have its effect. Second, long-term interest rates have, as others reported, risen noticeably. Third, energy prices continue to increase, reducing consumer purchasing power. Finally, we've been forecasting a slowdown in housing, but there is a risk that the slowdown could be actually larger than expected.

Of course, there are counterbalancing factors that would show continued growth. Those have been outlined by others, but certainly the past stimulus in the amount of liquidity in the market has its effects. In addition, we are seeing improvements in employment and in income, which should help keep the economy moving forward.

On the inflation outlook, as others have noted, the recent increase in inflation is a concern to me, but it is not a surprise. We have been expecting last year's increase in energy prices to feed into a temporary rise in core inflation. We've seen that. More recent increases in energy are going to complicate that situation.

So in the end, as we prepare for the next portion of this discussion this morning, I would agree with all my colleagues on one thing—monetary policy is going to be much more difficult in the next few months. [Laughter]

CHAIRMAN BERNANKE. Thank you. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. Since our last meeting, regional data and anecdotal information from our various contacts suggest that the Southeast region economy continues to have good momentum. Let me comment on just a few specific areas where what we're seeing in our District may help to inform our view of the larger national economy.

Regional employment gains continue to be strong, and we're hearing more and more stories of tighter labor markets for a number of skills, mostly in construction and skilled professional positions, and compensation is going up significantly in a number of those areas. At the same time, we also hear over and over about the lengths to which businesses are going to offset those wage increases with productivity gains, most making greater use of technology and process re-engineering.

Like others, we're continuing to see evidence of cooling in house sales and prices and a growing inventory of unsold homes in some of our markets. The CEO of one of the nation's largest home builders, who is headquartered in Atlanta and with whom I talk regularly, explained that a number of factors, in his view, have come together to precipitate that slowing—overbuilding, higher mortgage rates, a retreat of housing speculators, earlier conversion of many rental apartments to for-sale units, and now the wait-and-see attitude among those who still expect to purchase at some point. He reinforced my sense that, while the cooling-off in housing is being felt to some extent in most markets, so far it is only the frothy coastal markets, like South Florida, that have seen a significant adjustment.

The high cost of energy and industrial commodities is very much on people's minds in our area, but the pass-through of those costs still seems to be limited. Clearly, transportation costs are up significantly because of cost pass-through. Some construction projects, including a few that were substantially sold out in the preconstruction phase, are being canceled and deposits are being returned because the construction material costs would make projects unprofitable. An example of those cost pressures in construction: A large builder told me last week that what he paid for copper wiring most recently was four times what he paid just a year ago. As an example of energy price pass-through, one member of our Small Business, Agriculture, and Labor Advisory Council related a story last week that is just too good not to share. He said he was at a neighborhood gas station, in the middle of filling the tank of his big SUV, when the pumps suddenly stopped across the entire gas station. An attendant came on the speaker system and announced that they were instituting an increase of ten cents a gallon. [Laughter] And the ringer is that the increase would apply not only to the remainder of the gas he was about to pump but what he had already pumped. [Laughter] Good story. What I would call real-time pass-through. [Laughter]

While overall performance seems solid, the outlook is not nearly so bright in the hurricane-affected areas, with which we're still struggling. The situation is especially difficult in New Orleans, where the damage was due largely to flooding and standing water, compared with the Mississippi coast, where damage was due to storm surge and wind. Debris cleanup and infrastructure repairs still dominate the reconstruction efforts. Even the demolition of damaged structures in New Orleans has barely begun, and there are few signs of any rebuilding in many of the more heavily flooded areas of the city. New Orleans lost not only more than 200,000 jobs but also about the same number of homes, which were either destroyed or suffered major damage. Little progress has been made in replacing either the jobs or the homes, and less than one-half of the pre-Katrina population is now back living in the city.

There are a number of reasons for the lack of progress, including complex levee repairs; the need to redraw flood plains and set permit policies; political in-fighting; a shortage of workers and supplies; and insurance complications—just to mention a few. For instance, the Corps of Engineers, which has some 150 people working out of our New Orleans Fed office, managing their projects, expects to repair the levee system by June 1, which is the official start of the new hurricane season. But those repairs will bring the levees only to their pre-Katrina status, and longer-term solutions and spending will take years to implement. Even after eight months, oil and gas supplies still remain disrupted. Just under 23 percent of crude oil and 13 percent of natural gas production in the Gulf remain shut in, and the critical Mars platform, which accounts for about 40 percent of that shut-in, is still not up and running.

Critical to the slow recovery process is the lack of housing for either returning or temporary workers. Without housing, the economies in the affected areas will be slow to recover. There are practical realities that also need to be faced. People can’t continue to live in FEMA trailers forever, and those who are doing so are beginning to show signs of stress. We have twelve of our own employees in trailers in our parking lot. We’ve come to the view, which I’ve talked about before, that the experience from our past hurricanes may provide little guidance about either the pace or the path of recovery. We’re monitoring developments very carefully and also initiating some research projects to better understand the recovery process.

Turning to the national economy, I’m encouraged that our collective forecast for a rebound in the first quarter was in fact on target, but I am less certain about the path going forward. I, like others, see both upside and downside risks to real output and employment. Major downside risks continue to be rooted in the possible effects of energy cost increases on consumer spending and business costs; potential consequences of a greater-than-anticipated slowdown in housing; and the impact of both short-term and longer-term interest rates, which have risen.

Other key factors that could result in better-than-expected outcomes lie in the potential increase in investment spending; a surge in nonresidential and commercial construction; continued strength in consumer spending, particularly in durables and autos; and a pickup in inventory accumulation. While my own staff's forecasts for this meeting show a slowdown in the second half of the year, I'm not terribly confident about the specific sources from which that slowing will eventually come.

Of greater concern to me, however, is the inflation outlook. The core measures continue to be in the upper range of what most of us have indicated is acceptable. The trends in these and headline inflation measures are data that the public observe and that affect inflation expectations, and it behooves us not to ignore them in favor of more-benign forecasts. I am, therefore, concerned that we not do anything today to suggest that we have lost focus on either inflation or the way in which we intend to achieve our inflation objective. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. President Stern.

MR. STERN. Thank you, Mr. Chairman. The District economy continues to perform well, and the ongoing expansion is broadly based. Given that summary, let me just comment on three particular areas, beginning with a few things of interest that came out of a breakfast we had a couple of weeks ago with the leaders of the Twin Cities financial community.

First, hiring costs reportedly are rising significantly in order to attract college graduates and those with advanced degrees. This has implications for salaries more broadly because of internal compression and retention issues—perhaps not a surprise given the duration of the expansion and the gains in employment over the past several years.

Second, and this is largely by way of confirming things that have been in the press lately, distinctions between the activities of commercial banks and much more specialized firms like hedge funds, venture capitalists, and private equity firms are diminishing, as the last group is invading the banks' turf, especially in providing credit of one form or another to business. This was also a theme at a financial institutions dinner I attended a few weeks earlier. These competitive pressures may help to explain the results from the latest survey of senior loan officers indicating further easing of standards and terms for C&I (commercial and industrial) loans.

The third area I want to comment on is housing. Data through April show that activity in the District in terms of starts and permits is running so far this year at about the same pace that it ran last year. However, according to a variety of anecdotal reports, speculative building is slowing dramatically if not stopping altogether, and the high end of the housing market, interestingly enough, is doing better, perhaps far better, than the lower tiers. There are reports of price softening in the middle part of the market. Given the volume of projects that are currently under way in the District, I would judge that the inventory of unsold homes, especially of condominiums, will continue to rise, and the pace of price increase will moderate further, if not turn negative in some markets.

As to the national economy, growth appears to me to be healthy and is likely to be well sustained as best I can determine. Still, I think that there are a few straws in the wind that suggest that some deceleration is in the offing, including the evolution of housing activity and the diminution of the positive wealth effect, at least from that source. I do not want to exaggerate that effect at this moment. It is based largely on what we are seeing in the most recent data, but the anecdotes, at least that I am getting, are consistent with that. Also, while it seems pretty clear that the economy has weathered the run-up in energy prices well, we should not lose sight of its negative implications for real incomes and ultimately for spending. As for inflation, here it seems to me that uncertainty about the outlook has increased, as the core numbers have come in a touch above what I had earlier anticipated. Also, inflation expectations appear to have deteriorated. Still, in my experience, it is not a good idea to overemphasize high-frequency observations, and as a consequence of that, I am not ready yet to raise my inflation forecast.

CHAIRMAN BERNANKE. Thank you. Vice Chairman Geithner.

VICE CHAIRMAN GEITHNER. Thank you, Mr. Chairman. The basic contours of our forecast are essentially unchanged since March and are very similar to the Greenbook's. However, the balance of risks has changed a little in our view, somewhat to the upside on inflation. But as in March, we expect core PCE inflation to run a little over 2 percent in '06 and to moderate slightly below that in '07 as tighter policy works to slow overall demand growth. We expect real growth to rise in the vicinity of its potential rate—3¼, 3½ percent—throughout '07. So we are a little higher than the Greenbook in that sense.

As before, this forecast rests on some important assumptions: that little or no slack is left in resource utilization, that inflation expectations are held in check, and that term premiums remain relatively low by historical standards. The recent moves in medium-term inflation expectations and the rise in the other components of forward interest rates cast some doubts on these last two assumptions. For these and other reasons, we see a little more uncertainty around our central forecast than we did in our last meeting.

However, on the growth outlook, on balance the recent data seem to confirm the picture of real GDP moderating toward potential. We face the familiar sources of risk to the downside, but not all the risks are to the downside. We may be underestimating the momentum in final demand growth. I think it is important to note that it is hard to find evidence in credit spreads or in equity prices of a substantial growth slowdown in prospect.

On inflation, recent developments are not all that dark, but neither have they been entirely reassuring. Let me just go through the factors that we think are critical to the outlook on the inflation side. Almost every measure of underlying inflation that we look at is now above the level we generally associate with price stability. Headline inflation has been running and is still running substantially above core, and even with interest rates close to long-run measures of equilibrium, the staff forecast does not anticipate much moderation in core inflation over the two-year or even three-year or four-year period. Compensation growth does not yet appear to have accelerated significantly, and the growth of unit labor costs has remained reassuringly moderate. However, compensation to us seems likely to strengthen, and it is unlikely that productivity growth is going to accelerate significantly from current levels. Demand growth is still probably running a bit above potential here and in large parts of the world economy; with real short-term rates still quite low around the world and monetary policy only just beginning to tighten in many of those economies, global pressure on resource utilization may intensify or at least continue at its current intensity rather than moderate. And the rise in energy prices and commodity prices, of course, suggests a fair amount of strength in global demand.

Our assumption that energy prices follow the futures curve means that our forecast is, of course, still vulnerable as it has been over the past three years to further upside surprises. It would be easier to discount this risk if we could determine with confidence the extent to which temporary supply factors rather than unrecognized or unanticipated strength in global demand have accounted for the trajectory of energy prices over the past few years.

We face a lot of uncertainty about the likely path of the dollar, and the prospect of a significantly weaker dollar adds another source of upside risk to inflation and expected future inflation. We obviously have some uncertainty about the extent to which margins will prove flexible in the face of higher cost pressures.

Finally, we have seen a material rise in long-term inflation expectations in the United States over the past several months, and this should make us somewhat less confident that we can assume that the gap between headline and core will be closed with headline moving down to core. Inflation expectations seem to have risen more here than in other countries, and the recent changes in the relationship between changes in short-term expectations about U.S. monetary policy and changes in breakeven inflation rates is somewhat disconcerting, with expectations deteriorating when statements by Committee members were interpreted as lowering the probability of moves beyond our meeting today. This pattern is more troubling than the size of the rise in medium-term inflation expectations. And I just want to make one comment in response to something Janet said. Even if we could tell with confidence how much of this rise in breakeven inflation was about uncertainty or inflation risk premiums and how much was actually about future expectations about inflation and even if we thought a substantial amount of that was uncertainty, it is not clear that that would be particularly reassuring in terms of credibility or in terms of its implications for monetary policy. So underlying inflation is less contained than we would like it to be, and it is expected to moderate less than we might hope. Both short-term and long-term measures of expectations have moved up uncomfortably, and we see somewhat greater upside risk to our inflation forecast than we did in March.

Now, what might we learn over the next six weeks that would change our view about the outlook and its implications for monetary policy? We actually think it is unlikely that data are going to provide us with very strong signals that policy is markedly off track, but there are two important things to watch. One is the behavior of long-term inflation expectations. If those expectations were to continue to rise, that would obviously be a source of concern; and if inflation expectations were not responsive to changes in expectations about the path of the funds rate, that would also be troubling. On the data front, we at least will want to watch to see if the expected moderation in manufacturing activity in the United States materializes. If, in contrast, manufacturing activity here sustains its recent pace, it might suggest that growth abroad has picked up more than we thought or that the dollar is having a bigger effect in stimulating exports than we anticipated. These conditions would increase concern about upside risks to our central forecast because, of course, that forecast relies on a slowdown in overall domestic demand growth mitigating upward pressure on inflation over the forecast period.

Just a few points to end on the topic of uncertainty: Even though the fundamental news is pretty positive and reassuring, we are now at the point where the limits of our knowledge about the underlying forces that affect the outlook for aggregate demand, supply, and inflation matter more than they have in the recent past. Relatively small differences, differences well within the limits of our knowledge about trend growth and productivity or employment or other factors, have more impact on our choices about monetary policy in the near term than they would have had over the past two years.

What should we conclude from the substantial rise in real forward rates that we have seen over the past few months? This move, which has occurred across the major economies, brings expected real rates more in line with long-term averages, reducing, if not eliminating, the anomalistic line we had such trouble understanding. Now, does this mean we have less to do in terms of future tightening than we thought? Maybe. Or it might mean that monetary policy has been more stimulative than we thought and that we will have to do more to make up for that going forward. The fact that we cannot fully explain why these measures of expected real rates have moved around as much as they have just adds to the uncertainty we face today about how tight policy actually is. It is also a bit of a puzzle that measures of uncertainty about future interest rates have not increased very much, and I do think it is important that we try to continue encouraging—it is uncomfortable to say this—or to at least avoid discouraging an increase in uncertainty that is more commensurate with what we are experiencing ourselves. [Laughter] Monetary policy works through expectations, but our job is harder when we are not truly sure what we want to do to those expectations. Trying to make sure that we are not pushing down uncertainty as we continue to make sure that the markets understand that we're going to work to keep inflation low and stable remains our principal challenge. Thank you.

CHAIRMAN BERNANKE. I will comment as well on TIPS spreads, but those markets are fairly concentrated, and therefore, liquidity issues sometimes play a role in these high-frequency movements.

VICE CHAIRMAN GEITHNER. I agree. I am not sure that the movements are that large and that you can attribute that much to these differences, but I do think you want to look carefully at what happens to those expectations when expectations change about monetary policy in the near term. It is that pattern which is somewhat disconcerting.

CHAIRMAN BERNANKE. Governor Olson.

MR. OLSON. Thank you, Mr. Chairman. Mid-May in an election year is a good time to look at the effect of the fiscal budget on the economy. In an election year, any legislation that has not largely moved toward passage by Memorial Day likely is not going to happen. We have seen reports of federal receipts received to this point, and we have a good idea about what the budget impact would be.

The staff estimate now is that the 2006 budget deficit will be about $100 billion less than the original estimate of the Administration. That would be equal to 2.2 percent of GDP in ’06, compared with 2.6 percent in ’05. The improvement is largely revenue driven; as David indicated, government spending is up. Through April, revenues are up 15 percent from ’05 and, for April and May, up 25 percent over the previous year. Reasons for the increase will not be entirely known for a while, but there are several candidates. David Wilcox and others suggested capital gains—although if you use as benchmarks the distributed capital gains for mutual funds or the capital gains that may have resulted from stock market activity in ’05, it seems unlikely to be a strong candidate. Capital gains from real estate investments, given the exclusion allowed for couples selling a primary residence, also is not a strong candidate. So there are two other possibilities. One is that the BEA may be underestimating the income from Sub-S corporations that is passed through to individual tax returns or from income from partnerships. Another may be that there is a redistribution of income toward the higher tax brackets and therefore the unavoidability of the alternative minimum tax. Also, corporate income taxes are up again, indicating the very strong underlying economy.

On the legislative front, we have a tax bill. An agreement was reached on a tax reconciliation bill. It pushed out one more year the alternative minimum tax that expired in 2005 and extended for two more years the lower rates on dividends and capital gains set to expire in 2008. There will be a second tax bill that is right now tied to the pension reform bill. A supplemental appropriations bill has passed the House and the Senate. The House version is at $92 billion; the Senate version, $109 billion. The President has indicated that he would veto the Senate version should it move forward. That would be his first veto during his term as President. There is no indication whatsoever that any portion of the President's tax panel's report from last fall will be realized in any tax legislation soon or be an issue in the 2006 election. That is not a surprise. The tax panel members last fall indicated that, because of the timing of its release, the report was unlikely to generate legislation, and they specifically did not put the report in legislative language, indicating that they instead wanted to talk more broadly about tax policy.

Budget resolutions have passed the Senate but not the House. The House is still debating the level of the budget resolution they would want to pass for '07. There is more focus in this Congress than we have seen recently on budget issues. The focus is not driven by any effort whatsoever to reimpose, for example, a PAYGO provision, but the earmarking process that had basically hijacked the appropriations process and generated some focus on roads to nowhere and bridges to nowhere has brought about a rethinking in some quarters as to whether or not there ought to be renewed budget focus.

Overall, the net effect is that both spending and revenues in '06 and probably '07 will be back to their fifty-year averages, which is to say about 18 percent of GDP on the revenue side and 20 percent on the spending side, although the swings obviously from year to year have been very dramatic. Thus, in the near term, there will not be a surprise effect on the budget and therefore on the economy. However, the report that was issued this week by the trustees of Medicare and Social Security revised only slightly the time frame within which those two spending areas will overwhelm the budget if not ultimately addressed—and there is no indication that will happen. That is the report from the congressional side for now.

CHAIRMAN BERNANKE. Thank you. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. I agree with many of the rest of you that inflation risks rose over the intermeeting period, though I think I see a more limited rise than I sensed from some of the comments I have heard. Several factors do suggest higher inflation risk. Stronger growth than expected has left resource utilization a little higher than we thought—only a touch, I think, but still higher. The core CPI and PCE data were disappointing—were higher than anticipated. That, however, did follow several months in which those data came in lower than we had expected. And if you look at the Greenbook's 2006 projection, it reverses a downward revision from last time. That is not to say it is not worrisome, but we were revising down for a while, and now we have had an upward revision.

I think the commodity price increases are hard to understand, especially outside the energy area, where you can think about supply disruptions. Both the energy prices and the commodity prices could feed through to a limited extent into headline inflation. I think they do indicate, at the very least, that global demand has continued to be quite strong. In that regard, they would add to global inflation risks.

The decline in the dollar is a bit worrisome. The pass-through to import prices has been very, very small over recent decades. But to the extent that the lower dollar is not passed through to import prices, it would be squeezing the profits of those people who are exporting to the United States, and I think, through either channel, this suggests at least a slight reduction in the competitive pressures on domestic producers—not big, but a slight reduction.

We did have a small uptick in inflation expectations looked at through the markets or the Michigan survey. However, those expectations are still in the range of recent years, and I can recall a number of occasions post-Katrina and in the last few springs in which they have ticked up in similar situations and then come back down again, particularly after energy prices leveled out.

None of these signs of higher inflation are very significant in and of themselves or if they were taken one by one; but taken together, they cannot be dismissed. They do suggest at least a small rise in inflation expectations and a small rise in inflation risk that could start pushing up underlying inflation further.

That said, the data we have received over the intermeeting period should give us a little more confidence that conditions are being put in place or are in train to limit these risks and to keep the upside risk limited. The trajectory of information over the intermeeting period, especially on consumption and housing, points to quite a bit of moderation of growth in the second quarter. We are looking at 3-point-something, and the issue is what the point-something is; it is not 4-point-something or 5-point-something. Housing market information, I think, confirms that there is a slowdown in process that will restrain aggregate demand going forward. Sales have bounced around a lot, but inventories have risen substantially by any measure. That is going to be weighing on prices. The price data are ambiguous and hard to read. If you take a heroic leap and start seasonally adjusting the existing house prices on a month-by-month basis instead of a twelve-month basis, it looks as though they have been flattening out. But we will get better data later. If, indeed, prices are flattening out, we have not yet really seen that effect on consumption. So in that sense, the tightening of policy and the flattening-out of housing prices are still in the pipeline.

Higher long-term interest rates: Some of that increase is an endogenous response to global growth and would require a higher path of short-term rates to keep inflation under control, but some of it is in the risk premium. The extent to which the risk premium has risen will damp demand for any given course of monetary policy. The energy-price increase will contribute to moderating growth of domestic demand, provided that we do not allow that energy-price increase to reduce real interest rates.

Like some others here, I am kind of encouraged by the data on labor compensation. They are mixed, but I have interpreted them on balance to suggest that pressures on businesses from labor cost developments are muted. The ECI is certainly consistent with that, and so are four-quarter changes in compensation per hour and unit labor costs. The markup of price over unit labor cost actually increased from a very high level to an even higher level. I agree with President Poole that businesses will not voluntarily give up that markup, but we do have a recent experience if you look in the late ’90s. That markup peaked at the end of ’97, I believe, and dropped very, very sharply in ’98 and ’99, despite the fact that the economy was growing with some vigor. You can see that on page 39 of the Greenbook. So perhaps we need to think about that episode and how it happened. Certainly we have a precedent for vigorous growth and declining markup absorbing rising compensation costs.

So where does that leave me overall? I agree with the staff. The most likely outcome—given the structure of interest rates, financial conditions, markets, and a flattening of energy prices—is for stable underlying inflation, core PCE to stay in the neighborhood of 2 percent, where it has been since early 2004. But I am a little more nervous about the stability than I was at the last meeting. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Governor Bies.

MS. BIES. Thank you, Mr. Chairman. In preparing for the meeting, one of the things I focused on was the graph that I like that tracks the staff forecasts over time because I am really torn between where I see growth going and where I see inflation expectations. In looking at the graph, one can clearly see, if you look back through Greenbooks to September ’05, that staff forecasts of core PCE inflation have been basically flat whereas real GDP growth forecasts for this year have increased quite a bit. The ’07 numbers are stable at a lower inflation rate and a lower growth rate.

But what troubles me so much, and somebody already mentioned it, is how much the various indicators of core inflation have picked up over recent periods in the actual data. As President Lacker mentioned, we have core PCE up 2.4 percent in the past couple of quarters. We have core CPI up 2.7 percent. If you look at core GDP prices over the whole of last year, you are running at just under 3 percent over that period; and that is without what we cannot quite measure yet, which is how much energy prices are passing through. The longer companies see that energy prices are going to remain high or go even higher—instead of being just a one-shot hurricane effect—the more likely we are to see some of these prices being passed through. So I am getting concerned about whether the lagged effects of the monetary policy changes so far are going to be enough to moderate the inflation that we are now observing to reach the goal of lower core inflation numbers in ’07.

On the real side, one area that I think is critical is the housing market. As you all know, I have continued to worry about what is going on in housing and mortgages and have wanted to give you another perspective on what we are observing. Most of you are well aware that we put out some supervisory guidance for comment awhile back on nontraditional mortgage loans, which include various forms of interest-only, adjustable-rate, negative-amortization mortgages. If you look at the 2005 earnings reports of the large mortgage banks and the large savings and loans that do mortgage lending, these institutions have a really striking amount of interest rate risk embedded in their negative amortization loans. As you know, most of the product is securitized and sold. So the relative share of these products originated in the last couple of years that are on the banks’ books is small overall. But the numbers have gotten so bad that now the setters of accounting standards want banks to disclose how much interest income they are recognizing as income that they have not collected, through this negative amortization. In other words, they bill the customer for this interest, but instead of making the customer give them the cash every month, they just add the amount to the outstanding balance and it creates negative amortization. For some of these big organizations, the amount represents 5 or 10 percent of net income from last year. So the number is growing, and we are looking to make sure that banks are appropriately putting aside reserves for the portion that may not be collectible.

In the past few weeks, I have become aware that the rising interest rates are creating more problems for customers in servicing debt. What President Hoenig has observed in Colorado in interest-only adjustable-rate mortgages is just the beginning. The Greenbook showed how much the subprime sector is going up; and we know, because ARMs are a big chunk of those mortgages, that it is starting to be felt. As we go forward and more of these ARMs, especially those that have three-year lock-in periods, start to reprice, we will be seeing more of it.

Now, the mortgage industry, ever creative and ever worrying about the ability of homeowners to pay amid rising rates, has now decided to create negative-amortization, fixed-rate mortgages. What these mortgages do is say, "Just borrow for your house. You have a monthly payment, no amortization of principal, and you do not even have to pay the full fixed rate. We will just continue to add to your principal, and you pay what you can afford every month versus what you really owe us on the fixed rate every month." This process just continues, and one thing that bothers me for the long run is the extent to which housing could slow this year and slow the economy. I just wonder about the consumer's ability to absorb shocks. The buildup of home equity and the ability to borrow against it have helped individual homeowners when they have had layoffs, medical problems, divorces—all the things in life that create month-to-month problems for cash flow. With the growth of negative amortization, home equity is not being built up anymore. Negative amortization clearly helps consumer spending because consumers, in effect, have a smaller amount of their take-home pay that has to go to the mortgage payment every month, and so it is available to be spent elsewhere. It is probably a more pernicious type of home equity withdrawal because you don't take an action to withdraw it. Now it is planned that you will have negative amortization. It clearly changes the way we look at the role of savings as a precautionary balance to get the consumer through bad times, and it also has long-run implications regarding the importance of asset values vis-à-vis default rates both for the banking sector and for the household sector.

So the growing ingenuity in the mortgage sector is making me more nervous as we go forward in this cycle, rather than comforted that we have learned a lesson. Some of the models the banks are using clearly were built in times of falling interest rates and rising housing prices. It is not clear what may happen when either of those trends turns around.

CHAIRMAN BERNANKE. Thank you. Governor Warsh.

MR. WARSH. Thank you, Mr. Chairman. I hesitate to joke here at my second FOMC. I made a joke at my first that the inaugural meeting requires the new Governors to sing, and my colleague took me up on that. [Laughter] So I will not offer a joke about dancing this time. [Laughter] In the interest of time. [Laughter]

Going to the central tendency in terms of where the economy is, I suppose I consider myself much more optimistic than the Greenbook forecast about the state of the economy. I think some of the shocks to the economy, energy prices being the latest, speak in some ways to the durability, the flexibility, and the resilience of this economy which, on the one hand, I shake my head about but, on the other hand, I think we have to believe to some degree.

I will not go into too many of the facts, which have already been described, but consumption was up 5½ percent in the first quarter. Business capital expenditures were up about 16½ percent on an annualized basis, with strong durable goods orders. And the increase in tax receipts that Governor Olson spoke about is a very good leading indicator, even though some of the details behind that increase are hard to know.

President Poole referenced the growth in corporate profits. Let me add a couple of notes on that. What we are really seeing in the equity capital markets is, by and large, profitability-driven growth in the S&P and in the Dow as opposed to some sort of P/E multiple expansion. It does give some of us more confidence in the strength that we are seeing in the equity capital markets as well as another source of optimism as to what some of the income-statement benefits might be to consumers.

As we think about what might be the elephants in the markets, certainly the housing market is one from FOMC meetings that preceded my time here. The new elephants in the market in terms of tone and tenor are inflation and inflation expectations. I would like to talk about them more in just a moment.

When we look at the data since our last meeting, though there is a lot of noise, on balance I share the view that they tend to be more positive than expectations. Average nonfarm payroll growth in the past six months was almost 200,000, including the April figure, and the idea of less-robust labor markets appears belied by the solid gains that we have seen in hours worked, the acceleration in wages, and the low unemployment rate, which is still at 4.7 percent. So our thinking about a possible slowdown in the second half of the year has to at least be balanced or perhaps partly counterbalanced by what could be the first meaningful gains in take-home pay for nonsupervisory workers. Understanding those income-statement benefits to real consumers is probably a more certain exercise at this point than trying to figure out the effect on the consumer of the housing markets, which Governor Bies spoke about.

On the business front, I am at least as optimistic as I was six weeks ago about the state of business investment. CEOs, when they have seen the appreciation of share prices in the last quarter, even as they have seen prices appreciate for many of their competitors, remain more robust, more excited, and, I think, more eager to spend money.

We have seen an increase in the backlog in debt underwriting by most of the big bulge-bracket firms, and so though some of that money is, no doubt, being spent on stock repurchases, some debt is being raised in expectation of merger and acquisition activity. At least part of it is based on a view that, as there is more uncertainty priced in the markets for the second half, companies are getting their ducks in a row to obtain some extra liquidity.

Let me make one final point before briefly talking about inflation. I am encouraged, like the rest of you, about the synchronized global growth that we are talking about. My biggest concern, particularly in May of an election year, is about what is likely to be a bipartisan foray into creeping protectionism in the dialogue of politicians here in Washington between now and the November elections. The position discussions about free trade that we have heard on both sides of the aisle over the past several years are, I think, going to diminish very significantly. There could also be many more discussions in highly contested congressional election districts about the need to isolate the U.S. markets, to cut ourselves off from a lot of foreign opportunities. To be candid, the business community probably isn't that eager to enter this debate with a message oriented toward free trade. So I do think that creeping protectionism may become stronger between now and November and will have consequences for our economy to integrate with foreign markets and to continue to expand. We may have more difficulty fighting back in some of the export markets, even with some depreciation of the dollar. The Federal Reserve has a possible role in trying to moderate some of that discussion.

Finally, just a moment on inflation: I guess the way I would characterize it from a market perspective, and I think this is consistent with Dino's and the Vice Chairman's comments, is that market expectations of inflation are more fragile than they were some months ago. I would not describe myself as an alarmist about that. However, the traders at many of the securities firms and the folks who are hitting the trading buttons are contemporaries of mine. They are from a generation that has not experienced inflation at first hand the way that some folks around this table have. The psychological point of that statement is that, though we may have seen some laxity in their concern about inflation over the preceding six months and even today, that laxity could turn into some irrationality if inflation expectations get above our reasonable expectations and our comfort level. On balance, I think that the markets, particularly those marginal traders, are looking for some leadership from the Federal Reserve. Perhaps we have seen somewhat less market discipline in the TIPS markets and in some of the other markets, such as commodities. Other folks have spoken more eloquently than I about what is happening in the TIPS markets and some of the dangerous signs in the surveys, so I will only offer two final notes.

First, on the energy market side and on the commodity side, it is harder and harder to describe the run-up in prices as solely or even predominantly demand driven. When I think about the new retail products that are now finding their way to typical broker–dealer relationships at retail-oriented chains, I see a massive surge of inflows into new silver-oriented mutual funds and copper-oriented exchange-traded funds. A lot of that speculative money is coming very late into these markets, and that situation should suggest to us that some folks, rightly or wrongly, are assigning some sort of inflation hedge to that product, with retail investors, as usual, being the last to get in on it.

Finally, on the energy front, I have been thinking about the difference between where we are now and where we might be several months from now. I was encouraged by the same-store sales numbers that we saw in April, even in March and April together. Those numbers are very encouraging, but as we get into the summer driving season, the energy prices may be seen as persistent. The market may take a view that the higher prices are more permanent than most consumers believe now, and I think that's probably an extra reason for our caution on the inflation front. So on balance, Mr. Chairman, I am quite optimistic about the strength of the economy but at least as leery about the expectations for inflation going forward.

CHAIRMAN BERNANKE. It worries me that we are in the hands of some exuberant 30-year-olds. [Laughter]

MR. OLSON. He had to rub it in. [Laughter]

CHAIRMAN BERNANKE. Governor Kroszner.

MR. KROSZNER. Thank you very much, Mr. Chairman. You will hear me singing a familiar song from last time, although not exactly the same song, and unfortunately I did forget my tap shoes. The song that I want to sing from last time is the continued strength and resilience of the economy plus concerns about inflation expectations moving out of line.

Consumption growth has been moderating a bit, but exactly as Governor Olson said, with the continuation of some of the changes in the tax laws, real disposable income will still have a boost. We have seen very strong global demand, particularly on the consumption side in many countries that have been lagging in consumption. In addition, we are also seeing strong investment demand, both domestically and internationally, and I think that is something that we have to take into account going forward.

As for the key risks going forward, one, of course, is the housing market. There has been a lot of discussion of that, and I do not think I have very much more to add. We have to see what the lagged effects of interest rate changes are there, but that is something to be determined.

Some puzzles that have persisted since last time concern the lack of pass-through of a number of things. Of the heightened energy and commodity prices to core inflation, we have seen some uptick. But I share Governor Kohn's analysis, or his conclusions from the analysis, that there are some signs but that one should not be overly wary because we have had a bit of downtick, then a bit of uptick. When we are talking about monthly movements of 0.1 percent, a simple rounding error can make things seem suddenly much higher or much lower. It could be a 50 percent difference from what we expect when we really are just seeing a rounding error, although we do have to be very aware of this.

Obviously, we have not seen pass-through of higher productivity gains to compensation. This situation puzzles me quite a bit because, historically, by now we would be seeing more robustness of compensation, not just real disposable income, but compensation. We have not seen that. Productivity apparently continues to move fairly strongly. Looking forward, I am concerned about this area even though the current data seem to suggest that the costs of labor are perfectly reasonable. Rather than looking just at the current data but using a little theory to look forward suggests that this may be an area that could be coming up in the future.

Even if there are higher costs in the labor market, are they going to be pushed through to final demand prices? We have had a good discussion of the evidence on what has happened in the past. Will you necessarily see the margins staying up or moving down, and will that cause the changes in underlying cost to be passed forward? Potentially it won't, and potentially there could be large movements. But, again, we are in somewhat uncharted territory. We do not have a lot of evidence here.

Another set of puzzles concerns the yield curve term premiums, and we, of course, have already had a lot of discussion about those and about the slight uptick in both the survey-based and market-based measures of inflation expectations. Obviously, that is something that we need to be very, very concerned about because the last thing that we want is to allow our actions in any way to be interpreted as a lack of concern about inflation, which could lead to an unanchoring of inflation expectations. That said, I certainly do not see such unanchoring in the markets. Also, the yield curve, although it has certainly moved up from being flat or even slightly negative, is still showing a difference between the two-year and the ten-year of only 15-20 basis points, which is not very large. And the much flatter yield curves are a worldwide phenomenon, driven by factors not just within the United States and not just about U.S. expectations.

I also very much agree with President Stern that we should not put too much emphasis on high-frequency numbers. We have to think about the recent numbers in a more systematic way. What are we likely to see going forward? What are the risks going forward, given some theory, given some historical experience?

Coming back to the theme that I sang about last time—about Fed credibility not being the impossible dream, but a reality—I think we do have that reality, and it is certainly something we do not want to give up. Just to tweak President Geithner a bit, I hope his comments should not be interpreted as saying that we want to introduce uncertainty into the marketplace. The last thing that the FOMC should be doing is introducing uncertainty. Certainly we do not want to be producing moral hazard and having inappropriately low uncertainty when real risk factors may be out there. We certainly want to be very wary of that; we do not want to contribute to that. But as Tim said, and I very much agree, we are in a very uncertain time, and to suggest that we are uncertain about where the economy is going is valuable. But to suggest that the market participants are not focusing enough on uncertainty, that there should be more uncertainty, and that we should do something about it is perhaps not the way to go. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you, and thank you all for your very concise comments. [Laughter] We will take a fifteen-minute coffee break.

[Coffee break]

CHAIRMAN BERNANKE. At this point I would normally try to summarize the remarks around the table. But since you have all just heard them and since my own views are not terribly different from many who have spoken, I think in the interest of time I will just go ahead and talk briefly on my own behalf about what I see the economy doing, and then we will turn to the policy go-round.

First of all, with respect to growth, I think we are following the path laid out by the Greenbook toward greater moderation in the second half. The main difference is that, since our last meeting, the uncertainty around that prospective path has increased. Obviously, the key to this moderation is the housing market, and fundamental analysis would suggest that the combination of high prices and rising interest rates would make affordability a problem and would bring housing starts and housing prices down. So far we are seeing, at worst, an orderly decline in the housing market; but there is still, I think, a lot to be seen as to whether the housing market will decline slowly or more quickly. As I noted last time, some correction in this market is a healthy thing, and our goal should not be to try to prevent that correction but rather to ensure that the correction does not overly influence growth in the rest of the economy.

I would also note that there are going to be some offsets to the decline in residential investment. We've noted increases in nonresidential construction, which is about half the size, as a share of GDP, of residential construction and, in terms of contribution to GDP, could make up something like a half of the direct impact of a decline in residential spending. We also have gotten a sense that capital spending is relatively strong, and world growth is also strong, which may enhance our exports. So there are some countervailing factors to help cushion the presumed decline in the housing market.

But as we talk about the housing market, which is 6 percent of GDP, or nonresidential construction, which is 2.7 percent of GDP, we have to pay very close attention to consumption, which is 70 percent of GDP and which really is the center of the forecast for the rest of the year. The soft landing scenario viewed in the Greenbook requires that consumption grow the rest of the year at something around 3.4 percent, which is roughly what it has been doing in the last year or so on average. I think that is broadly plausible. There are factors on both sides of it. Supporting consumption, obviously, are some increases in compensation likely coming forward both in terms of hourly wages and in terms of hours worked, job availability, and to some extent maybe increases in stock prices. On the negative side, many people have pointed out the effect of rising interest rates and softening in housing prices. Energy is actually a bit of a mixed bag. Energy prices are obviously a negative for consumption in level terms, but we have had a big drag on consumption for the past two years from increasing energy prices, and so if energy prices do stabilize, the drag will actually be less in 2006 than in previous years. So, again, I do think that the slowdown that has been forecast by the Greenbook is plausible, but like a number of people around the table, I would note that so far it is largely a prospective slowdown and that the data have only begun to support that development.

On the inflation side, I have somewhat more concern, like a number of people. Core inflation has been remarkably stable, and I do not think it is going to rise very much; but to the extent that there are risks, they are very largely to the upside. And I also have some concerns about the possible emergence of some inflation psychology, which is a very negative thing for our policymaking. The factors that support higher inflation are well known. First, energy and commodity prices. I would point out that, rather than being transitory, they have now undergone a long, sustained increase, which evidently must at some point get into the cost structure of firms. Second, the weakening dollar over the past month or so may be sufficient to add some pressure. Third, the effect of compensation, I understand, is a little ambiguous. There are some factors working in the other direction, including markups and productivity, but clearly the sense around the table is that compensation is beginning to move up somewhat, and the risks there I think are also to the upside. Finally, it is worth noting that, at a technical level, some of the components of the inflation indexes are moving upward—in particular, owners' equivalent rent. It economically makes sense that, if house prices have risen so much, rents will begin to rise. Since that is a very large share of both the CPI and the PCE core measures, that is going to be an upside risk for us.

Now, again, I do not want to overstate the problem. I think that core inflation will remain contained, to use our language, but I am concerned about those risks. Clearly, the markets have seen a strengthening of the economy and increased inflation risk. Despite all of our communication and language, it is summarized by an increase of about 25 basis points in where they think the federal funds rate is going to end up later this year. We have seen and already discussed the increase in inflation compensation and in other measures of inflation expectations. Much of our confidence that the pass-through from energy, from the dollar, and from labor costs to final goods inflation will be low is predicated on the view that inflation expectations are low and well contained. When that premise begins to break down, then all the other elements of the analysis also begin to come under pressure.

Finally, as a number of people have noted, although we do not have an official definition of price stability, we are at the upper level of what might plausibly be called the region of price stability, and further increases will be difficult and potentially costly to reverse. So looking forward to the policy discussion, I think we are going to have to take into account the emerging inflation risk. At the same time, there is an awful lot of uncertainty about what is going on in the economy. It is going to be a difficult balancing act to try to maintain as much flexibility as possible so that policy can respond to new data as they arrive. At this point I would like to turn over the floor to Vincent, who will talk about the policy options.

MR. REINHART.[2] Thank you, Mr. Chairman. Over the intermeeting period, the data came in stronger than the tone of the Committee's deliberations in March would have led any listener to suspect. As a result, Committee communications that reflected that discussion—including the minutes, speeches by some of you, and the Chairman's testimony—tended to pull down the expectations of future policy action, plotted in the top panel of your first exhibit, even as data releases tended to push them up. On net, the data won, and the path of policy expectations, the middle left panel, rotated up 25 to 35 basis points. The term structure of nominal Treasury yields also rotated up, implying increases in nominal forward rates, the blue bars in the middle right panel, of 25 to 55 basis points. These gains outstripped the rise in real forward rates, the green bars, resulting in significant increases in inflation compensation, the difference in the height of the bars.

Inflation compensation over the next five to ten years is plotted in the bottom panel. How you interpret these movements is likely a critical element in your policy choice today. On the one hand, the recent rise in inflation compensation, the shaded yellow area, has not moved it noticeably above its range of variation in the past two years. Indeed, at 2¾ percent, forward inflation compensation is lower than at times when the Committee described inflation or inflation expectations in previous policy statements as "contained" or "well contained," the blue shaded areas. If you think that is still the case, then you also probably believe that you have scope to be patient in policy setting. On the other hand, if you focus on the 20 basis point rise over the intermeeting period, you might conclude that there's been a partial outbreak of inflation jitters—not a pandemic, mind you, but the first instance of trader-to-trader transmission. [Laughter] The anti-virus typically prescribed is a vigorous assertion of your willingness to tighten policy.

Other evidence of possible inflation concerns is the subject covered at the top of your next exhibit. From left to right, survey measures of household inflation expectations have moved up for both near-term and longer-term horizons, and the value of the dollar has fallen sharply on foreign exchange markets. It might be that financial market participants place some weight on domestic spending retaining considerable momentum, putting pressures on resources. One such scenario was played out in the Greenbook and is summarized in the

[2] The materials used by Mr. Reinhart are appended to this transcript (appendix 2).

middle panels. In the "Domestic Boom" alternative scenario, the growth of spending does not moderate much—perhaps because a slowing in house-price appreciation does not materialize and firms begin to dip into their ample cash coffers to fund investment. Inflation differs little from the baseline, but that is, in part, because policy responds, raising the nominal funds rate to 6¼ percent—as in the dashed line at the right. This provides an opportunity to repeat a point made at Monday's briefing. Such an action would be inconsistent with current market expectations in that it would place the rate at the top of the 90 percent confidence band implied by options prices (the blue span). But our understanding of the economy—as encapsulated in stochastic simulations of the FRB/US model—is sufficiently imprecise (the green range) that such an outcome shouldn't be all that surprising.

Speaking of surprises, a major objection to tightening 50 basis points at this meeting to show your anti-inflation resolve, as in alternative C of the Bluebook, is that it would catch market participants unaware. Indeed, as shown in the bottom panel, it would be the biggest surprise of the modern era of FOMC announcements, at least as measured from futures market readings just before the statement had been released.

In contrast, the 25 basis point action discussed in exhibit 3 is exactly what the market is looking for. Moreover, the staff projects that the economy will hit what you might consider to be a sweet spot, with the unemployment rate (the top left panel) zeroing in on its natural rate and core PCE inflation (the top right) receding to 2 percent. That forecast is predicated on firming action today and none thereafter.

Alternative B in the Bluebook was structured to accompany such an action with the message that there is some chance that you might be done today, but you might not. As can be seen in the middle left panel, energy prices have moved up sharply, which poses the classic tension of dragging down spending while imparting some lift to inflation. In that regard, the relationship between changes in energy prices and core inflation—as at the middle right—has been tenuous at best over the past twenty years, suggesting you might prefer to focus more on the consequences of the oil shock on aggregate demand than inflation. If so, you might view that source of additional restraint as a substitute for further monetary policy firming. A ¼ point hike today will bring the real federal funds rate, the solid line in the bottom panel, toward the high end of the range of estimates of its equilibrium—another reason you might view yourself as done, or at least close to done.

Indeed, if you give credence to the simulations presented in the Bluebook you might view yourself as already done, which is why we included alternative A, the subject of exhibit 4. If you have an inflation goal of 2 percent and agree with the staff assessment that the equilibrium real rate is around 2¾ percent, then the current nominal funds rate of 4¾ percent probably has a lot of appeal. When we ran simulations of the version of the FRB/US model in which market participants are forward looking, holding the funds rate at 4¾, as in the top left panel, instead of tightening some and backing off a bit later, does not matter much for the paths of the unemployment rate and inflation (the bottom panels). Thus, from the perspective offered by the staff model, you can go home now and not come back until the next decade, which by the way will make the work of Governor Kohn's subcommittee easier. [Laughter]

> Your last exhibit gives alternative statement language, where the items in red denote new wording relative to the March statement and those in blue represent changes relative to what you saw in the Bluebook. Some concern was expressed that alternative B did not convey sufficient concern about inflation risks, so we've tightened it up somewhat. As can be seen, this alternative, first, stresses that current economic growth is quite strong (row 2); second, in row 3 it now simply repeats the March language verbatim; and third, it drops the word "modest" in referring to the outlook for policy firming. One last one-word change did not get onto the table. In the second sentence of row 2, we're proposing to go back to the March language and refer to a growth as "likely to moderate to a more sustainable pace" instead of "toward a more sustainable pace." That concludes my prepared remarks.

CHAIRMAN BERNANKE. Thank you, Vincent. Are there any questions for Vincent? If not, I hope we can have a go-round and have people's views on the policy. President Lacker.

MR. LACKER. As I said before, I think we are essentially okay on the real side, but my concerns have risen about inflation. I recognize the potential for slowdown later this year, but my sense is that our inflation problem is much more of an immediate issue for us. I think we have to take seriously the possibility that inflation expectations might deteriorate further even though, as Vince said, they are within the band that we have characterized as contained. My sense is that any statement today that moves the market's expected policy path down is going to cause inflation expectations to move up. That's my bottom line today, and I think we should strive to avoid that.

Second, and here I will echo something I said and something the Vice Chair said, I am very unhappy with the way in which markets have reacted over the past several weeks. As I said earlier, markets marked up their expected policy path but also marked up expected inflation. It would have been better, in my view, if they had marked up the policy path more and the inflation path less. I just do not see the utility of the market's believing in a reaction function for us that has oil price shocks pushing core inflation materially higher when they occur.

Our statement today is an important opportunity to influence the public's understanding of our reaction function, and that is the lens I am using to think about policy today. It is fine to say that policy is going to be data dependent, but it is important how the public believes our policy is going to depend on the incoming data. Unfortunately, we are at a difficult point here. The public is suspecting that a pause might be imminent, and so increasing the statement's emphasis on data dependence is likely to increase the probability they assign to a pause and thus bring down the yield curve. As I said, I think that would be a mistake. We need to strengthen the public sense of how strongly we intend to respond to increases in core inflation. So this has to do with the slope of the reaction function. Ultimately the data dependence that the market expects is going to be informed by the data dependence that the market actually sees. This is why I proposed in my memo on Friday that we modify row 4 in alternative B to place more emphasis on inflation risks. The way it is worded in the version that Vince just circulated does that very well—in fact, better than I did. But in any event, whatever we do, we should strive to make sure our statement does not bring down the expected policy.

CHAIRMAN BERNANKE. Thank you. President Poole.

MR. POOLE. Thank you, Mr. Chairman. I have some notes. I do not usually write them out, but I have them written out today.

First, let me say that I agree with the comment that Governor Warsh made awhile back that the economy is strong and has excellent growth prospects. The economy is not fragile, and our job, of course, is to keep it that way. Our interest rate policy should depend on the state of the real economy and not just on the inflation threat. In the model with contained actual and expected inflation, the real rate of interest would fluctuate with the state of the economy. Given the worldwide integration of capital markets, what is relevant is the state not just of the U.S. economy but also of the world economy. The fed funds rate target should depend on the GDP gap even though the predictive value of the gap for inflation is low. This is a message that markets ought to hear because monetary policy must be responsive both to the state of the real economy and to inflation risks.

Now, as for the lag in monetary policy effects, which I think is an important part of the concern that we will overstay or overshoot on the tight side, we should note that the increases in the federal funds rate through late last year were predicted in the market at the outset of the rate increases in mid-2004. Roughly speaking, the economy should already have reacted to the first 300 basis points of fed funds rate increases. The lag argument applies to rate increases beyond the 4 percent fed funds rate. Inflation expectations have risen roughly 20 basis points since our March meeting. Raising the funds rate target 25 basis points today barely keeps up with inflation expectations.

Many of us have commented that we are between the Scylla of unemployment and the Charybdis of inflation. Now, I went back and actually looked up a bit about that story, and quite frankly, it was because I did not know how to spell Charybdis. [Laughter] And then I found that this story, written over 2,000 years ago, was actually an example of risk management. Some of you who are better classical scholars than I will remember that in Homer's *Odyssey*, Odysseus is given advice by Circe to sail closer to Scylla for Charybdis could drown his whole ship. Odysseus then successfully navigates the ship past Scylla and Charybdis, but Scylla manages to catch six of his men, devouring them alive.

Well, Charybdis is our inflation risk. We would like to navigate down the center of these hazardous waters, but in conducting monetary policy, we are in a pre-GPS world. Visibility is limited, and as I look at the data and talk with business contacts, I think I hear breakers, if you will, in the direction of Charybdis, which is our inflation risk. But as every sailor knows, the fog does funny things to sound. I may be wrong, but I think I hear inflation breakers in the distance.

I have concern both about ending rate increases too soon and about overshooting on the high side. These two risks need to be balanced in light of the relative cost of increasing rates too much or too little. In my view, it is better to take the risk of raising the funds target too much than of stopping too soon. If we stop too soon and inflation rises further, the costs of bringing inflation back down are likely to be considerable. We may not lose the ship, but Charybdis can cause a lot of damage. As we have learned all too painfully over the years, Charybdis is not just inflation, but rather inflation now plus higher unemployment later. Charybdis, therefore, has her own Scylla just behind her as demonstrated very nicely in alternative simulation number five.

Even if inflation does not rise but we conclude that a strong economy requires further restraint, market disruption and mixed signals from the FOMC could be a problem. It is not helpful for the market to view the FOMC as a source of whipsawing, which would be the case if we pause and then resume rate increases relatively quickly. When we pause, we should be reasonably confident that we can expect, although not commit, to pause for several meetings. Under current circumstances, we would confuse the market by pausing for only one meeting, I believe.

Conversely, pausing later after further rate increases or backing rates down a bit after a pause should encourage fairly prompt resumption of expansion and minimize market disruption. If we take monetary restraint too far, the Scylla of unemployment risk may claim a few victims, but I would rather take that risk than the risk of getting any closer to Charybdis.

If we raise the funds target 50 basis points, the message to markets should be that the FOMC will now make policy decisions one meeting at a time without commitment as to decisions at future meetings. The message ought not to be that the funds rate is likely to be unchanged. No guidance is not the same as "no change" guidance. If we cannot get this message across in the statement, we certainly should be able to do so in the minutes. Markets should not interpret our policy decision at this meeting as a precursor to a pause.

If we raise the funds rate target 25 basis points, we will probably have to maintain forward guidance to avoid sending misleading signals. We could end forward guidance by indicating in the minutes that we do not intend to use similar language in June but that dropping the forward guidance is not necessarily a precursor to a pause. We will make that judgment meeting by meeting as we assess the significance of new information for the outlook.

I am well aware that 50 basis points would be a large shock to the market, and to be very honest with myself about what that might mean, I have said to myself that the Dow might fall as much as 150 or 200 points and the long bond yields might rise 10 to 15 basis points. I am willing to impose this shock to get ahead of the markets. I believe it would be better to act decisively now rather than later in response to accumulating bad news.

I want to talk just a moment also about the minutes of this meeting. These minutes will appear shortly after the May 25 release of the preliminary first-quarter GDP number, which the staff now puts at 5.3. So the upward revision there is significant. I think that the next unemployment report comes out on June 2, which would be shortly after the minutes also. I made a couple of points that I think are very important. One, the minutes need to be true to the transcript, which will be released a little less than six years from now. It is extremely important for the long-run credibility of the institution that there not be any disconnect between the minutes and the transcript. I believe that the minutes should report that the Committee discussed alternative C.

Two, we have an opportunity in the minutes to do several things that I think are important. First, we can use them to show the Committee’s concern with inflation and inflation expectations. We have had extensive discussion beginning with the staff presentation about those issues. I think that the market is actually going to take that concern as something of a surprise and a shock because it has viewed our stance as being not very concerned about inflation. If we reflect in the minutes the discussion around the table, I think the market will take that as some genuinely new information. Second, we ought to use the minutes as an opportunity to get out from under the forward guidance and to explain that the guidance is not intended to provide any signal about what our action is likely to be. I would not take the guidance out of the statement of this meeting for the reasons that I think Jeff has explained very well. But we should be able to use the minutes to say that, when the Committee wants to make such an announcement that a pause is likely, we will do so directly with plain language—we are not going to do it indirectly. I think we ought to be able to make that clear in the minutes. Third, we should also say in the minutes that policy decisions will be based on the implication of new information for the economic outlook that we receive between meetings. So those are things I think we could get across in the minutes with the space to do so. Thank you.

CHAIRMAN BERNANKE. Thank you. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. I want to share, as I did the last time, a little different perspective on this. I continue to agree with the Greenbook and others' projections that the economy should slow as we move through the rest of this year and next year. I think that's an important factor to consider because the policy actions we take today are geared toward those periods as well.

I don't want to give the impression that I'm not concerned about inflation, because I am. Part of my concern is not that we will end too soon but that we will be too quick to reverse our position. Let me explain. What we have now is that current GDP growth and some of the inflationary events are the effect of past substantial accommodative policy. Now our instincts are to keep increasing the rates until we actually see the slowing. Thus, we tend to overshoot in terms of tightness. That sounds familiar to me. I think I've seen this movie, and that's part of my concern.

As I said, I am concerned about inflation. In fact, I wish we had gotten where we are today a little sooner, but we didn't. Our challenge is to hold firm now and to hold firm when the economy begins to slow, and our instincts will be to ease, especially as the speculative excesses begin to wash out of the economy and we have a lot of people saying that it's absolutely imperative that we ease to offset that speculative washout.

I think that's really our challenge. I'm not concerned so much about just today. It's more the larger context ahead of us. What I'm trying to say is that I judge we are about where we ought to be. We should allow the market to work the rest of the yield curve and the economy, so that we bring the imbalances that are in play now back into balance and, when that happens, we hold our discipline and not let our instincts to ease and offset that discipline very quickly take over. That's really the future challenge of monetary policy as we work through the rest of this year and into the next. Thank you.

CHAIRMAN BERNANKE. Thank you. President Fisher.

MR. FISHER. Well, I think Bill Poole has summarized a lot of what I would have said. I forecasted that in the memo that was sent around. I would advocate tightening 50 basis points. I would dispute only one comment of President Poole's. Getting ahead of the markets is less important than getting ahead of the economy. I do take note of your FOMC surprise chart. The question really is, If we undertake an action, will it lead to a market reaction that might affect the economy negatively? It's not so much that we have a market surprise. We're going to have market surprises at any time, and I can walk you through, after thirty years of operating a hedge fund, a four-year cycle of market surprises. A market surprise is going to hit us at some point, but the question is, Is it a trip wire? There is a risk that the trip wire would be the housing market. We've discussed that to a great degree, although you, Mr. Chairman, I think gave us some good data on the offset.

I think it's important for us to get ahead of what I view—not just because of the anecdotal evidence we have but also because of the work done by our staff—as a significant expansion in capital expenditures with growth shifting to very strong business investment, excess liquidity that is going to fuel that investment, and as we all discussed, significant indications that inflation is stronger than we would like to see it. We see that analytically, as I said earlier, with the way we calculate inflation in Dallas, but also from the anecdotal evidence.

Having said that, I think the wording that is now in alternative B is more attractive. I know there are some who would like to provide what I call a full frontal view of what we look like and what we discussed. But as I like to say, Mr. Chairman, in romancing the market sometimes a little modesty might be more effective in achieving the ultimate goal. I think we've achieved that to an extent. I do not like the language that we see growth as likely to moderate because I don't have confidence in that statement and I'm not sure it's necessary. I'd prefer the wording that President Poole sent around in terms of its brevity. However, in the interest of perhaps more exposure, or a more-revealing presentation, I would like to add one word, which is the word "global" before "resource utilization." [Laughter] Thank you very much.

CHAIRMAN BERNANKE. Thank you. President Minehan.

MS. MINEHAN. Thank you, Mr. Chairman. In the last couple of meetings I have had concerns that I think others are sharing, or did share, that we not go too far in this round of tightening, given what I thought were perhaps transitory price pressures, some extra capacity in labor markets, and financial markets that were finally becoming less accommodating with all that would mean for asset markets, in particular housing.

Certainly there continue to be these downside risks. The housing falloff that we're beginning to see signs of could hit not just residential construction but also consumption harder than we expect, and rising energy costs could exact a greater tax on spending. But as I noted, we have yet to see much of that projected slowing in the incoming data. It's still a forecast. Others have focused on that as well.

The more important thing that has happened, and it has certainly changed my mind with regard to the balance of risk, is the change in the inflation environment. Market contacts tell me that they perceive the Fed as being behind the curve on inflation. Now, normally I wouldn't take market chatter very seriously. But given the tilt in incoming data, thinking about it a bit is worthwhile if we are concerned, as we should be, about our continuing credibility.

At this point, as I said earlier, I am more uncertain than I have been about where policy should be and how fast it should get there, and that uncertainty automatically takes me to alternative B. I think 25 basis points, not 50, is the right move today even though over the course of the next several meetings we may well move for 50 or beyond that. I just think that 50 basis points would come as a shock to markets and, frankly, given that I'm really not certain about where things are, would overdo things in terms of my own perspective of where we need to be right now. When you are uncertain, moving slowly is usually the wiser policy. So that's my policy perspective—25 basis points.

I was going to fool around with alternative B, and I have a whole bunch of language in here to fool around with alternative B, but it gets me to exactly the same place as this new language. [Laughter] So I'm really happy that we have taken out the references to inflation being contained—I think it was in row 3—and modest firming in row 4. Not that things might not work out that way, it's just that I'm not as certain that I want to say that directly and give the impression, which would have been reinforced by that language, that we're more likely than not to stop at the next meeting. I agree with others who have said that, if possible, we should aim for making things a little—I hesitate to use this word—more uncertain about what we're going to do at the next meeting rather than give the certainty of a pause.

I have a question, however. The second part of the sentence in row 4 and the sentence in row 5 seem to me to say about the same stuff. Do we need them both? I must be missing something subtle here because to me they just seem to overlap a lot and make us double data dependent.

CHAIRMAN BERNANKE. It's the belt-and-suspenders approach. [Laughter] However, when we get to the final discussion, I'll ask for a straw vote on whether to drop row 5.

MS. MINEHAN. Thank you. That's it.

CHAIRMAN BERNANKE. President Pianalto.

MS. PIANALTO. Thank you, Mr. Chairman. As I stated earlier, I basically agree with the staff's current baseline projection that, with the rate action today, we have a monetary policy that supports the return of GDP growth to somewhere near its long-term potential, along with both core and headline inflation beginning to turn back down as the year proceeds.

I stated at our last meeting that I was willing to see the fed funds rate move above my best estimate of where neutral is to a level that might be somewhat restrictive as insurance against some of the adverse inflation effects of energy-price shocks that have hit the economy for more than two years now. I noted with interest that a member of the Board staff reported on Monday at the Board briefing that the staff thinks that energy shocks will add ¾ percent to core PCE inflation this year. Estimates such as this one give me some comfort in deciding to reach beyond my estimate of neutral, but there are limits as to how far I'm willing to reach.

We all know that there is a historical relationship between energy-price shocks and weakness on the real side of the economy. I also know, Mr. Chairman, that some economists, for whom I have a great deal of respect, have suggested that the weakness was partly associated with monetary policy action taken in response to those shocks. I think we have reached a point where further policy actions to head off potential price pressures may come at the expense of tipping the scales in the direction of increasingly greater risk to economic activity.

I admit that I'm not happy with the degree and speed of the decline in core inflation in the long-term projections included in the Bluebook. It has been frustrating for me to watch the headline inflation numbers keep moving up as a result of energy shocks and to see our timetable for moving core inflation lower get pushed further and further into the future. But if the Board staff's estimate of the effects of energy-price shocks on core PCE is reasonable, it suggests that there is room for some further improvement in core inflation once the energy shocks end, other things being equal of course.

One fundamental element of the outlook that might not be equal is the dragging of the inflation expectations anchor. I know that, as prudent central bankers, we have to be constantly alert to the possibility that inflation expectations will take off. Our worst fear, most certainly, is that they will creep up covertly and catch us unawares. So I applaud the diligence of the Bluebook authors in looking for these weapons of mass destruction, but I'm not convinced that the evidence that we've compiled should provoke us to attack just yet.

At the last meeting, I indicated that I was inclined to pause after this meeting. That's still my inclination. But the last CPI report, coupled with little direct evidence that the pace of economic activity is slowing, has moved me closer to putting even odds on our appropriate choice at the June meeting. I said in March that I would not like a statement that induced market participants to automatically expect a better than 50 percent chance for a rate hike in June. It's clear to me from our discussion today that some are leaning toward a rate increase in June and that they're going to wait and see if the data will talk them out of it. I also know that some people are thinking about a pause, and we're going to wait and see if the data are going to talk us into it. The most common theme I'm hearing is "wait and see," and in my opinion the wisest course is to make the smallest possible number of changes in our statement and hope that the data will speak more convincingly over the next month and a half.

So my preference is to make as few changes as possible to the statement that we made last month. I think alternative B does that. I like adding the language. The second half of passage 4 reinforces the message of last month's minutes that were widely interpreted as "wait and see." So that's where I am: I support alternative B. Thank you.

CHAIRMAN BERNANKE. Thank you. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. I'd actually rather think about the metaphor of President Fisher—full frontal nudity—for our subcommittee than I would about the weapons of mass destruction and attack. [Laughter]

MR. FISHER. I never used the word "nudity" now. [Laughter]

MR. KOHN. Full frontal. Okay. [Laughter]

MS. MINEHAN. Take it out of the transcript. [Laughter]

MR. KOHN. "Let's move on to monetary policy," he said blushing. [Laughter] I think we do face an interesting and challenging situation here. I agree, as I said before, that the inflation risks are higher than they seemed a month or two ago and appear more palpable, more immediate, than they did. That has to be balanced against a forecast that things are in train that will end up containing those risks—maybe not driving inflation down to where some people want it but at least keeping it from rising. But we haven't really seen a lot of evidence that those things in train to contain the risks are there yet. I acknowledge—President Hoenig made a very good point—that there is some risk of overshooting. I think in a situation like this, we have to be forward looking but we also need to make really sure on the inflation front. So I'd rather risk overshooting than undershooting at this point in the game.

We do need to strongly resist any tendency for inflation to rise, and the public needs to understand that that's where our focus is. In my view, that requires ¼ point today and conveying a sense that we still see upside risks and are prepared to act if those upside risks to inflation materialize. Like President Lacker, I'd like to see market rates at least at their current level. I'd rather see us ending up with rates a little higher than they are now than otherwise. Conveying this thought would probably leave rates intact and also leave market reactions to incoming data constructive. If we say we're worried about inflation and inflation comes in a little higher, markets will react very quickly. I think the new language of alternative B does this, and I support it. I think the key part is in row 4: "The Committee judges that some further policy firming may yet be needed to address inflation risks." That's so close to last time that I think the markets will interpret it correctly.

At the same time, we have to be open-minded about when any further increase will be required. I always thought a sensible path for policy here would be to go up quickly and then kind of flatten out the trajectory. We kind of got caught in an every-time escalator and never were able to flatten out that trajectory. But we're in a position where we can both be concerned about inflation and put the market on notice that the trajectory of any further rise will be a little flatter. I think that's constructive, and B does that, so I support that language.

CHAIRMAN BERNANKE. President Stern.

MR. STERN. Thank you, Mr. Chairman. Overall, I think policy is currently well positioned to maintain price stability over time, and a ¼ point increase today, which I favor, will on the margin enhance that position. As I noted earlier this morning, I do think the uncertainty about the inflation outlook has increased, and it may be that the risks are now tilted to the upside. But on the other side of that particular observation is the well-known lag in monetary policy between our actions and their effects. We have cumulatively moved a lot, and some of those moves have been recent, and so I don't think all of the effects are currently evident.

In the past, I have emphasized with some frequency the underlying flexibility and resilience of the economy. As a consequence of that, I'm not really worried that we might go too far or overshoot. I think the economy absorbs these things pretty well, but our obligation is to try to get it right. I'm not exactly sure where right is, and so as a consequence of that I want to make sure that we have some flexibility going forward and that we continue to emphasize the data-driven nature of our decisions. I think alternative B accomplishes all of that, so I'm in favor of both the action and the language associated with it.

CHAIRMAN BERNANKE. President Moskow.

MR. MOSKOW. Thank you, Mr. Chairman. I favor the 25 basis point increase, and, generally, the language of alternative B. But I do have some specific suggestions on it that I'll mention at the end of my comments.

First, I want to say a few words about a topic that many of us have been speaking about publicly, which is our price stability goals and our comfort zones for inflation. This talk is getting a lot of attention, and my current thinking is that the zone is 1 percent to 2 percent on core PCE. The more we use this language of a comfort zone or—as I think, Mr. Chairman, you said in your comments—a zone of price stability, the more it frames the public's interpretation of our inflation outlook and our policy moves. That's not a bad thing, in general, but I am concerned that many analysts are interpreting this comfort zone as a range of acceptable outcomes so that it doesn't matter where we are within that zone of indifference.

I don't view it that way. My preference is to see inflation moving toward the center of the zone, like the Bluebook alternative simulation that we talked about before. For me, having our inflation forecasts consistently run at or above the top end of my comfort zone is a problem. Market participants will ratchet up their views of the zone, and our credibility is then going to suffer. I would hope that our policy actions would be aimed at having inflation heading more clearly for the interior of that range—subject, of course, to the constraints of our dual mandate.

With regard to today's decision, I certainly prefer that markets clearly understand that, if necessary, we're ready to move to a rate above 5 percent. I think the language in alternative B does that. I suggest one major change to it, which I think people would consider major, and that is in number 3.

Number 3 now is, as I understand, exactly the same as it was last time. The phrase in there that really concerns me is "and inflation expectations remain contained." Bill Poole talked about the minutes reflecting accurately the meeting, and I don't think that statement accurately reflects the discussion at this meeting. A lot of concern has been expressed here about inflation expectations—different degrees of concern, but certainly the atmosphere is different from that in the last meeting in which we discussed it. One way to deal with that is just to delete those five words and end the sentence with the word "check." Another would be to go back to the language we had before. I would go either way on that, but I don't think we should put that language in the statement.

CHAIRMAN BERNANKE. First Vice President Stone.

MR. STONE. Thank you, Mr. Chairman. Given that I see the risk to growth as reasonably balanced and the risk to inflation as slightly more to the upside, I support raising the funds rate 25 basis points. With resource utilization at high levels and core inflation near the top of the range I consider consistent with price stability, any positive aggregate demand shock could result in inflation higher than we would like. So I think that we should take some action today to lean against this possibility, and I see that 25 basis points would do that. I don't sense right now that we're behind the curve and that we need to do more.

I think the funds rate is approaching the level that's consistent with stable inflation and growth at potential, but I'm not sure whether today's move will be the last or when the next move will be required. That will depend on what the incoming data tell us about where the economy is headed and our assessment of the risk to that forecast.

There has been a perception by some, and it's been discussed around the table, that the FOMC often makes one or two moves too many. At the last meeting, I said I would rather accept the risk of taking one or two moves too many than of coming up short. The risk associated with this would be magnified if it proved difficult for the FOMC to reverse itself, should it perceive ex post that rates have been raised too high. We recently did a study to look at our past behavior, and the staff analysis shows that there have been numerous episodes in which the FOMC has paused and then continued along the policy path and even paused and reversed course. So that gives me some comfort that we have the flexibility to take the appropriate actions based on incoming data.

Turning to the language, I had about three pages worth of material, most of which I can throw away. I think alternative B comes very close to the language that I think appropriate. I have some sympathy with President Lacker’s and President Moskow’s comments that leaving the phrase about inflation expectations the way it was in the last meeting does not fairly represent the tenor of the discussion today. Balancing that a little is the change in the language in row 4, which now addresses the inflation issue more head-on and thus shows the change in the tenor of the discussion a bit. But we certainly would not want the markets to perceive a lower policy path by reading that in the language, and maybe the inflation expectations phrase might do that. That concludes my comments.

CHAIRMAN BERNANKE. Thank you. President Guynn.

MR. GUYNN. Thank you, Mr. Chairman. Let me see if I can be reasonably concise. First of all, I don’t think we have any viable alternative except the 25 basis points of tightening today, so I support that. We’ve probably had more consensus around the table this morning than I remember in a long time about the way we want to convey the risk that is clearly on the inflation side. The changes that have been made in the alternative B language from the first version that we saw are clearly in the right direction. The language is much crisper and cleaner and emphasizes the point.

I would associate myself most closely with President Lacker’s comments. I want to repeat a comment that I made, though, in the pre-meeting comments, and I think it’s still applicable as we think about the way this statement evolves until the Kohn group’s work is finished. I hope we’ll try to avoid expanding the language and being tempted to add more words, more precision, and more careful forward-looking guidance until we have those fundamental strategic discussions that I think are going to come from Don’s work group. I’m glad we did not go through with the idea of including an employment forecast. We still have in row 2 what I consider to be a second-level detail on where the moderation is going to come from. I think the list probably reflects the discussion, but until we deal with the Kohn subcommittee’s work, we ought to avoid the temptation to say more and explain more fully and give more guidance and more precision to our guidance. I don’t think that serves us well.

As I said before, I think we’re close to where we need to be. I think that’s what the group said this morning. We do need some flexibility. I’m not as concerned as some that that suggests some uncertainty on our part. We can’t take uncertainty away from the markets. So I hope that we’ll talk about the issue that Michael Moskow raised about whether we’re being too reassuring about inflation expectations. I’m generally comfortable with the current construct of alternative B. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. President Yellen.

MS. YELLEN. Thank you, Mr. Chairman. I support alternative B. I favor raising the funds rate 25 basis points, not 50 basis points, today. The statement helps us get off the treadmill we’ve been on and enhances flexibility, but it doesn’t tie our hands into pausing in June if the data between now and then are so strong as to necessitate, in our view, a further move at that time. I think B does leave open the door to as much additional tightening as may be needed, whereas C actually suggests that we think the tightening is over.

Now, personally, I judge the additional amount of tightening needed to be modest, although I think a bit of additional restraint is probably desirable. I think we are close to being done because I’m comfortable with the Greenbook forecast, and I also think our policy stance is roughly appropriate based on a variety of rule-based metrics. I do think a bit more tightening is needed because I'd prefer to see core inflation gradually head down toward the center of my comfort range rather than see it stabilize in the vicinity of 2 percent, as in the Greenbook forecast. I want to emphasize that only a bit is required, not a show of overwhelming force, because, as one example, the benchmark Taylor rule would suggest that a ½ percent reduction in the target inflation rate, say from 2 to 1½, the center of my comfort zone, calls for an additional increase of only 25 basis points in the funds rate, and various simulations using optimal policies as opposed to rules would similarly show a quite slow convergence toward the lower target rate. We've seen that in past Bluebooks.

I strongly favor a pause in our campaign in order to evaluate the effect of our policy actions to date, unless incoming data after this meeting contain large upside surprises. Like President Hoenig, I do certainly understand the urge to continue raising rates at every meeting until we're sure the economy is slowing. I still remember very well the 1994 tightening episode, and then, as now, there was a sense of great momentum in the economy, posing significant upside risks to inflation. In circumstances like that, the urge to continue tightening is natural. It is instinctual. Unfortunately, with policy lags such a strategy is a sure recipe for overshooting. If we're lucky enough to stop at exactly the right point this time, as I believe we actually did in '95, we can be sure that it will feel risky at the moment we stop and wise only in retrospect. The risks for policy, in my view, are now two-sided, and this is especially true with the substantial run-up since our last meeting in longer-term interest rates.

Downside risks due to a possible policy overshooting are now balanced in my mind with the upside risk that we have not done enough, and I would consider a pause to evaluate where we stand as desirable and appropriate, unless of course there is new and surprising information.

CHAIRMAN BERNANKE. Thank you. Governor Olson.

MR. OLSON. Thank you, Mr. Chairman. I suppose I could just support the comments that President Yellen made and shut up, but I won't. [Laughter] I recall in previous meetings that I said that increases would be harder and harder to justify, and I certainly expected that by this time we would have paused, although I do believe that a ¼ point raise is appropriate this time. Were we to accept alternative A, having conditioned the market to think that we would raise until we are done, it seems to me that we would send a signal that we were done if we did pause at 4¾ percent. On the other hand, the analysis that suggests that there will be a slowing of the economy has been a compelling argument made in the Greenbook, and therefore the description in sentence 2 seems to me to be accurate. Were we to raise 50 basis points, it would have to be on the basis of an analysis that is more a gut feeling than an analytical approach. Therefore, I think that alternative B, the ¼ point, is appropriate.

We are at an inflection point. As I have heard many of you say many times, the inflection point is the most difficult part of the cycle, when the most difficult decisions have to be made. I think President Hoenig made that point earlier. The wording that I think is going to attract the most attention is in part 4 when we say "the extent and timing." By that wording we are conveying that we are at an inflection point and that we may move away from the every-meeting 25 basis point move, or at least that is how I interpret it. So I am in favor of alternative B as written.

CHAIRMAN BERNANKE. Governor Bies.

MS. BIES. Thank you, Mr. Chairman. I support a 25 basis point increase at this meeting, and I like the changes that have been made to alternative B because I wanted to make sure that we came out of this with a statement that left our options open at the next meeting.

While the recent inflation trends—recent being the last six months or, in other words, from before the hurricanes to where we are now—have give me a little more anxiety, I can visualize scenarios that will make us want to pause or stop at the next meeting. That is why I, too, like the words "extent and timing" in line 4 that Governor Olson just cited. That wording allows us to stop or keep going and to choose the timing. I think the wording there is excellent.

"Inflation expectations remain contained": I have no suggestions about how to change that line, but after listening to the dialogue around the table, I have to admit that it is the one line that gives me pause. The various measures of core inflation have been running in the upper 2 percent area in the past six months, and that is above my personal comfort zone. If other folks are looking at those measures, then that is perhaps partly why we're getting some of these movements in long-term rates. The wording does leave me uncomfortable. At least "well" is gone; inflation expectations are now just "contained." [Laughter] But they are contained at a level above what I would be comfortable with. How we change the wording I do not know, but I agree that that particular phrase in the statement does create some anxiety.

CHAIRMAN BERNANKE. Governor Kroszner.

MR. KROSZNER. I agree with the 25 basis point move at this time. I think we have seen some beginnings of evidence of heightened inflation risk relative to six weeks ago, and I think it is also very important, as President Yellen mentioned, that looking back historically, we do not want to get too far out ahead and then have some regrets. But we also have to be concerned about how our actions will be interpreted by the market and to think about the longer-run expectations. We have to convey that we do have some uncertainty about where the economy is going, and I think that is well reflected in our discussion here and in alternative B.

But it is extremely important to keep our powder dry. I really like the idea of saying that not only will we be looking at the data as we normally do in our due diligence but also we are going to be looking at things because there is uncertainty. We do not have an ideological view that we must make sure that every last concern about inflation is stamped out, without concern about growth, or vice versa.

Also, as I said last time, it is hard to know exactly where we need to go to be at the right level. At best, we can be within 25 basis points of where we would hope things would be, but obviously, it is quite literally a moving target since the underlying economy is moving. That said, I think it is very important to emphasize in the statement what First Vice President Stone mentioned: If you look at what we say in line 4, we do specifically mention that some further policy firming may yet be needed to address inflation risks, which is not something that we had specifically singled out before and which I think helps offset the concern about the phrase "inflation expectations remain contained."

Although we have discussed that inflation expectations have moved up somewhat, I think that to say they are no longer contained is incorrect. We have seen a bit of tick-up of actual inflation and a bit of tick-up of some, but not all, measures of inflation expectations. As Vince mentioned, the most recent numbers coming from Blue Chip suggest that the professional forecasters are not saying that inflation expectations are moving up. I am concerned that, if we took out that phrase, which we have had for a while, we would be suggesting that we do think things are becoming unhinged and that might be a self-fulfilling prophecy moving in exactly the wrong direction. So I think the balance that we have now heightens our emphasis on inflation risk in number 4 but does not say that inflation expectations have moved too far beyond (and I do not think they have moved too far beyond) where they were before or that they have become unhinged. I like the balance that is there between the two.

I also like keeping in the red phrase in the second part of line 4; but a small amendment to make it perhaps a bit easier to swallow and to make it seem not repetitive with the statement in number 5 is that, rather than saying "in any event," we simply say, "The Committee thus will respond to changes in economic prospects as needed to support the attainment of its objectives." Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. Governor Warsh.

MR. WARSH. Thank you, Mr. Chairman. I support alternative B and would like to echo Governor Kroszner with respect to the reference to inflation expectations remaining contained. In light of where the market's expectations are, for better or for worse going into today and June, the omission of that language would be a very loud omission. I think that alternative likely would not be expected or generate the kind of balanced reaction that we are trying to achieve. The other emphasis that we have in section 4 addresses what I think is the balance of the discussion that we had today. I also like in alternative B the reference to the current state of the economy in the first line of part 2, where we say that it has been quite strong so far this year. This wording provides some credibility to some of the data that the markets are perhaps not as focused on as they should be.

So on balance, I do support alternative B as written and would make only a couple of points. As we approach our last move, or potentially our last move, with respect to this tightening cycle, it does strike me that the burden of persuasion, if not the burden of proof, rests with us to change course. I do not think that there is any evidence to this point that we ought to stop or even suggest to the market that a pause is in some way imminent. We have all largely agreed that the risks of policy error here have increased, and that is why a lot of consistency between the alternative B language and our March FOMC language is perfectly appropriate.

As the Vice Chairman referenced in the earlier round, we are trying to express to the markets our view of uncertainty so that they do not take what we say as a guarantee of future results but look at the data in real time as we look at the data rather than look directly just at us. The balance that has been struck in section 4 does that very well. Should we get to a pause at some point over the course of the next several meetings, it needs to be preceded by vigilance, which I do see reflected in section 4. I would conclude only that it is better to leave interest rate expectations higher at this moment until we see some real signs of inflation falling more into that zone of comfort, which President Yellen and others referenced. Thank you.

CHAIRMAN BERNANKE. Vice Chairman Geithner.

VICE CHAIRMAN GEITHNER. Thank you. My sense is that we probably have a bit more to do, and it would be helpful to signal that. Of course, we cannot be sure we have more to do, and we certainly cannot be sure how much more, if anything, we have to do.

We have sort of debated two views on the optimal path going forward at various times. One option is that we move until we are confident that after the move we can leave policy expectations flat. Another option is to say we move until just short of that and pause at a point that leaves some positive slope to the path going forward. I guess I am a little more comfortable with the latter strategy than with the former. Even if we knew with confidence what was clearly optimal, we really would not know at this point when that pause should come. We always face some uncertainty about the band that defines the appropriate policy path, but I think we still want to err on being at the upper edge of that band, wherever it is. We probably want to stop tightening before inflation peaks, given the lags with which policy operates, but we probably do not want to signal that we are going to stop when expectations at long horizons are still moving up a bit.

A few final points: I think inflation expectations require a difficult balance. We don’t want to look as though we are spooked by the rise in inflation expectations, nor do we want to look as though we are indifferent to them. I can see lots of ways we can strike that balance.

A rhetorical preference: We all like to use the simplifying rhetorical device of saying that we are going to be more “data dependent” going forward. I prefer that we say that we are going to be more “outlook dependent” or “forecast dependent” so that we do not look as though we are going to be a little too volatile in responding to near-term changes in the data. I am broadly comfortable with the language in B, and I think we should obviously move 25 basis points today.

CHAIRMAN BERNANKE. Thank you. Let me just talk a bit about the policy option and the statement. I think we are facing two goals that are difficult to achieve at the same time. The first one is to respond to some increase in inflation risk and what might be a bit of an inflation scare in the bond markets. In order to respond to that, we would have to signal that we are willing and able to continue to respond to inflation as it rears its ugly head. If you like, inflation is the nail, and monetary policy is the hammer. We do not have to strike the nail, but we have to show that we are not putting down the hammer. We have to keep it in our hand. [Laughter] In that respect, I think it is important that we not signal that there is a definite pause. I am also disturbed by the response of inflation compensation to those signals. We need to keep the option open to respond once or even more than once if the inflation data and the economic outlook dictate that response. I do think that the use of the further policy firming language in part 4, which repeats the March statement, will be viewed as hawkish and will probably have some upward effect on yields.

Our second objective is to maximize our flexibility, given the degree of uncertainty that we now face in the economy. I agree with Vice Chairman Geithner that an optimal policy can well include pauses for two reasons—perhaps more than two, but here are two. The first is that we gather information over time; to the extent that we gather useful information and uncertainty is resolved, we can make a better decision. Between now and June we are going to see two CPI reports, two rounds of housing sales and starts and permits, two retail sales figures, and two industrial production figures, just to note some of the data that we will be seeing between now and the next meeting. So I think it is useful for us to indicate that we will be responding to changes in the outlook and to leave ourselves the flexibility to respond in June according to how the outlook evolves.

I am very sensitive to the issue of overshooting. At least in principle, the correct response is that we look at the outlook, not at the current data. To the extent that our forecasts incorporate the lagged effects of interest rates, we should, in principle at least, be trying to accommodate that issue. So I recommend a 25 basis point increase today. I recommend alternative B.

I have a couple of questions for the group. I gather that most people have acceded to that statement, but let me just ask a couple of questions about the language. The first is, Could we drop number five? It does reemphasize the broad principle that we respond to changes in economic prospects, but it is a bit redundant given the previous statement. So that is the first question I am going to ask you. The second question has to do with inflation expectations. I think it would be a big mistake to somehow indicate that we thought they were not contained. First of all, it is not factually correct, as Vincent's demonstration showed. Second, it would convey a concern about the state of expectations that is greater than the one we actually have. What we could do—and I am a little reluctant, but I am open to the suggestion—would be to say in that sentence, "Inflation expectations have risen slightly but remain contained" or something like that.

MS. MINEHAN. Instead of saying "remain," you could just say "are."

CHAIRMAN BERNANKE. Or "are contained."

MS. MINEHAN. "And inflation expectations are contained."

CHAIRMAN BERNANKE. Well, I would say "remain" because, remember, it is even after the change. They were contained before, and now they remain contained, despite the increase.

MS. MINEHAN. Yes, but "remain" seems to me to say that they are at the same level as they were before, whereas "are" says they are in the container.

CHAIRMAN BERNANKE. No, it just says they are still contained. President Moskow.

MR. MOSKOW. Mr. Chairman, I like the change you suggest. The important point is for the outside world to be aware that we recognize there has been a change in inflation expectations. I mean, if we keep it exactly as we had it before, we look as though we are not aware of what is happening in the marketplace. So I think your change is a very good one.

CHAIRMAN BERNANKE. Is there anyone who has an opposite view?

MR. KROSZNER. I think as you said, Mr. Chairman, putting in number 4 that we are singling out one of the two objectives—addressing inflation—is going to be perceived as a hawkish move relative to what we had before. Therefore, I do not think making the additional change is necessary because I think that has largely been conveyed. Given the relatively small changes in inflation expectations, to even acknowledge that there are small changes—although saying so is factually correct—goes further than is necessary. But I share your concern about wanting to make sure that we are very clear that we are concerned about inflation and inflation expectations.

CHAIRMAN BERNANKE. President Hoenig.

MR. HOENIG. I would not change the language. I would leave it as it is because inflation expectations are contained, and we want to make sure they stay contained. That is what the two sentences independent of one another do. I think it is a good balance.

CHAIRMAN BERNANKE. President Pianalto.

MS. PIANALTO. I agree with President Hoenig and Governor Kroszner.

CHAIRMAN BERNANKE. First Vice President Stone.

MR. STONE. Even though I said I certainly would think about it, I am satisfied from what I have heard around the table about the balance between part 4 and part 3. The probability is of doing more harm than good with changing that, and so even modest changes in the wording are probably not worth making.

CHAIRMAN BERNANKE. President Fisher.

MR. FISHER. Mr. Chairman, in the subsequent sentence we have “the potential to add to inflation pressures,” and then in the first sentence in paragraph 4 we say that “further policy firming may be needed to address inflation risks." So you want to be careful you do not have overkill here, even though I am very worried about inflation.

CHAIRMAN BERNANKE. Thank you for these comments. If it is all right with you, President Moskow, I would like to hold off on this until the evidence is a little clearer that inflation expectations have moved up. Other comments? Governor Bies.

MS. BIES. Mr. Chairman, in number 5, I always felt it was redundant when we had clearly communicated we were on this long trajectory. But when we are near a turning point or a pausing point, it is probably more important to remind the market that things can happen that we do not expect, that it is not a precise forecast, and I find that this sentence is more useful at turns than it is when we are on a long-run trajectory. So I just do not feel good about taking it out now when we have had it when it was really redundant.

CHAIRMAN BERNANKE. President Lacker.

MR. LACKER. I can see that taking out "remain contained" would signal a change in our container size that would probably confuse the markets, but I am broadly sympathetic to Michael's point, and as inflation expectations evolve further, I am going to be more sympathetic to that. With regard to five, taking it out strikes me as likely to cause markets to view what is read in alternative B, part 4, as the rewording of what is part 5 in the March statement, and so I do not think they are going to view it as a withdrawal of substantive indication of the extent to which we are going to be outlook dependent. So I would be in favor of taking it out.

CHAIRMAN BERNANKE. President Minehan.

MS. MINEHAN. I am in favor of taking it out unless someone can tell me what different thing it says other than what is said in the last part of sentence 4. Maybe I am missing something, but I think sentence or row 4, whatever we call it, says that we are going to firm, to address inflation risks, but we emphasize that the extent and timing will depend importantly on the evolution of the economic outlook as implied by incoming information. How is that different from what we are saying in row 5?

CHAIRMAN BERNANKE. The slight difference is that it refers specifically to firming whereas the last paragraph says that as a broad general principle.

MS. MINEHAN. Do we think that the last sentence gives us the ability then to reduce rates in the context?

CHAIRMAN BERNANKE. If necessary.

MS. MINEHAN. Because there are ways you could change the language in row 4 to deal with that. But if that is what you think, if you feel that that gives us a little more flexibility, I guess I do not have a problem with it.

CHAIRMAN BERNANKE. Governor Kohn.

MR. KOHN. I support leaving row 5 in, and I support it because the old row 5 referred to the dual objectives of price stability and sustainable growth, which came in row 4. The new row 4 does not refer to sustainable growth at all. This is vague, but if challenged, we could at least say that we have not forgotten about our dual objectives. If we omit any even indirect reference to the dual objectives, it does not describe our reaction function and would not be the right thing to do.

CHAIRMAN BERNANKE. Yes.

VICE CHAIRMAN GEITHNER. I would append to Governor Kohn’s remark and just say that for that reason, President Minehan, it does have the benefit of adding to flexibility.

CHAIRMAN BERNANKE. President Yellen.

MS. YELLEN. I strongly support what Governor Kohn said.

CHAIRMAN BERNANKE. All right. President Fisher.

MR. FISHER. This is slight heresy, but after the word “information” in row 4, I would just put “in support of the attainment of our objectives” or “its objectives.” Take out the black stuff. It is a slight change. That achieves what Cathy wants.

MS. MINEHAN. There are easy ways to modify row 4 to make it do the same thing.

MR. FISHER. That is what I mean.

CHAIRMAN BERNANKE. At this point, having heard the discussion, I would like to propose to the group that we keep line 5 where it is. Line 4 talks specifically about this firming proposal and the possibility of a pause. Line 5 responds to both of our objectives and re-emphasizes the fact that we do have, of course, symmetric employment/inflation objectives. I think I have heard around the table a few times in previous contexts that any change has implications that we may or may not be able to predict very well. Any other comments on this statement? Yes, President Poole.

MR. POOLE. I would like to ask Vince if he would give us a judgment about how the language of alternative B is likely to affect the market’s probability of action in June.

MR. REINHART. Oh, I thought that question was directed to Dino. [Laughter]

MR. POOLE. I would be happy to have you both address it.

MR. REINHART. In yesterday’s quotes, the July fed funds contract was at 5.07; so that is basically a 7-out-of-25 chance that the Committee would act. In the design of B, we thought that the probability would move it up into the 50-50 to 60-40 range. I think it is probably a little tougher than what is in the Bluebook, so I am a little more confident it would be above 50-50.

MR. KOS. It would raise it.

MR. POOLE. I will tell you my instinct is that the part that is in red will be viewed as actually producing a presumption that the first part will not be carried through. As it says, “policy firming may yet be needed.” But then the part in red, it seems to me, tempers that very, very substantially, and it is not clear to me at all that this language is likely to increase the market's odds on a further increase in June. That is my own feeling.

CHAIRMAN BERNANKE. The test I would apply would be what the odds are as of October. There is the possibility that there might be some shifting in timing between, say, June and August, for example.

MR. POOLE. Obviously this is something that is very hard to gather any evidence on in advance. I am just telling you my gut feeling for what's going to happen is that this will reduce the market's expectation about action in June, and I would be surprised if that were just simply switched out later in the year.

MR. REINHART. Well, President Poole, the most unsatisfying paragraphs in the Bluebook meeting after meeting are the ones that try to divine what the market reactions to alternative statements will be. We do not have a scientific way of doing it.

MR. POOLE. The reason I raise the question is that I agree very much with Jeff that we do not want language that reduces the market expectation of another action in June, unless the data between now and then change the outlook sufficiently.

CHAIRMAN BERNANKE. There are two parts, though. Part is the effect today. My guess is that it will be hawkish on net, but there is a lot of uncertainty, and so you may be right. The other part of this is the indication of responsiveness to data. So if the intermeeting data—and I noted how many different things we are going to be seeing—are suggestive of greater inflation pressures, I imagine that when we sit down here in June we will have a much better idea of what is expected and what we are likely to do at that point. Dino.

MR. KOS. Again, the three words that the market would be looking for are "further policy firming." Those are the three that they will be looking for and that will be taken as the signal of likely action in June. Now, what follows actually creates a bit more uncertainty because it is not as direct as some previous statements have been. So I think the probability goes up, but maybe not to 100 percent or to 80 or 90 percent. So I think Vince is in the right ballpark in his judgment.

MR. REINHART. One last point is that the second part of the sentence in row 4 is partly already in markets because it is a repetition of what was in the Joint Economic Committee testimony. So in that sense, I agree with Dino that they will be looking at the earlier words.

CHAIRMAN BERNANKE. Are there any other comments? Yes.

MR. MOSKOW. I just had a question. It is a slight, minor change, but would it make any difference if you took out the two words "emphasizes that" from number 4?

CHAIRMAN BERNANKE. I think it would make a difference because it would focus the market very much on the first part of the sentence, which basically is saying that we are going to move again in June. What we want to do is retain the flexibility to move or not move, depending on the flow of data between now and then.

MR. MOSKOW. So it is intentional that those two words are in there.

CHAIRMAN BERNANKE. Yes. Any other comments?

MS. DANKER. I will be reading the directive from page 29 of the Bluebook.

"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."

And the risk assessment from the press release that's being handed around:

"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."

Chairman Bernanke	Yes
Vice Chairman Geithner	Yes
Governor Bies	Yes
President Guynn	Yes
Governor Kohn	Yes
Governor Kroszner	Yes
President Lacker	Yes
Governor Olson	Yes
President Pianalto	Yes
Governor Warsh	Yes
President Yellen	Yes

CHAIRMAN BERNANKE. The Governors need to join me.

[Recess]

CHAIRMAN BERNANKE. Thank you, everyone. There are a couple of other quick items. First, I would like to ask Governor Kohn to give a brief report on his subcommittee on communications.

MR. KOHN. Thank you, Mr. Chairman. Presidents Stern and Yellen have agreed to serve with me on this subcommittee, the full-frontal subcommittee, I guess. [Laughter] We see our mission as helping the Committee—bringing issues to the Committee, helping frame the discussion, trying to figure out the topics and the logical order in which they should be addressed, and reaching out to Committee members. We do not see our mission as coming up with hard and fast recommendations to the FOMC but as just helping the discussion along. If we do see some consensus developing as we talk to you, we will certainly let you know.

The Chairman has made it very clear to me that everything is on the table in terms of communication between the Committee members and the outside world. We will think about goals and how best to meet them, how we can accomplish this. Our objective for the coming intermeeting period is to put an agenda together, to figure out the topics that we collectively should be talking about and some order in which to approach this. So we will be talking to you between now and the June meeting to get your views on what should be on the table and how we should approach some of these issues.

CHAIRMAN BERNANKE. Thank you. We have now had experience with both a two-day and a one-day meeting. I hope that maybe in June we will be able to make some kind of decision about how to schedule meetings going forward. I am going to ask Vincent to poll everyone during the intermeeting period about preferences as to meeting structure, scheduling, and the like. If anyone would like to make a comment at this point about today's meeting or this general issue, this would be the time. I hear none. You will be hearing from Vincent, and we will put this on the agenda for discussion next meeting.

The final formal action is just to note that the next meeting will be a two-day meeting on June 28 and 29. Thank you. We are adjourned.

END OF MEETING