Records

Record of Policy Actions of the Board of Governors

Regulation A
Extensions of Credit
by Federal Reserve Banks

Regulation D
Reserve Requirements
of Depository Institutions

October 31, 2002—Amendments

The Board amended Regulations A and D to implement new discount window programs, effective January 9, 2003.

> Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn.

The revisions to Regulation A replace the adjustment and extended credit programs with new primary and secondary credit programs, reorganize and streamline the rule, and would facilitate a reduction of the primary credit rate in the event of a financial emergency. The Board also amended Regulation D to conform the calculation of penalties for reserve deficiencies, which are based on the discount rate, to the new discount rate framework.

Under the new primary credit program, the Federal Reserve Banks offer very short term credit, at an interest rate above the targeted federal funds rate, as a backup source of liquidity to depository institutions that are in generally sound financial condition. The Reserve Banks establish the primary credit rate at least every two weeks, subject to review and determination by the Board, through the same procedure that had been used to set the adjustment credit rate. A secondary credit program, with an interest rate initially 50 basis points above the primary credit rate, is available in appropriate circumstances to depository institutions that do not qualify for primary credit.

The revisions are intended to improve the functioning of the discount window and do not indicate a change in the stance of monetary policy. The seasonal credit program, used mainly by small banks that have pronounced seasonal funding needs, remains essentially unchanged.

Regulation C
Home Mortgage Disclosure

January 23, 2002—Amendments

The Board approved amendments to Regulation C, which implements the Home Mortgage Disclosure Act, to expand the amount of data and number of lenders subject to the reporting requirements of the act, effective January 1, 2003.

> Votes for this action: Messrs. Ferguson, Meyer, and Gramlich, Ms. Bies, and Mr. Olson.

The Home Mortgage Disclosure Act requires covered lenders to collect, report, and publicly disclose certain data on home purchase and home improvement loans (both loans they originate and those they purchase) and applications that do not result in originations. These data include the race, ethnicity, sex, and income of the applicants and borrowers and the location of the property. The amendments require, among other things, that lenders report loan-pricing data showing the spread between the annual percentage rate charged for originated loans and the rate on U.S. Treasury securities having comparable maturity periods, if the spread equals or exceeds certain thresholds set by the Board. Lenders are also required to identify loans subject to the Home Ownership and Equity Protection Act and report denials of applications for credit received through certain preapproval programs. In addition, the amendments expand the regulation's coverage of nondepository lenders by adding a dollar-volume test of $25 million in total home purchase loan originations (including refinancings of home purchase loans) for the preceding year.

The Board published for comment a proposal that reporting thresholds for first-lien loans be set at 3 percentage points above the U.S. Treasury rate and 5 percentage points above that rate for subordinate-lien loans. The Board also requested public comment on requiring lenders to collect, for applications and originated loans, data on whether the application or loan is secured by a first or subordinate lien on a dwelling or is unsecured (the lien status) and requiring lenders to request, for loan applications made by telephone, the race, ethnicity, and sex of the applicant.

May 2, 2002—Delay of Effective Date and Interim Amendment

The Board extended the effective date for most of the amendments to Regulation C, which expand the amount of data and number of lenders subject to the reporting requirements of the Home Mortgage Disclosure Act, from January 1, 2003, to January 1, 2004. The Board also adopted an interim amendment to require reporters under the act to use 2000 census data, effective January 1, 2003.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Mr. Olson.

The Board extended for one year the effective date of amendments approved on January 23, 2002, as discussed above, to give institutions sufficient time to implement the new reporting requirements. The extension allows institutions to fully implement the new rules without jeopardizing the quality and usefulness of the data and without incurring substantial additional implementation costs that could be avoided by a delay in the effective date. The Board also adopted an interim amendment to improve the accuracy and usefulness of the data submitted under the act by requiring reporters to use 2000 census data, effective January 1, 2003.

June 3, 2002—Amendments

The Board approved amendments to implement the following proposals made in connection with the January 2002 amendments to Regulation C: establish reporting thresholds for loan-pricing data and require reporting of lien-status data, effective January 1, 2004, and require lenders to request additional information in telephone applications, effective January 1, 2003.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Mr. Olson.

As discussed above, the Board approved amendments to the data collection requirements of Regulation C on January 23, 2002. It also published for comment proposals that would establish thresholds for reporting loan-pricing data based on a rate spread (between the annual percentage rate on a loan and the yield on comparable U.S. Treasury securities) of 3 percentage points for first-lien loans and 5 percentage points for subordinate-lien loans; require lenders to report the lien status of applications and originated loans; and require lenders to request the race, ethnicity, and sex of telephone applicants. The Board approved these proposals with the effective dates indicated.

Regulation D
Reserve Requirements of Depository Institutions

October 1, 2002—Amendments

The Board amended Regulation D to increase the amount of net transaction accounts at depository institutions to which a lower reserve requirement applies (low reserve tranche) and the amount of reservable liabilities exempt from reserve requirements (reservable liabilities exemption level) for 2003, effective for the reserve computation period beginning November 26, 2002, for institutions reporting weekly.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn.

Under the Monetary Control Act of 1980, depository institutions, Edge and agreement corporations, and U.S. agencies and branches of foreign banks are subject to reserve requirements set by the Board. The act directs the Board to adjust annually the amount of the low reserve tranche on the basis of percentage changes in net transaction accounts at all depository institutions over the one-year period ending on the most recent June 30. The growth in total net transaction accounts from June 30, 2001, to June 30, 2002, warranted an increase in the low reserve tranche from $41.3 million to $42.1 million, and the Board amended Regulation D accordingly.

The Garn–St Germain Depository Institutions Act of 1982 establishes a zero percent reserve requirement on the first $2 million of an institution’s reservable liabilities. The act also provides for annual adjustments to that exemption amount based on percentage increases in reservable liabilities at all depository institutions over the one-year period ending on the most recent June 30. The growth in total reservable liabilities from June 30, 2001, to June 30, 2002, warranted an increase in the reservable liabilities exemption level from $5.7 million to $6 million, and the Board amended Regulation D accordingly.

For institutions that report weekly, the amendments adjusting the low reserve tranche and the reservable liabilities exemption level are effective for the fourteen-day reserve computation period beginning Tuesday, November 26, 2002, and for the corresponding fourteen-day reserve maintenance period beginning Thursday, December 26, 2002. For institutions that report quarterly, the amendments are effective for the seven-day reserve computation period beginning Tuesday, December 17, 2002, and for the corresponding seven-day reserve maintenance period beginning Thursday, January 16, 2003.

Nonexempt depository institutions that have total reservable liabilities greater than the amount exempted from reserve requirements ($6 million in 2003) report either weekly or quarterly depending on the amount of their total deposits. To ease the reporting burden on small institutions, the Board requires nonexempt depository institutions with total deposits below a specified level (nonexempt deposit cutoff level) to report their deposits and reservable liabilities quarterly or less frequently, while larger institutions must report weekly.[1] To reflect the growth of total deposits at all depository institutions from June 30, 2001, to June 30, 2002, the Board increased the nonexempt deposit cutoff level from $106.9 million to $112.3 million, to be implemented in September 2003.

Exempt institutions (those with total reservable liabilities equal to or less than the reservable liabilities exemption level of $6 million in 2003) with at least $6 million in total deposits may report annually, and exempt institutions with less than $6 million in total deposits are not required to file deposit reports.

Regulation H
Membership of State Banking Institutions in the Federal Reserve System

May 30, 2002—Amendments

The Board amended Regulation H to include any branch of a bank controlled by an out-of-state bank holding company under the prohibition against using interstate branches primarily for deposit production, effective October 1, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Mr. Olson.

1. All U.S. branches and agencies of foreign banks and Edge and agreement corporations are required to submit the Report of Transaction Accounts, Other Deposits, and Vault Cash (FR 2900) weekly regardless of size. In addition, depository institutions that obtain funds from non-U.S. sources or that have foreign branches or international banking facilities continue to be required to file the Report of Certain Eurocurrency Transactions (FR 2950/FR 2951) at the same frequency as they file the FR 2900 report.

Regulation H implements the provision of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 that prohibits a bank from establishing or acquiring a branch outside its home state primarily for the purpose of deposit production. That act also provides guidelines for determining whether the bank is reasonably helping to meet the credit needs of the communities served by the branch. Congress enacted the prohibition to ensure that the authorization for interstate branches would not result in banks' taking deposits from a community without reasonably helping to meet the credit needs of that community.

The Gramm–Leach–Bliley Act of 1999 expands the prohibition against deposit-production offices to include any branch of a bank controlled by an out-of-state bank holding company. The Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency jointly amended their regulations on June 5, 2002, to conform to the expanded prohibition.

Regulation H
Membership of State Banking Institutions in the Federal Reserve System

Regulation Y
Bank Holding Companies and Change in Bank Control

January 28, 2002—Amendments

The Board reduced, for state member banks and bank holding companies, the risk weighting in capital standards for certain claims on securities firms, effective July 1, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, Meyer, and Gramlich, Ms. Bies, and Mr. Olson.

The Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision jointly amended their risk-based capital standards for supervised banking and savings institutions on March 27, 2002, to reduce the risk weight applied to certain claims on, and claims guaranteed by, qualifying securities firms incorporated in the United States and in other countries that are members of the Organisation for Economic Co-operation and Development (OECD). The Federal Deposit Insurance Corporation and the Office of Thrift Supervision also conformed their capital standards to those of the other agencies by permitting a zero percent risk weight for certain claims on qualifying securities firms that are collateralized by (1) cash on deposit in the lending institution or (2) securities issued or guaranteed by the U.S. government or its agencies or OECD central governments.

Regulation K
International Banking Operations

December 30, 2002—Amendments

The Board amended provisions of Regulation K on international lending supervision to conform to technical changes adopted by the other federal banking agencies, effective February 10, 2003.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn.

Subpart D of Regulation K, which implements the International Lending Supervision Act of 1983, governs international lending by state member banks, bank holding companies, and Edge and agreement corporations engaged in banking and specifies when reserves are required for particular international assets. The amendments conform these provisions to those of the other federal banking agencies by eliminating requirements for a particular accounting method for fees on international loans and requiring instead that institutions follow generally accepted accounting principles (GAAP) for such fees.

Regulation W
Transactions between Member Banks and Their Affiliates

October 31, 2002—New Regulation

The Board approved new Regulation W, which comprehensively implements sections 23A and 23B of the Federal Reserve Act, effective April 1, 2003.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn.

Sections 23A and 23B of the Federal Reserve Act restrict loans by a member bank to its affiliates, asset purchases by a member bank from its affiliates, and certain other transactions between a member bank and its affiliates. The purpose of the statute is to limit a member bank's risk of loss in transactions with affiliates and to limit a member bank's ability to transfer to its affiliates the benefits arising from its access to the federal safety net. Regulation W unifies in one document previous interpretations of sections 23A and 23B as well as new interpretations of the statute, including interpretations that address derivative transactions, intraday extensions of credit, and financial subsidiaries.

The Board also approved a preamble to Regulation W that provides a detailed explanation of the rule. In addition, the Board published for comment a proposed rule that would limit the current exemption from section 23A for certain loan purchases from an affiliate.

Policy Statements and Other Actions

February 11, 2002—Statement on Equity Hedging Activities by State Member Banks

The Board issued a statement indicating that it would not apply section 9 of the Federal Reserve Act to prohibit a state member bank from acquiring equity securities to hedge its bank-permissible equity derivative transactions if such transactions are conducted in accordance with the same restrictions applicable to national banks, effective February 21, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Mr. Olson.

Section 9 of the Federal Reserve Act provides that state member banks are subject to the same limitations and conditions on the purchase, sale, underwriting, and holding of investment securities and stock that apply to national banks. The Office of the Comptroller of the Currency has determined that national banks may acquire equity securities to hedge their exposure to customer-driven equity derivative transactions lawfully entered into by the bank. Such transactions may include equity swaps, equity-index swaps, equity-index deposits, and equity-linked loans. Accordingly, the statement provides that the Board would not apply section 9 of the act to prohibit a state member bank from purchasing equity securities to hedge risks arising from equity derivative transactions entered into by the bank with an unaffiliated third party if such purchases are made under the same conditions and restrictions applicable to national banks. A state member bank must receive the prior approval of the Board's Director of the Division of Banking Supervision and Regulation to engage in equity hedging activities and must conduct its equity derivative and equity hedging activities in accordance with applicable law.

April 5, 2002—System Regulations for Federal Reserve Law Enforcement Officers

The Board approved regulations governing the exercise of law enforcement authority by designated Federal Reserve System personnel, effective June 7, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Mr. Olson.

The USA PATRIOT Act of 2001 amended section 11 of the Federal Reserve Act to provide federal law enforcement authority for protection personnel at the Federal Reserve Banks, and for special agents in the Protective Services Unit and security officers at the Board. The implementing regulations, which were subsequently approved by the Attorney General of the United States in accordance with the act, authorize designated on-duty personnel to carry firearms when protecting System personnel, property, or operations; make arrests for violations of federal law; and obtain law enforcement information. The regulations also contain specific training requirements and rules governing the use of law enforcement authority. The Board delegated authority to each Reserve Bank to designate law enforcement personnel.

April 18, 2002—Joint Agency Statement on Parallel-Owned Banking Organizations

The Board approved an interagency statement on the potential risks posed by parallel-owned banking organizations and the supervisory approach to address those risks, effective April 23, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Mr. Olson.

The Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision jointly issued a statement on parallel-owned banking organizations on April 23, 2002. A parallel-owned banking organization is created when a U.S. depository institution and a foreign bank are both controlled directly or indirectly by one person or a group of persons rather than by a bank or thrift holding company subject to supervision by a federal regulator. Accordingly, each of the organization's banks is supervised by only the regulatory authority for the home country of the bank. The interagency statement contains guidance on identifying parallel-owned banking organizations, reviews the risks associated with them, and discusses actions that the agencies may take to minimize those risks. It also describes the agencies' approach to applications and notices filed by U.S. depository institutions in parallel-owned banking organizations.

August 13, 2002—Policy Statement on Payments System Risk

The Board decided not to adopt two proposed changes to its payments system risk policy that would (1) lower self-assessed net debit caps and eliminate two-week average caps and (2) reject all payments with settlement-day finality that would cause an institution to exceed its daylight overdraft capacity level.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn.

These proposed changes were among several modifications to its payments system risk policy that the Board had published for comment in June 2001 after a broad review of the policy. An institution's net debit cap refers to the maximum dollar amount of uncollateralized daylight overdrafts that it may incur in its Federal Reserve account. A daylight overdraft occurs when a depository institution's Federal Reserve account is in a negative position at any time during the business day.

Although the Board chose not to implement the two proposals in the foreseeable future, it will continue to analyze the benefits and potential drawbacks of a third proposed modification: a two-tiered pricing system for daylight overdrafts in which institutions that pledge collateral to the Federal Reserve Banks would pay a lower fee on their collateralized daylight overdrafts than on their uncollateralized daylight overdrafts.

Discount Rates in 2002

During 2002, the Board of Governors approved one change in the basic discount rate charged by the Federal Reserve Banks. On November 6, the basic rate was reduced by ½ percentage point to a level of ¾ percent. The rates for seasonal and extended credit, which were recalculated biweekly in accordance with market-related formulas, exceeded the basic rate by different amounts during the year. On October 31, the Board approved new discount window programs, effective January 9, 2003.

Basic Discount Rate

The Board's decisions on the basic discount rate were made against the background of the policy actions of the Federal Open Market Committee (FOMC) and related economic and financial developments. These developments are reviewed more fully in other parts of this Report, including the minutes of the FOMC meetings held in 2002.

Reduction in the Basic Rate in November 2002

Before November 6, the Board reviewed, but took no action on, requests by a number of Federal Reserve Banks to raise or lower the basic discount rate. The Board's decision on November 6 was consistent with its practice in recent years generally to adjust the basic rate when the FOMC makes changes to its target for the federal funds rate. Underlying the decisions on both rates in 2002 was the persistence of a high degree of uncertainty about the outlook for continued economic recovery in the context of an uneven pace of expansion and, particularly over the summer and fall, a predominance of downside risks to the economy. By early November, generally disappointing information on the performance of the economy seemed to presage a longer-lasting spell of subpar economic growth than had been anticipated earlier. Although the stance of monetary policy was already accommodative, the FOMC and the Board on November 6 approved relatively sizable reductions of ½ percentage point in the target rate for the federal funds rate and the basic discount rate to enhance the prospects of a strengthening economic recovery over the coming year. There were no further decisions on the basic discount rate in 2002.

Structure of Discount Rates

The basic discount rate was the rate normally charged on loans to depository institutions for short-term adjustment credit, and it continued to be set on the basis of general monetary policy considerations. The Federal Reserve Banks provided two other types of discount window credit: (1) seasonal credit, whose purpose was to assist smaller institutions in managing liquidity needs that arose from regular seasonal swings in loans and deposits, and (2) extended credit, which was available in appropriate circumstances to depository institutions that experienced somewhat longer-term liquidity needs. The rates on both types of credit were calculated every two weeks in accordance with formulas based on market interest rates. Under those formulas, the rates charged for seasonal credit in 2002 were somewhat higher than the basic discount rate, and the rate on extended credit was 50 basis points higher than that for seasonal credit. During 2002, the rate for seasonal credit ranged from a high of 1.85 percent to a low of 1.30 percent, and the rate for extended credit ranged from a high of 2.35 percent to a low of 1.80 percent. At the end of 2002, the structure of discount rates was as follows: a basic rate of 0.75 percent for short-term adjustment credit and rates of 1.30 percent for seasonal credit and 1.80 percent for extended credit.

Board Votes

Under the Federal Reserve Act, the boards of directors of the Federal Reserve Banks are required to establish rates on loans to depository institutions at least every fourteen days and must submit the rates to the Board of Governors for review and determination. During 2002, the Reserve Banks submitted, on the same schedule, requests to renew the formulas based on short-term market interest rates for calculating the rates on seasonal and extended credit. Votes on the reestablishment of the formulas for these flexible rates are not shown in this summary. All votes taken by the Board of Governors during 2002 were unanimous.

Vote on the Basic Discount Rate

November 6, 2002. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of New York, Dallas, and San Francisco to reduce the basic discount rate by ½ percentage point to ¾ percent. The same decrease was approved for the remaining Federal Reserve Banks, effective November 7, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn.

New Discount Window Programs

On October 31, 2002, the Board amended its Regulation A to establish two new forms of discount window credit, primary and secondary credit, to replace adjustment and extended credit, effective January 9, 2003. Primary credit will be made available for very short terms as a backup source of liquidity to depository institutions that, in the judgment of the lending Federal Reserve Bank, are in generally sound financial condition. Primary credit will be extended at a rate above the federal funds rate to be established at least every two weeks, subject to the Board's review and determination. By applying an above-market rate and restricting eligibility to generally sound institutions, the primary credit program is expected to substantially reduce the need for the Federal Reserve to review the funding situations of borrowers and monitor their use of borrowed funds. Secondary credit will be available in appropriate circumstances to depository institutions that do not qualify for primary credit. When the new programs were approved, the Board expected that Reserve Banks would initially establish a primary credit rate at a level 100 basis points above the federal funds target rate and a secondary credit rate at a level 50 basis points above the primary rate.[2] The seasonal credit program was not affected by these changes. The rate on seasonal credit will continue to be set by a formula based on market interest rates.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn. ■

2. On January 7, 2003, the Board of Governors approved requests by the twelve Reserve Banks to establish primary credit rates of 2¼ percent and secondary credit rates of 2¾ percent, which were 100 basis points and 150 basis points respectively above the FOMC's target rate for the federal funds rate.

Minutes of Federal Open Market Committee Meetings

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

The minutes of the meetings contain the votes on the policy decisions made at those meetings as well as a résumé of the information and discussions that led to the decisions. The summary descriptions of economic and financial conditions are based on the information that was available to the Committee at the time of the meetings rather than on data as they may have been revised later.

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

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market operations, the Federal Reserve Bank of New York operates under three sets of instructions from the Federal Open Market Committee: an Authorization for Domestic Open Market Operations, Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues, and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Committee operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations. These policy instruments are shown below in the form in which they were in effect at the beginning of 2002. Changes in the instruments during the year are reported in the minutes for the individual meetings.

Authorization for Domestic Open Market Operations

In Effect January 1, 2002

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

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the

United States in the open market, from or to securities dealers and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $12.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

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

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

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding but that in no event shall be less than 1.0 percent per annum of the market value of the securities lent. The Federal Reserve Bank of New York shall apply reasonable limitations on the total amount of a specific issue that may be auctioned, and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

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

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat

in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues

In Effect January 1, 2002

1. System open market operations in Federal agency issues are an integral part of total System open market operations designed to influence bank reserves, money market conditions, and monetary aggregates.

2. System open market operations in Federal agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

Domestic Policy Directive

In Effect January 1, 2002[1]

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 reducing the federal funds rate to an average of around 1¾ percent.

The Committee also approved the sentence below for inclusion in the press statement to be released shortly after the December 11, 2001, meeting:

1. Adopted by the Committee at its meeting on December 11, 2001.

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Authorization for Foreign Currency Operations

In Effect January 1, 2002

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

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

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

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

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

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

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

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

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

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

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

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

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

7. The Chairman is authorized:

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

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

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

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

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

Foreign Currency Directive

In Effect January 1, 2002

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

2. To achieve this end the System shall:

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

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

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

3. Transactions may also be undertaken:

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

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

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

4. System foreign currency operations shall be conducted:

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

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

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

Procedural Instructions with Respect to Foreign Currency Operations

In Effect January 1, 2002

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

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

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

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

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

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

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

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

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

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

Meeting Held on January 29–30, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, January 29, 2002, at 2:30 p.m. and continued on Wednesday, January 30, 2002, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Jordan
Mr. McTeer
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter,[2] Deputy General Counsel
Ms. Johnson, Economist
Mr. Reinhart, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Howard, Lindsey, Ms. Mester, Messrs. Oliner, Rolnick, Rosenblum, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

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

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

2. Attended Tuesday session only.

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

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

Messrs. Kamin[3] and Whitesell, Deputy Associate Directors, Divisions of International Finance and Monetary Affairs respectively, Board of Governors

Messrs. Gagnon[3] and Reifschneider,[3] Assistant Directors, Divisions of International Finance and Research and Statistics respectively, Board of Governors

Mr. Small,[3] Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Morton,[4] Senior Economist, Division of International Finance, Board of Governors

Messrs. Lebow[4] and Williams,[3] Senior Economists, Division of Research and Statistics, Board of Governors

Messrs. Ahearn[3] and Wright,[3] Economists, Division of International Finance, Board of Governors

Mr. Zakrajšek,[4] Economist, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Office of Board Members, Board of Governors

Mr. Lyon, First Vice President, Federal Reserve Bank of Minneapolis

3. Attended portion of meeting relating to the discussion of monetary policy near the zero bound on nominal interest rates.

4. Attended portion of meeting relating to the above discussion and to the Committee's review of the economic outlook.

Messrs. Beebe, Eisenbeis, Fuhrer, Goodfriend, Hakkio, Hunter, Ms. Krieger, and Mr. Rasche, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Boston, Richmond, Kansas City, Chicago, New York, and St. Louis respectively

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 2002, and ending December 31, 2002, had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

William J. McDonough, President of the Federal Reserve Bank of New York, with Jamie B. Stewart, Jr., First Vice President of the Federal Reserve Bank of New York, as alternate.

Anthony M. Santomero, President of the Federal Reserve Bank of Philadelphia, with J. Alfred Broaddus, Jr., President of the Federal Reserve Bank of Richmond, as alternate.

Jerry L. Jordan, President of the Federal Reserve Bank of Cleveland, with Michael H. Moskow, President of the Federal Reserve Bank of Chicago, as alternate.

Robert D. McTeer, Jr., President of the Federal Reserve Bank of Dallas, with Jack Guynn, President of the Federal Reserve Bank of Atlanta, as alternate.

Gary H. Stern, President of the Federal Reserve Bank of Minneapolis, with Robert T. Parry, President of the Federal Reserve Bank of San Francisco, as alternate.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first regularly scheduled meeting of the Committee after December 31, 2002, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee:

Alan Greenspan	Chairman
William J. McDonough	Vice Chairman
Donald L. Kohn	Secretary and Economist
Normand R.V. Bernard	Deputy Secretary
Gary P. Gillum	Assistant Secretary
Michelle A. Smith	Assistant Secretary
J. Virgil Mattingly, Jr.	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Karen H. Johnson	Economist
Vincent R. Reinhart	Economist
David J. Stockton	Economist

Thomas A. Connors, Christine Cumming, David H. Howard, David E. Lindsey, Loretta J. Mester, Stephen D. Oliner, Arthur J. Rolnick, Harvey Rosenblum, Mark S. Sniderman, and David W. Wilcox, Associate Economists

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first regularly scheduled meeting of the Committee after December 31, 2002.

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

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

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

Authorization for Domestic Open Market Operations (Reaffirmed January 29, 2002)

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

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $12.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting.

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

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

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding but that in no event shall be less than 1.0 percent per annum of the market value of the securities lent. The Federal Reserve Bank of New York shall apply reasonable limitations on the total amount of a specific issue that may be auctioned, and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

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

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

By unanimous vote, the Committee approved until the Committee's first regularly scheduled meeting in 2003 a further extension of the temporary suspension of paragraphs 3 to 6 of the Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues. For the year ahead, the Guidelines therefore continued to read as shown below:

Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues (Reaffirmed January 29, 2002)

1. System open market operations in Federal agency issues are an integral part of total System open market operations designed to

influence bank reserves, money market conditions, and monetary aggregates.

2. System open market operations in Federal agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

By unanimous vote, the Authorization for Foreign Currency Operations was reaffirmed in the form shown below.

Authorization for Foreign Currency Operations (Reaffirmed January 29, 2002)

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

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

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

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

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

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

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

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

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

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

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transac-

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

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

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

7. The Chairman is authorized:

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

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

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

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

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

By unanimous vote, the Foreign Currency Directive was reaffirmed in the form shown below.

Foreign Currency Directive (Reaffirmed January 29, 2002)

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

2. To achieve this end the System shall:

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

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

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

3. Transactions may also be undertaken:

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

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

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

4. System foreign currency operations shall be conducted:

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

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

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

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

Procedural Instructions with Respect to Foreign Currency Operations (Reaffirmed January 29, 2002)

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

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

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

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

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

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

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

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

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

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

On January 17, 2002, copies of the continuing rules, regulations, and other instructions of the Committee had been distributed with the advice that, in accordance with procedures approved by the Committee, they were being called to the Committee's attention before the January 29–30 organization meeting to give members an opportunity to raise any questions they might have concerning them. Members were asked to indicate if they wished to have any of the instruments in question placed on the agenda for consideration at this meeting, and no requests for consideration were received. Accordingly, all of these instruments remained in effect in their existing form.

By unanimous vote, the minutes of the meeting of the Federal Open Market

Committee held on December 11, 2001, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period December 11, 2002, to January 29, 2002. By unanimous vote, the Committee ratified these transactions.

At this meeting, members discussed staff background analyses of the implications for the conduct of policy if the economy were to deteriorate substantially in a period when nominal short-term interest rates were already at very low levels. Under such conditions, while unconventional policy measures might be available, their efficacy was uncertain, and it might be impossible to ease monetary policy sufficiently through the usual interest rate process to achieve System objectives. The members agreed that the potential for such an economic and policy scenario seemed highly remote, but it could not be dismissed altogether. If in the future such circumstances appeared to be in the process of materializing, a case could be made at that point for taking preemptive easing actions to help guard against the potential development of economic weakness and price declines that could be associated with the so-called "zero bound" policy constraint.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that economic activity probably steadied in the fourth quarter after a sizable drop in the summer. Final demand appeared to have increased appreciably, reflecting strength in consumer spending and a smaller decline in business purchases of durable equipment and software. However, businesses met a good part of the pickup in final demand through a large runoff of inventories, and as a consequence manufacturing activity and payroll employment continued to weaken late in the year, though at a slower pace. Falling energy prices and widespread discounting of goods held down consumer price inflation.

The labor market deteriorated somewhat further in December, and the unemployment rate continued to climb, to 5.8 percent. Private nonfarm payrolls fell considerably, with manufacturing again experiencing the largest job losses, but the decrease was less than in previous months and aggregate hours worked by private production workers leveled out after six months of decline. Recent data on initial claims for unemployment insurance pointed to a further moderation in employment losses in January.

Industrial production edged down in December after having fallen sharply in previous months. A number of industries experienced further reductions in output, with weakness most pronounced in consumer nondurables and business equipment. In contrast, motor vehicle assemblies rose to a still higher rate, presumably in response to the robust sales of the preceding two months, and the production of semiconductors and computers continued to strengthen. The rate of utilization of total manufacturing capacity declined a little further in December, and the average rate for the fourth quarter was at its lowest quarterly level since 1983.

Growth of consumer spending strengthened considerably late in the year after a slow advance in the third quarter. A surge in purchases of motor vehicles in response to attractive financing incentives was a key factor in the pickup, but expenditures on goods other than motor vehicles evidently also accelerated slightly. By contrast, spending on services expanded at a reduced pace, owing at least in part to relatively low demand for residential heating services.

Despite unseasonably warm and dry autumn weather, residential construction slowed somewhat in the fourth quarter. For the year as a whole, though, homebuilding and home sales remained relatively brisk as very low mortgage rates tended to offset the effects of a weakening job market and sluggish growth in personal income. An apparent consequence of reduced income growth and of lower equity prices was a change in the mix of single-family homebuilding, with less emphasis on construction of high-priced homes.

Business expenditures on durable equipment and software contracted less rapidly in the fourth quarter, and monthly data indicated that such spending might be bottoming out late in the year despite further decreases in business output and continuing weakness in corporate cash flows. Business purchases of motor vehicles accounted for some of the improvement, and expenditures for computers and related equipment apparently recorded a small gain. Elsewhere, though, acquisitions of communications equipment were still on a downward trend, and business spending in sectors other than high technology and transportation remained weak. Nonresidential construction declined sharply further in the fourth quarter despite favorable weather over much of the country. Spending on industrial structures plunged, reflecting low capacity utilization in manufacturing and rising vacancy rates. Office building activity also fell as increasing amounts of available space and uncertainties regarding rents and property values weighed on the office market.

Nonfarm inventory liquidation apparently was very rapid in the fourth quarter, but inventory–sales ratios remained elevated in an environment of weak sales. The book value of manufacturing and trade inventories plunged in October and November (latest data), but progress in getting inventory overhangs under control was limited. In manufacturing, the sector's stock–shipments ratio persisted at a high level despite continuing sizable rundowns in inventories since the spring. Wholesalers apparently stepped up their runoffs of excess stocks in recent months, yet the aggregate inventory–sales ratio for the sector had fallen only slightly since midyear. Retailers made greater progress in reducing inventories, and despite relatively sluggish sales the sector's inventory–sales ratio dropped considerably and appeared to be at a fairly comfortable level.

The U.S. trade deficit in goods and services narrowed slightly on balance in October and November (latest data) from the third-quarter level (adjusted to exclude large, one-time payments by foreign insurers related to the events of September 11) as the value of imports for the two-month period fell by more than the value of exports. The available information suggested further slight slippage of economic activity in the foreign industrial countries in the fourth quarter. The Japanese economy remained very weak, economic activity in the euro area and Canada seemed to have contracted, and growth in the

United Kingdom apparently slowed. There were some indications, however, of a brighter economic outlook ahead in the euro area, Canada, and the United Kingdom that would result in part from monetary easing actions that their respective central banks had taken. Economic conditions in the major emerging-market countries were mixed. There were increasing signs of a recovery in developing Asia, especially in some of the countries that had been hurt by the global high-tech slump, but conditions in Latin America remained relatively weak, with the Argentine economy having deteriorated further.

Consumer price inflation was quite low at year-end. With energy prices declining, both the consumer price index (CPI) and the personal consumption expenditure (PCE) chain-type price index edged down on balance in November and December. Moreover, excluding the effects of volatile oil prices, core consumer price inflation was held down late in the year by widespread discounting of goods. Consumer price inflation as measured by the core PCE index declined somewhat on a year-over-year basis, while core CPI inflation increased slightly in 2001. At the producer level, core prices for finished goods changed little in November and December, and the index for core producer inflation slowed noticeably last year. With regard to labor costs, growth of average hourly earnings of production or nonsupervisory workers picked up in November and December, but the average wage increase for the year was moderate and slightly less than that for 2000.

At its meeting on December 11, 2001, the Committee adopted a directive that called for implementing conditions in reserve markets consistent with a decrease of 25 basis points in the intended level of the federal funds rate, to about 1¾ percent. The members also agreed that the balance of risks remained weighted toward conditions that could generate economic weakness in the foreseeable future. The members noted that there were preliminary signs of some abatement of the contractionary forces acting on the economy, but they believed that a subpar economic performance was likely to persist for a time. They also recognized that the stance of policy was already quite accommodative and that much of the effect of recent monetary easing actions was yet to be felt. In the circumstances, they saw a modest further reduction of the federal funds rate as providing some added insurance against a more extended contraction of the economy at little risk of a pickup in inflation.

Federal funds traded at rates close to the Committee's target level of 1¾ percent during the intermeeting period. The Committee's action had been widely anticipated, but the financial markets evidently interpreted the announcement as indicating that the FOMC's assessment of the economic outlook was weaker than had been assumed. Corporate announcements of downward revisions to forecasts of future revenues and capital spending also contributed to some marking down by market participants of prospects for economic activity. Yields on Treasury coupon securities declined slightly over the intermeeting period, risk spreads on corporate debt securities changed little, and major indexes of equity prices edged lower on balance.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies increased somewhat on balance over the intermeeting period and reached its highest level since the mid-1980s. Weakness of the Japanese yen was an important factor in that rise, as market participants focused on continuing problems in the Japanese economy and on comments by Japanese officials that seemed to signal a willingness to accept a weaker value for the yen. The dollar also appreciated slightly against the euro, perhaps reflecting a market view that the U.S. economy was likely to lead the rebound from the global slowdown. In addition, the exchange value of the dollar increased slightly in terms of an index of the currencies of other important trading partners, in part because of the depreciation of the Argentine peso.

Growth of M2 slowed slightly in December from November's robust pace and moderated considerably further in the early weeks of January. The brisk expansion of liquid deposits over recent months had been associated with the effects of mortgage refinancing activity and the substantial decline in the opportunity costs of such deposits that was related to previous easing actions. The currency component of M2 also had been strong in the latter part of 2001, largely the result of a pickup in demand for U.S. currency abroad. The debt of the domestic nonfinancial sectors was estimated to have expanded at a slightly slower rate in December, reflecting some moderation in business debt financing, a slightly slower pace of household borrowing, and little net borrowing by the federal government.

The staff forecast prepared for this meeting suggested that economic activity likely would start to turn up early in 2002 as inventory liquidation tapered off, and would gather strength only gradually. The monetary ease and fiscal stimulus already in place would provide impetus for the recovery, though the wealth effects of earlier reductions in equity prices, sluggish growth abroad, and the dollar's strength would tend to offset some of that support for a time. The gradual strengthening of the recovery would be associated with a marked slowing in the contraction of business capital investment and the added consumer purchasing power arising from recent declines in oil prices. Economic expansion was projected to strengthen appreciably by the second half of 2002 and subsequently, as the climate for business fixed investment continued to improve and as a strengthening of foreign economies led to somewhat greater demand for U.S. exports. The unemployment rate would begin to edge down. Subpar expansion over the next few quarters was expected to foster an appreciable further easing of pressures on resources and some moderation in core consumer price inflation.

In the Committee's discussion of current and prospective economic conditions, members commented that the recent information was more positive than they had anticipated and seemed on the whole to indicate that economic activity was bottoming out and a recovery might already be under way. Important impetus to economic activity in the period immediately ahead likely would be provided by a turnaround in inventory investment following several quarters of increasingly large liquidation that had culminated in the outsized decline in inventories reported for the fourth quarter. Looking beyond the near term, members expressed considerable uncertainty about the prospective strength of final demand. The stimulus from fiscal and monetary actions taken in 2001, the impetus to growth from the inducement to new investment provided by improving technology, and the persisting uptrend in household spending would support the economic recovery. However, household spending had been relatively robust during the cyclical downturn and likely had only limited room for a pickup over coming quarters, and intense competitive pressures could well constrain profits, investment, and equity prices. As a result, the members were concerned that the acceleration in final demand could be modest, at least for a time. Against this background, the prospects for continued low inflation remained favorable, given the currently reduced utilization of resources and indeed the prospect for some added slack should economic growth remain below potential in coming quarters, as many members anticipated. Moreover, the further passthrough of earlier declines in energy prices would continue to ease pressures on prices and costs more generally throughout the economy.

In preparing for the semi-annual monetary policy report to the Congress, the Board members and Reserve Bank presidents provided their individual projections for the growth of GDP, civilian unemployment, and consumer price inflation for the year 2002. They projected that the economy would begin to recover this year from the generally mild downturn experienced in 2001, but the pace of expansion would pick up only gradually and the unemployment rate would climb somewhat further. The central tendency of their forecasts of growth in real GDP for 2002 was 2½ to 3 percent, measured as the change between the fourth quarter of 2001 and the fourth quarter of 2002, while their forecasts of the civilian unemployment rate in the fourth quarter of the year were centered on 6 to 6¼ percent. The forecasts of consumer price inflation this year, as measured by the PCE chain-type price index, were narrowly clustered around 1½ percent.

With regard to the prospective course of the projected recovery, members generally anticipated that a positive swing in inventory investment abetted by further growth in consumer spending would provide an important upward thrust to the expansion over the nearer term. The inventory correction that had occurred over the past year was of a magnitude that would inevitably result in a reduced rate of liquidation and an eventual restocking unless, contrary to current expectations, consumer spending were to weaken markedly. The accompanying fillip to production and incomes would have positive feedback effects over time on household expenditures and business investment. The extent and timing of the turnaround in inventory investment for the economy as a whole were subject to a considerable degree of uncertainty, but members noted that some firms already appeared to have adjusted their inventories to what they viewed as acceptable levels, and there were indications that some manufacturing firms were making efforts to rebuild inventories in the context of improving orders. More generally, however, business firms appeared to have remained very cautious in setting their inventory investment plans.

The evidence of unexpected strength in overall final demand indicated by the just-released GDP report was supported by anecdotal commentary from around the nation. Regional economic reports were somewhat mixed in that declining activity still characterized conditions in some areas, but the pace of the declines appeared to have moderated in those areas and improved conditions were noted in other parts of the country. Business sentiment, while still quite depressed in some areas, was described in many reports as having shifted toward cautious optimism.

Concerning prospective developments in final demand in major sectors of the economy, several members underscored what they viewed as the key role of household expenditures. Such spending had held up remarkably well in the face of major adverse developments, including sharp declines in stock market wealth and rising unemployment, that were exacerbated by the events of September 11. But with households remaining confident about the future and equity prices having rebounded from their post-attack declines, sustained growth in household expenditures was seen as a likely prospect. Such spending also would be supported in part by some strengthening or less weakness in other important sectors of the economy. Some members nonetheless cited a number of potential negatives relating to the prospects for consumer spending, including the possibility of adverse effects on consumer confidence of further anticipated increases in unemployment and the risk that generally disappointing business profits or more widespread downward restatements of reported profits might generate sizable declines in stock market prices and consumer wealth. Moreover, the unusually large sales of motor vehicles and to a degree other durable goods during the closing months of 2001 might have borrowed to some extent from sales in coming months. On balance, the positive and negative factors bearing on the outlook for consumer spending suggested that moderate growth was a reasonable expectation.

Residential construction expenditures, like household spending for consumer goods and services, had held up well despite the cyclical downturn in employment and sizable net losses in stock market wealth. Low mortgage interest rates and, in recent months, favorable weather conditions had provided vital support to this sector of the economy. Recent housing activity, including record sales in some areas, suggested persisting underlying strength in residential construction. Even so, the large additions to the supply of new homes in earlier years tended to indicate that additional impetus, if any, from housing construction would be limited over the next several quarters.

The outlook for business capital expenditures was improving, but anecdotal reports suggested that business executives were still notably cautious in formulating their spending plans, and indications of accelerating capital investment were still quite limited. In the high-tech sector, positive signs were noted in the demand for computers and peripherals, but the outlook for communications equipment was still very negative. Business spending for other equipment was also expected to remain soft. On balance, the capital investment sector seemed likely to retard the overall advance in economic activity during the quarters immediately ahead as many firms continued to pare excess capacity and businesses awaited clearer indications of rising demand and profits. Beyond the nearer term, however, the favorable outlook for productivity growth and related profit opportunities pointed to a revival of robust capital spending. Indeed, past experience suggested that once a rebound in capital spending took hold it easily could exceed current forecasts of moderate acceleration.

Fiscal policy would continue to provide substantial stimulus to the economy this year in light of the ongoing effects of the tax reduction measures enacted in 2001 and the sharp increase in federal government spending in train. This outlook did not incorporate the possible enactment of further tax cut legislation, whose prospects now seemed to be remote. A partial offset to federal government stimulus was the likelihood of considerably reduced spending growth at the state and local government levels, where numerous government entities were experiencing severe budget strains associated with recession-related weakness in tax revenues.

The external sector of the economy was seen as a source of some potential downside for the domestic economy in the period just ahead. Generally weak foreign economies and the recent strength of the dollar in foreign exchange markets were expected to continue to restrain U.S. exports. Economic recoveries in many foreign nations seemed likely over the course of this year, but the strength of those recoveries was subject to considerable uncertainty, and the risk that serious difficulties in some important economies might spread could not be overlooked. Recovery abroad, notably in some key U.S. trading partners, would be tied to an important extent to the course of U.S. economic activity and would not be providing much impetus to U.S. exports over coming quarters. At this point signs of an upturn in foreign trade were not entirely lacking, notably in some high-tech goods, but those indications were still very limited.

Inflation was likely to remain quite subdued. Indeed, core inflation could well edge lower. The indirect effects of the declines that had occurred in energy prices would continue to hold down other input prices and be passed on more fully to final purchasers. More generally, the low rate of resource utilization anticipated over the year ahead, rising productivity, and highly competitive market pricing could be expected to moderate price pressures. Against that background, members continued to view the greater risks to the economy as those relating to concerns about economic activity rather than prices.

In the Committee's discussion of policy for the intermeeting period ahead, all the members agreed that recent developments argued for keeping the stance of policy unchanged at this time. Monetary policy had been eased substantially over the past year, and, with the real federal funds rate at an unusually low level, policy seemed well positioned to support an economic recovery as the forces restraining demand abated. In fact, a growing number of indicators pointed to a reduction in the pressures holding back the economy and to an emerging business recovery. In these circumstances, a pause seemed desirable to monitor the still-incomplete effects of the Committee's easing over the past year—a significant part of which had been implemented in recent months—and the contours of the turnaround in economic activity.

All the members indicated that they could support the issuance of a public statement indicating that the risks remained tilted toward economic weakness. Although the economy was probably strengthening, a variety of factors could well keep the pace of expansion below the rate of growth of potential for a while, even at the current policy stance. Moreover, inflation was running at a fairly low rate and quite possibly would edge down a little further over coming quarters. In these circumstances, the risk to achieving the Committee's objective for fostering sustainable economic growth seemed to be greater than to its objective of maintaining reasonable price stability. In the view of a few members, an argument could be made for moving to a balanced-risks statement, given that they could envisage developments that could strengthen the economy beyond their current forecasts. However, they agreed that a shift to balanced risks in conjunction with an unchanged policy stance could at this point be misread in financial markets as an indication of a much more optimistic view of the economic outlook than the members currently entertained. Such an interpretation might foster unwarranted and counterproductive adjustments in financial markets. In any event, emerging economic conditions in line with the members' current forecasts would provide ample opportunity to shift to a balanced-risks statement at a future meeting when it might be more clearly appropriate.

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

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¾ percent.

The votes encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting.

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

> Votes for this action: Messrs. Greenspan, McDonough, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, McTeer, Olson, Santomero, and Stern. Vote against this action: None. Absent and not voting: Mr. Meyer.

Disclosure Policy

In accordance with the Committee's routine practice of reviewing its rules and regulations at its first regular meeting of each year, the members discussed their policies regarding the extent of the information that is released to the public about its discussions and decisions along with the timing of the release of such information. They noted that the changes in disclosure policy and practices implemented in recent years, including the announcement of policy actions and brief explanations of the basis for those actions, have served both the Federal Reserve and the public well. They also believed that it would be appropriate to explore whether there might be scope for some further evolution in the Committee's policies in the direction of greater transparency, though additional study and analysis would be needed. They agreed to discuss the issues further at a future meeting.

It also was agreed that the next meeting of the Committee would be held on Tuesday, March 19, 2002.

The meeting adjourned at 12:30 p.m. on January 30, 2002.

Donald L. Kohn
Secretary

Meeting Held on March 19, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, March 19, 2002, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Jordan
Mr. McTeer
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Ms. Johnson, Economist
Mr. Reinhart, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Howard and Lindsey, Ms. Mester, Messrs. Oliner, Rolnick, Rosenblum, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

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

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

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

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

Ms. Low, Open Market Secretariat Assistant, Office of Board Members, Board of Governors

Ms. Pianalto and Mr. Stewart, First Vice Presidents, Federal Reserve Banks of Cleveland and New York respectively

Messrs. Beebe, Eisenbeis, Fuhrer, Goodfriend, Hakkio, Hunter, and Rasche, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Boston, Richmond, Kansas City, Chicago, and St. Louis respectively

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

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on January 29–30, 2002, were approved.

By notation vote completed on March 19, 2002, the members of the Federal Open Market Committee voted unanimously to accept the Report of Examination of the System Open Market Account conducted as of the close of business on November 14, 2001, by the Division of Reserve Bank Operations and Payment Systems of the Board of Governors.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period January 30, 2002, through March 18, 2002. By unanimous vote, the Committee ratified these transactions.

At this meeting the staff requested Committee guidance on the priorities, given limited staff resources, it should attach to further studies of the feasibility of outright purchases for the System Open Market Account (SOMA) of mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA-MBS) and the addition of foreign sovereign debt securities to the list of collateral eligible for U.S. dollar repurchase agreements by the System. Such alternatives could prove useful if outstanding Treasury debt obligations were to become increasingly scarce relative to the necessary growth in the System's portfolio, and the Committee had previously requested initial staff exploration of these options. Noting that many of the staff engaged in these studies were also involved in contingency planning, which had been intensified after the September 11 attacks, the consensus of the members was to give the highest priority to such planning. All the members preferred continued reliance to the extent feasible on direct Treasury debt for outright System transactions, and they were persuaded that budget developments over the last year meant that constraints on Treasury debt supplies would not become as pressing an issue as soon as they had previously thought. Still, given the inherent uncertainty of budget forecasts, the likely significant needs for large SOMA operations in coming years and the lead times needed to implement new procedures, the Committee decided that the study of alternative market instruments should go forward once it was possible to do so without impeding the contingency planning effort. With regard to the two proposed alternatives for broadening the System's options for open market operations, the members instructed the staff to give a higher priority to further examination of outright purchases of GNMA-MBS. Although these securities have a number of shortcomings as an outright investment vehicle from the System's perspective, the market for GNMA-MBS was well developed and the securities were guaranteed by the full faith and credit of the U.S. government.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that economic activity had turned up in the final quarter of last year and strengthened further since then. Consumer spending on goods other than motor vehicles was brisk in the early part of this year, business purchases of equipment and software appeared to be beginning to recover from their marked decline of last year, and housing starts turned back up. Amid signs that most firms had worked down their inventories to more comfortable levels, industrial production increased slightly after having declined for nearly a year and a half, and payroll employment appeared to be bottoming out. Inflation remained low despite some firming of energy prices.

Private nonfarm payroll employment moved up in February, retracing part of January's drop. Layoffs in manufacturing slowed further, the construction industry added back some workers in February, and the retail trade and services sectors continued to hire in both months. The unemployment rate edged down again in February to 5.5 percent, and initial claims for unemployment insurance continued to drop.

Industrial production increased somewhat in January and February after a steep decline from its June 2000 peak. Manufacturing output rose in both months, and the factory operating rate moved up slightly from its low level at year-end. The pickup in manufacturing this year was spread across several major industries, including chemicals, computers and semiconductors, paper, and tobacco. In addition, output of communications equipment steadied after having plunged for more than a year. In contrast, production of motor vehicles and parts changed little over January and February after a surge late in 2001.

Consumer spending remained strong in the early part of the year, despite a sizable drop in purchases of light vehicles in January that was followed by a rebound in February as manufacturers switched from attractive financing terms to cash rebates. Outlays for retail items other than motor vehicles expanded further in February after the large increases recorded in the two prior months. Outlays for services continued to rise moderately in January (latest data). Consumer purchases were supported by a sizable gain in disposable personal income in January, and readings on consumer sentiment were close to their historical averages.

Residential construction had been very strong in the past several months, with new starts reaching their highest level in almost two years. The strength in homebuilding was associated in part with unusually warm and dry weather, but very low mortgage rates also continued to play an important role.

Business spending on durable equipment and software appeared to be turning upward after a marked moderation in the fourth quarter of the steep decline recorded in the two previous quarters. Shipments and orders of nondefense capital goods were unexpectedly strong in January. There were signs of recovery in the high-tech sector, with shipments of computers and peripherals increasing for a fifth straight month, but shipments of communications equipment turned down in January after a December bounce. Shipments in most other sectors recorded increases and were particularly robust for machinery, engines, and turbines. Business demand for motor vehicles remained mixed, with fleet sales of light vehicles higher and purchases of medium and heavy trucks somewhat weaker. Nonresidential construction remained in a slump, with spending on new office buildings and industrial structures down sharply in an environment of elevated vacancy rates.

The pace of liquidation of manufacturing and trade inventories, excluding motor vehicles, slowed in January after a very rapid rundown in the fourth quarter, and with sales higher the aggregate inventory–sales ratio declined to its lowest level since midyear 2000. Manufacturers' stocks were drawn down sharply further in January, and the sector's stock-to-shipments ratio fell appreciably. At the wholesale level, the rate of inventory runoff slowed somewhat, but the sector's inventory–sales ratio declined further. The level of inventories at the retail level increased somewhat despite a rise in sales, and the sector's aggregate inventory–sales ratio was at an historically low level.

The U.S. trade deficit in goods and services widened somewhat in January. The value of exports changed little but the value of imports rose appreciably, to about the November level. The available information indicated that economic activity in the foreign industrial countries showed little net change in the fourth quarter. The Canadian economy rebounded from a weak third quarter, but economic expansion in the United Kingdom nearly came to a halt in the fourth quarter, economic activity in the euro area slipped a little, and the Japanese economy recorded a steep drop. There were indications, however, of a gradually improving economic outlook in several of these economies in the first quarter as a consequence of previous monetary policy easing actions that their respective central banks had taken and from the effects of an improved economic performance in the United States. Among the major emerging-market countries, the exports of a number of Asian economies were benefiting from the nascent recovery in high-tech industries around the world. In Latin America, although Argentina remained in a steep downward trend, the Mexican and Brazilian economies seemed to be recovering from weakness in the fourth quarter.

Consumer price inflation picked up a bit in January as energy prices posted their first increase since September. However, on a year-over-year basis, core price inflation as measured by the consumer price index leveled out at a moderate rate, while core PCE (personal consumption expenditure) price inflation declined appreciably. Labor costs also appeared to have decelerated recently. The employment cost index for hourly compensation in private industry rose moderately in the fourth quarter of last year and for the year as a whole. Both the salary and benefits components recorded slightly smaller increases last year. Average hourly earnings of production and nonsupervisory workers advanced only slightly in January and February of this year, and the average wage increase during the twelve months through February was slightly lower than that for the twelve-month period ending in February 2001.

At its meeting on January 29–30, 2002, the Committee adopted a directive that called for implementing conditions in reserve markets consistent with keeping the intended level of the federal funds rate at 1¾ percent. The members noted that policy had been eased substantially over the past year and that the inflation-adjusted federal funds rate was at an unusually low level. As a result, policy was positioned to support an economic recovery as forces restraining aggregate demand abated. Nonetheless, the members agreed that there were factors that might keep the pace of expansion below the rate of growth of potential for a while, and thus the balance of risks continued to be tilted toward economic weakness in the foreseeable future.

The federal funds rate remained close to the Committee's target level of 1¾ percent during the intermeeting period. However, short-term market rates increased slightly over the intermeeting interval, and yields on longer-term Treasury instruments and high-grade corporate bonds rose by more. The rise in rates was sparked initially by market participants' reading of the Committee's press statement as suggesting greater-than-expected optimism about the economy going forward. That assessment was subsequently strengthened by data on spending and output released during the intermeeting interval that came in well above market expectations. Speculative-grade bond yields fell somewhat in reaction to the improved economic outlook and the perceived reduction of credit risk. Most major indexes of equity prices moved up sharply on the bullish economic reports.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies eased slightly on balance over the intermeeting period. The dollar fell more against the yen than the euro despite negative economic news from Japan and the disappointing reaction to the Japanese government's announcement of an "anti-deflation" package. The exchange value of the dollar changed little in terms of an index of the currencies of other important trading partners, in part because of the further depreciation of the Argentine peso.

Expansion of M2 rebounded somewhat in February from January's lackluster rate, but growth in the early part of the year was down sharply from the robust pace of late last year. The slowdown apparently was related to the ebbing effect of earlier declines in opportunity costs of holding M2 assets and to the shift of large amounts of money from retail money market funds into bond and equity mutual funds as concerns about volatility in financial markets eased. Reduced demand for mortgage refinancing also seemed to have contributed to the deceleration of M2. The debt of the domestic nonfinancial sectors was estimated to have increased at a relatively slow rate in January, reflecting weak demand for business debt financing and little net borrowing by the federal government.

The staff forecast prepared for this meeting suggested that economic activity was expanding briskly in the early months of the year after having turned up and increased modestly in the fourth quarter. Elevated household spending and a shift from inventory liquidation to accumulation would provide significant impetus for the recovery in the context of the substantial monetary ease and fiscal stimulus already in place. Moreover, the recently enacted federal incentive for new business equipment investment along with the outlook for continued robust gains in productivity were expected to help boost business capital spending. At the same time, still-depressed equity prices, limited growth abroad, and the dollar's strength would tend to hold down the pace of recovery. On balance, recent developments suggested that the course of final sales now had a more positive contour over the forecast horizon and that resource utilization would rise somewhat more than anticipated earlier despite higher projected growth in structural productivity. Even so, overall activity would remain below estimates of the economy's potential output for some time, and the persistence of underutilized resources was expected to keep downward pressure on core price inflation.

In the Committee's discussion of current and prospective economic developments, members commented that the decidedly positive information received over the intermeeting period provided strong evidence that an economic recovery was now under way, though its prospective strength remained subject to substantial uncertainty. In this regard it was noted that the economy was undergoing significant structural changes and those changes were adding to the usual difficulty of projecting the trajectory of economic activity after a turning point. Unexpected strength in household expenditures, much reduced weakness in business capital spending, and substantial slowing in inventory liquidation had produced an earlier upturn in economic activity than many had anticipated. A further strengthening of inventory investment would probably generate appreciable further growth in business activity over the quarters just ahead. Once the ongoing inventory correction was completed, however, it was not clear to what extent final demand in key sectors of the economy, notably business capital investment, would provide support for further economic growth. While the members agreed that the stimulative fiscal and monetary policies currently in place would undergird further economic expansion, most continued to anticipate a relatively subdued rate of expansion that would only gradually erode current margins of underutilized productive resources. The members viewed the outlook for core price inflation as still quite benign, largely reflecting the ample availability of labor and other producer resources to accommodate rising economic activity and the favorable prospects for further robust growth in productivity.

Anecdotal commentary from around the country was somewhat less positive on the whole than the recent macroeconomic data for the nation. Business conditions were reported to be improving in most areas and industries, but the pickup was uneven, with continued weakness still characterizing numerous industries. Many business contacts, although somewhat less pessimistic about the economic outlook, still did not appear to be anticipating a strong upturn this year. Gradual recovery was reported in the depressed tourism and travel industries. The manufacturing sector, where much of the economy's weakness had been concentrated, was displaying increased signs of stabilizing, with activity actually picking up in a number of industries and some firms anticipating increases in their payrolls over the next several months after experiencing large declines. However, employers in manufacturing and other sectors of the economy generally remained cautious in their hiring policies and in their plans for capital spending.

In their discussion of developments in key expenditure sectors of the economy, members commented that inventory investment was likely to remain a pivotal factor in the nearer-term performance of the economy. Firms had moved rapidly to correct earlier inventory imbalances. Data indicating a very large drawdown of inventories in the fourth quarter and further, albeit much diminished, liquidation in January along with anecdotal commentary suggested that inventories were now close to desired levels in many industries, notably in the retail sector, and the swing toward smaller drawdowns was giving a boost to industrial production. Looking ahead, inventory investment likely would turn toward accumulation as business firms facing brisk demand and depleted stocks stepped up their new orders, providing a source of significant strength in fostering economic recovery over the near term.

A major uncertainty in the economic outlook was the extent to which growth in final demand by households and business firms would provide ongoing support for the expansion as the impetus from inventory investment dissipated. The prospects for consumer spending remained favorable against the backdrop of a solid uptrend in disposable incomes associated to an important extent with an improving employment picture, robust underlying growth in labor productivity, and the further phase-in of personal income tax cuts enacted in 2001. Consumer confidence had improved considerably in recent months and consumer expenditures had displayed surprising strength. Members nonetheless cited some negatives in the outlook for consumer spending including the possibilities that a negative stock market wealth effect stemming from large earlier declines and the somewhat elevated rate of unemployment would weigh on consumer confidence. Importantly, because consumer spending for automobiles and other consumer durables had been well maintained through the extended period of economic weakness, further gains in such expenditures were likely to be limited over coming quarters in contrast to the typical surge in past economic recoveries. Moreover, energy price increases, especially if they were to become more pronounced, would tend to hold back household spending. On balance, members saw moderate further growth in consumer spending as a reasonable prospect for coming quarters.

After a lull during the fall of 2001, housing activity had displayed renewed vigor in recent months, in part as a consequence of widely favorable weather conditions. Indeed, single-family construction was described as a particularly bright sector in a number of local economies. Looking ahead, the favorable factors affecting consumer spending more generally along with relatively low mortgage interest rates were expected to sustain a high level of housing expenditures this year. In keeping with the outlook for consumer durables, however, a long period of active housing construction suggested that significant additional strength in housing was unlikely in coming quarters.

The members generally viewed business fixed investment spending as the key to the strength of economic activity once the thrust from inventory restocking had run its course. The outlook for business capital expenditures would be governed to an important extent by business expectations regarding sales and profits. After the steep declines in business investment over the past year, anecdotal reports from around the country provided scattered indications of an upturn but no evidence at this point of any broad-based improvement. According to such reports and despite the strength of recent economic statistics, which had boosted the economic forecasts of many observers, business confidence remained at a low level, evidently reflecting a weak outlook for profits in the business community in the context of strong competitive pressures. Negative factors bearing on the outlook for investment in capital equipment included the persistence of large margins of excess capacity in many industries. The outlook for commercial and other nonresidential construction seemed even less promising, at least for the next several quarters, given high vacancy rates in commercial structures in many parts of the nation. Members nonetheless cited some positives in this outlook that included the favorable effects on incentives to purchase capital equipment stemming from the outlook for relatively rapid growth in productivity and the recent passage of legislation providing a temporary tax incentive for investments in equipment and software. On balance, a substantial pickup in overall capital spending seemed likely to be delayed in the absence of surprising strength in final demand, but a wide range of possible outcomes could not be ruled out for this key sector of the economy.

Several members referred to the currently high degree of fiscal policy stimulus, which had been augmented by recent legislation. Much of the added stimulus from the investment incentive component of that legislation was not likely to be felt for some period and might occur at a time when the economy would already be expanding at a solid pace. Federal spending was increasing rapidly and its growth could taper off more slowly than current budget estimates implied. An at least partially offsetting factor was the prospect that state and local government expenditures would increase at a reduced pace this year amid widespread budget pressures that had emerged as tax receipts weakened along with the economy. However, some reports indicated that spending on local infrastructure projects was continuing at a solid pace in some parts of the nation.

Members saw a number of downside risks from potential developments abroad. In particular, concern was expressed about heightened tensions in the Middle East and their possible impact on oil markets and the cost of energy. For a variety of reasons, oil prices already had risen appreciably since the start of the year. With regard to the outlook for foreign trade, members reported some indications of an improving volume of trade with some Asian nations. However, the nation's net export position could deteriorate further when much of the impetus to world economic growth was coming from the U.S. economy.

The members expected price pressures to remain relatively contained over the next several quarters in the context of what they anticipated would be only a gradual reduction of the excess capacity in labor and product markets as the recovery progressed. Moreover, the prospects of relatively robust growth in productivity in a highly flexible and competitive economy likely would moderate the extent of any potential buildup in inflationary pressures in the future. Members nonetheless mentioned some potential negatives in this outlook, notably the possibility of rising wage pressures as labor markets became more fully employed and upward price pressures stemming from increasing steel, energy, and insurance costs.

In the Committee's discussion of policy for the intermeeting period ahead, all the members supported a proposal to maintain an unchanged policy stance, with the target for the federal funds rate staying at 1¾ percent. While the economy currently appeared to be expanding at a fairly vigorous pace, the advance importantly reflected a temporary swing in inventory investment and considerable uncertainty surrounded the outlook for final demand over the quarters ahead. Against this background, the members judged the currently accommodative stance of monetary policy to be appropriate for now, especially in light of the relatively high unemployment rate, low capacity utilization rates in numerous industries, and quiescent inflation pressures.

Looking ahead, however, the stance of policy would need to be adjusted at some point to provide less stimulus as the members gained more confidence that the recovery was becoming better entrenched and the risks had shifted toward rising inflationary pressures. The need to adjust monetary policy during the early stages of a recovery presented a special challenge with regard to its timing and extent in that raising rates prematurely or too precipitately could weaken or abort the recovery, while waiting too long could risk a pickup in inflationary pressures later. Members concluded that the Committee would be in a better position to assess the appropriate timing of a policy change at the May meeting when it would have more information to gauge the economy's performance in two critical areas, namely developments relating to inventory investment and the implications of trends in sales and profits for capital investment. A reference to the Committee's currently accommodative policy stance in the press announcement to be issued shortly after this meeting would alert the public to the need to firm policy at some point in the future.

All the members indicated that they could accept a proposal to move the balance of risks statement from potential weakness to a neutral position. It was clear that significant downside risks remained in the economy even apart from any major unanticipated shocks to business and consumer confidence, but in light of the strength of the recent economic information nearly all the members agreed that a balanced risks statement now best represented their consensus regarding the economic outlook over the foreseeable future. Members noted that a neutral statement did not preclude a tightening policy move should the latter seem warranted by rapidly evolving economic conditions.

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

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¾ percent.

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

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are balanced with respect to prospects for both goals in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, McTeer, Olson, Santomero, and Stern. Votes against this action: None.

Disclosure Policy

By unanimous vote, the Committee approved a proposal to include the vote on monetary policy in the press statement released after every meeting, beginning with this meeting. In addition to identifying the voters, the press release would indicate the policy preferences of dissenters, if any. Such information could prove useful to market participants, who on occasion had employed indirect and frequently misleading information to gauge the Committee's vote before it was released as part of the minutes after the next meeting.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 7, 2002.

The meeting adjourned at 1:30 p.m.

Donald L. Kohn
Secretary

Meeting Held on May 7, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 7, 2002, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Jordan
Mr. McTeer
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Reinhart, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Howard and Lindsey, Ms. Mester, Messrs. Oliner, Rolnick, Rosenblum, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

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

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

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

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

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

Ms. Low, Open Market Secretariat Assistant, Office of Board Members, Board of Governors

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

Messrs. Eisenbeis, Fuhrer, Goodfriend, Hakkio, Hunter, Judd, and Ms. Perelmuter, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Boston, Richmond, Kansas City, Chicago, San Francisco, and New York respectively

Messrs. Altig and Coughlin, Vice Presidents, Federal Reserve Banks of Cleveland and St. Louis respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 19, 2002, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period March 19, 2002, through May 6, 2002. By unanimous vote, the Committee ratified these transactions.

By unanimous vote, the Committee approved the extension for one year beginning in December 2002 of the System's reciprocal currency ("swap") arrangements with the Bank of Canada and the Bank of Mexico. The arrangement with the Bank of Canada is in the amount of $2 billion equivalent and that with the Bank of Mexico in the amount of $3 billion equivalent. Both arrangements are associated with the Federal Reserve's participation in the North American Framework Agreement. The early vote to renew the System's participation in the swap arrangements maturing in December relates to the provision that each party must provide six months prior notice of an intention to terminate its participation.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that economic activity expanded rapidly early in the year. Consumer spending increased moderately after large gains around the turn of the year, business outlays on durable equipment and software apparently steadied after a long decline, and single-family housing activity persisted at a relatively high level. Industrial production picked up in response to the advance in final demand and a slowdown in the runoff of excess inventory stocks. The demand for labor began to firm in April. Available information suggested that labor productivity had risen substantially in the first quarter. Although the recent surge in energy prices boosted headline consumer inflation in the first quarter, core measures of inflation had trended lower over the past year.

Private nonfarm payroll employment turned up in April after having posted small declines in February and March and steep reductions earlier. Job gains in April were spread across a wide range of industries. The services sector registered a sizable increase, with much of that rise occurring in the temporary-help industry that provides many of its workers to the manufacturing sector. In addition, layoffs continued to slow in the manufacturing sector, and some industries recorded their first solid advances in employment in more than a year. By contrast, the construction industry posted another large job decline as hiring again fell short of the usual seasonal rise. Despite the pickup in private payrolls, the unemployment rate rose to 6.0 percent in April, perhaps reflecting to an important extent the incentives created by the new federal program of extended unemployment benefits for some jobless workers to continue, or resume, looking for work.

Industrial production increased for a third straight month in March after the lengthy decline from its June 2000 peak. In the manufacturing sector, output in the first quarter retraced a little more than half of its fourth-quarter plunge. The gain was widespread across market groups and industries. High-tech equipment, notably computers and semiconductors, and motor vehicles and parts led the upturn with very large increases, while the telecommunications and aircraft industries weakened sharply further. Capacity utilization in manufacturing continued to rise in March from its low level at year-end, but at the end of the first quarter it was still substantially below its long-run average.

Consumer spending was well maintained in the first quarter, supported by sizable gains in disposable income. Demand for light motor vehicles remained robust, though somewhat below the fourth-quarter pace, in an environment of continued aggressive manufacturer pricing and low financing rates. Expenditures on a wide range of other consumer goods and services expanded briskly.

Residential housing activity surged in the first three months of the year, evidently spurred by unusually mild winter weather and low mortgage rates. Starts of single-family homes reached a twenty-three-year high in February before moderating somewhat in March, but multifamily starts were only slightly above the relatively slow pace in 2001. New home sales moderated a bit in the first quarter from the very strong pace of the fourth quarter, while quarterly sales of existing homes rose on the strength of a record high in February.

Business outlays for durable equipment and software had changed little thus far this year following the steep decline recorded in 2001. Spending on computer equipment continued to rise rapidly in the first quarter, and outlays for communications equipment generally stabilized after a large and lengthy decline. By contrast, business purchases of both motor vehicles and aircraft slowed sharply. In the nonresidential construction sector, investment slumped in office buildings, industrial structures, lodging facilities, and in drilling and mining. Moreover, available information indicated that this sector would remain depressed: Vacancy rates for office and industrial buildings continued to rise, with deterioration in the office sector especially pronounced in areas dominated by high-tech firms, and property values and rents for retail space and warehouses weakened.

The pace of liquidation of manufacturing and trade inventories slowed sharply in January and February after a notably large contraction in the fourth quarter, and the aggregate inventory–sales ratio declined a bit further. Stocks of manufacturers continued to fall through March (latest data). Wholesalers also continued to reduce their inventories during January and February (latest data), and the sector's inventory–sales ratio dropped further. At the retail level, stocks jumped in January and February, but almost all of the increase occurred at automotive dealers. The inventory–sales ratio for retail trade edged up over the two months but was still at a relatively low level.

The U.S. trade deficit in goods and services widened in January and February, reflecting a considerably larger expansion in the value of imports than in that of exports. The rise in imports related in part to the royalties and license fees paid to the International Olympics Committee for the rights to broadcast the Winter Olympic Games. With regard to economic activity abroad, the available information indicated that, on balance, foreign economic output had rebounded in the first quarter. The economies of the technology-sensitive Asian countries had already turned up in the fourth quarter and seemed to have grown rapidly in the early months of the year. The Canadian economy appeared to have expanded robustly in the first quarter, and economic activity in Europe evidently had turned upward. By contrast, available indicators suggested that the Japanese economy was still contracting, though at a less rapid rate.

Although higher energy prices continued to push up headline consumer price inflation in March, inflation had moved downward over the past twelve months. Both the overall consumer price index (CPI) and the personal consumption expenditure (PCE) chain-linked index decelerated significantly over the past year. Moreover, excluding their volatile food and energy components, both measures of inflation also fell over the past year. At the producer level, prices for finished goods echoed the pattern of consumer prices: Both total and core finished goods inflation decelerated on a year-over-year basis. Labor cost growth, as measured by hourly compensation in private industry, also appeared to have slowed a bit over the latest twelve-month period.

At its meeting on March 19, 2002, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the intended level of the federal funds rate at 1¾ percent. With the economy expanding at a significant pace, the Committee now saw the risks to achieving its long-term goals as balanced. Members noted that the impetus for the economic advance was to a large extent a temporary swing in inventory investment rather than a clear and substantial upswing in final demand. As a result, the outlook for the economy remained somewhat uncertain, and the current accommodative stance of policy continued to be viewed as appropriate. The members contemplated, however, that the stance of monetary policy would have to become less accommodative once clearer evidence emerged that a healthy expansion was firmly established.

The federal funds rate remained close to the Committee's target level of 1¾ percent during the intermeeting period. However, doubts about the strength of the recovery owing to the tone of the Committee's press statement along with mixed incoming data on final demand, announcements of weaker-than-expected corporate earnings, and heightening tensions in the Middle East prompted declines in yields on short- to intermediate-term Treasury securities. Yields on investment-grade bonds tended to edge higher, however, in the wake of concerns about the transparency of the accounting statements of some firms. Most major indexes of equity prices moved down sharply in response to the outlook for a weaker economic recovery and the adverse implications for corporate profits of economic and other developments.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies eased somewhat over the intermeeting period. Much of the dollar's decline occurred late in the period in response to the mixed character of U.S. economic data and relatively small declines in benchmark longer-term yields abroad. The dollar rose slightly on average in terms of an index of the currencies of other important trading partners, in part because of the further depreciation of the Argentine peso.

M2 and M3 contracted in March and April. The declines evidently reflected in part the rising opportunity costs of holding M2 assets as yields on the components of M2 declined in lagged response to the earlier easing of monetary policy and fostered transfers out of M2 funds, especially from retail money market funds to stock and bond mutual funds. Reduced demand for mortgage refinancing and lower nonwithheld federal payments also contributed importantly to the weakness in the broad monetary aggregates.

The staff forecast prepared for this meeting suggested that the expansion in economic activity was slowing substantially in the current quarter but would pick up in the second half of the year and continue at a moderate pace next year. An emerging shift by businesses from inventory liquidation to some replenishment of stocks would help boost activity over the next several quarters, but the ongoing recovery would depend increasingly on growth in spending by households and businesses. Such spending would be fostered by the monetary ease and fiscal stimulus already in place and abetted by vigorous anticipated growth in structural productivity, which would support household incomes and business investment incentives. With a relatively robust contour for the course of final sales over the forecast horizon, the pressure on resources would rise somewhat despite the anticipated higher growth of structural productivity. Nonetheless, activity would remain below the economy's potential for a period ahead and the persistence of underutilized resources was expected to contribute to damped core consumer price inflation.

In the Committee's discussion of current and prospective economic developments, members commented that recently available statistical data and anecdotal reports suggested that the expansion in business activity was continuing. However, it had slowed considerably from its pace earlier in the year when it had received substantial impetus from a marked slowing in the runoff of inventories. How much final demand would strengthen going forward was still uncertain. A pause in the expansion was not an unusual development during the early stages of a cyclical recovery, and the members generally viewed a pickup in growth as a reasonable expectation. The currently stimulative stance of both fiscal and monetary policy would tend to undergird final demand, especially in the context of an economy that had exhibited a marked degree of resilience and strength in underlying productivity growth that would bolster household incomes and provide incentives for business capital spending. Members noted, however, that an already high level of consumer spending pointed to more limited than usual scope for further growth in such spending, and gloomy business sentiment in the face of disappointing sales and profits raised a question about the extent to which business investment would help to lift final demand over coming quarters. Given growth in economic activity broadly in line with current expectations, inflation was likely to remain benign for some time in the context of an apparently strong uptrend in structural labor productivity, excess capacity in many labor and product markets, and a related absence of pricing power in generally very competitive markets.

In their review of developments and prospects in key expenditure sectors of the economy, members commented that household spending had continued to be well maintained. In the consumer area, recent anecdotal reports provided a somewhat mixed, but on the whole positive, picture of consumer spending across the nation. Sales of motor vehicles had moderated after a surge during the closing months of 2001, but they remained relatively high and other consumer outlays had continued to increase. Looking ahead, some growth in overall consumer spending appeared likely in association with the now more firmly entrenched economic expansion. However, the pickup likely would be limited inasmuch as household spending had remained elevated through the period of economic weakness. Members commented that such an outlook was subject to uncertainties in both directions. On the upside, faster-than-anticipated growth could well materialize in an environment of monetary and fiscal policy ease and of gradually firming labor markets and rising productivity that would be boosting income growth. On the other hand, employment growth had been very sluggish to date, with employers remaining quite cautious in their hiring practices, and continued softness in labor markets could damp consumer confidence. The run-up in energy prices also was a negative for household purchasing power.

Household expenditures on new homes were likewise at an elevated level, although members reported weakness in some price segments and geographic areas of the housing market. In general, however, housing displayed ongoing strength in response to low mortgage rates, with rising prices in many areas, and the downside risks to this sector of the economy appeared to be limited. At the same time, members anticipated that growth, if any, in homebuilding activity would be subdued over the next several quarters after an extended period of strong expansion.

The members generally viewed business fixed investment as the key sector that would determine the strength of the expansion. Such investment had contracted further in the first quarter, but the decline was the smallest in a year. Looking ahead, the members anticipated a sluggish and delayed upturn in capital expenditures in the next few quarters against the backdrop of persistently gloomy business sentiment and large margins of excess capacity in numerous industries. Many business contacts commented on their unwillingness to expand capacity until they saw persuasive evidence of growing sales and profits. Accordingly, much of their current investment spending was focused on cost-saving equipment and software in an effort to bolster profits in a stable price environment that made it difficult to pass on rising costs. The recent passage of temporary legislation that permitted a partial acceleration of tax expensing was expected to provide some impetus to capital investments, but the legislation appeared to have had little effect thus far. With regard to the outlook for nonresidential construction, members saw little prospect of any material increase in such construction over the next several quarters, given widespread anecdotal and statistical reports of high vacancy rates and excess capacity.

The markedly reduced pace of inventory liquidation in the first quarter of the year accounted for much of the step-up in GDP growth in that quarter and provided a strong indication that the period of inventory liquidation under way for more than a year probably was coming to an end. Indeed, anecdotal reports suggested that efforts to rebuild inventories were now being undertaken in a number of industries, such as steel and motor vehicles, and one regional survey indicated that businesses planned to accumulate inventories over the next six months. However, businesses remained quite cautious about the outlook for sales, and many firms might also be in the process of adapting to much reduced levels of inventories in relation to sales rather than restoring earlier inventory–sales ratios. A shift to inventory stocking in the near term, possibly in the current quarter, was seen as a reasonable expectation, but with numerous firms having already moved production into closer alignment with sales, members anticipated much less impetus to overall economic activity from inventories over coming quarters.

Recent and immediately prospective legislation had increased the fiscal stimulus in the federal budget, and members commented that the current dynamics of the budget process could result in larger increases in government spending than foreseen in recent budget estimates. In this regard some expressed concern about the longer-term implications of what they saw as a decline in fiscal discipline. At the state and local government levels, however, deteriorating fiscal positions in 2001 had impelled many states and localities to curb spending and raise various taxes and fees.

Although foreign economic activity appeared to be picking up to some extent and the dollar had edged lower, net exports were expected to remain a negative factor in the growth of the domestic economy. Members cited anecdotal reports that tended to support statistical evidence of strengthening economies in Europe and a number of developing Asian nations. Nonetheless, given a recovery in U.S. domestic demand approximating their current forecasts, growth in imports likely would exceed that of exports by a wide margin over the forecast horizon.

The outlook for inflation remained favorable. Nearly all measures of total and core prices had decelerated over the past year, and in the context of forecasts implying a continued sizable gap between actual and potential output, the risk that inflationary pressures would intensify significantly over coming quarters appeared to be quite limited; indeed, inflation might edge a bit lower in the early stages of the expansion. The deceleration in labor costs over the past several quarters, evidence of a surprisingly strong uptrend in structural labor productivity, low and stable inflation expectations, and the widespread absence of pricing power in highly competitive markets were signs that upside inflation risks in the period ahead were relatively small. The members recognized nonetheless that there were upward pressures on costs in a number of areas. These included significant increases in energy costs in recent months, evidence of an upturn in some industrial prices, sharp increases in many insurance costs, continuing upward pressures on medical costs, and modest recent declines in the foreign exchange value of the dollar. With the stance of monetary policy currently quite accommodative, the members saw the need for careful monitoring of the potential for rising inflation pressures as the economic recovery gained momentum.

In the Committee's discussion of policy for the intermeeting period ahead, all the members agreed on the desirability of maintaining an unchanged policy stance, with the target federal funds rate staying at 1¾ percent. The economic recovery was clearly continuing, but its rate of advance had moderated considerably and the economy's future course was subject to a marked degree of uncertainty. While the longer-term outlook for a strengthening economy remained favorable, a firming of policy at this time would be premature and would incur an undue risk to a healthy expansion. The members recognized that monetary policy exerted its effects with a considerable lag and that the current stance of policy probably was inconsistent with the Committee's inflation objective over time. However, current inflation pressures were subdued and were expected to remain so for a considerable period, thereby providing adequate opportunity to evaluate ongoing developments and tighten policy as needed later.

All the members favored the retention of a neutral balance of risks statement to be released shortly after this meeting. Against the longer-term inflation risks inherent in the current stance of policy, the members weighed the possibility that the expansion could be relatively subdued for a time, damping prices further and failing to reduce margins of underutilized resources. In any event, a neutral statement regarding the risks to the economy in the foreseeable future would not preclude a preemptive tightening adjustment in the stance of policy stance should new evidence bearing on the strength of the expansion and the outlook for inflation warrant such a policy move.

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

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¾ percent.

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

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are balanced with respect to prospects for both goals in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, McTeer, Olson, Santomero, and Stern. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, June 25–26, 2002.

The meeting adjourned at 12:15 p.m.

Donald L. Kohn
Secretary

Meeting Held on June 25–26, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, June 25, 2002, at 2:30 p.m. and continued on Wednesday, June 26, 2002, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Jordan
Mr. McTeer
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Broaddus, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Ms. Johnson, Economist
Mr. Reinhart, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Howard and Lindsey, Ms. Mester, Messrs. Oliner, Rolnick, Rosenblum, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

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

Messrs. Freeman[5] and Whitesell, Deputy Associate Directors, Divisions of International Finance and Monetary Affairs respectively, Board of Governors

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

Messrs. Reifschneider[6] and Wascher,[6] Assistant Directors, Division of Research and Statistics, Board of Governors

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

Mr. Brayton,[6] Ms. Dynan,[5] Messrs. Lebow[6] and Roberts,[6] Senior Economists, Division of Research and Statistics, Board of Governors

Mr. Bomfim,[5] Senior Economist, Division of Monetary Affairs, Board of Governors

5. Attended portion of meeting relating to the discussion of economic developments.

6. Attended portion of meeting relating to a special agenda discussion of inflation.

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

Ms. Low, Open Market Secretariat Assistant, Office of Board Members, Board of Governors

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

Messrs. Eisenbeis, Fuhrer, Goodfriend, Hakkio, Hunter, Judd, Ms. Krieger, and Mr. Rasche, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Boston, Richmond, Kansas City, Chicago, San Francisco, New York, and St. Louis respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on May 7, 2002, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on recent developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period May 7, 2002, through June 24, 2002. By unanimous vote, the Committee ratified these transactions.

The Committee voted unanimously to update its longstanding authorization for the Federal Reserve Bank of New York to enter into agreements that would enable another Federal Reserve Bank to conduct System open market operations on a temporary basis in an emergency after designation by the Committee or the Chairman.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that economic activity continued to expand in recent months, though at a slower pace than earlier in the year. Consumer purchases, residential housing outlays, and government spending recorded smaller gains, but business investment in durable equipment and software appeared to be leveling out after a long decline. Industrial production continued to pick up. Employment had risen a little, but not enough to lower the unemployment rate, and labor productivity seemed to be trending sharply upward. The surge in energy prices this year had boosted headline inflation, but core measures of inflation had trended lower.

Private nonfarm payroll employment edged up in April and May after a slowdown in the first quarter in the pace of layoffs and job separations. Hiring was relatively brisk in the services sector in the April–May period, with most of the advances occurring in the temporary-help industry. Manufacturing payrolls recorded small declines in both months, while the number of jobs in construction steadied in May after a large drop in April. The civilian unemployment rate moved down somewhat, to 5.8 percent in May, but the average rate for the April–May period remained above the level in the two previous quarters.

Industrial production rose for a fifth straight month in May. In manufacturing, output increases in April and May continued to be spread widely across market groups and industries. The high-tech sector, notably computers and semiconductors, and the motor vehicles and parts sector remained strong, while the telecommunications and aircraft industries weakened further. Capacity utilization in manufacturing in May was a little above its depressed level at year-end, but substantially below its long-run average.

Growth of consumer spending slowed appreciably in April and May from the brisk pace of the first quarter. Retail sales slumped in May after a sizable rise in April, largely reflecting weaker spending at apparel stores and general merchandise outlets and an apparent pause in purchases of light motor vehicles after an April surge. Real outlays on services in April (latest data) were unchanged.

Residential housing activity remained elevated during April and May. Housing starts jumped in May after a small decline in April. The strength in starts over the two months evidently reflected the persistence of very positive home-buying attitudes arising at least in part from low mortgage rates. In May, sales of new single-family homes established a new record high, and sales of existing single-family homes were only slightly below the peak reached in the first quarter.

The decline in business outlays for durable equipment and software had moderated further in the first quarter, and the available information suggested that spending on equipment and software was turning upward in the second quarter. Shipments of nondefense capital goods other than aircraft rose in April and May; shipments of computers and peripherals remained strong, shipments of communications equipment were still weak, and shipments of other durable goods continued to advance. In the nonresidential construction sector, outlays for office and industrial structures, lodging facilities, and public utilities declined substantially. In addition, expenditures for drilling and mining continued to drop. By contrast, construction of retail space, warehouses, and institutional structures picked up.

Liquidation of manufacturing and trade inventories continued in April at about the pace of the first quarter, and the aggregate inventory–sales ratio declined further. In manufacturing, the rate of liquidation slowed substantially, and the aggregate stock–shipments ratio for the sector was at a very low level. Wholesalers ran down their inventories in April at a somewhat faster rate than in the first quarter; the sector's inventory–sales ratio fell sharply further to a relatively low level. Retailers boosted their stocks slightly in April, with all of the increase occurring at automotive dealers. The sector's aggregate inventory–sales ratio edged up in April but remained relatively low.

The U.S. trade deficit in goods and services widened somewhat in April from both the March and the first-quarter levels, as the value of imports increased significantly more than that of exports. The rise in imports from March to April reflected higher prices for imported oil along with greater demand for a wide range of goods. The monthly step-up in exports was also broadly spread across categories of goods. With regard to economic activity abroad, the available information indicated that, on balance, foreign economic output had rebounded in the first half of the year, though the pace of recovery was uneven across regions and countries. Australia, Canada, and emerging Asia had experienced strong growth; the euro area also was expanding, but at a slower rate; and Japan appeared to have experienced a limited upturn in its economy. In South America, Brazil's economy was expanding but its financial markets had come under considerable stress, and elsewhere on the continent economic activity was generally weak, particularly in Argentina and Venezuela.

Both the consumer price index and the personal consumption expenditure chain-linked index indicated that consumer price inflation was moderate during the April–May period. Moreover, both measures showed that core price inflation during the first five months of the year had been a bit lower than in 2001. At the producer level, prices for core finished goods changed little over April and May and decelerated on a year-over-year basis. Labor costs, as measured by the average hourly earnings of production or nonsupervisory workers, also decelerated.

At its meeting on May 7, 2002, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the intended level of the federal funds rate at 1¾ percent, and it also retained a neutral balance of risks statement. The Committee's press statement, with its language indicating that the Committee remained uncertain about the extent and timing of the strengthening of final demand, was viewed by market participants as expressing less confidence in the strength of the recovery than had been expected, and yields on Treasury securities declined slightly in response. Subsequently, investors became more risk averse in reaction to a mixture of economic data releases, growing geopolitical tensions, further warnings about terrorism, and additional revelations regarding questionable corporate accounting practices. Yields on Treasury securities dropped somewhat on net over the period, rates on lower-quality bonds rose, and equity prices fell sharply further. The federal funds rate remained close to the Committee's target level of 1¾ percent during the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies dropped somewhat over the intermeeting period. The dollar's decline against the major foreign currencies occurred as questions about the strength of U.S. economic recovery and corporate earnings and the related lowering of expectations for near-term monetary tightening led to concerns that net foreign capital inflows might not be consistent with a stable exchange value for the dollar in the context of growing U.S. net international indebtedness. By contrast, the dollar rose slightly on average in terms of an index of the currencies of other important trading partners, notably the currencies of several Latin American countries that were experiencing political and economic problems.

Growth of the broad monetary aggregates picked up in May owing to the unwinding of distortions from final tax payments and, apparently, to falling equity prices. The heightened volatility of equity markets may have enhanced the attractiveness of safe and liquid M2 assets, including liquid deposits and retail money market funds.

The staff forecast prepared for this meeting suggested that the expansion of economic activity would pick up in the last half of the year from the sluggish pace of the second quarter and reach a relatively brisk pace next year. The considerable monetary ease and fiscal stimulus already in place and the continuing sizable gains in productivity would provide significant impetus for spending, though weakness in equity prices would tend to offset some of that support. With business capital stocks moving closer to desired levels, investment spending would be boosted by a gradually improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software. A more robust contour for final sales over the forecast horizon would lead to somewhat greater pressure on resource margins, despite the expected strong growth of structural productivity, though the level of activity would remain below the economy's potential for some time. The persistence of underutilized resources was expected to foster some moderation in core price inflation.

In the Committee's discussion of current and prospective economic conditions, members commented that there had been little change since the May meeting in the factors bearing on what they viewed as a favorable outlook for a pickup in the expansion. Although financial markets, and perhaps business and household confidence, had been shaken by revelations of accounting irregularities, the economy had continued to expand and the prospects for accelerating aggregate demand remained positive. Some members observed, however, that they had expected to see firmer indications of a strengthening recovery by the time of this meeting. The degree of impetus from decelerating inventory liquidation and growth in final demand had moderated during the spring, and anecdotal and other evidence indicated that the performance of various industries and firms had remained uneven. Looking ahead, the timing and strength of an upturn in the expansion remained subject to considerable uncertainty, but in the absence of major further adverse shocks to confidence the members anticipated that economic activity would accelerate over coming months to a pace in the vicinity of, and perhaps somewhat above, the rate of growth of the economy's potential. In support of this view, members cited the accommodative stance of both fiscal and monetary policy and the continuation of impressive growth in productivity that should buttress household incomes and spending and encourage a pickup in business investment. The strength in productivity also would help to hold down cost and price pressures and, given an economic expansion and resource utilization in line with the members' forecasts, would reinforce the prospect that core price inflation would remain low.

In preparation for the midyear monetary policy report to Congress, the members of the Board of Governors and the presidents of the Federal Reserve Banks submitted individual projections of the growth of GDP, the rate of unemployment, and the rate of inflation for the years 2002 and 2003. The forecasts of the rate of expansion in real GDP had central tendencies of 3½ to 3¾ percent for 2002, implying growth in the second half of the year at a rate close to that currently estimated for the first half, and 3½ to 4 percent for 2003. These rates of growth were expected to keep the civilian rate of unemployment in a central tendency of 5¾ to 6 percent in the fourth quarter of 2002 before it fell to 5¼ to 5½ percent by the fourth quarter of 2003. Forecasts of the rate of inflation, as measured by the chain-type price index for personal consumption expenditures, pointed to little change from recent inflation levels and were centered on a range of 1½ to 1¾ percent for both this year and 2003.

With imbalances in inventories apparently largely worked off and the contribution of inventory investment to the expansion likely diminishing in coming quarters, final demand would play its usual primary role in determining the strength of the expansion. In that regard, consumer spending was seen as likely to provide some continuing, though moderate, impetus to the growth of the economy. A favorable factor in this outlook cited by members was the ability and willingness of households to extract sizable financing resources for consumer and other expenditures by drawing on the appreciated equity in their homes in one form or another. The ample availability of credit to most consumers was another positive factor. Although consumer confidence as measured by national surveys recently had declined somewhat from relatively elevated levels, reports of strength in motor vehicle sales and in other retail sales in several parts of the nation in recent weeks suggested that consumer spending was continuing to be well maintained. The members recognized that a typical recovery-period surge in consumer spending was unlikely inasmuch as expenditures had registered solid growth through the economic downturn, implying an absence of significant pent-up demands. Moreover, forecasts of even moderate growth in spending were subject to downside risks emanating, for example, from possible further shocks to confidence and household wealth should weakness in stock prices persist, and from political turmoil overseas and threats of terrorism at home.

Homebuilding, though down after an unsustainable surge earlier in the year, had been well maintained in recent months. Recent statistics supported by widespread anecdotal reports pointed to persisting strength in housing activity, though there were indications of softness in high-priced homes in at least some parts of the country. Looking forward, members expected a high level of home construction to continue. A key factor in this outlook was the ready availability of mortgage financing to most borrowers at very attractive rates. Members also referred to growing population pressures, abetted by sizable immigration, on increasingly scarce buildable land in numerous areas. On balance, however, given its already robust level, housing was not seen as likely to provide much added stimulus to the expansion.

A pickup in business spending was viewed as a key to sustained solid growth, and questions about the timing and strength of such a pickup was a major source of uncertainty about the pace of the expansion in coming quarters. The preconditions for a robust advance in investment spending appeared to be largely in place, including the evident progress over the past several quarters in adjusting capital stocks to desired levels, the temporary tax incentive, and the need for competitive reasons to take advantage of the availability of increasingly productive equipment. In fact, recent orders and shipments data suggested an upturn in spending for new equipment, but the improvement was still quite limited, unevenly distributed across industries, and not yet firmly indicative of a sustained advance. While the members expected further gains in spending on equipment, they continued to report widespread pessimism among their business contacts, though exceptions had begun to emerge, and the persistence of a high degree of caution that was leading business executives to defer numerous investment projects until they saw more conclusive evidence of stronger sales and profits.

The outlook for nonresidential construction activity remained bleak amid indications of a widespread overhang of available space and attendant declines in rents and property values. Indeed, the drop in such construction did not appear to have run its course for the nation as a whole. Even so, the ongoing adjustment of nonresidential capacity to demand had been substantial in recent quarters and likely would give way to a modest recovery during the year ahead.

For the economy as a whole, the liquidation of business inventories appeared to be near completion in the current quarter, and some rebuilding in association with forecasts of moderate expansion in sales seemed a likely prospect for coming quarters. The restocking was expected to proceed gradually, given the probable persistence of a relatively high degree of uncertainty and caution in the business community. Such an outlook implied that inventory investment would supply positive but limited impetus to the expansion over the forecast horizon.

The federal tax cuts and large increases in federal spending legislated over the past year were expected to provide support for aggregate demand over the projection period. Some members expressed concern, however, about what they perceived to be the erosion of long-term fiscal discipline and increasing prospects that federal deficits would persist even after the economy recovered, with adverse effects on the domestic savings available for investment. Concurrently, however, at the state and local government level where budget flexibility was more limited, sizable budgetary shortfalls likely would hold down expenditures and induce some tax increases, with restraining effects over a period of time.

With regard to the outlook for the external sector of the economy, the sizable decline in the foreign exchange value of the dollar since the start of the year had given rise to market forecasts of appreciable further depreciation. The factors that governed the exchange value of the dollar were complex, and historically forecasts of trends in exchange rates had not been reliable. To the extent that the depreciation of the dollar was not reversed or that it continued, it would of course tend to boost net exports. Exports would in any event be likely to strengthen somewhat as a consequence of the evidently improving economies of a number of the nation's important trading partners. Indeed, members provided anecdotal reports of better export markets for a number of U.S. products. At the same time, however, severe problems being experienced by a number of large countries in South America raised the specter of a deepening financial crisis within that region and the possibility of more widespread contagion.

Given their anticipation of strong productivity growth and continuing slack in labor and other markets, members expected inflation to remain low over the next several quarters. An underlying factor in the good inflation performance of recent years and its extension into the future was the continuing absence of pricing power throughout the economy, evidently related in part to increased price competition in markets around the world stemming from globalization. Members cited examples of rising prices for a few products, notably steel, and the possibility that energy prices might raise costs. They also referred to the potential for upward pressure on prices associated with the recent depreciation of the dollar. Nonetheless, with rising productivity and moderate wage gains likely continuing to help hold down unit labor costs, the outlook for subdued inflation remained promising, especially for the nearer term.

The discussion of the inflation outlook was held against the backdrop of an earlier consideration at this meeting of the factors behind the decline in inflation in the 1990s and the value of structural models for forecasting inflation. Most Committee members, while acknowledging the deficiencies of structural models, viewed them as useful in their efforts to understand how the inflation process was changing and also as input to inflation forecasts. The members saw greater productivity growth, changing labor markets, and increased competition in product markets as having played a part along with monetary policy in lowering inflation. They agreed that more research—across countries as well as across time—was needed before they could become more confident about the value and stability of such models.

In the Committee's discussion of policy for the intermeeting period ahead, all the members agreed that recent developments argued for maintaining an unchanged policy stance, with the target for the federal funds rate remaining at 1¾ percent. The members saw favorable prospects for a significant acceleration in the expansion from the reduced pace in the current quarter, but considerable uncertainty still surrounded the timing and strength of the pickup. In the current situation, retention of the currently accommodative policy stance was desirable to counter the lingering effects of financial and other shocks to the economy that were continuing to exert a depressing impact on output and resource use. Inflation was still edging down, inflation expectations appeared to be low and stable, and going forward the members' forecasts for growth and productivity implied that unit costs and prices would remain subdued for some time.

A number of members noted that the current policy stance was too accommodative to be consistent over time with the Committee's objectives of price stability and maximum sustainable economic growth. Economic performance in line with their current forecasts would at some point require an adjustment to policy toward a less accommodative stance once more definitive indications of sustained strengthening started to emerge. And given the lags in monetary policy such an adjustment would probably need to be made at a time when the incoming economic information was still somewhat mixed. Still, in current circumstances, there was little risk of triggering an increase in inflation by waiting for a better reading on the course of the economy. Some members were concerned that markets might not fully appreciate the inevitability of eventual policy tightening. However, others pointed out that market participants seemed to have little doubt about the Committee's determination to keep inflation low and in that context markets were likely to anticipate Committee action once incoming information suggested it was becoming appropriate.

The members said that they could see risks on both sides of their forecasts, which indicated that growth would pick up and inflation would remain low over coming quarters at the current stance of policy. Accordingly, they agreed to retain an assessment of balanced risks to their long-term objectives in the Committee's post-meeting press release. Such a statement would not be an impediment to adjusting policy should a significant and unanticipated change in economic conditions materialize in the near term.

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¾ percent.

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

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are balanced with respect to prospects for both goals in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, McTeer, Olson, Santomero, and Stern. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 13, 2002.

The meeting adjourned on June 26, 2002, at 11:40 a.m.

Vincent R. Reinhart
Secretary

Meeting Held on August 13, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 13, 2002, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Jordan
Mr. Kohn
Mr. McTeer
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Howard and Lindsey, Ms. Mester, Messrs. Oliner, Rolnick, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

Messrs. Slifman and Struckmeyer, Associate Directors, Divisions of Research and Statistics, Board of Governors

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

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

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

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

Ms. Low, Open Market Secretariat Assistant, Office of Board Members, Board of Governors

Messrs. Connolly and Stewart, First Vice Presidents, Federal Reserve Banks of Boston and New York

Messrs. Goodfriend, Hakkio, Hunter, and Rasche, Senior Vice Presidents, Federal Reserve Banks of Richmond, Kansas City, Chicago, and St. Louis respectively

Messrs. Bryan, Cox, and Cunningham, Ms. Hargraves, Messrs. Rudebusch and Tootell, Vice Presidents, Federal Reserve Banks of Cleveland, Dallas, Atlanta, New York, San Francisco, and Boston respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on June 25–26, 2002, were approved.

By unanimous vote, Vincent R. Reinhart was elected as Secretary and Economist of the Committee for the period until the first regularly scheduled meeting in 2003.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period June 26, 2002, through August 12, 2002. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that economic activity expanded only slightly in the second quarter. Businesses added a bit to their inventory positions after an extended period of sizable declines, but final sales changed little: business capital spending weakened somewhat further while growth in consumer spending, residential housing expenditures, and government outlays slowed. The scant information available for the third quarter, principally July's very strong motor vehicle sales, suggested that domestic demand was still recovering but relatively sluggishly. Industrial production had continued to advance since the first quarter, but the demand for labor services had increased only slightly and the unemployment rate had risen. Importantly, labor productivity continued on a strong upward trend. Overall price inflation had fallen sharply over the past year, largely reflecting developments in the food and energy sectors, and core inflation had eased a little.

Private nonfarm payroll employment inched up in July after a mild increase in June, though aggregate hours worked by production or nonsupervisory workers declined steeply. The help-supply portion of the services sector and the construction industry recorded substantial net job losses over the June–July period, but manufacturing registered its smallest payroll decline in two years in July, and hiring was relatively brisk in services other than help-supply. The civilian unemployment rate edged up in June, to 5.9 percent, and was unchanged in July.

Industrial production jumped in June, and gains in output were widespread across market groups and industries. However, the limited available information indicated that output leveled out in July after six consecutive months of increases. Capacity utilization in manufacturing moved a little higher in June but remained substantially below its long-run average.

Retail sales were relatively brisk in June and July despite plunging equity prices and an apparently marked erosion in consumer confidence. Households spent heavily on motor vehicles in response to incentives offered by auto manufacturers, and their expenditures on other retail categories were generally well maintained.

Residential housing activity remained strong in the second quarter, buoyed by a very favorable mortgage financing environment. The pace of homebuilding in the quarter continued well above that seen during the past few years even though single-family housing starts in June did not reach the elevated May level. Sales of new single-family homes in June remained at a record high, but sales of existing homes declined noticeably. In the multifamily sector, June starts were in the lower end of their range over recent quarters. Market conditions in the condominium and cooperative apartment portion of the housing sector appeared to be favorable, but rising vacancy rates and weaker rents apparently hindered the rental apartment segment.

Business investment in equipment and structures declined further in the second quarter as the continuing downdraft in nonresidential construction more than offset a pickup in business spending for durable equipment and software. Despite gradually improving fundamentals—rising output and profits, new tax incentives, and a low cost of capital—firms remained cautious about stepping up their investments in equipment and software, and recent data on orders and shipments of nondefense capital goods coupled with anecdotal reports suggested further lackluster gains in spending in coming months. In the nonresidential construction sector, outlays for office, industrial, and other structures, lodging facilities, and public utilities declined substantially further. By contrast, construction of institutional structures was up again in the second quarter.

Nonfarm inventory investment turned slightly positive in the second quarter after several quarters of heavy liquidation. Success in pruning inventories had resulted in inventory–sales ratios that generally were at very low levels across the manufacturing, wholesale, and retail sectors. There appeared to be only a few industries with still sizable inventory overhangs.

The U.S. trade deficit in goods and services widened further in May and for the April–May period. The expansion of the deficit over the two months reflected a sharp rise in the value of imports that exceeded a sizable gain in the value of exports. The step-up in imports was spread widely across almost all the major trade categories, with notable increases in motor vehicles, consumer goods, and machinery. The advance in exports was primarily in automotive parts, industrial supplies, and capital equipment. With regard to economic activity abroad, the available information, which is released in many cases only with a considerable lag, indicated that foreign economic output generally continued to rebound during the first half of the year, though the pace of recovery was uneven across regions and countries. Growth was strong in Canada, the United Kingdom, and emerging Asia, but expansion in the euro area and Japan remained sluggish, owing to continued weakness in final domestic demand. In South America, economic and financial conditions had deteriorated significantly during the intermeeting period, especially in Brazil and Uruguay, and economic activity remained particularly weak in Argentina and Venezuela.

Consumer price inflation trended down over the past year. Much of the drop reflected developments in the food and energy sectors, but core inflation also eased a little. In May and June, both the consumer price and the chain-weighted personal consumption indexes exhibited little change in total and core prices. Moreover, at the producer level, inflation in core finished goods was at a low rate in the May–June period and the past twelve months. With regard to labor costs, the employment cost index for hourly compensation of private industry workers increased at a somewhat faster rate during the three months ended in June, reflecting a surge in benefit costs. From a somewhat longer perspective, however, growth of compensation costs over the twelve months ended in June was the same as in the previous twelve-month period.

At its meeting on June 25–26, 2002, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the intended level of the federal funds rate at 1¾ percent, and it also retained a neutral balance of risks statement. There was little market reaction to the Committee's rate decision or its statement. Instead, market participants focused their attention on further revelations of corporate malfeasance, fears that more earnings restatements would be announced in the run-up to the August 14 deadline for certifying corporate financial statements, and concerns that second-half corporate earnings might prove disappointing. In this environment, equity prices plunged before recovering somewhat later in the intermeeting period; on net, the major broad equity indexes were down substantially. Yields on Treasury securities also fell markedly on balance in volatile trading, as investors sought a safe haven for their funds and trimmed their expectations about the path for the intended federal funds rate in coming quarters. However, doubts about corporate balance sheets and the prospects for earnings growth led to steep increases in corporate debt yields, particularly for lower-quality issues.

In foreign exchange markets, the trade-weighted value of the dollar changed little on balance in terms of the major foreign currencies over the intermeeting period, though early in the period the dollar declined sharply against those currencies amid further disclosures of U.S. corporate accounting irregularities and concerns about the strength of the U.S. recovery. Against the background of a similar combination of disappointing concerns, European stock prices dropped more than those in the United States, while Japanese equity prices declined less as incoming data seemed to point to a mild pickup of economic activity in Japan. Across all the major industrial economies, investors tended to shift funds toward less risky instruments and to lower their expectations for policy rates. The dollar also was little changed on balance against the index of currencies of other important trading partners, even though several South American countries were experiencing difficult financial and political problems.

Borrowing by domestic nonfinancial businesses had been weak recently, likely reflecting deteriorating conditions in credit markets and reduced requirements for funds to finance capital spending projects. Growth of M2 surged in July in association with large inflows to liquid deposits and retail money market funds.

The staff forecast prepared for this meeting suggested that, in light of weaker-than-expected incoming economic data, the expansion of economic activity would pick up gradually over the next year and a half from the very sluggish pace of the second quarter. The considerable monetary ease and fiscal stimulus already in place and the continuing sizable gains in structural productivity would provide significant impetus for spending, though the persisting volatility and weakness in equity prices would tend to offset some of that support. Inventory overhangs appeared to have been largely eliminated and business capital stocks to have moved closer to desired levels. As a consequence, a gradually improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to boost business investment spending. However, a less robust pickup in final sales was now expected over the forecast period, which would put somewhat less pressure on resource margins than had been anticipated previously, and the level of activity would remain below the economy's potential for a somewhat longer time. The persistence of underutilized resources was expected to foster some moderation in core price inflation.

In the Committee's discussion of current and prospective economic developments, members commented that much of the incoming information on economic activity had been disappointing, and many indicated that they had marked down their growth forecasts for the months ahead. Even so, with recent weakness concentrated in volatile high-frequency data that might well prove to be transitory and with business and consumer confidence unlikely to deteriorate further in the absence of a major shock to the economy, members continued to place favorable odds on an underlying outlook of strengthening expansion. Factors cited for this positive outlook included the stimulative stances of fiscal and monetary policy, the apparent completion in most industries of efforts to bring inventories and capital facilities into desired alignment with expected sales, and the support to consumer incomes and business incentives provided by the continued rise in structural productivity. Further gains in productivity and the prospect for relatively contained demand pressures on resources, which were likely to be somewhat more limited for a time than members had anticipated earlier, would contribute to keeping price inflation subdued.

A number of members commented on financial developments that appeared to be holding back the pace of the expansion. While prices in equity markets had turned up from their recent lows, the cumulative losses in financial wealth incurred since early 2000 clearly were having an adverse impact on expenditures by households and the higher cost of equity capital was inhibiting business investment. The declines in equity prices had been accompanied by a heightened degree of risk aversion that had led to widened credit spreads in financial markets and the curtailment of credit availability to potential borrowers whose repayment prospects were viewed as questionable. To an extent that was difficult to determine, the current skittishness in debt and equity markets reflected lender and investor reactions to the ongoing revelations of corporate governance failures. Those reactions, which were proving to be more severe and probably would be longer-lasting than many had anticipated, appeared to be contributing to more cautious business spending and hiring, at least temporarily. It was unclear when the associated uncertainties would diminish and confidence would begin to rebuild, though the outlook might come into better focus after the mid-August SEC deadline for the certification of financial statements by corporate executives. On the positive side, home mortgage financing remained widely available at low interest rates and was providing important support to household spending. More generally, interest costs had declined for borrowers with acceptable credit ratings, and the overall condition of the banking system remained sound with bank credit widely available. Moreover, for many households, the negative wealth effects stemming from losses on equities were offset, at least to some extent, by continuing increases in home equity values. These ongoing factors suggested to some members that the effects of the financial restraints on economic activity might be fairly limited at this point.

In their review of demand prospects in key sectors of the economy, members noted that household spending was continuing to play a key role in sustaining the expansion. Retail sales, buttressed by strength in motor vehicles, had been well maintained in recent months despite survey evidence of declining consumer confidence. The extraction of funds from increases in home equity evidently remained an important source of financing for household expenditures, especially including outlays for home modernization. Looking ahead, the anticipated pickup in employment and related gains in incomes, undergirded by continued robust growth in structural productivity, was seen as supporting further expansion in consumer spending. Some members commented, however, that the declines in equity wealth and the possible persistence of turmoil in equity markets might continue to restrain the pickup in consumer expenditures in the months ahead.

In the housing sector, low mortgage interest rates remained a key factor in sustaining homebuilding activity at a relatively elevated level. Housing markets continued to exhibit strength across much of the country, with few indications of any moderation except for sales of high-priced homes. It was noted that, in the absence of an unanticipated downturn in general economic activity, underlying pressures for housing as the population expanded coupled with the scarcity of viable homebuilding sites in urban areas likely would preclude any substantial decline in housing activity or housing prices in the foreseeable future.

The weakness in business fixed investment was still a depressant on overall economic activity, though the decline in business outlays had abated since the latter part of 2001; indeed, spending for equipment and software had edged up in the second quarter. With excess stocks of capital inventories seemingly worked down to more acceptable levels in many industries and with expansion in final sales expected to become more firmly established, an acceleration in spending for equipment and software was likely in store. As they had at earlier meetings, however, members observed that business sentiment remained extraordinarily cautious on the whole and that business firms in most industries continued to direct their investment spending primarily toward enhancing the productivity of their operations rather than also increasing capacity. Exceptions cited by members included the enlargement of production facilities by some firms in industries that were currently enjoying vigorous demand, such as producers of motor vehicles. How soon the gloom surrounding the outlook for a pickup in sales and profits and the associated concerns in financial markets would dissipate was subject to substantial uncertainty, but increasing needs for capital as the economy continued to expand, further growth in investment opportunities in conjunction with the uptrend in structural productivity, and the temporary tax incentive provision for equipment and software likely would support a sustained recovery in investment expenditures over coming quarters that would provide essential impetus for lifting economic growth.

The prospects for an upturn in nonresidential construction appeared to many to be more bleak. Reports from around the nation pointed to high, and in many areas still rising, vacancy rates for commercial and industrial space, and hotel construction continued to be held down by the problems afflicting the travel industry. Against this backdrop, overall nonresidential building activity seemed likely to decline further over the next several quarters.

Business inventories edged up in the second quarter after declining persistently since early 2001. Indeed, the strengthening was sufficient to account for the small advance in GDP in the latest quarter. With inventories now apparently close to desired levels in many sectors of the economy and reportedly below such levels for some retailers, the expected strengthening in final sales would probably foster some inventory accumulation over coming quarters, thereby adding impetus to the projected growth of the economy.

Government spending also was expected to provide ongoing stimulus to the expansion, especially given the prospects for further spending initiatives in forthcoming federal legislation. In addition, already enacted income tax cuts and the tax expensing provision for certain investment outlays would help to support both consumer and business expenditures. Concurrently, though, state and local governments facing large shortfalls in revenues in a sluggish economy were holding down the overall growth in their expenditures. Anecdotal reports suggested, however, that sizable spending on a variety of construction projects was continuing, financed in part through bond issues. On balance, the government sector was expected to remain a positive factor in the economic recovery.

The depreciation of the dollar and overall strengthening in foreign economic activity were projected to foster moderate added growth in U.S. exports over the next several quarters. However, recent developments, including indications of weaker-than-projected economic recovery in Europe, growing questions about the outlook for several important economies in South America, and the continued sluggish performance of the Japanese economy, threatened to limit the improvement in exports, at least over the nearer term. Providing a partial counterweight were anecdotal reports indicating sizable growth in U.S. exports to a number of Asian countries.

The outlook for inflation remained very favorable in the context of continuing slack in labor markets and robust growth in structural productivity. Under these conditions, increases in trend unit labor costs were likely to remain subdued over the next several quarters despite likely further escalation in the cost of worker healthcare benefits. Indeed, the risks of any significant run-up in inflation appeared to have receded, and more time than anticipated earlier was likely to elapse before the expansion reached a pace that would begin to reduce margins of underutilized labor and other producer resources. Even so, examples of rising cost and price pressures were not entirely absent. In addition to healthcare insurance costs, these pressures included insurance costs more generally, steel prices, some materials costs, and, in association with the dollar's depreciation, some upward pressures on import prices. On balance and barring a major supply shock to the economy, members saw little reason for concern about the prospect of an increase in inflation in the foreseeable future.

In the Committee's discussion of policy for the intermeeting period ahead, all the members were in favor of an unchanged policy stance consistent with retaining a target rate of 1¾ percent for the federal funds rate. Although some economic and financial indicators had deteriorated since the June meeting and the members generally had scaled down their economic forecasts, they continued to see favorable prospects for a strengthening economy over time. To be sure, a further significant weakening in economic prospects—for example, that might be associated with additional deterioration in financial markets—might well call for a policy response, but for now the members viewed the current degree of monetary accommodation as appropriately calibrated to provide the stimulus needed to foster a solid expansion that would bring the economy to fuller resource utilization.

All the members indicated that they could accept, and most said they preferred, a proposal to shift the Committee's assessment of the risks to the economy from the currently neutral statement to one that was tilted toward weakness in the foreseeable future. A few expressed a preference to retain the current balanced risks statement for the press release to be issued shortly after this meeting. In support of this view, they underscored the considerable uncertainty surrounding the outlook for financial and economic conditions and the prospect that many observers in financial markets could misread a shift in the Committee's assessment of the risks to the outlook as a signal that the Committee was contemplating easing in the near term. All the members agreed, however, on the desirability of communicating in some form—whether in the text of the post-meeting press release or through a shift in the risks statement or both—their view that the expansion recently had been less robust than expected and that for the foreseeable future the risks of a more extended period of subpar growth had increased while those of inflation had declined. Several also commented that while the shift under consideration might raise expectations of some easing in coming months, those expectations and related market adjustments would be shaped principally by the tenor of the incoming economic information.

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

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¾ percent.

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

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, Kohn, McTeer, Olson, Santomero, and Stern. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 24, 2002.

The meeting adjourned at 12:40 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on September 24, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 24, 2002, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Jordan
Mr. Kohn
Mr. McTeer
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Howard, and Lindsey, Ms. Mester, Messrs. Oliner, Rolnick, Rosenblum, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

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

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

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

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

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

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

Mr. Moore, First Vice President, Federal Reserve Bank of San Francisco

Messrs. Eisenbeis, Fuhrer, Hakkio, Judd, Lacker, and Steindel, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Boston, Kansas City, San Francisco, Richmond, and New York respectively

Messrs. Coughlin, Elsasser, and Sullivan, Vice Presidents, Federal Reserve Banks of St. Louis, New York, and Chicago respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 13, 2002, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period August 13, 2002, through September 23, 2002. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that the economy continued to expand in the third quarter, though the tenor of incoming reports was mixed. Data on household and business spending had been solid for the most part, and residential construction remained high. Motor vehicle production provided a sizable boost to economic activity, but other factory output changed little on net. Employment continued to expand unevenly, while labor productivity remained on a strong upward trend. Overall price inflation had fallen over the past year, reflecting favorable developments in the food and energy sectors and a decline in core inflation.

Aggregate labor market conditions had been mixed in recent months. While nonfarm payroll employment registered further small gains in July and August, the aggregate hours worked by production or nonsupervisory workers declined on balance over the two-month period. The manufacturing and retail trade sectors registered sharp job losses in August, but those were more than offset by hiring in the services and construction sectors. A hefty increase in government jobs at the federal, state, and local levels also boosted payroll employment. The civilian unemployment rate fell to 5.7 percent in August despite advances in claims for unemployment insurance.

Industrial production declined in August, largely offsetting July's rise. Excluding motor vehicles, manufacturing output was unchanged in both July and August after sizable advances in the first half of the year. Production in the high-tech sector jumped in August, the manufacture of aircraft and parts fell further, and output in the remainder of the industrial sector was mixed. Capacity utilization in manufacturing changed little in August and was substantially below its long-run average.

Retail sales remained relatively brisk in August despite further decreases in stock prices and consumer confidence. Households boosted their already high level of spending on motor vehicles in response to zero percent financing and larger cash incentives offered by auto manufacturers, and household purchases of goods other than motor vehicles continued to advance at a moderate pace. According to the latest available data, outlays for services rose moderately in July.

Residential housing activity slowed a little in July and August from the robust pace of the second quarter as further declines in mortgage rates apparently helped to support housing activity in an environment of sluggish employment and diminishing household wealth. Starts of single-family units fell in August to their lowest rate since last November, while starts in the multi-family sector in the July–August period were at their average rate for the first half of the year. Sales of new single-family homes posted a record high in July, and the inventory of unsold new homes remained low. Sales of existing single-family homes in July partially retraced a large drop in June.

Based on the limited information available, business investment in equipment and software seemed to be advancing at a solid pace in the third quarter. This reflected an acceleration in spending that was associated importantly with notably stronger motor vehicle sales and a halt to the contraction in aircraft expenditures. Outside the transportation sector, outlays on equipment continued to expand at a moderate pace; in addition, the level of orders in July (latest data) moved above shipments for the first time since early last year, and the backlog of unfilled orders edged up. Nonresidential construction activity remained on a steep downtrend in July, with further reductions of spending in all major categories except office buildings.

The book value of manufacturing and trade inventories excluding motor vehicles registered a second straight monthly gain in July after many months of heavy liquidation. Despite the rise in stocks, gains in sales and shipments drove inventory–sales ratios to even lower levels across the manufacturing, wholesale, and retail sectors. Survey and anecdotal information suggested that few industries were burdened with sizable inventory overhangs.

The U.S. trade deficit in goods and services narrowed appreciably in July after two quarters of large increases. The smaller deficit in July reflected continued strong expansion of the value of exports coupled with a decrease in the value of imports. The step-up in goods exports occurred mostly in motor vehicles and aircraft, while the gain in exports of services was spread across travel and other private services. The decline in imports was concentrated in consumer and capital goods, royalties, and license fees. The very limited available information on economic activity abroad in the third quarter suggested continued sluggish expansion in the euro area and Japan, moderate growth in the United Kingdom, further brisk recovery in Canada, and ongoing recovery in emerging Asia. Conditions in South America remained fragile: Economic activity was still very weak in Argentina and Venezuela, and the Brazilian economy had been adversely affected by the turbulence in financial markets, though those markets had stabilized recently. By contrast, Mexico experienced brisk growth in the second quarter.

Despite a slight pickup in consumer price inflation in August, the increase in consumer prices (measured by either the consumer price index or the chain-indexed personal consumption expenditure index) for the year ending in August was considerably smaller than that for the previous twelve-month period. Much of the drop in inflation reflected developments in the food and energy sectors, but core inflation also declined noticeably. Producer prices for core finished goods likewise signaled a drop in inflation over the last year. With regard to labor costs, average hourly earnings of production or nonsupervisory workers decelerated sharply over the twelve months ended in August, reflecting the effects of both the rise in unemployment and the drop in consumer price inflation.

At its meeting on August 13, 2002, the Committee retained a directive that called for maintaining conditions in reserve markets consistent with keeping the intended level of the federal funds rate at 1¾ percent, but it shifted from a statement of a neutral balance of risks to one that was tilted toward economic weakness in the foreseeable future. Market participants read the tilt and the wording of the announcement as indicating that economic activity in the coming months likely would be weaker than had been expected, and some short-term interest rates eased slightly while broad indexes of equity prices moved lower. The following day's deadline for the recertification of corporate financial statements passed uneventfully and equity markets rallied. Subsequently, however, a weaker tone to incoming data on production and employment, a gloomier outlook for business profits, and heightening tensions over Iraq seemed to lead investors to revise down their outlook for the economy. Over the intermeeting period, intermediate- and longer-term Treasury security yields and broad equity indexes fell considerably on balance.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies appreciated slightly on balance over the intermeeting period as projections for growth of foreign industrial countries, particularly Germany and Japan, were marked down more than those for the United States. The dollar moved within narrow ranges against most major currencies but rose somewhat against the yen and the currencies of other important trading partners.

M2 growth remained elevated in August, though somewhat below July's rapid pace. Much of the strength of the aggregate's liquid components likely was associated with the continuing historically low opportunity costs of holding such deposits, the recent surge in mortgage refinancing activity, and the safe haven provided from volatile equity prices. Borrowing by domestic nonfinancial businesses remained weak, likely reflecting reduced requirements for funds to finance capital spending projects and perhaps the improved tone in the corporate bond market and a modest increase in the issuance of corporate debt.

The staff forecast prepared for this meeting suggested that, in light of weaker-than-expected incoming economic data, the expansion of economic activity would pick up more gradually but would still reach a relatively brisk pace late next year. The considerable monetary ease and fiscal stimulus already in place, continuing gains in structural productivity, and improving business confidence would provide significant impetus for spending. Inventory overhangs appeared to have been largely eliminated, and business capital stocks appeared to have moved closer to desired levels. As a consequence, a gradually improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to boost business investment spending. However, a less robust pickup in final sales was now expected over the forecast period, which would put somewhat less pressure on resource margins than had been anticipated previously, and the level of activity would remain below that of the economy's potential for a longer time. The persistence of underutilized resources was expected to foster some moderation in core price inflation.

In the Committee's discussion of current and prospective economic conditions, members commented that economic growth appeared to have picked up in the third quarter but that the most recent information had been mixed, raising questions about whether the pace of the expansion going forward would be strong enough to erode margins of underutilized labor and capital resources. For now, a high degree of business caution in the context of substantial uncertainties, exacerbated recently by apparently increased concerns about the geopolitical outlook, continued to restrain business investment and hiring. Even so, the economy appeared to be well positioned for solid gains over time in light of the progress that had been made in bringing inventories and capital stocks into better alignment with sales, the stimulus provided by accommodative fiscal and monetary policies, and the implications of the strong uptrend in productivity for profitable investment opportunities and growth in consumer incomes. With the growth of economic activity nonetheless expected to remain below the economy's potential for some time, pressures on labor and other resources would be limited and in turn wage and price increases likely would continue to edge lower.

In their review of developments in and prospects for key sectors of the economy, members commented that household spending had continued to be well maintained. Buttressed by exceptional strength in sales of motor vehicles, consumer spending had displayed solid growth during the summer months. While survey indicators of consumer confidence had declined this year, the high levels of consumer spending on homes, motor vehicles, and other big-ticket items were, in the view of at least some members, perhaps a better gauge of consumer confidence. The value of homes had continued to rise in most areas, and unusually low interest rates were inducing people to refinance mortgages and in the process to extract and spend some of the embedded equity gains. Increasing home equity values probably were also providing some counterweight to the impact on consumer spending of the negative wealth effects associated with the declines in stock market prices since the spring of 2000. Other positive factors cited as helping to undergird the persisting strength in consumer spending included reductions in federal income tax rates; the availability of financing for consumer durable goods at relatively attractive interest rates, including zero interest rates for selected motor vehicles; and the cumulative effects of productivity gains on current and expected real consumer incomes. Looking ahead, sales of motor vehicles likely would moderate to some extent over coming months from their currently unsustainable levels, and some members referred to indications of slower growth in retail sales in late summer and somewhat downbeat forecasts for coming months reported by a number of retailer contacts. Moreover, the absence of significant growth in employment, should it persist, could at some point have significant adverse repercussions on consumer spending. On balance, consumer spending was seen as likely to remain a positive but possibly a more limited source of support for the expansion over the next several quarters.

In the context of sustained growth in incomes, low mortgage interest rates, by facilitating the extraction of homeowners' equity, had played a key role in inducing a high level of spending on residential structures and home improvement expenditures. Tending to confirm currently available data on housing activity, members cited persisting anecdotal reports of robust home sales and residential construction in many regions, though indications of softening were noted in some areas and market segments, particularly in the high-price sector of the housing market. Some members questioned whether generally rising housing prices and elevated levels of refinancings would persist. However, given the anticipated continuation of accommodative conditions in mortgage markets and forecasts of rising incomes, the overall outlook for housing remained favorable.

Business fixed investment remained a significant question mark in the outlook for economic expansion. Recent readings on business spending for equipment and software pointed to gradual improvement, but nonresidential construction activity continued to be severely depressed in many areas. It was unclear whether the recent strength in orders and shipments signaled a significant acceleration in capital outlays, and in this regard the new information that would become available in the next few weeks might provide important evidence on the outlook for capital spending and thus for the performance of the economy more generally. At least for now, however, anecdotal reports suggested that a high degree of caution continued to characterize business investment decisions in the face of an elevated level of uncertainty. Much of the current spending for equipment and software reportedly represented replacement demand largely associated with the short useful lives of various types of equipment, and there appeared to be little spending that would entail capital deepening. At the same time, several positive factors in the outlook for capital spending could be cited including the greater productivity of new capital equipment, the temporary accelerated expensing tax incentives, generally strong business cash positions, and the relatively rapid depreciation of existing capital equipment. For the present, however, business contacts widely reported that because of prevailing uncertainties they were deferring major investment initiatives until they saw clear evidence of an increased need for capital to meet growing demand.

Business firms appeared to be in the process of moving from inventory liquidation to accumulation, and the available evidence suggested that inventory positions were getting tighter. Accordingly, prospective growth in final demand would have to be met through increased production. And as demand rose over the next several quarters, businesses were expected to accumulate inventories to maintain desired inventory–sales ratios, adding in the process some limited impetus to the growth of GDP.

The growth of economic activity in most major foreign countries appeared to be falling below expectations earlier in the year, with adverse implications for U.S. exports. Among those nations, only Canada had experienced a robust economic recovery thus far this year. Current forecasts continued to anticipate strengthening activity abroad, but as in the case of the U.S. economy substantial uncertainties surrounded the timing and pace of the improvement.

In the context of limited demand pressures on labor and other resources, current forecasts continued to point to quite low and perhaps declining inflation over the next several quarters, although there appeared to be significant crosscurrents in the outlook for prices. Rapid increases in healthcare and other insurance costs and the lagged passthrough of large increases in oil prices would tend to maintain upward pressure on prices. Tending to oppose those forces, though, were the effects on resource use of an extended period of economic activity below the economy's potential as well as the effects of robust productivity gains on costs, apparently declining inflation expectations, and the persistent absence of pricing power in highly competitive markets. Indeed, the members did not rule out the emergence of appreciably lower inflation. In this regard, some observed that a significant decline in inflation from current levels could imply an unwelcome tightening of monetary policy in real terms. In addition, further sizable disinflation that resulted in a nominal inflation rate near zero could create problems for the implementation of monetary policy through conventional means in the event of an adverse shock to the economy that called for negative real policy interest rates.

In the Committee's discussion of policy for the intermeeting period ahead, all but two of the members endorsed a proposal to maintain an unchanged policy stance. In the view of all the members, current forecasts clearly were subject to the risk that economic growth would not be sufficient to reduce excess capacity in labor and capital markets. However, the members who favored a steady policy course noted that the recent data on household and business spending had been a bit stronger than expected and that a number of factors pointed to solid growth over time. In these circumstances, they believed that in the context of prevailing uncertainties more evidence of subpar expansion was desirable before policy was eased further. It was noted in this regard that the information that would become available over the next several weeks should provide an improved basis for assessing the recent anecdotal reports from around the nation that pointed to a possibly slowing expansion. Several members indicated that if compelling evidence of a weak economy were to materialize they would be prepared to ease promptly. Two members preferred an immediate easing action because they were persuaded by what they viewed as already strong evidence of a persisting unsatisfactory, and perhaps weakening, economic performance. While the current stance of policy was already accommodative, they felt that greater stimulus was now called for to foster an acceptable pace of economic expansion.

All the members agreed that the risks to the economy remained tilted toward weakness and that such an assessment needed to be incorporated in the statement to be released shortly after today's meeting. The members also accepted a proposal to add a reference in the statement regarding what they viewed as recently heightened geopolitical risks that appeared to constitute a major source of the uncertainty currently prevailing in the economy. The addition was not intended to signal that any particular policy response would be forthcoming in the event of a crisis. Rather, consistent with its usual practice, the Committee would assess the implications of any such development for the domestic economy before deciding on an action. Indeed, if the geopolitical uncertainties were to ease significantly along with what already were apparently diminishing concerns about corporate governance issues, the resulting improvement in business and consumer sentiment could generate a more robust economic expansion.

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¾ percent.

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

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

> Votes for this action: Messrs. Greenspan, McDonough, Bernanke, Ms. Bies, Messrs. Ferguson, Jordan, Kohn, Olson, Santomero, and Stern. Votes against this action: Messrs. Gramlich and McTeer.

Messrs. Gramlich and McTeer dissented because they preferred to ease monetary policy at this meeting. The economic expansion, which resumed almost a year ago, had recently lost momentum, and job growth had been minimal over the past year. With inflation already low and likely to decline further in the face of economic slack and rapid productivity growth, the potential cost of additional stimulus seemed low compared with the risk of further weakness.

It was agreed that the next meeting of the Committee would be held on Wednesday, November 6, 2002.

The meeting adjourned at 1:30 p.m.

Notation Vote

By notation vote completed on September 30, 2002, the Committee authorized Vice Chairman McDonough to accept the "Decoration of Merit" honor to be awarded by the government of Argentina.

> Votes for this action: Messrs. Greenspan, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, Kohn, McTeer, Olson, Santomero, and Stern. Votes against this action: None. Abstention: Mr. McDonough.

Vincent R. Reinhart
Secretary

Meeting Held on November 6, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, November 6, 2002, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Jordan
Mr. Kohn
Mr. McTeer
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Howard, Lindsey, Ms. Mester, Messrs. Oliner, Rosenblum, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

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

Messrs. Kamin and Whitesell, Deputy Associate Directors, Divisions of International Finance and Monetary Affairs respectively, Board of Governors

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

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

Mr. Nelson,[7] Senior Economist, Division of Monetary Affairs, Board of Governors

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

Mr. Forte,[7] Senior Technical Editor, Division of Research and Statistics, Board of Governors

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

Mr. Varvel, First Vice President, Federal Reserve Bank of Richmond

Mr. Lang, Executive Vice President, Federal Reserve Bank of Philadelphia

Messrs. Eisenbeis, Fuhrer, Goodfriend, Hakkio, Hunter, Judd, Ms. Perelmuter, and Mr. Rasche, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Boston, Richmond, Kansas City, Chicago, San Francisco, New York, and St. Louis respectively

Mr. Peach, Vice President, Federal Reserve Bank of New York

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on September 24, 2002, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period September 24, 2002, through November 5, 2002. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting suggested that economic growth had slowed from the moderate pace of the third quarter. Residential construction activity remained high, but

7. Attended portion of meeting relating to the discussion of alternatives to holding Treasury securities in the System Open Market Account.

consumer spending had softened and business investment was still sluggish. Industrial production had slipped in recent months and private payroll employment had changed little, while labor productivity remained on a strong upward trend. Overall price inflation had fallen over the past year, reflecting both favorable developments in the food and energy sectors and a continuing decline in core inflation.

Aggregate labor market conditions weakened further in October. Private nonfarm payroll employment declined in September and October after four previous months of modest gains in hiring. The number of jobs in manufacturing and related industries continued to fall, with losses widely spread. The construction, transportation, and utilities industries also registered further job losses. By contrast, the services sector continued to expand despite job reductions in the help-supply industry, and the strong housing market and mortgage refinancing activity led to brisk hiring in the finance, insurance, and real estate industries. Total hours worked by private production workers moved down in October, and initial claims for unemployment insurance were at a relatively elevated rate. The civilian unemployment rate rose to 5.7 percent in October.

Industrial production decreased slightly further in September, and available weekly information pointed to another reduction in output in October. Softness in the manufacturing sector was widespread. In the high-tech sector, output continued to rise, but much less rapidly than earlier in the year. Motor vehicle assemblies ebbed a little from the robust third-quarter pace. Elsewhere in manufacturing, production weakened in many categories, including commercial aircraft, non-auto consumer goods, and various types of business equipment. Capacity utilization in manufacturing edged lower in September and was substantially below its long-run average.

In the context of limited gains in personal income and declining consumer confidence, retail sales weakened in September after two months of robust increases. The earlier gains were fueled mainly by very large manufacturer discounts on 2002 models of motor vehicles. Incentives on 2003 models were smaller in September, and consumer response was tepid. Retail sales of non-auto goods also decreased in September after having registered only modest growth in July and August. Outlays for services edged up in September.

Residential housing activity, supported by mortgage rates near historical lows, remained very strong in September despite an environment of sluggish employment and declining household wealth. Starts of single-family units reached a twenty-three year high in September, and starts in the multifamily sector were a little above their average since January of this year. Sales of new homes edged up to a record level in September, and sales of existing homes continued to be brisk, though a little below the exceptional pace of the first half of the year. The strength of housing demand was also reflected in further rapid gains in home prices.

Business fixed investment edged up in the third quarter, as a pickup in expenditures for equipment and software nearly offset a further sharp decline in spending on nonresidential structures. The return to positive growth of spending for equipment and software was led by robust business outlays for computers and peripheral equipment and for motor vehicles. By contrast, investment in telecommunications equipment and aircraft remained on a steep downward trend. Nonresidential construction activity also continued to decline rapidly, with considerable further reductions in all major categories.

The book value of manufacturing and trade inventories excluding motor vehicles registered consecutive gains in July and August after months of heavy liquidation. Despite the recent accumulation, inventory–sales ratios in most industries were at, or near, historic lows.

The U.S. trade deficit in goods and services widened in August, and the average deficit for July and August was virtually unchanged from that for the second quarter. The value of both imports and exports changed little in the July–August period. The available information on economic activity abroad in the third quarter suggested mixed results. Canada apparently grew briskly, and the United Kingdom recorded further moderate economic expansion. In the euro area and Japan, growth appeared to be weakening. The pace of recovery in most of emerging Asia also appeared to have slowed, though China evidently remained on a path of robust expansion. In South America, economic conditions generally remained fragile. Economic activity was still very weak in Argentina and Venezuela, and the Brazilian economy continued to be adversely affected by uncertainties concerning the economic policies of the incoming government. Mexico has been largely unaffected by the financial and political problems of major South American countries, but it nonetheless experienced slower economic growth in the third quarter.

Consumer price inflation continued to trend downward in September. The rise in consumer prices for the year ending in September was considerably smaller than that for the previous twelve-month period. While much of that drop reflected developments in the food and energy sectors, core inflation also declined noticeably. Judged by consumer surveys, slower price increases over the past year apparently led consumers to lower their expectations of near-term inflation. At the producer level, prices for core finished goods likewise decelerated over the twelve months ended in September. With regard to labor costs, growth in average hourly earnings of production or nonsupervisory workers declined significantly over the twelve months ended in September, evidently reflecting the effects of both the rise in unemployment and the drop in consumer price inflation.

At its meeting on September 24, 2002, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the federal funds rate around 1¾ percent, and it also retained a balance of risks statement that was tilted toward economic weakness in the foreseeable future. Market participants had anticipated the unchanged policy stance and risk assessment, but the inclusion in the policy announcement of a reference to heightened geopolitical risks led to downward revisions to expectations for the future path of the federal funds rate. The subsequent release of better-than-expected news on profits for several major corporations buoyed equity prices and lifted market interest rates and predicted policy rates. Later in the intermeeting period, weaker-than-anticipated economic data along with press reports suggesting that the FOMC was inclined to ease by year-end led again to downward revisions of the expected path of the federal funds rate target. Over the intermeeting period as a whole, broad equity indexes registered sizable gains and intermediate- and longer-term bond yields increased somewhat.

The dollar traded in a narrow range in foreign exchange markets during the intermeeting period. It depreciated slightly in terms of an index of major foreign currencies and was little changed on balance against the currencies of other important trading partners.

M2 grew more moderately on average in September and October, with aggregate spending apparently softening, the effects of past monetary easing actions wearing off, and significantly weaker foreign demand for currency emerging. By contrast, the high level of mortgage refinancing activity provided a continuing boost to deposit growth.

The staff forecast prepared for this meeting suggested that, in light of further weaker-than-expected incoming economic data, the expansion of economic activity would be relatively muted for some time. Moreover, current and prospective sluggish economic growth among major trading partners would damp U.S. exports, and businesses and households were likely to hold their spending down while faced with the possibility of a military conflict as well as persisting concerns about the near-term course of economic activity and corporate earnings. Nonetheless, those restraining influences were expected to abate over time and economic activity strengthen gradually. The considerable monetary ease and fiscal stimulus already in place, continuing gains in structural productivity, and anticipated improvement in business confidence would provide significant impetus for spending. Inventory overhangs already had been largely eliminated, and business capital stocks had moved closer to desired levels. As a consequence, a slowly improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to boost business investment spending. Even so, a less robust pickup in final sales was now expected over the forecast period, which would put somewhat less pressure on resource margins than had been anticipated previously, and the level of activity would remain below the economy's potential for a longer time. The persistence of underutilized resources was expected to foster a slight moderation in core price inflation.

In the Committee's discussion of current and prospective economic conditions, members commented that the recent data on the performance of the economy had been disappointing and had tended to confirm widespread anecdotal indications that economic growth had slowed to a pace well below that experienced earlier in the year. Even so, the members acknowledged that the economy had displayed remarkable resiliency over the past year despite being subjected to severe adverse shocks. While the latter clearly had taken their toll on confidence, notably in the business sector, consumer spending had held up relatively well. Business investment expenditures continued to be constrained by a high degree of uncertainty and related caution. Looking beyond the near term, the members anticipated that as the prevailing uncertainties began to diminish, the economy's resiliency abetted by broadly accommodative monetary and fiscal polices and the continuation of a strong uptrend in productivity would underpin a gradual economic recovery. Indeed, some members commented that an even more robust recovery could not be ruled out in the absence of further major shocks to confidence. With pressures on labor and other resources expected to be limited over coming quarters, inflation was likely to remain subdued and perhaps even to edge a little lower.

In their review of developments and prospects in key expenditure sectors of the economy, members noted that consumer spending appeared to have decelerated since midsummer, while an anticipated and hopefully compensating strengthening in business investment had not yet materialized. Factors cited by the members that appeared to help account for the recent softness in consumer demand included substantial decreases in equity wealth, declining consumer confidence in the context of geopolitical and other uncertainties, the waning effects of earlier income tax cuts, and the failure of the most recent round of motor vehicle sales incentives to maintain the extraordinary level of sales seen during the summer. Looking ahead, some members referred to subdued expectations among their retailer contacts regarding the upcoming holiday season, with sales prospects likely to be held back at least marginally by the lingering effects of the recent West Coast dock strike on the availability of merchandise. There also was some question as to whether funds extracted from rising home equity values would continue to provide as important a source of financing for purchases of consumer durables as they had for some time unless mortgage interest rates declined from their already low levels. Members also mentioned a number of favorable factors bearing on the longer-term outlook for consumer spending. These included the prospect of strengthening consumer confidence if geopolitical uncertainties began to dissipate, the gradual diminution of the negative wealth effects from earlier stock market declines, and importantly the outlook for continued robust growth in structural labor productivity and its favorable effects over time on wages and salaries.

High and persisting uncertainty and concomitant aversion to risk among business executives apparently continued to hold down business investment spending. While such expenditures remained at a high level, members saw few signs of a significant pickup in the nearer term. Apart from notably adverse business sentiment and disappointing growth in sales and profits, factors that were curbing capital expenditures cited by members included persisting capital overhangs stemming from what were now seen as excessive earlier buildups in equipment and software and substantial idle capacity in many industrial and commercial structures. Some divergence of opinion was expressed regarding the overall extent of capital overhangs, though it was clearly evident in some industries and in high vacancy rates in nonresidential buildings in many areas of the country. Looking to the future, the timing and strength of a decisive upturn in capital expenditures, a key factor in the outlook for some improvement in the performance of the overall economy, would depend critically on the dissipation of prevailing uncertainties, including those associated with geopolitical risks, and increasing prospects for profits. In the latter regard, it was suggested that in the context of rising productivity, profits could prove to be stronger than many now expected, with favorable implications for cash flows and in turn investment activity.

Cautious business attitudes and expectations of sluggish sales over coming months were inducing business firms to continue to hold down what were already generally lean inventories. Nonetheless, some members commented that inventory accumulation was likely to provide some limited impetus to the economy over the next several quarters to the extent that an acceleration in economic activity occurred and businesses sought to maintain an acceptable balance between their inventories and sales. Indeed, with inventories at unusually low levels in many industries, efforts to rebuild such inventories appeared inevitable.

Housing activity had remained at a generally elevated level in recent months and in the context of low mortgage interest rates likely would continue to provide important support to the economy over the forecast period. Most regional reports indicated persisting strength in the housing sector, though there was evidence of modestly flagging activity in some areas. In this regard, it was noted that the declining trend in mortgage interest rates probably would not continue once forecasts of a strengthening economic expansion began to materialize. Indeed, the rise in bond yields since the September meeting associated with the improvement in the stock market had induced a small increase in mortgage rates from their very low levels. At some point the extraordinary levels of cash-outs from mortgage refinancings and home sales would undoubtedly moderate, with adverse implications for spending on home improvements and consumer durables more generally. Still, household spending probably would continue to be supported by the increases in income and wealth associated with strengthening economic expansion and rising productivity.

Members commented that fiscal policy remained accommodative, but an analysis cited at this meeting suggested that the stimulus embodied in current legislation had diminished considerably since earlier in the year. Reference also was made to the partial expensing provision of the tax legislation enacted in March of this year, which was seen as a positive but not in itself a compelling factor in inducing expenditures on business equipment and software. Some members observed that further federal tax cuts, should they be enacted, would likely take effect too late to foster much added spending over the year ahead. At the state and local government levels, efforts to control very large deficits likely would lead to tax and spending legislation that would offset at least part of the remaining stimulus inherent in the federal budget.

Members commented that little if any stimulus could be expected from the export sector of the economy in light of current and prospective shortfalls in the economic performance of important U.S. trading partners. Indeed, recent forecasts incorporated downward revisions to the growth of overall foreign economic activity.

With the economy evidently on a lower-than-anticipated growth path and with slack in labor and product markets at elevated levels, members anticipated that inflation would remain quite subdued over the year ahead even in the context of some anticipated acceleration in economic activity. Indeed, the prospect of some persisting slack in resource use over coming quarters pointed to further disinflation. In this regard, some members referred to the possibility, which they viewed as remote, of a period of deflation in the event of a strongly negative demand shock.

In the Committee's discussion of policy for the intermeeting period ahead, all the members favored a proposal to reduce the target for the intended federal funds rate by 50 basis points to 1¼ percent. While the current stance of monetary policy was still accommodative and was providing important support to economic activity, the members were concerned that the generally disappointing data since the previous meeting, reinforcing the general thrust of the anecdotal evidence in recent months, pointed to a longer-lasting spell of subpar economic performance than they had anticipated earlier. In the circumstances, a relatively aggressive easing action could help to ensure that the current soft spot in the economy would prove to be temporary and enhance the odds of a robust rebound in economic activity next year. A further reason cited by some members for a sizable easing move related to their perceptions of a diminishing stimulus from earlier policy easing actions and indications that overall financial conditions, including bank lending terms, had become more restrictive this year even though the nominal federal funds rate target had not been changed since late 2001. The members agreed that monetary policy could do little to improve the performance of the economy in the near term, but some emphasized that a 50 basis point easing likely would feed through to some degree to market interest rates, with favorable implications for spending next year.

Members commented that the potential costs of a policy easing action that later proved not to have been needed were quite limited in that there was little risk that such a move would foster inflationary pressures under likely economic conditions over the next several quarters. Moreover, the policy easing could readily be unwound without significant effects on financial markets if the reversal appeared to be warranted by growing pressures on resources in a strengthening economy. In contrast, a failure to take an action that was needed because of a faltering economic performance would increase the odds of a cumulatively weakening economy and possibly even attendant deflation. An effort to offset such a development, should it appear to be materializing, would present difficult policy implementation problems.

All the members indicated that, in light of the contemplated 50 basis point easing action, they could support a shift in the Committee's assessment of the risks to the economy from tilted toward economic weakness to balanced for the foreseeable future, although some voiced reservations about the need for such a shift. The economy probably would continue to underperform in the period immediately ahead, but in the absence of unpredictable adverse shocks this sluggish performance was more likely to be balanced by subsequent economic strength in light of the policy action. A 50 basis point move would tend to have a more pronounced effect than usual in financial markets, at least initially, because it would be largely unexpected and would come after an extended hiatus in implementing policy changes. In the view of many members, retaining the assessment that the risks were tilted toward weakness would raise the odds of an overreaction in financial markets, which might well misread the Committee's decision as a sign that the members were more concerned about the potential for greater economic weakness than was in fact the case and that therefore the Committee currently saw a likely need for further easing later. Some members saw a lesser risk of such a development, partly because of widespread market expectations that even with a sizable reduction in the intended federal funds rate the Committee would not change its assessment of unbalanced risks to the economy in present circumstances. Although they had at least a marginal preference for retaining the current tilt toward weakness, these members were willing to accept a balanced statement in light of the uncertainties that surrounded prospective market reactions. While the possible market response was not a primary factor determining the desirability of a policy action, the Committee needed to take it into account in gauging the potential effects of particular policy moves.

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

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 1¼ percent.

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

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are balanced with respect to prospects for both goals in the foreseeable future.

> Votes for this action: Messrs. Greenspan, McDonough, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, Kohn, McTeer, Olson, Santomero, and Stern. Votes against this action: None.

Use of Alternative Assets in Open Market Operations

At this meeting the Committee provided further guidance to the staff on priorities for the continuing study of alternatives to Treasury securities in the conduct of System open market operations. At its meeting in March of this year, the Committee had reaffirmed its preference for the use of Treasury securities to implement the System's monetary policy, contingent upon the continued availability of a sufficient outstanding volume of such obligations to accommodate the System's very large operations. As was already apparent at the time of the March meeting, fiscal policy developments made it clear that earlier concerns about a contracting supply of securities in the U.S. government securities market would not likely impose constraints on the System's open market operations in the near term.

Even so, the members expressed a consensus in favor of continuing to study alternatives to Treasury obligations for potential future use. Pursuant to the Committee's instructions in March, the staff had activated its study of the possible employment of mortgage-backed securities guaranteed by the Government National Mortgage Association (Ginnie Maes) in outright System open market operations. Such obligations were already being utilized for temporary additions to the System's portfolio through repurchase agreements. During their discussion at this meeting, the members recognized that outright purchases of Ginnie Maes for permanent additions to the System's portfolio would present a number of difficulties and would require extensive preparations for their effective integration, if deemed desirable at a later date, into the conduct of outright System open market operations. Still, in view of their possible advantages in helping to meet SOMA portfolio objectives at some point in the future, the Committee instructed the staff to continue to focus available resources on the possible use of Ginnie Maes for such operations. The Committee also decided to discontinue further consideration of the possible use of foreign sovereign debt obligations as collateral for repurchase agreements in light of the problems that were envisaged in the employment of such securities.

At this meeting the Committee also reviewed work that had been done on the potential use of an auction credit facility (ACF) that could serve as a partial substitute for Treasury or other securities. In addition, the Committee reviewed a study that considered whether an ACF might be adapted for use in a contingency (CACF) as a full substitute for open market operations. Many of the members commended the staff for its careful assessment of the potential for such operations. The members concluded, however, that significant resources should not be assigned at this time to the further study of these alternatives to open market operations given the prospects for an enlarged supply of Treasury obligations, the decision to focus on Ginnie Maes, and the introduction of a new discount window program, the System's primary credit facility, scheduled for implementation in early 2003. In addition, the CACF had been made unnecessary by the implementation of contingency plans and backup facilities since September 2001. The members concurred with the staff's recommendation that the staff studies prepared for the Committee in January 2001, when it discussed in detail various alternatives to holding U.S. government securities, should be released to the public after light editing was completed.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 10, 2002.

The meeting adjourned at 1:55 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on December 10, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 10, 2002, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Jordan
Mr. Kohn
Mr. McTeer
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Howard and Lindsey, Ms. Mester, Messrs. Oliner, Rolnick, Rosenblum, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

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

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

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

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

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

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

Ms. Holcomb, First Vice President, Federal Reserve Bank of Dallas

Messrs. Eisenbeis, Fuhrer, Goodfriend, Green, Hakkio, and Rasche, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Boston, Richmond, Chicago, Kansas City, and St. Louis respectively

Messrs. Elsasser and Furlong, Vice Presidents, Federal Reserve Banks of New York and San Francisco respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 6, 2002, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period November 6, 2002, through December 9, 2002. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting suggested that economic growth had been sluggish on balance since midsummer. Housing demand remained strong, but business fixed investment was still in the doldrums and consumer spending had flagged in late summer before apparently picking up somewhat in the autumn. Payroll employment had changed little since midyear, and industrial production still seemed to be on a downward trend. Most price indexes continued to indicate that inflation had declined over the past year.

Private nonfarm payroll employment remained stagnant in the third quarter and edged down in October and November. Job losses in manufacturing were again large in the two months, and employment declined in construction and in the wholesale and retail trade industries. By contrast, services (except help-supply) and the finance, insurance, and real estate grouping recorded further solid gains. The unemployment rate rose to 6 percent in November, a level more consonant with other recent labor market indicators. Labor productivity in the nonfarm business sector continued to climb briskly, with the advance over the last four quarters being the largest since 1973.

Industrial production dropped sharply further in October, with roughly half of the decline related to a slowdown in motor vehicle assemblies and the manufacture of related parts. The rest of the manufacturing sector also was weak on balance, with output down in almost all market groups. The high-tech sector was an exception, although the rise in output of computers and semiconductors in

October was smaller than earlier in the year and the production of communications equipment continued to fall. Consistent with the poor performance of industrial production, capacity utilization in manufacturing fell again in October and remained substantially below its long-run average.

Against the backdrop of smaller gains in disposable personal income and low readings on consumer confidence, growth of consumer spending had been quite sluggish in the last several months. Much of the weakness reflected a falloff in spending on new motor vehicles in September and October, largely because of reduced manufacturer discounts. Apart from motor vehicles, personal consumption expenditures picked up in October following two months of softness. Increases in outlays for services in September and October remained modest and about equal to the average rate of rise earlier in the year.

Housing starts dropped moderately in October, which was an unusually wet month across much of the country. However, residential housing activity had been very strong on balance this year despite an environment of sluggish employment and declining household wealth. Mortgage rates near historical lows had provided important support for single-family housing demand, and sales of new and existing homes had remained buoyant. In the multifamily sector, starts plunged in October to the slowest pace in almost six years. While some of the decline likely was attributable to inclement weather, apartment vacancy rates had risen significantly over the past year, perhaps partly in response to the single-family housing boom.

Business spending on equipment and software increased moderately in the third quarter, but the recent monthly pattern of data on shipments and orders for nondefense capital goods, along with anecdotal reports from businesses, signaled renewed weakness. Shipments of nondefense capital goods rebounded in October, led by a rise in computing equipment. In contrast, shipments of communications equipment plunged. Construction in the nonresidential sector slowed sharply further in the third quarter, but a few signs, including a rise in activity in October, suggested some moderation in the rate of decline.

The aggregate book value of manufacturing inventories changed little in October: declines in stocks of many types of durable goods were offset by modest stockbuilding of nondurables, and the ratio of stocks to shipments remained very low. Anecdotal information suggested that disruptions of West Coast dock operations stemming from a labor dispute had been quite small.

The U.S. trade deficit in goods and services changed little in September and the third quarter. The available information on economic activity abroad in the third quarter indicated that economic expansion remained moderate in the United Kingdom and sluggish in the euro area. Economic growth subsided somewhat from elevated second-quarter rates in Canada, Japan, and emerging Asia. Economic conditions in South America were generally still fragile.

Core consumer price inflation, as measured by the consumer price index (CPI) and the chain-weighted personal consumption expenditure (PCE) index, continued to trend lower in October. Inflation, in terms of both indexes, was down over the last twelve months when compared with the previous twelve-month period. At the producer level, core price inflation for finished goods over the twelve months ended in October was at a very low rate. With regard to labor costs, average hourly earnings of production or nonsupervisory workers increased moderately in November, and the growth in those earnings over the last twelve months fell considerably, evidently reflecting the slack in labor markets.

At its meeting on November 6, 2002, the Committee adopted a directive that called for lowering the target for the intended federal funds rate by 50 basis points, to 1¼ percent. The Committee also agreed that, in light of the decision to ease, it would be appropriate to indicate in the press release that the risks were balanced for the foreseeable future. Market participants had expected a 25 basis point cut and retention of a statement of risks toward weakness. The unexpectedly large reduction in the federal funds rate target led to an initial decline in Treasury coupon yields. That drop was reversed when market participants apparently focused on the shift to balanced risks and concluded that the odds of pronounced economic weakness had fallen. The subsequent release of better-than-expected economic data and earnings news provided reassurance to investors, though more mixed economic reports became available late in the intermeeting period. Over the period as a whole, major equity indexes registered mixed changes, and yields on longer-term Treasury bonds increased somewhat. In private debt markets, rates on investment-grade debt issues eased a little, and those on speculative-grade bonds fell considerably more.

The dollar appreciated slightly in terms of an index of major foreign currencies, principally against the yen, and changed little against the currencies of other important trading partners. The dollar edged lower against most major currencies in the aftermath of the policy easing on November 6, but those losses were subsequently retraced after the release of U.S. economic data that were seen as suggesting relatively better economic conditions in the United States.

M2 growth slowed a little in November from October's elevated pace. The further advance again was concentrated in liquid deposits. The low level of opportunity costs and heavy mortgage financing continued to support the demand for liquid assets.

The staff forecast prepared for this meeting suggested that the expansion of economic activity would be relatively muted over the near term. Faced with heightened geopolitical tensions as well as persisting concerns about the near-term course of economic activity and corporate earnings, businesses and households were likely to hold down their spending, and the outlook for continued sluggish economic growth among most major trading partners would damp U.S. exports. However, those restraining influences were expected to abate over time, and the considerable monetary ease and fiscal stimulus already in place, continuing strong gains in structural productivity, and anticipated improvement in business confidence would provide significant impetus to spending. Inventory overhangs had been largely eliminated and business capital stocks had moved closer to desired levels. As a consequence, a slowly improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to provide a gradual boost to business investment spending. The persistence of underutilized resources was expected to foster a slight moderation in core price inflation.

In the Committee's discussion of current and prospective economic conditions, members noted that the recent information had continued on the whole to suggest quite sluggish economic growth. Uncertainties about the outlook remained substantial, and downside risks stemming from potential shocks, notably those associated with a high level of geopolitical risks, could not be dismissed. Nonetheless, the behavior of financial markets in recent weeks suggested that investor concerns about an actual downturn in the economy had diminished, as data on economic developments took on a more mixed tone after having been somewhat negative for some time. The improvement in financial markets reinforced the members' expectations that a gradual strengthening of the economic expansion was likely over coming quarters, with the growth in economic activity gaining momentum over time in the absence of major adverse shocks to business and consumer confidence. Their assessment took account of the currently very accommodative stance of monetary policy, likely further fiscal policy stimulus, and the positive effects on business and consumer spending of a strong uptrend in labor productivity. With regard to the outlook for inflation, the gap between actual and potential output was anticipated to diminish only slowly unless aggregate demand expanded much more rapidly than the members currently foresaw. Given the persistence of limited pressures on resources, cost and price increases were expected to remain subdued and possibly to edge lower.

The improvement of overall conditions in financial markets had provided an additional positive element to the economic outlook. The improvement began before the November meeting and had been given added impetus by the Committee's sizable easing at that meeting. The general calming of financial markets was reflected in some decline in risk spreads from very high levels and sizable new issuance in private bond markets; in equity markets, issuance had edged up and stock prices, though recently declining somewhat, were still well above the lows of early October. Some of this improvement in financial markets seemed to be related to apparently lessening concerns about new revelations of corporate governance issues as a result of the passage of time without further significant incidents. In addition, many business firms had continued to enhance their prospects for rising profits through productivity improvements and debt restructurings that were strengthening their balance sheets and liquidity. Concurrently, indicators of credit quality in the household sector appeared to have remained essentially stable. Reference also was made to the continued robust growth in reserve and money measures.

The better tone in financial markets might also have been signaling a modest reduction in uncertainty and risk aversion among business executives from the extraordinarily elevated levels that had been constraining investment spending. Lingering excess capacity in a number of industries undoubtedly was continuing to inhibit new investment outlays as well. The members agreed that a pickup in capital spending remained the essential factor in the outlook for substantial strengthening of economic activity. On the positive side, spending for business equipment had turned up since early this year, and with efforts to reduce excess capacity seemingly well under way or completed in many industries, further firming in such capital expenditures was anticipated as the year 2003 progressed. However, nonresidential building was expected to continue to lag, especially given high vacancy rates in industrial and office structures in many major markets.

The household sector of the economy had continued to provide major support to the recovery in economic activity. The increase in consumer spending evidently had moderated in the current quarter, largely as a result of a decline in sales of motor vehicles from an extraordinary pace during the summer. However, the latest information on retail sales, including anecdotal reports, pointed to some improvement in recent weeks, and key measures of consumer confidence had turned up from their recent lows. While some uncertainty surrounded the prospects for consumer spending, members cited continued sizable increases in income, more stable wealth-to-income ratios, and the ongoing stimulus of equity extractions from housing as favorable factors in the outlook for consumer expenditures.

Housing activity had continued to display solid overall strength, though members mentioned weakness in multifamily construction and the high-end sector of the single-family market. Historically low mortgage interest rates along with rising incomes evidently were continuing to sustain the robust demand for housing. In addition, large extractions of equity from appreciated housing values continued to foster not only added consumer spending but also improvement in the financial condition of many households through debt consolidation and repayments and reduced interest charges. However, there were anecdotal indications of decreasing refinancing activity in the housing sector.

The outcome of the recent Congressional elections had fostered expectations that fiscal policy might be more expansive than previously anticipated, although the size, timing, and composition of federal budget initiatives were subject to substantial uncertainty. Members commented that added fiscal stimulus might prove to be a useful complement to an accommodative monetary policy in the period immediately ahead when economic activity was likely to remain below the economy's potential. In this regard, some observed that additional stimulus on the federal level would be an offset to measures that were being taken by numerous state and local governments to address severe budget deficits. At the same time, a number of members expressed the hope that new fiscal legislation would not endanger the prospects for federal budget discipline over the longer run, given the desirability of supporting national saving and capital accumulation.

With regard to the external sector, members commented that the growth of the nation's important trading partners had remained sluggish, and there seemed to be little basis for anticipating any appreciable impetus to the U.S. economy from significant strengthening in demand for U.S. exports. Indeed, economic growth abroad was widely viewed as dependent to a significant extent on the performance of the U.S. economy. Conditions in some major Latin American countries were especially problematic, and adverse developments there could have negative repercussions on international financial markets and trade.

Members believed that the economy probably would continue to operate with significant margins of slack in both labor and product markets. Moreover, in an environment characterized by highly competitive markets and the absence of pricing power, business firms would persist in their efforts to hold down or reduce costs, with favorable implications for productivity. In these circumstances, inflation pressures could be expected to remain subdued and some further disinflation might well occur. In this regard, members commented that appreciable disinflation seemed unlikely, but if that were to occur it could present difficult problems for monetary policy. One member noted, however, that declining inflation or even some deflation in the context of rapid growth in productivity could turn out to be relatively benign.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal to retain the current stance of policy. The members agreed that, given what was now a quite accommodative policy following the relatively aggressive easing move in November, monetary policy was well positioned to support a strengthening economic expansion in line with their expectations for coming quarters. Although it was uncertain how long the current period of below-par growth would persist, the economic outlook remained subject to upside as well as downside risks. Indeed, all the members also supported the retention of the current balanced-risks statement in the post-meeting press release, with some commenting that recent developments had established a firmer basis for such a risk assessment than at the November meeting when it was adopted. The November easing had contributed to some improvement in financial markets that, in conjunction with prospects for further stimulus from fiscal policy, should bolster the anticipated acceleration of economic activity. At the same time, the members saw little risk of any significant increase in inflationary pressures over the foreseeable future. Against this background, the members concluded that there was no need to change the stance of monetary policy; they would continue to assess emerging economic and financial developments, retaining the flexibility to adjust monetary policy as emerging conditions might warrant.

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

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¼ percent.

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

> Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are balanced with respect to prospects for both goals in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, Kohn, McTeer, Olson, Santomero, and Stern. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, January 28–29, 2003.

The meeting adjourned at 12:05 p.m.

Vincent R. Reinhart
Secretary

Litigation

During 2002, the Board of Governors was a party in three lawsuits or appeals filed that year and was a party in seven other cases pending from previous years, for a total of ten cases; in 2001, the Board had been a party in a total of twenty cases. None of the lawsuits or appeals filed in 2002 raised questions under the Bank Holding Company Act. As of December 31, 2002, six cases were pending.

Litigation under the Gramm–Leach–Bliley Act

Trans Union LLC v. Federal Trade Commission, et al., No. 01-5202 (D.C. Circuit, filed June 4, 2001), was an appeal of a district court order upholding challenged provisions of the interagency rule Privacy of Consumer Financial Information (145 F. Supp. 2d 6, April 30, 2001). On July 16, 2002, the court of appeals affirmed the district court's decision upholding the regulation (295 F.3d 42).

Other Actions

Sedgwick v. United States, No. 02-5378 (D.C. Circuit, filed November 26, 2002), is an appeal of the dismissal of appellant's claim for a declaratory judgment under the Federal Tort Claims Act and the Constitution regarding the banking agencies' alleged failure to intervene on his behalf in civil litigation involving a regulated institution.

Albrecht v. Board of Governors, No. 02-5235 (D.C. Circuit, filed October 18, 2002), is an appeal of a district court order dismissing a challenge to the pension funding method applicable to certain Board employees under the Board's retirement plan.

Caesar v. United States, No. 02-0612 (EGS) (D. District of Columbia, removed on April 1, 2002, from the Superior Court of the District of Columbia), is an action seeking damages for personal injury.

Community Bank & Trust v. United States, No. 01-571C (Court of Federal Claims, filed October 3, 2001), is an action challenging on constitutional grounds the failure to pay interest on reserve accounts held at Federal Reserve Banks.

Laredo National Bancshares, Inc. v. Whalen v. Board of Governors, No. 01-CV-134 (S. D. Texas, removed on September 5, 2001, from Webb County, Texas, district court), was a third-party petition seeking indemnification or contribution from the Board in connection with a claim asserted against defendant Whalen that alleged tortious interference with a contract. On September 27, 2002, the district court dismissed all claims against the individual third-party defendants, granted the United States' motion to substitute the United States for the third-party defendants, and dismissed all claims against the Board and the United States.

Radfar v. United States, No. 1:01CV1292 (D. District of Columbia, filed June 11, 2001), was an action under the Federal Tort Claims Act for injury on Board premises. On October 3, 2002, the action was dismissed on the stipulation of the parties.

Artis v. Greenspan, No. 01-0400 (D. District of Columbia, filed February 22, 2001), is an employment discrimination action. An identical action, No. 99-2073

(EGS) (D. District of Columbia, filed August 3, 1999), was consolidated with this action on August 15, 2001.

Howe v. Bank for International Settlements, No. 00CV12485 (RCL) (D. Massachusetts, filed December 7, 2000), was an action seeking damages in connection with gold market activities and the repurchase by the Bank for International Settlements of its privately owned shares. On March 26, 2002, the district court granted the defendants' motion to dismiss the action.

In *Fraternal Order of Police v. Board of Governors,* No. 98-3116 (D. District of Columbia, filed December 22, 1998), plaintiffs seek a declaratory judgment regarding the Board's labor policy governing Federal Reserve Banks. ■