Records

Record of Policy Actions of the Board of Governors

Regulation B
Equal Credit Opportunity

Regulation E
Electronic Fund Transfers

Regulation M
Consumer Leasing

Regulation Z
Truth in Lending

Regulation DD
Truth in Savings

[Docket Nos. R-1168, R-1169, R-1170, R-1167, and R-1171]

On June 22, 2004, the Board withdrew revisions proposed in December 2003 to define more specifically the standard for providing "clear and conspicuous" disclosures to consumers and to provide a more uniform standard for those disclosures among the regulations. In light of public comment, the Board concluded that improving the effectiveness of the disclosures required by each regulation rather than adopting general definitions and standards would better ensure that consumers receive noticeable and understandable information about consumer financial products and services.

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

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

Regulation C
Home Mortgage Disclosure

[Docket No. R-1186]

On December 10, 2004, the Board revised the tables used to publicly disclose mortgage lending data in light of revisions to the regulation that require lending institutions to report additional data, including loan pricing and other data, under the Home Mortgage Disclosure Act. The new data reporting requirements begin January 1, 2004, and the revised tables are expected to be implemented in summer or fall 2005.

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

Regulation D
Reserve Requirements of Depository Institutions

[Docket No. R-1213]

On October 5, 2004, the Board approved amendments to reflect the annual indexing of the low reserve tranche and of the reserve requirement exemption for use in 2005 reserve requirement calculations. The amendments increase the 3 percent low reserve tranche for net transaction accounts to $47.6 million (from $45.4 million in 2004) and the reserve requirement exemption to $7 million (from $6.6 million in 2004).

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

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

Regulation Y
Bank Holding Companies and
Change in Bank Control

[Docket No. R-1162]

On July 19, 2004, the Board, acting with the other federal bank and thrift regulatory agencies, approved interagency amendments to provide for the risk-based capital treatment of asset-backed commercial paper program assets that have been consolidated in accordance with Financial Accounting Standards Board Interpretation No. 46, as revised (FIN 46-R). The amendments are effective September 30, 2004, and replace an interim risk-based capital treatment approved in October 2003 and extended in April 2004.

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

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

Regulation K
International Banking Operations

Regulation V
Fair Credit Reporting

Regulation Y
Bank Holding Companies and
Change in Bank Control

[Docket No. R-1199]

On December 16, 2004, the Board, acting with the other federal bank and thrift regulatory agencies, approved interagency amendments to implement provisions of the Fair and Accurate Credit Transactions Act that require financial institutions to adopt measures for properly disposing of consumer information derived from consumer reports. The amendments are effective July 1, 2005.

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

Regulation J
Collection of Checks
and Other Items by
Federal Reserve Banks and
Funds Transfers through Fedwire

[Docket No. R-1202]

On October 22, 2004, the Board approved amendments to provide for the rights and obligations of depository institutions and Federal Reserve Banks in connection with items handled in electronic form by the Reserve Banks. The amendments ensure that the regulation covers the entire range of check-processing services that the Reserve Banks will offer in light of the Check Clearing for the 21st Century Act. They are effective October 28, 2004.

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

Regulation V
Fair Credit Reporting

[Docket Nos. R-1172, R-1175, and R-1187]

On February 5, 2004, the Board, acting with the Federal Trade Commission, approved interagency amendments to establish effective dates for certain provisions of the Fair and Accurate Credit Transactions Act (FACT Act). The amendments establish December 31, 2003, as the effective date for the FACT Act provisions that preempt state laws regulating areas governed by the Fair Credit Reporting Act. The amendments also establish March 31, 2004, as the effective date for FACT Act provisions that require no changes, or minimal changes, to existing business procedures and December 1, 2004, as the effective date for provisions that involve changes requiring a significant implementation period or regulatory action. The amendments are effective March 12, 2004, and replace an interim rule adopted in December 2003 that established the December 31 effective date.

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

On June 8, 2004, the Board approved amendments providing model notices that financial institutions may use to comply with the notice requirements of the FACT Act when furnishing negative information to consumer reporting agencies. The amendments are effective July 16, 2004.

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

Regulation Z
Truth in Lending

[Docket No. R-1167]

On March 25, 2004, the Board approved amendments to clarify that the term ‘‘amount’’ in the description of disclosure requirements refers to a numerical amount and to provide guidance on consumers’ exercise of the right to rescind certain home-secured loans. The amendments are effective April 1, 2004, and compliance is mandatory by October 1, 2004.

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

Regulation BB
Community Reinvestment

[Docket No. R-1181]

On July 16, 2004, the Board withdrew proposed amendments that would have (1) raised the asset threshold for streamlined Community Reinvestment Act (CRA) evaluations of state member banks from $250 million to $500 million and (2) allowed examiners to lower a state member bank’s CRA rating if the bank engaged in a pattern or practice of abusive asset-based lending. In light of public comment, the Board concluded that the uncertain savings to institutions from increasing the threshold did not clearly justify the potential adverse effects on community development in certain rural communities. It also noted that commenters were united in their opposition to defining abusive asset-based lending in the regulation to the exclusion of other abusive practices. The Board and the other federal bank and thrift regulatory agencies had proposed identical amendments to their CRA regulations in February 2004.

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

Regulation CC
Availability of Funds and Collection of Checks
[Docket No. R-1176]

On July 27, 2004, the Board approved amendments that add a subpart D, with commentary, to implement the Check Clearing for the 21st Century Act. Subpart D sets forth the new requirements for banks, including indorsement and identification requirements for substitute checks, and contains model notices, including a model consumer-awareness disclosure. The amendments also clarify provisions of the regulation and its commentary. They are effective October 28, 2004, with the exception of appendix C's model consumer-awareness disclosure, which is effective immediately, and appendix D's requirement that bank indorsements and identifications be printed in black ink, which is effective January 1, 2006.

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

Rules of Practice for Hearings
[Docket No. OP-1211]

On September 20, 2004, the Board approved amendments to increase the maximum amount of each statutory civil money penalty under its jurisdiction to account for inflation, as required by the Debt Collection Improvement Act. The amendments are effective October 12, 2004.

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

Policy Statements and Other Actions

Unfair or Deceptive Acts or Practices by State-Chartered Banks [Interagency Guidance]

On March 9, 2004, the Board, acting with the Federal Deposit Insurance Corporation, issued interagency guidance on the standards used by the two agencies to determine whether acts or practices by state-chartered banks are unfair or deceptive under the Federal Trade Commission Act. The guidance also addresses measures and "best practices" that banks may use to avoid such acts or practices.

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

Policy Statement on Payments System Risk
[Docket Nos. OP-1182 and OP-1191]

On September 22, 2004, the Board revised its policy to modify the daylight overdraft measurement rules for interest and redemption payments on securities issued by government-sponsored enterprises (GSEs) and certain international organizations and to align the treatment of the general corporate account activity of these entities with that of other Federal Reserve account holders that do not have regular access to the discount window. The revised policy also reflects recent changes to the operating hours of the online Fedwire Funds Service and clarifies or updates certain items. The revisions related to GSEs and certain international organizations are effective July 20, 2006, and the other revisions are effective September 22, 2004.

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

On November 24, 2004, the Board revised the part of its policy dealing with risks and risk management in payments and securities settlement systems. In general, the revisions expand the policy's scope to include those Federal Reserve Bank payments and securities settlement systems that meet the policy's application criteria, revise general risk-management expectations for systems subject to the policy, and incorporate standards for payments and securities settlement systems that are systemically important. The revisions are effective January 2, 2005.

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

Bank Holding Company Rating System

[Docket No. OP-1207]

On December 1, 2004, the Board revised its bank holding company rating system to emphasize risk management, implement a comprehensive and adaptable framework for analyzing and rating financial factors, and provide a framework for assessing and rating the potential impact of a bank holding company's nondepository entities on its subsidiary depository institutions. The revised rating system is effective January 1, 2005.

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

Discount Rates in 2004

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

Primary Credit Rate

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

During 2004, the Board approved five increases in the primary credit rate, bringing the rate from 2 percent to 3¼ percent. The Board reached its determinations on the primary credit rate recommendations of the Reserve Bank boards of directors in conjunction with the FOMC's decisions to raise the target federal funds rate from 1 percent to 2¼ percent and related economic and financial developments. In the first half of the year, disappointing employment growth and the continued slack in resource utilization led the Board and FOMC to maintain a highly accommodative stance of monetary policy. By midyear, however, output and employment had begun to show persistent improvements and there were indications of some increase in inflation, so the Board and FOMC began to gradually move the structure of policy rates toward a more neutral setting. Monetary policy developments are reviewed more fully elsewhere in this report (see the section ‘‘Monetary Policy and Economic Developments’’ and the minutes of FOMC meetings held in 2004).

Secondary and Seasonal Credit Rates

Secondary credit is available in appropriate circumstances to depository institutions that do not qualify for primary credit. The secondary credit rate is set on the basis of a formula at a spread—50 basis points in 2004—above the primary credit rate.

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

At year-end, the secondary and seasonal credit rates were 3¾ percent and 2.35 percent, respectively.

Votes on Discount Rate Changes

About every two weeks during 2004, the Board approved proposals by the Reserve Banks to maintain the formulas for computing the secondary and seasonal credit rates. Details on the five actions by the Board to approve changes in the primary credit rate are provided below.

June 30, 2004. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 2¼ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective July 1, 2004.

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

August 10, 2004. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 2½ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective August 11, 2004.

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

September 21, 2004. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 2¾ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective September 22, 2004.

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

November 10, 2004. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, and Kansas City to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 3 percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective November 12, 2004.

The Board also approved identical actions subsequently taken by the directors of the Federal Reserve Banks of San Francisco, effective November 10, 2004, and Dallas, effective November 12, 2004.

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

December 14, 2004. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 3¼ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective December 15, 2004.

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

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 2004. 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, 2004

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 a meeting and ending with the close of business on the day of the next such meeting;

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

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

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

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, 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, 2004

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, 2004[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 maintaining the federal funds rate at an average of around 1 percent.

The Committee also approved the sentences below for inclusion in the press statement to be released shortly after the December 9, 2003, meeting:

The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation.

Authorization for Foreign Currency Operations

In Effect January 1, 2004

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.

1. Adopted by the Committee at its meeting on December 9, 2003.

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, 2004

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, 2004

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 27–28, 2004

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., starting at 2:00 p.m. on Tuesday, January 27, 2004, and continuing at 9:00 a.m. on Wednesday, January 28, 2004.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Messrs. McTeer, Moskow, Santomero, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

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

Mr. Connors, Ms. Cumming, Messrs. Fuhrer, Hakkio, Howard, Madigan, Rasche, Slifman, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Ettin[2], Deputy Director, Division of Research and Statistics, Board of Governors

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

Messrs. Clouse,[2] and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

2. Attended Wednesday's session only.

Mr. Kamin and Ms. Zickler,[3] Deputy Associate Directors, Divisions of International Finance and Research and Statistics respectively, 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

Messrs. Nelson and Wood,[3] Senior Economists, Divisions of Monetary Affairs and International Finance respectively, Board of Governors

Mr. Carpenter,[3] Economist, Division of Monetary Affairs, Board of Governors

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

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

Messrs. Eisenbeis, Evans, Goodfriend, Ms. Mester, Messrs. Rolnick and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Chicago, Richmond, Philadelphia, Minneapolis, and Dallas respectively

Messrs. Elsasser and Rudebusch, Vice Presidents, Federal Reserve Banks of New York and San Francisco 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, 2004, and ending December 31, 2004, had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

Timothy F. Geithner, President of the Federal Reserve Bank of New York, with a vacancy in the position of alternate member for the Federal Reserve Bank of New York

Cathy E. Minehan, President of the Federal Reserve Bank of Boston, with Anthony M. Santomero, President of the Federal Reserve Bank of Philadelphia, as alternate

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

William Poole, President of the Federal Reserve Bank of St. Louis, with Robert D. McTeer, Jr., President of the Federal Reserve Bank of Dallas, as alternate

Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City, with Gary H. Stern, President of the Federal Reserve Bank of Minneapolis, as alternate

Following this meeting the board of directors of the Federal Reserve Bank of New York appointed Christine M. Cumming to the position of First Vice President of the Bank, effective February 6, 2004. The directors also elected her to serve as an alternate member of the Federal Open Market Committee representing the Federal Reserve Bank of New York. Subsequently, Ms. Cumming executed her oath of office as an alternate member of the Committee, effective for the period from February 20 to December 31, 2004.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until

3. Attended portion of meeting relating to the Committee's review of the economic outlook.

the election of their successors at the first regularly scheduled meeting of the Committee after December 31, 2004, 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
Timothy F. Geithner	Vice Chairman
Vincent R. Reinhart	Secretary and Economist
Normand R.V. Bernard	Deputy Secretary
Michelle A. Smith	Assistant Secretary
J. Virgil Mattingly, Jr.	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Karen H. Johnson	Economist
David J. Stockton	Economist

Thomas A. Connors, Christine M. Cumming, Jeffrey C. Fuhrer, Craig S. Hakkio, David H. Howard, Brian F. Madigan, Robert H. Rasche, Lawrence Slifman, 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, 2004.

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.[4]

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

By unanimous vote, the Committee amended its Program for Security of FOMC Information on January 27, 2004, by making small clarifying additions or changes relating especially to electronic transmissions of confidential information.

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

Authorization for Domestic Open Market Operations

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 a meeting and ending with the close of business on the day of the next such meeting;

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal

Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

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

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

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

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

The amendment to the authorization for domestic open market operations involved the addition of a reference in paragraph 3 to accounts held at the Federal Reserve Bank of New York pursuant to fiscal agency instructions from the Secretary of the Treasury. Accounts listed in paragraph 3, which include those maintained by the Bank on behalf of official foreign and international accounts, are eligible for participation in the Bank's short-term investment facility, the so-called "repo pool."

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

Authorization for Foreign Currency Operations

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

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

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

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

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

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

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

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

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

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

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

Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

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

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

7. The Chairman is authorized:

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

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

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

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

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

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

Foreign Currency Directive

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

2. To achieve this end the System shall:

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

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

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

3. Transactions may also be undertaken:

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

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

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

4. System foreign currency operations shall be conducted:

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

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

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

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

Procedural Instructions with Respect to Foreign Currency Operations

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 9, 2004, 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 27–28 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.

The Committee considered a report from the Manager of the System Open Market Account that discussed the feasibility and costs of purchasing mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA), a federal government agency. A potential advantage of transactions in such GNMA obligations was their use to supplement purchases of direct Treasury securities in periods when large federal surpluses reduced market supplies of Treasury debt. However, the resumption of large federal deficits had led to sizable increases in market supplies of Treasury obligations, which members saw as the preferred vehicle to supply the need for permanent additions to the System Open Market Account. The report concluded that outright transactions in mortgage-backed GNMA securities were feasible but would involve sizable start-up costs and would tend to complicate the conduct of System open market operations. Against this background the Committee decided not to initiate outright transactions in mortgage-backed GNMA obligations. It was understood, however, that such GNMA obligations would continue to be eligible as collateral for System repurchase agreements.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on December 9, 2003, 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 federal agency obligations during the period December 9, 2003 to January 27, 2004. By unanimous vote, the Committee ratified these transactions.

At this meeting the Committee engaged in a broad-ranging discussion of its communication practices.

A portion of this discussion focused on the report of a working group that had been directed to study how the Committee's announcements might be improved. In the course of the discussion, members stressed the importance that they attached to conveying clearly to the public information regarding the reasons for policy decisions and how those decisions related to the Committee's longer-term objectives. However, only limited support emerged for the use of particular standard wording to express the Committee's appraisals of the economic outlook and views about the balance of risks. Indeed, several members were in favor of discontinuing the use of statements regarding the balance of risks to the outlook and instead focusing mostly on the reasons for their policy decisions in the announcement. At the same time, all the members indicated that they could support a flexible approach in which the wording of the Committee's announcements, including the assessment of the balance of risks going forward, would be adjusted gradually over time in keeping with evolving economic conditions.

In further discussion the members reviewed the potential value and drawbacks of accelerating the publication of Committee minutes. Possible benefits would include the provision of more complete information sooner after meetings on the considerations that led the Committee to adopt the current stance of policy. Some members expressed concern, however, that accelerated release of the minutes might have the potential to feed back adversely on the deliberations of the Committee and on the minutes themselves. The members also emphasized the importance of allowing sufficient time for them to review and comment on the minutes and for reconciling differences of opinion among the members of a large and geographically dispersed committee. At the conclusion of this discussion, staff was asked to study the issue further.

The members also discussed the possible advantages of making some changes in the content, time horizon, and frequency of the individual forecasts that are summarized in the semi-annual Monetary Policy Reports to the Congress. In general, the members saw little to be gained by altering the Committee's current practices in any significant way, although some proposed relatively minor changes. It was agreed that there was no need to reach a decision on such changes at this time, but staff was instructed to ascertain the degree of interest on the part of the members in making possible minor adjustments to current procedures.

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

The economy appeared to have expanded at a robust pace in the fourth quarter, though well below the exceptional pace recorded in the third quarter. Consumer spending continued to increase at a solid rate over the final three months of the year, and activity in the residential sector remained at a very high level. On the business side, outlays for equipment and software likely posted moderate gains in the fourth quarter, and firms apparently accumulated inventories for the first time in three quarters. Despite the strong pace of economic activity, the labor market was improving only slowly, with private payrolls showing a small acceleration in the fourth quarter. Core consumer price inflation continued to slow, and inflation expectations remained subdued over the closing months of 2003.

The December employment report suggested that the labor market had not gained as much momentum as previously appeared to be under way. Private nonfarm payrolls increased only slightly in that month, and their level in November was revised down appreciably. The average monthly increase in employment in the fourth quarter was indicative of a fairly weak recovery in the labor market, although it was a clear improvement over the average monthly loss during the first half of the year. Manufacturing payrolls continued to shrink in December at about the same pace as in the previous few months, and holiday-related hiring in retail trade was below average. In other sectors, job gains were recorded in construction, education and health services, and professional and business services. Average weekly hours of production or nonsupervisory workers declined somewhat in December, reversing the gains of the previous two months. Aggregate hours worked by nonfarm employees fell in December but in the fourth quarter as a whole posted their first quarterly increase since 2000. Despite the weak payroll data, the unemployment rate, which is measured by the household survey, fell to 5.7 percent in December, in part because of a further decline in the labor force participation rate. Initial claims for unemployment insurance continued to drift down in the weeks following the reference week for the December employment report, suggesting improved job growth in January.

The pace of expansion in the industrial sector picked up in the fourth quarter. Total industrial production rose at the fastest rate since the second quarter of 2002, and manufacturing production posted solid and widespread gains. High-tech industries, including those producing semiconductors, computers, and communications equipment, accounted for nearly one-third of the increase in total industrial production in the fourth quarter. After having surged in the third quarter, the production of motor vehicles and parts moved up in the fourth quarter at about the same rate as overall manufacturing. Outside the manufacturing sector, output at mines increased modestly in the quarter, while output at utilities rose appreciably, led by a solid advance in electricity generation that mirrored the strengthening in the manufacturing sector. Capacity utilization was unchanged in December and remained well below its long-term average.

Sales of light vehicles jumped in December, and the fourth-quarter average, although below the torrid third-quarter pace, was well above that recorded for the first half of the year. These data, along with those on retail sales excluding autos, were consistent with a solid increase in real personal consumption expenditures in the fourth quarter. Real disposable personal income advanced smartly in November. Spending was also supported by the recent stock market gains, and by greater consumer confidence as reflected in the Michigan Survey Research Center's index of consumer sentiment and the Conference Board's index of consumer confidence, both of which stood significantly above their average readings for 2003.

Activity in the housing market remained very robust. In December, single-family starts edged down only a bit from the exceptional rate they had reached in November, and multifamily starts moved up to the highest level in almost four years. New home sales declined in November for the third consecutive month, but they were still not far below the record highs registered earlier in the year. Existing home sales had fallen back from September's high, though the level in November was still noticeably higher than average monthly sales in the first half of 2003.

The available data suggested that business purchases of transportation equipment strengthened in the fourth quarter and that spending on other capital goods advanced at a moderate pace. Business expenditures on aircraft rebounded noticeably in the fourth quarter, albeit to a level that was still far below the levels that prevailed before the downturn following the terrorist attacks in 2001. Both fleet sales of light vehicles and truck sales also rose significantly. In the high-tech sector, real outlays for computing equipment and for software again appeared to have posted sizable increases in the fourth quarter, while spending on communications equipment was little changed after three quarters of double-digit growth. Outside transportation and high tech, nominal shipments were about unchanged in the fourth quarter, but the upward trend in orders established since the beginning of last year was consistent with further gains in spending. After holding roughly steady, on balance, in the first half of 2003, real spending on private nonresidential construction appeared to have slipped further in the third and fourth quarters. In the commercial and health-care sector and in the manufacturing sector, average nominal outlays in October and November were about unchanged from the previous quarter. However, spending on other types of construction moved down.

The book value of manufacturing and trade inventories excluding motor vehicles posted the third consecutive significant monthly increase in November. Stocks at manufacturers were down a little on average in October and November, but non-auto wholesalers and retailers accumulated inventories at a brisk pace. Strong increases in sales, however, kept book-value inventory–sales ratios at or near their recent lows. Motor vehicle and parts inventories ended the year noticeably above the level at the end of the third quarter.

The international trade deficit in November shrank to its lowest level in about a year. Exports of goods and services increased to a level not recorded since early 2001, while imports fell moderately. Recent data indicated that the pickup in economic activity in the major foreign industrial countries continued in the fourth quarter. Japanese exports, machinery orders, and industrial production rose strongly in October and November. Euro-area manufacturing data exhibited increasing strength, particularly in Germany. In the United Kingdom, indicators of business and retail sales in December pointed to a maintained expansion. And Canadian employment and sales data were strong in the fourth quarter, with the housing sector continuing to make a significant contribution to growth.

Prices of consumer goods and services other than food and energy continued to decelerate through the end of 2003. Overall consumer prices were flat, on balance, over the past three months, as a small increase in core prices and a large rise in food prices were offset by a sizable drop in energy prices. Over the year, the consumer price index posted a moderate increase that was noticeably below that in the previous year. Core consumer prices decelerated more sharply and rose only slightly over the year. Producer prices for finished goods were up moderately over the year, and the advance was substantially above that over the previous year. The rise last year was due almost entirely to substantial increases in food and energy prices as core producer prices rose only a little after having edged down over 2002. With regard to labor costs, the average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls rose modestly in the twelve months ending in December, an increase somewhat below that over 2002.

At its meeting on December 9, 2003, the Federal Open Market Committee (FOMC) adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the federal funds rate at around 1 percent. In reaching this decision, the Committee members generally perceived the upside and downside risks to the attainment of sustainable growth for the next few quarters to be roughly equal. They also judged that the probability of an unwelcome fall in inflation had diminished in recent months and now appeared almost equal to that of a rise in inflation. Nevertheless, with inflation quite low and resource use slack, the Committee believed that policy accommodation could be maintained for a considerable period.

The Committee's decision at the December meeting to keep its target for the federal funds rate at 1 percent appeared to have been fully anticipated in financial markets, and interest rate futures for the first half of 2004 were essentially unchanged after the announcement. But futures rates for the second half of the year rose a few basis points, presumably in response to the Committee's assessment that the probability of an unwelcome decline in inflation had fallen in recent months to a level almost equal to that of a rise in inflation. Subsequently, however, the release of the minutes for the October FOMC meeting, which indicated that at that time the Committee was concerned about the possibility of persistent slack arising from rapid productivity growth, and the publication of surprisingly modest growth in employment in December led most market participants to push back the date of the expected onset of tightening by several months to some time in the fall. Reflecting the change in policy expectations, intermediate- and longer-term nominal Treasury yields declined substantially over the intermeeting period. Yields on inflation-indexed debt fell by nearly as much, suggesting that the drop in nominal yields owed more to lower real interest rates than to reduced inflation compensation. Yields on investment-grade and most speculative-grade securities moved down by about the same amount as Treasury yields. Major equity indexes rose strongly in response to the declines in yields and positive news about the outlook for profits.

The exchange value of the dollar, as measured by the major currencies index, declined moderately on net over the intermeeting period. Ongoing investor concerns about the ability of the United States to finance its current account deficit reportedly were again a primary factor exerting pressure on the dollar.

M2 fell in December, the fourth consecutive monthly decline. The decline in M2 over the fourth quarter was the largest on record since the start of consistent data collection in 1959. The weakness was concentrated in liquid deposits and, to a lesser extent, in retail money market mutual funds and appeared to be due in large part to the unwinding of a previous buildup in deposits associated with heavy mortgage refinancing activity and to portfolio shifts by households into equities.

The staff forecast prepared for this meeting indicated that the momentum in economic activity that had built up in the second half of 2003 would carry over into the first half of the current year and that the ongoing gains in spending and production would soon result in a more visible improvement in labor market conditions. The considerable stimulus being provided by fiscal and monetary policies was expected to keep aggregate demand on a solid uptrend. In addition, improving labor market conditions and the effects of strong productivity growth on permanent income were projected to support household spending, while business investment spending was seen as strengthening in response to the acceleration in business output, swelling profits, and continued favorable financing conditions. Some slight downward pressure on core consumer price inflation was anticipated in the forecast given the ongoing slack in labor and product markets.

In the Committee's discussion of current and prospective economic developments, the members commented that the information that had become available since the December meeting had tended to validate their earlier assessment that the expansion was firmly established and that robust economic growth, under way since about mid-2003, was likely to continue as the year progressed. Many emphasized that business expenditures now appeared to be on a solid upward trajectory amid widespread reports of much improved business sentiment. Indeed, business expenditures had broadened the sources of significant strength in the expansion, which earlier had been sustained mainly by household and government spending. Factors underlying a favorable outlook for economic activity continued to include stimulative fiscal and monetary policies, accommodative conditions in financial markets, and the positive effects of a strong uptrend in productivity on business investment incentives and, with some lag, on household incomes. The members nonetheless expressed disappointment that the acceleration in economic activity had thus far failed to generate significant strengthening in employment, though they pointed to a number of positive signs in labor markets. Given their expectations of persisting above-trend economic growth, they saw increasing demand for workers as a likely prospect going forward. Regarding the outlook for inflation, members observed that wide margins of slack in labor and product markets continued to hold down wages and prices, especially given the concurrent strength in productivity. Core consumer inflation appeared to have drifted lower recently, and a number of members mentioned the possibility of a modest further decline in such inflation from its current subdued level. Over the year ahead, however, the members generally anticipated little net change in consumer price inflation.

In keeping with the practice at meetings preceding the Federal Reserve's semi-annual report to the Congress on the economy and monetary policy, the members of the Board of Governors and the presidents of the Federal Reserve Banks had provided individual projections of the growth of GDP, the rate of unemployment, and consumer price inflation for the year 2004. The forecasts pointed to a continuation of relatively vigorous growth in economic activity, some further decline in unemployment, and a quite low rate of inflation. Specifically, the forecasts of the expansion in real GDP between the fourth quarter of 2003 and the fourth quarter of 2004 had a central tendency of 4½ to 5 percent and a full range of 4 to 5½ percent. The projections of the civilian unemployment rate in the fourth quarter of 2004 were all in a range of 5¼ to 5½ percent. Forecasts of consumer price inflation for the year, as measured by the PCE chain-type price index, were centered in a range of 1 to 1¼ percent, with a full range of 1 to 1½ percent.

In their discussion of developments across the nation, members emphasized growing indications of rising business confidence and, despite persisting softness in a number of industries, more widespread signs of increasing business spending for equipment and software and for inventories. The members cited a variety of factors that pointed to a further pickup in business capital expenditures over the coming year, including the strength in new orders and shipments, increasing profits and cash flow, the improved financial condition of many business firms, the general availability of financing on favorable terms, and the temporary tax incentive on expenditures for new equipment. Anecdotal reports from business contacts about capital spending plans were indicative of appreciable further acceleration in business expenditures on a widening range of capital goods. While many contacts indicated that replacement demand or the cost-saving opportunities provided by more productive new equipment were still the driving factors in guiding investment decisions, there were more reports of investment spending to expand capacity.

The members also viewed business inventory investment as likely to provide some support to the economic expansion over the year ahead. Business inventories were at exceptionally low levels in relation to sales, and if further brisk growth in demand broadly in line with current forecasts materialized this year, business firms could be expected to make commensurate additions to their inventories. Indeed, inventories appeared to have turned up in the fourth quarter after declining on balance earlier in 2003 as businesses evidently became more confident that increases in their sales would be sustained.

While business expenditures had turned up, employers had continued to display a high degree of caution in hiring new workers. Employment had trended up since mid-2003 after a protracted period of job losses, but the gains were significantly weaker than was typical at similar stages of earlier business cycles. A key factor that had tended to hold down hiring was the continuing ability of business firms to meet increasing demand by improving productivity with existing workforces rather than hiring new workers. Against this background, labor markets continued to be described as soft in most areas, albeit with more signs of at least modest improvement. In this regard, members referred to positive developments such as the decline in initial claims and the rise in aggregate hours worked in the fourth quarter. Looking ahead, the members saw considerably faster growth in employment as a likely prospect in the context of further strengthening in aggregate demand and expectations of some slowing in the growth of productivity from its extraordinary pace in recent quarters. Several emphasized, however, that the timing and extent of the improvement in employment were subject to considerable uncertainty.

The household sector was continuing to supply major impetus to the expansion. Household spending was benefiting from stimulative fiscal and monetary policies, the wealth effects of rising real estate and equity prices, and increased consumer confidence about the economic outlook. Members noted that retailers in many parts of the country reported solid sales during the holiday period. With respect to the outlook for overall consumer spending, it was suggested that the elevated growth of productivity could be expected to raise incomes over time and thereby help to buttress consumption even as the stimulus from earlier tax cuts faded. Residential construction activity remained at a high level, evidently supported in part by recent declines in mortgage interest rates. Contacts in the housing industry indicated that they expected a high level of construction activity in 2004, though perhaps not as robust as in 2003.

Fiscal policy was providing considerable stimulus to the economy and would continue to do so in the first part of this year, reflecting the large tax refunds anticipated as a result of overwithholdings in 2003. Beyond the nearer term, however, the fiscal stimulus was projected to diminish under existing legislation. In this regard, one member questioned whether a robust expansion would be sustained once the fiscal impulse was removed. Some members expressed concern about the longer-run prospects for large federal deficits and their implications for the future performance of the economy.

In their comments about the international economy, members noted that the strengthening in economic activity abroad and the decline in the foreign exchange value of the dollar had boosted exports. Even so, the ongoing strength in imports was still producing a widening trade deficit, and net exports were expected to be a small arithmetic drag on domestic economic activity over the year ahead. Some members indicated that they were concerned about the implications of the nation's rapidly growing external debt for domestic financial markets and the economy over time.

In the Committee's discussion of the outlook for inflation, the members agreed that increases in core consumer prices were likely to remain muted this year, with ongoing strength in the expansion only gradually reducing the current output gap and anticipated gains in productivity exerting downward pressure on costs and prices. Some members commented, however, that the relationship between the output gap and inflation was quite loose and that the outlook for productivity remained uncertain. Accordingly, while members agreed that changes in core consumer price inflation were likely to be limited, there was some divergence of opinion about the most probable direction. In the view of many, some modest further disinflation appeared to be the most likely prospect. A few members noted that such disinflation, if it was associated with rapid growth in productivity, could be viewed as non-threatening. Moreover, the expected strength in aggregate demand would curb the extent of disinflation over time. A few members expressed the differing view that core consumer prices might well edge up over the course of the year in light of the considerable stimulus stemming from current monetary and fiscal policies and the possibility that the expected pickup in economic activity and employment, especially if it were on the high side of current forecasts, would be associated with slower growth in productivity. The evidence pointing to the possibility of an uptick in inflation was still quite limited, but some members noted that in addition to sizable advances in the prices of many commodities including oil, reports from business contacts indicated that a few firms had been able to raise their selling prices and maintain them at higher levels in an effort to pass on increases in costs. Overall, however, the pricing power of business firms remained quite limited.

In the Committee's discussion of policy for the intermeeting period ahead, all the members favored an unchanged policy stance that was directed toward maintaining reserve conditions consistent with a target federal funds rate of 1 percent. While the members were persuaded that a relatively vigorous economic expansion was now firmly established and was likely at some point to call for a move toward a more neutral policy stance, they concluded that such an adjustment was not warranted under current circumstances. In this regard they stressed that unused labor and other resources remained substantial, that inflation was at a very low level, and that inflation was not expected to change appreciably in either direction over the year ahead. Members acknowledged that there were risks in maintaining what might eventually prove to be an overly accommodative policy stance, but for now they judged that it was desirable to take risks on the side of assuring the rapid elimination of economic slack.

With regard to the wording of the Committee's press statement to be released shortly after the meeting, members discussed at some length the desirability of retaining a reference from earlier statements to the prospect that an accommodative policy could be maintained "for a considerable period." The existing language had been explicitly qualified at the December meeting by tying it to low inflation and slack in resource use, thereby underscoring the notion that a move away from the current degree of policy accommodation would depend on economic conditions rather than simply on the passage of time. All the members agreed that a change in wording was desirable, not to signal a policy tightening move in the near term, but rather to increase the Committee's flexibility to take such an action when it was deemed to be desirable and to underline that any such decision would be made on the basis of evolving economic conditions. However, some differences of opinion arose with regard to the specific proposal under consideration, namely to remove the reference to "considerable period" and to substitute one referring to "patience." Those who fully endorsed the proposal believed that the new wording conveyed important information about the Committee's strategy in an environment of price stability and economic slack and under those circumstances was unlikely to have outsized effects in financial markets. A number of members commented that expectations of sustained policy accommodation appeared to have contributed to valuations in financial markets that left little room for downside risks, and the change in wording might prompt those markets to adjust more appropriately to changing economic circumstances in the future. A few members, while expressing agreement with respect to the merits of a language change, nonetheless preferred to drop the reference to a "considerable period" entirely without substituting a reference to the Committee's ability to be patient. In this view, even the replacement language would tend to shape expectations in ways that could complicate the conduct of policy, and with the economy in a strong uptrend, the Committee no longer needed to utilize such special language.

At the conclusion of the meeting, 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 1 percent.

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

> The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation. With inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, March 16, 2004.

The meeting adjourned at 1:45 p.m. on January 28, 2004.

Vincent R. Reinhart
Secretary

Meeting Held on March 16, 2004

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 16, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Messrs. McTeer, Moskow, Santomero, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

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

Messrs. Connors, Fuhrer, Howard, Madigan, Rasche, Sniderman, Slifman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

Messrs. Clouse, Freeman, and Whitesell, Deputy Associate Directors, Divisions of Monetary Affairs, International Finance, and Monetary Affairs respectively, 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

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

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

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

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

Messrs. Eisenbeis, Evans, Judd, Lacker, Mses. Mester and Perelmuter, Messrs. Rolnick, Rosenblum, and Steindel, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Chicago, San Francisco, Richmond, Philadelphia, New York, Minneapolis, Dallas, and New York respectively

Mr. Kahn, Vice President, Federal Reserve Bank of Kansas City

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 28, 2004, through March 15, 2004. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that economic activity continued to expand at a solid pace in early 2004. Consumer spending growth appeared to have picked up somewhat, and activity in the housing market remained at high levels. In the business sector, spending for equipment and software was apparently advancing vigorously, and firms were adding modestly to their inventories. Still, the increases in economic activity had not yet generated sizable gains in employment. Core consumer price inflation remained low, and expectations of future inflation continued to be subdued.

The January and February employment reports depicted a labor market that was slow to pick up momentum. The modest gains posted in private nonfarm payrolls over the period were smaller than had been expected by most forecasters. Employment in the manufacturing sector, which had fallen continually for over three years, was essentially unchanged in February, while employment in other sectors showed mixed changes. Average weekly hours of production or nonsupervisory workers edged above the average level of the fourth quarter of 2003. Despite the weakness in employment, the unemployment rate in January and February came in below its fourth-quarter level.

Industrial production moved up briskly in January and February following strong increases in the fourth quarter. These gains in production were realized across a wide set of industries. High-tech industries, including semiconductors, computers, and communications equipment, posted particularly strong advances, while the production of motor vehicles and the output of other manufacturing sectors were also strong. Outside the manufacturing sector, power generation by utilities surged in January but fell back in February in response to outsized swings in average temperatures during those months. Capacity utilization continued to move higher in January and February, although it remained below its longer-run average.

Consumer spending growth in recent months appeared to pick up somewhat from its pace in the fourth quarter of 2003. Retail sales rose briskly, on average, in January and February, and spending on services was up in January (the most recent month for which data were available). In contrast, purchases of motor vehicles slipped in January and February from the strong pace in the fourth quarter. Overall, expenditures were supported by sizable gains in real disposable personal income and increases in household wealth owing to rising home and equity prices. Disposable income was boosted by significant growth in private wages and salaries and by a drop in taxes that was due to the lower final payments and higher refunds associated with last year's tax cut. Surveys indicated that consumer sentiment moved higher in January but subsequently fell back. Despite the pullback, sentiment remained above the levels seen during most of 2003.

Activity in the housing market moderated in January and February from its elevated pace in the fourth quarter. Single-family housing starts and permits stepped down, although both measures remained above their average levels of the first three quarters of 2003. Housing starts in the multifamily sector slipped only slightly from the fourth quarter pace, even though vacancy rates reached a record high level in the fourth quarter. Sales of new and existing homes slowed in January, but this change retraced only a small part of the extraordinary run-up in home sales that began last spring. Home prices continued to rise briskly.

Spending on capital goods had advanced at a vigorous pace in the fourth quarter and appeared to be continuing that growth early this year. Spending by businesses was supported by increases in their sales and the continuation of strong cash flows and a low user cost of capital. Nominal shipments of computing and communication equipment moved up sharply in recent months, as did shipments outside the high-tech sector. By contrast, business investment in transportation equipment was mixed. Data for new orders of nondefense capital goods excluding aircraft suggested that the strength in capital expenditures would continue going forward. As has been the case for some time, real spending on private nonresidential structures languished, and vacancies in industrial buildings and office properties were at high levels.

Real nonfarm inventory investment remained modest in recent months. Although manufacturers' inventories moved higher in January, that increase primarily reflected stockbuilding at producers of petroleum and coal products. Retail inventories also rose in January, as stocks at auto dealers increased;

wholesalers accumulated inventories at a modest pace. Inventory–sales ratios in these sectors lingered at or near their historical lows.

The U.S. international trade deficit rose to a record high level in January. Exports of goods and services fell, owing importantly to a drop in agricultural exports. Imports edged lower, with higher oil imports partly offsetting declines in most other categories. Recent data suggested that economic activity in major foreign industrial countries strengthened outside the euro area, notably including a sizable jump in Japan's output in the fourth quarter. Growth in the euro area remained tepid.

Core consumer price inflation stayed very low in early 2004. Over the twelve months ending in January, the increase in core consumer prices was around 1 percent—about ¾ percentage point below the increase over the preceding twelve months. Total consumer price inflation, however, was boosted in January by a surge in energy prices. Incoming information on trends in labor costs were more mixed. The average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls rose modestly over the twelve months ending in February, decelerating from its year-earlier pace. By contrast, the employment cost index for hourly compensation in private industry grew a bit faster over the twelve months ending in December than over the year-earlier period.

At its meeting on January 27–28, 2004, the Federal Open Market Committee decided to leave its target for the federal funds rate unchanged at 1 percent. The Committee also retained its assessment that the upside and downside risks to the attainment of sustainable growth were roughly equal as well as its judgment that the probability of an unwelcome fall in inflation had diminished and was almost equal to that of a rise in inflation. With inflation low and resource use slack, the Committee saw no need for tightening policy in the near future. However, to provide additional flexibility to adjust monetary policy at a later date once such action was deemed appropriate given economic developments, the Committee removed from its post-meeting statement the explicit reference to a "considerable period" and substituted a statement that conveyed the sense that it could be patient in removing its policy accommodation.

Although the Committee's decision at the January meeting to keep the federal funds rate unchanged had been widely anticipated, the changes in the wording of the accompanying statement elicited a sharp reaction in financial markets. Investors moved up the date when they expected policy tightening to commence, resulting in a jump in Treasury yields. Over the balance of the intermeeting period, however, the Chairman's testimony on monetary policy and data on nonfarm payroll employment with a weakish cast persuaded investors that policy tightening was still some ways off. Treasury yields declined considerably in response and ended the intermeeting period lower, on balance. Yields on inflation-indexed securities also fell, leaving measures of inflation compensation little changed.

Yields on investment-grade bonds generally moved in tandem with those on Treasuries over the intermeeting period, but spreads on high-yield bonds widened as investors reassessed credit risks in light of the negative tone of some incoming economic data. The disappointing employment data and renewed concerns about terrorism contributed to a decline in broad equity price indexes. Technology-related issues, which had registered very large gains over the preceding year or so, fell more sharply. The foreign exchange value of the dollar against other major currencies declined through the middle of February but subsequently rebounded to end the intermeeting period higher.

After four consecutive months of decline, M2 rose slightly in January and accelerated markedly in February. The effects of mortgage refinancing, which had depressed M2 growth in the second half of last year, appeared to wane, allowing the expansion in nominal income to show through to M2 growth.

The staff forecast prepared for this meeting indicated that economic activity would continue to expand at a solid pace through 2005. Monetary policy is expected to support growth over the projection period, and fiscal policy is anticipated to remain accommodative through 2004. In addition, structural productivity growth is projected to remain substantial this year and next. Strong advances in real disposable income were expected to keep consumer spending on a solid upward trajectory. Business spending on equipment and software was seen as increasing briskly as a result of sizable profits, an improving outlook for demand, and continued favorable financing conditions. Also, inventory investment was anticipated to rise gradually as businesses became more convinced that final demand was expanding along a sustainable track. The pace of economic expansion was forecasted to be sufficient to reduce resource slack over this year and next, although the employment data received over the intermeeting period indicated that this process would begin from a higher rate of unused resources than had been previously expected. Core inflation was projected to remain low over the forecast period.

In the Committee's discussion of current and prospective economic developments, the members noted that overall economic activity still seemed to be increasing at a solid pace, though perhaps not quite as quickly as some members had anticipated at the time of the January meeting. Investment spending had continued to advance, and the manufacturing sector, which had lagged the rest of the economy earlier in the expansion, had extended recent gains. Residential construction activity was down somewhat from the very high levels posted late last year, but increases in household wealth and the effects of last year's tax cuts continued to buoy consumer spending. Despite the gains in spending and production, however, employment growth had been disappointing. While job losses had moderated, hiring had yet to strengthen, holding down net increases in employment. Nonetheless, the breadth of the expansion was seen as providing considerable assurance of its sustainability, and Committee members generally expected that accommodative monetary policy, favorable financial market conditions, and, at least in the near term, fiscal stimulus would continue to foster a pace of output growth that exceeded that of its potential. Although economic slack likely would be declining, it was expected to be a little higher than previously had been anticipated. Prices for energy, commodities, and non-oil imports were rising, however, and some business contacts had reported seeing a return of "pricing power." On balance, inflation was expected to remain near its current low level.

In their discussion of economic developments across the nation, a number of Committee members noted some slippage in business and consumer confidence from the high levels reached late last year. While business contacts in some regions remained optimistic about prospects for their sales and planned to increase investment and, in some cases, employment, firms in other parts of the country had become somewhat more uncertain about the pace of the expansion going forward. Those firms, as a result, were more wary about committing to new investment plans or increased hiring. Financial markets also seemed a little less positive about the outlook, with stock prices lower and some risk spreads wider than at the time of the last meeting. The reasons for the reduced optimism were not entirely clear but may have included higher energy and commodity prices as well as renewed concerns about terrorism. Some members also pointed to the persistent weakness in employment, which might be seen as reducing the odds that household spending would continue to expand briskly once the stimulative effects of tax cuts waned. Lingering business caution likely accounted for a good deal of the lag in job creation, but some members also pointed to a number of other factors that might be restraining hiring, including ongoing opportunities to increase efficiency through organizational changes and new investments, the effects on labor costs of increases in the costs of benefits, and, in some selected industries and regions, a shortage of job candidates with appropriate skills. The extent and duration of the resulting restraint on hiring were difficult to assess, however, and the Committee continued to expect employment growth to pick up as the expansion progressed.

In their comments about demand in key sectors of the economy, members indicated that investment spending had continued to expand at a robust pace. Members anticipated vigorous growth in investment outlays going forward, supported by rapid productivity growth, high profits and cash flow, and accommodative financial markets. Despite this generally upbeat assessment, a number of members reported that firms were investing primarily to replace old equipment or to reduce costs, but remained hesitant to expand capacity. The commercial real estate sector remained weak, on balance, although some members suggested that market conditions were stabilizing and, in a few cases, even beginning to improve.

Committee members noted that activity in the housing sector, while still quite elevated, had fallen back from its extraordinary pace of late last year. However, some of the moderation may have owed to the effects of severe winter weather rather than more lasting influences, and the recent decline in mortgage interest rates was expected to support the housing sector going forward. Reports from some contacts suggested that speculative forces might be boosting housing demand in some parts of the country, with concomitant effects on prices, suggesting the possibility that house prices might be moving into the high end of the range that could be consistent with fundamentals.

Consumer spending outside the auto sector had remained strong, with data and retail contacts generally suggesting continued growth in sales this year. Committee members noted that sales had been bolstered by rising asset prices and the effects of last year's tax cuts on refunds and final payments. By contrast, sales of motor vehicles had fallen back noticeably, reflecting in part reductions in incentives. However, members anticipated that sales would pick up again, partly in response to an anticipated rebound in incentives. Looking forward, gains in employment and the pass-through of higher productivity to wages and salaries were also expected to boost consumer spending, even as the stimulus to growth from tax cuts faded and increases in home and equity prices likely slowed from their rapid pace in recent quarters.

The Committee anticipated that government spending would provide some further support for aggregate demand going forward. The budget pressures that had constrained state and local government expenditures of late were easing in some cases, and federal outlays were expected to rise. Fiscal policy was seen as providing less stimulus to aggregate demand in 2005 than this year, but the federal budget deficit was expected to remain substantial.

In their remarks concerning the external sector of the economy, members cited the decline in the value of the dollar on foreign exchange markets since the middle of last year and stronger economic growth in many of our trading partners as factors boosting the demand for exports in a variety of industries. While exports were likely to continue to advance, the value of U.S. imports was expected to rise as well, implying continued very large current account deficits. Some Committee members noted that opportunities to cut costs had led some of their business contacts to consider moving production abroad.

In their review of the outlook for prices, members generally anticipated that core inflation would remain near current low levels, with output growth only gradually eliminating slack in labor and goods markets and strong growth in productivity limiting increases in unit labor costs. Some members thought that core inflation had stabilized and was unlikely to move lower. Increases in the prices of energy, other commodities, and non-oil imports, as well as reports from some business contacts that higher costs were increasingly being passed through to prices, suggested that the downtrend in inflation had ended. Moreover, if, as some members thought likely, productivity growth slowed as employment picked up, the result could be reductions in slack accompanied by higher unit labor costs and associated pressures on prices. Other members were less certain that inflation had leveled out. Recent price trends were not clear, with some measures of core inflation still declining. Increases in commodity prices remained limited to a few selected industries, and with the persistence of slack in labor and product markets, core inflation might well edge lower once any transitory influences had ebbed. Moreover, if productivity were to expand at a rapid pace rather than slowing, unit labor costs could fall, putting downward pressure on prices.

In the Committee's discussion of policy for the intermeeting period, all the members favored the retention of the current target rate of 1 percent for the federal funds rate. This preference for an unaltered stance of policy was based on the absence of significant changes in economic conditions or in the members' basic assessment of the outlook since the January meeting. To be sure, some of the incoming information—notably with regard to labor market developments—had been somewhat disappointing, but the Committee continued to see the conditions in place for further solid economic growth. Similarly, despite the rise in energy and commodity prices and reports of increased pricing power in some sectors, many Committee members commented that persisting slack in labor and output markets would keep inflation low. In these circumstances, the current accommodative stance of monetary policy remained appropriate. Some members, while supporting an unchanged policy at this meeting, nonetheless emphasized that the maintenance of a very accommodative monetary policy over an extended period in concert with a stimulative fiscal policy called for careful attention to the possible emergence of inflationary pressures. And, while adjustments in financial markets to low rates had generally been consistent with the usual operation of the monetary transmission mechanism, some members were concerned that keeping monetary policy stimulative for so long might be encouraging increased leverage and excessive risk-taking. Such developments could heighten the potential for the emergence of financial and economic instability when policy tightening proved necessary in the future. At present, however, the persistence of low inflation coupled with soft labor markets underscored the desirability of a monetary policy strategy characterized by continued patience.

In the Committee's discussion of its statement to be released shortly after this meeting, the members saw merit in not changing the characterization of the risks to the outlook for inflation and economic activity. Many members held that a case could be made for moving to a balanced risk assessment with regard to the outlook for inflation, with a number of them expressing a marginal preference for such a change. However, other members thought the evidence for a balanced risk assessment was not yet compelling and pointed out that with inflation quite low and slack in labor and output markets likely to persist for a while longer, the costs to the economy associated with a further decline in inflation likely outweighed those associated with a comparable increase. While many viewed it as a close call, all members indicated that they could support a proposal to retain the existing wording involving a slight tilt toward the possibility of some further disinflation. The members also agreed on the desirability of retaining the assessment that the risks with regard to the outlook for economic growth were balanced. Accordingly, it was agreed that the only changes in the post-meeting statement would be to update the descriptions of the economic expansion and labor market conditions in light of the information received over the intermeeting period.

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 1 percent.

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

> The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation. With inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 4, 2004.

The meeting adjourned at 1:00 p.m.

Notation Vote

By notation vote completed on March 18, 2004, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on January 27–28, 2004.

Vincent R. Reinhart
Secretary

Meeting Held on May 4, 2004

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 4, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Messrs. McTeer, Moskow, Santomero, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus and Guynn, Presidents of the Federal Reserve Banks of Richmond and Atlanta respectively

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

Messrs. Connors, Fuhrer, Hakkio, Howard, Madigan, Rasche, Struckmeyer, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

Messrs. English and Sheets, Assistant Directors, Divisions of Monetary Affairs and International Finance respectively, 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

Mr. Bassett, Economist, Division of Monetary Affairs, Board of Governors

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

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

Messrs. Connolly and Moore, First Vice Presidents, Federal Reserve Banks of Boston and San Francisco respectively

Messrs. Eisenbeis, Evans, Goodfriend, Judd, Ms. Mester, and Mr. Rolnick, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Chicago, Richmond, San Francisco, Philadelphia, and Minneapolis respectively

Mr. Altig, Ms. Hargraves, and Mr. Koenig, Vice Presidents, Federal Reserve Banks of Cleveland, New York, and Dallas respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 16, 2004, were approved.

By unanimous vote, Joseph S. Tracy was elected to serve as associate economist until the first regularly scheduled meeting of the Committee after December 31, 2004, with the understanding that in the event of the discontinuance of his official connection with a Federal Reserve Bank or with the Board of Governors, he would cease to have any official connection with the Committee.

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.

By unanimous vote, the Committee voted to extend for one year beginning in mid-December 2004 the 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 vote to renew the System's participation in the swap arrangements maturing in December was taken at this meeting because of the provision that each party must provide six months prior notice of an intention to terminate its participation.

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 16, 2004, through May 3, 2004. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that the economy expanded at a rapid pace in the first quarter. Consumer spending and the housing market continued to exhibit strength. Business fixed investment grew smartly, reflecting increased outlays for equipment and software that more than offset a significant fall in investment in nonresidential structures. The labor market displayed further signs of improvement during the quarter, capped by a significant increase in private payrolls in March. Recent increases in the prices of imports and commodities showed through to a pickup in core consumer price inflation during the first quarter, although some of the categories that registered large gains had posted unusually small increases earlier.

The labor market showed renewed vigor during the first quarter. The growth in payroll employment during March pushed the average monthly gain for the first quarter as a whole well above that of the fourth quarter of last year. Hiring during the quarter was widespread across industries, with large increases in construction, retail trade, and business and nonbusiness services. Net job losses in manufacturing, which had waned during the winter, reportedly came to an end by March. Some surveys of business hiring intentions also suggested renewed strength. However, a small decline in the average workweek during March held down the increase in aggregate hours, which rose at a slightly slower pace in the first quarter than in the fourth quarter. Moreover, the unemployment rate ticked up to 5.7 percent in March, and the labor force participation rate remained low.

Despite a weather-related decline in output at utilities during March, the pace of industrial production quickened during the first quarter, and the gains were widespread across industry and market groups. The high-tech sector accounted for a significant part of the increase, as output of computers and semiconductors rose rapidly. Production of other business equipment also increased markedly, and indexes for business and construction supplies were up notably. Motor vehicle assemblies were slightly higher for the first quarter as a whole, although they slowed in March. Manufacturing capacity utilization rose for the second consecutive quarter, but to a rate well below its long-run average. Available weekly physical product data for April were up slightly.

Real consumer spending grew at a somewhat faster pace in the first quarter than it had in the fourth quarter. Retail sales rose briskly, with strength widespread across spending categories, while expenditures on services also posted a substantial increase. Light vehicle sales were down slightly for the first quarter as a whole, but they firmed in March. Solid growth in wages and salaries and an increase in tax refunds generated a large increase in real disposable personal income in the first quarter. Measures of consumer confidence were roughly stable in March and April.

Residential housing activity remained high in the first quarter despite a marked rise in mortgage interest rates. Smoothing through weather-related swings in the volatile monthly data, the underlying pace of single-family housing starts continued to display appreciable strength. Sales of new homes jumped to a record level in March, and sales of existing homes increased to their highest level since last September. In the multifamily sector, construction activity also remained robust through March, even though the vacancy rate for multifamily units reached a record high in the first quarter.

Business fixed investment continued to be supported by favorable underlying fundamentals, including increased corporate cash flow, a low user cost of capital, and, at least as judged by survey data, increased business confidence in the sustainability of the economic expansion. Outlays for equipment and software expanded at a vigorous pace in the first quarter, with the exception of spending on transportation equipment. Shipments of nondefense capital goods excluding aircraft were strong, especially outside the high-tech industries. Within the high-tech sectors, rapid growth of shipments of communications equipment offset declines in the computers and peripherals category. By contrast, investment in nonresidential structures fell considerably in the first quarter, and vacancy rates for industrial buildings and office properties remained high.

Real nonfarm inventories increased a bit more in the first quarter than they had in the fourth quarter. Motor vehicle inventories at the retail and wholesale levels accounted for the entire increase, while non-auto inventories ran off slightly. In particular, manufacturers continued to reduce their stocks, though at a slower pace than last year. Inventory accumulation lagged growth in sales and shipments, and the inventory–sales ratio edged down further.

The U.S. international trade deficit shrank in February from January's record high, with exports increasing across a range of major categories of goods. Economic growth in the major industrialized countries in the first quarter was uneven. The economies of Japan and the United Kingdom likely continued to expand, though at paces below those of late last year. In the euro area, economic indicators were mixed. A moderation of growth in Canada led the Bank of Canada to ease monetary policy for the third time this year, citing a need to support aggregate demand. Inflation was little changed in Canada and the euro area, but it slipped further in the United Kingdom. In Japan, consumer prices were about unchanged, while wholesale prices edged up in March relative to their level of a year earlier and posted the first increase on a twelve-month basis since July 2000.

In the United States, the core consumer price index advanced at a faster rate in the first quarter than it had in the fourth quarter, reflecting the pass-through of higher energy prices and a leveling off of goods prices after sizable declines last year. The higher goods price inflation owed, in part, to the recent run-up in the prices of non-oil imports, energy, and other commodities. The price index for core personal consumption expenditures also rose at a faster rate in the first quarter than it had late last year. Despite the rise in inflation this year, however, the cumulative increase in the overall consumer price index for the year ending in March was somewhat less than the advance for the twelve months ending in March 2003. In the year ending in March, the increase in the price index for total personal consumption expenditures was similar to that of a year earlier. Survey measures of near-term inflation expectations edged up somewhat in March and April, but measures of longer-term expectations decreased. With regard to labor costs, average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls rose notably less for the twelve months ending in March than they had in the year-earlier period. The overall increase in the employment cost index for private industry for the twelve months ending in March was about the same as that for the twelve-month period ending a year earlier, as wages and salaries decelerated and benefits accelerated.

At its meeting on March 16, 2004, the Federal Open Market Committee decided to keep its target for the federal funds rate unchanged at 1 percent. In its announcement of this decision, the Committee indicated that the upside and downside risks to sustainable growth were roughly equal and that the probability of an unwelcome fall in inflation had declined further so that it was almost equal to that of a rise. The Committee also noted in March that although output had continued to expand at a solid pace, new hiring had lagged, and increases in core consumer prices were muted and expected to remain low. As a result, the Committee determined that it could remain patient in removing its policy accommodation.

The Committee's decision at its March meeting to leave the intended level of the federal funds rate unchanged had been fully anticipated in financial markets. However, market participants reportedly viewed the accompanying statement as suggesting that the Committee had a slightly weaker outlook for the economy than had been expected, and longer-dated futures rates and Treasury yields declined a few basis points after the announcement. In response to the generally positive tone of economic data—especially the release of the much stronger-than-expected employment report for March—and congressional testimony by

Chairman Greenspan, investors pushed market interest rates substantially higher over the intermeeting period. By the time of the FOMC meeting in early May, quotes on federal funds futures contracts suggested that market participants expected policy tightening to begin sooner than previously anticipated and to proceed at a faster pace once it began. The revision to policy expectations showed through to interest rates on nominal Treasury securities, which climbed significantly. Yields on inflation-indexed Treasury securities rose almost as much, implying that inflation compensation only edged a little higher. Yields on investment-grade corporate bonds rose a bit less than those on comparable-maturity Treasuries, but risk spreads on below-investment-grade bonds narrowed significantly as their yields increased by a more modest amount. Major equity price indexes were about unchanged, as the downward pressure exerted by higher interest rates was offset by the effects of strong earnings reports, upward revisions to expected future earnings, and other positive economic news.

In foreign exchange markets, the dollar appreciated against most major currencies over the intermeeting period, and it also gained against an index of the currencies of other major U.S. trading partners. The dollar fell sharply against the yen early in the intermeeting period, but subsequently about reversed the decline. Market participants attributed the dollar's overall gains particularly to the stronger-than-expected U.S. economic data and the weaker-than-expected performance of the Canadian economy and economies in the euro area.

M2 grew briskly during March and April as continued low opportunity costs and the temporary effects of mortgage refinancing boosted liquid deposits. The strength was likely offset somewhat by the effects of individual non-withheld tax payments in April, which were lower than last year and therefore probably led to a smaller buildup in liquid deposits than incorporated in the seasonal adjustment factors. Although currency growth continued to be held down in the first quarter by weak demand from abroad, it moved closer to its long-term trend in April.

The staff forecast prepared for this meeting suggested that the economy would continue to expand briskly for the rest of 2004 before decelerating somewhat in 2005 as fiscal policy shifted to a slightly restrictive stance. The considerable monetary and fiscal stimulus this year and still-strong advances in structural productivity were expected to cause businesses to shed still more of the caution they had been exhibiting in investing and hiring. The labor market was projected to show steady improvement through the end of 2004, but the forecasted pace of hiring was expected to slow a little next year as economic growth moderated. The staff anticipated that inventories would increase at a modest rate during the forecast horizon as businesses responded to continued strength in demand. Business spending on equipment and software was expected to remain strong, with the expiration of the partial-expensing tax provision at the end of 2004 adding impetus this year. The rise in mortgage rates was not likely to show through to demand for housing until the second half of 2004 and was expected to be partially offset in the longer term by rising employment and personal income. The increases in employment and income were also projected to continue to boost consumer spending. In light of recent increases in some price measures, the staff anticipated a transitory rise in the pace of core inflation in the near term. However, it was expected that the remaining slack in resource utilization and strong productivity growth would keep core inflation at a low level over the forecast period.

In the Committee's discussion of current and prospective economic developments, a number of members noted that the outlook for production and employment had improved distinctly in the period since the March FOMC meeting. Newly available data as well as commentary from business contacts almost uniformly suggested that the expansion had continued to broaden and had become more firmly established. Statistical releases confirmed that consumer spending was rising at a brisk rate, housing activity remained at a high level, and business fixed investment was growing vigorously. Significantly, the most recent data also provided evidence that the pace of hiring had begun to pick up, a development that was expected to provide further support to the expansion going forward. Anecdotal information gathered from business contacts across the nation—particularly commentary suggesting rising orders, improving confidence, and a growing willingness to increase payrolls—tended to confirm the data that pointed to increasingly solid expansion. Prospects for growth continued to be supported by fiscal policy, which was expected to remain stimulative through 2004, and by the effects of monetary policy accommodation. Overall, Committee members were now more convinced that robust growth would be sustained, and most likely at a pace that would be adequate to make appreciable headway in narrowing margins of unutilized resources. Regarding the outlook for inflation, members took particular note of recent data pointing to jumps in consumer and producer prices. Many members indicated that the surprisingly large advances had substantially reduced the odds of further disinflation and also had increased their uncertainty about prospective price trends. Still, most members saw low inflation as the most likely outcome.

In their comments about key economic sectors, a number of members pointed to developments that were likely to support increased investment spending going forward. Many business firms appeared to be experiencing a significant pickup in demand. Anecdotal information suggested that some manufacturers had seen a notable rebound in orders, with several members citing, in particular, stronger demand for high-tech products as well as for machine tools, various types of heavy machinery, and aircraft. Also, optimism regarding economic prospects among business executives seemed to be mounting, no doubt prompted in part by the increased demand they were experiencing and robust growth in profits. Business contacts in several districts had indicated that, as a result of the improved outlook, they were taking steps to expand their capacity to produce, both by starting to augment work forces and by boosting fixed investment. Committee members generally perceived overall business fixed investment as accelerating considerably, especially for equipment and software. In contrast, investment in nonresidential structures remained sluggish, as vacancy rates in many markets were elevated and considerable excess capacity persisted in many production plants. Drilling, however, was said to be strengthening in response to high oil and gas prices.

While Committee members saw an overall brightening in the outlook for business fixed investment, a number of policymakers commented that some of the considerable caution that had earlier marked business attitudes apparently lingered. The pace of hiring seemed to be picking up only gradually, fixed investment was still moderate in comparison with the strong cash flow being generated by robust profits, and anecdotal information indicated that firms in most industries were continuing to exercise tight control over inventories. Indeed, several members remarked that the rate of inventory investment was surprisingly modest in the first quarter, although motor vehicle inventories were on the high side. On the whole, the evidence of continued caution and disciplined spending in the business sector was seen as boding well for the durability of the expansion.

Members viewed the household sector as continuing to play a key role in the expansion, with recent data as well as anecdotal information indicating that consumer spending was rising at a solid pace. After dropping back in January, auto sales had accelerated over the remainder of the first quarter and appeared to be well maintained in April. Expenditures for consumer services seemed to be expanding steadily. Several members noted that tourism in their regions was picking up. In addition, housing activity had stayed strong across the nation and was still climbing in some regions, with reports of growing backlogs in deliveries and substantial price increases in some markets. The overall vigor in household spending was being supported by substantial gains in disposable income, partly reflecting tax cuts, generally sound balance sheets, accommodative financial conditions, and increases in consumer sentiment over the past year or so. To date, the backup in fixed mortgage interest rates in recent months seemed to have had little adverse effect on homebuying, although it was noted that an appreciable further rise in longer-term market rates would represent a potential source of restraint on future household spending.

Fiscal policy was viewed as likely to buoy the expansion of economic activity through 2004. Real federal expenditures had jumped in the first quarter and were expected to rise further over the balance of the year. Next year, fiscal impetus was likely to diminish, largely owing to the expiration of the tax provision permitting partial expensing of certain capital outlays. Assessing the prospects for fiscal policy, however, was complicated by a lack of legislative progress to date in passing federal appropriations bills. Regarding the longer-term federal budgetary outlook, an apparent breakdown in fiscal discipline was seen as an ongoing concern. However, some progress was noted in reducing budgetary imbalances at the state and local levels.

The external sector was expected to provide limited support for U.S. economic growth over the next two years. Expansion of foreign economies was likely to fuel increases in U.S. exports, with strength expected particularly in computers and semiconductors. Real imports, however, also appeared likely to continue rising strongly as domestic demand climbed further, leading to a widening of already substantial trade and current account deficits. Some members saw a risk that growth in certain rapidly expanding regions abroad could slow, perhaps sharply, with potentially significant effects on the demand for U.S. exports as well as on global commodity prices.

After a protracted period of meager gains in employment, conditions in the U.S. labor market evidently were improving in recent weeks. In addition to noting the substantial jump in payrolls in March, several members relayed anecdotal information from business contacts around the nation that hiring was continuing to pick up and that firms were planning further increases in workforces. Some temporary help firms reported rising demand, a possible precursor of a pickup in permanent hiring. A number of members cited reports of difficulties in hiring within certain job families in which specialized skills were in short supply together with indications that wage increases in those occupations tended to be larger than average. Even so, considerable slack seemed to remain in the labor market overall, and wage gains on the whole were moderate.

Data on consumer and producer prices over the intermeeting period had generally come in on the high side of expectations, following considerable increases in commodity prices. A significant number of Committee members reported information from their contacts that businesses were increasingly able to pass on cost increases to their customers and to boost prices more generally. Some members cited instances in which earlier price discounts had been canceled and noted that surcharges for higher energy and steel prices were being added to base prices for certain goods. Nonetheless, the extent to which these developments signaled an upturn in underlying inflation was unclear. To some degree, the recent uptick in various price measures partly reflected factors, such as jumps in the prices of energy and non-oil imports, that were unlikely to be repeated. Also, the recent evidence could be interpreted as indicating that the surprisingly sharp decline in measured inflation in 2003 exaggerated the drop in the underlying rate of inflation. Indeed, some members saw underlying inflation as relatively stable and put low odds on the possibility that prices now were accelerating. In their view, a range of factors was continuing to restrain inflation, including slack in resource utilization, strong productivity gains and corresponding downward pressures on unit labor costs, currently high price markups, and longer-term inflation expectations that apparently remained contained. Others, however, were less confident about the degree of restraint on prices, noting that inflation predictions based on estimated output or employment gaps were subject to considerable error.

In the Committee's discussion of policy for the intermeeting period, all of the members favored maintenance of the existing target of 1 percent for the federal funds rate. It was recognized that the Committee would need to initiate a process of removing monetary policy accommodation at some point, and the recent experience suggested that the time at which policy firming appropriately would commence might be closer than previously had seemed most probable. However, the appreciable rise in real long-term interest rates over the intermeeting period implied that financial market conditions had already tightened on balance. Moreover, the evidence of a significant acceleration in hiring was still limited, and some members referred to the possibility that growth could falter, particularly if market yields were to rise sharply further. With inflation low and resource use slack, the Committee saw a continuation of its existing policy stance as providing a degree of support to the economic expansion that was still appropriate.

With regard to the Committee's announcement to be released after the meeting, it was understood that the recent evidence that hiring had picked up, as well as the continued solid growth in output, would be highlighted. Policymakers also concurred that, with the expansion apparently well established, the statement should again indicate that the upside and downside risks to sustainable growth for the next few quarters seemed to be roughly equal. Members saw both downside and upside risks to prospects for inflation. The probable persistence of slack in the economy for at least several more quarters, together with the likelihood that recent substantial gains in productivity would be extended, should continue to exert slight downward pressures on inflation. At the same time, though, the recent stronger-than-expected increases in a number of price measures, anecdotal information suggesting a greater ability of businesses to implement and sustain price hikes, and multiplying signs of solid economic growth suggested that the upside risks to inflation had increased. The members agreed that, all things considered, the risks to the goal of price stability had moved into balance in the period since the last meeting.

The Committee also discussed at length the advantages and disadvantages of modifying or dropping its statement in the announcement following the March meeting that "With inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation." All of the members agreed that, with policy tightening likely to begin sooner than previously expected, the reference to patience was no longer warranted. The Committee focused instead on a formulation that would emphasize that policy tightening, once it began, probably could proceed at a pace that would be "measured." A number of policymakers were concerned that such an assertion could unduly constrain future adjustments to the stance of policy should the evidence emerging in coming months suggest that an appreciable firming would be appropriate. Others, however, saw substantial benefits to inclusion of the proposed language. These members noted that current economic circumstances made it likely that the process of returning policy to a more neutral setting would be more gradual, once under way, than in past episodes when inflation was well above levels consistent with price stability. In addition, some policymakers observed that the timing and magnitude of future policy adjustments would ultimately be determined by the Committee's interpretation of the incoming data on the economy and prices rather than by its current expectation of those developments. On balance, all the members agreed that they could accept an indication in the statement that ". . . policy accommodation can be removed at a pace that is likely to be measured."

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 Open Market 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 1 percent.

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

> The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. Similarly, the risks to the goal of price stability have moved into balance. At this juncture, with inflation quite low and resource use slack, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, June 29–30, 2004.

The meeting adjourned at 1:15 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on June 29–30, 2004

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 29, 2004, at 2:30 p.m. and continued on Wednesday, June 30, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Ms. Cumming, Messrs. McTeer, Moskow, Santomero, and Stern, Alternate Members of the Federal Open Market Committee

Mr. Guynn and Ms. Yellen, Presidents of the Federal Reserve Banks of Atlanta and San Francisco respectively

Mr. Lacker, President-Elect of the Federal Reserve Bank of Richmond

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

Messrs. Connors, Fuhrer, Hakkio, Howard, Madigan, Sniderman, Slifman, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

Mr. Kamin,[5] Deputy Associate Director, Division of International Finance, Board of Governors

Messrs. Gagnon,[5] Leahy,[5] and Sheets, Assistant Directors, Division of International Finance, Board of Governors

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

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

Mr. Thomas,[5] Section Chief, Division of International Finance, Board of Governors

Ms. Kusko[6] and Mr. Zakrajšek, Senior Economists, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

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5. Attended portion of the meeting relating to the discussion of prospective external adjustment.

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

Mr. Carpenter,[6] Economist, Division of Monetary Affairs, Board of Governors

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

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

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

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

Mr. Judd, Executive Vice President, Federal Reserve Bank of San Francisco

Messrs. Eisenbeis, Evans, Goodfriend, Mses. Mester and Perelmuter,[5] Messrs. Rolnick and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Chicago, Richmond, Philadelphia, New York, Minneapolis, and Dallas respectively

Ms. Goldberg[5] and Mr. Thornton, Vice Presidents, Federal Reserve Banks of New York and St. Louis respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on May 4, 2004, 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 May 4, 2004, through June 29, 2004. By unanimous vote, the Committee ratified these transactions.

At this meeting, the Committee discussed staff papers and presentations on adjustment of the U.S. external accounts. At more than $500 billion, the deficits in trade and current account balances are quite large in comparison with aggregate income. Financing of the deficits had recently included both large foreign private purchases of U.S. securities and increased foreign official inflows. The sizable current account deficit could be viewed as reflecting very low levels of national saving, in both its government and private components, in relation to investment opportunities in the United States that were very attractive. The staff noted that outsized external deficits could not be sustained indefinitely. However, the historical evidence indicated that such deficits could be quite persistent, and the adjustment of imbalances was not necessarily imminent. The adjustment, once under way, might well proceed in a relatively benign fashion, particularly if fiscal, monetary, and trade policies were appropriate, but the possibility that the adjustment could involve more wrenching changes could not be ruled out. In any case, a movement toward balance in the trade and current accounts would likely have effects that differ appreciably across sectors of the U.S. economy. Members of the Committee noted that monetary policy was not well equipped to promote the adjustment of external imbalances but could best contribute by maintaining an environment of price stability that would foster maximum sustainable economic growth. Fiscal policy had a potentially larger role to play by promoting an increase in national saving, but the adjustment would involve shifts in demand and output both domestically and abroad, and changes to U.S. fiscal policy alone probably would not be sufficient to foster the adjustment.

The information reviewed at this meeting suggested that the economy continued to expand at a solid pace during the second quarter. Although growth in consumer spending appeared to have slowed somewhat, the demand for housing increased from its robust first-quarter pace. Business fixed investment, boosted by surging outlays on equipment and software, also grew rapidly. The labor market improved further during the quarter, with large gains in employment registered in April and May. Core consumer price inflation picked up, reflecting in part the pass-through of substantial advances in energy prices and non-energy import prices.

The labor market rebounded strongly in recent months. Private nonfarm payrolls grew rapidly in April and May, with hiring widespread across industries. The manufacturing sector appeared to be on a more solid footing, as manufacturers added jobs in each of the past four months after more than three years of declines. Aggregate hours moved up in both April and May, bringing the level of hours substantially above its trough of last summer. Despite the recent strength in hiring, the unemployment rate changed little in recent months, and the labor force participation rate remained low.

Industrial production accelerated in April and May after a sizable advance in the first quarter. Output at utilities surged in the latter month, reflecting weather-related factors, and factory output excluding motor vehicles, buoyed by strong gains in both high-tech manufacturing industries and in most non-high-tech industries, expanded sharply in both months. In contrast, the production of motor vehicles declined as automakers trimmed outsized inventory positions. Capacity utilization moved higher but stayed below its long-run average.

Growth in real consumer spending appeared to have slowed somewhat in recent months from its first-quarter pace. Although outlays for motor vehicles in May more than retraced their April decline and purchases of services advanced at an appreciable rate, spending on nondurable goods remained sluggish. Despite higher energy prices, real disposable personal income continued its uptrend in recent months, benefiting from an improved labor market and last year's tax cut. Home prices also continued to rise at a rapid pace, contributing importantly to increases in household wealth. Survey measures of consumer confidence moved up in June from already favorable levels.

Activity in the housing market increased in April and May despite a considerable rise in mortgage interest rates. Single-family housing starts edged above their rapid first-quarter pace, and sales of both new and existing homes reached record levels in May. In the volatile multifamily sector, housing starts fell somewhat in May, but, more generally, construction activity in this sector had been surprisingly resilient in light of the high vacancy rate for such units.

Business investment spending appeared to have advanced at a brisk pace in the second quarter, as rising output, low user cost of capital, and increased corporate cash flow continued to foster a favorable environment for capital spending. Although new orders and shipments of nondefense capital goods excluding aircraft dipped in May, both series remained on a solid uptrend, and, with orders exceeding shipments, backlogs continued to grow. Spending on transportation equipment, which dropped in the first quarter, appeared to rebound in recent months, while outside the transportation and high-tech sectors, increases in spending moderated from their rapid first-quarter pace. After declining in the first quarter, overall investment in nonresidential structures appeared to pick up a little in the second quarter, though the performance of the major types of construction remained mixed. Spending on office buildings and manufacturing structures continued to be depressed by high vacancy rates, while outlays for commercial buildings moved up in conjunction with declines in vacancy rates for such structures. In addition, judging by the number of natural gas drilling rigs in operation, spending on drilling and mining structures rose in recent months.

The pace of inventory accumulation remained subdued. Although the book value of manufacturing and trade inventories increased appreciably in the first quarter and continued to rise at about the same pace in April, the recent large increases in the book-value data were due importantly to a jump in the price of oil and a run-up in the prices of intermediate materials. Inventory–sales ratios in manufacturing and retail trade edged higher in April but remained near their historical lows; meanwhile, inventory–sales ratios in the wholesale trade sector trended lower.

The U.S. international trade deficit reached a new record in April, reflecting in large part a sharp decline in exports of goods. The fall in goods exports was widespread, with notable decreases in capital goods, industrial supplies, and agricultural products. Exports of services, in contrast, increased in April. Imports of goods edged higher, as a large decline in the value of imported oil was offset by an increase in imports of non-oil products, and imports of services increased. Real GDP in the major foreign industrial countries expanded at a healthy pace in the first quarter. Indicators of economic activity in the second quarter for Canada and the United Kingdom were also favorable, whereas those for the euro area were somewhat mixed. Japan’s economy, supported by robust private domestic demand and rising consumer confidence, evidently continued to expand strongly in the second quarter. Mainly as a result of higher energy prices, consumer price inflation moved up a bit in the second quarter in Canada, the United Kingdom, and the euro area, while slight deflation persisted in Japan.

Consumer price inflation turned up this year from the very low rates registered in 2003, both for overall measures and for those that exclude food and energy. Overall consumer prices rose more quickly than core prices, reflecting the direct contributions of substantial increases in prices of food and energy. But the step-up in core inflation was also due in part to the pass-through of higher energy and import costs into core consumer prices. Some survey measures of short-term inflation expectations moved higher in recent months, but longer-term expectations remained reasonably well contained. Commodity prices escalated sharply during the early months of 2004, but indexes of spot prices for industrial materials and for wholesale gasoline retreated appreciably in recent weeks. Meanwhile, labor costs appeared to have turned up in the first half of the year. Hourly compensation in private industry rose in the first quarter at the same rate as in 2003, but with the pace of productivity advance moderating, unit labor costs moved higher. In April and May, increases in average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls exceeded the monthly gains registered in the first quarter and were well above the increases in the fourth quarter of 2003.

At its meeting on May 4, 2004, the Federal Open Market Committee decided to leave its target for the federal funds rate unchanged at 1 percent. The Committee retained its assessment that the upside and downside risks to the attainment of sustainable growth were roughly equal, but it announced that the risks to the goal of price stability had moved into balance. The Committee also noted that output had continued to expand at a solid pace, new hiring had appeared to pick up, and although incoming data on inflation showed that it had moved somewhat higher, longer-term inflation expectations had remained well contained. Reflecting these developments, the Committee concluded that it could remove policy accommodation at a pace that was likely to be measured.

The Committee's decision at its May meeting to leave the intended level of the federal funds rate unchanged had been fully anticipated by market participants. Likewise, the replacement of the sentence in the announcement reporting that the Committee could be patient in removing policy accommodation with one indicating that policy accommodation can be removed at a pace that is likely to be measured had little net effect on money market futures rates on the day of the announcement. Over the balance of the intermeeting period, however, market participants marked up significantly the extent of expected policy tightening in response to data that indicated robust gains in employment and spending and somewhat elevated inflation, as well as to comments by Committee members providing reassurance that policy would be tightened as necessary to contain any incipient inflationary pressures. Revisions to policy expectations showed through to interest rates on nominal Treasury securities, which increased commensurately. Yields on inflation-indexed Treasury securities rose almost as much as those on their nominal counterparts, leaving inflation compensation only slightly higher, on net, by the end of the intermeeting period. Yields on investment- and speculative-grade corporate securities rose about the same amount as those on comparable Treasuries, leaving risk spreads about unchanged. Generally positive economic news and further improvements in the outlook for corporate earnings evidently offset the influence of higher interest rates, and major equity indexes edged higher over the intermeeting period. In foreign exchange markets, the dollar depreciated somewhat against major currencies, and it rose a bit against an index of currencies of other major U.S. trading partners.

M2 continued to expand rapidly in May. The upswing in M2 growth since late winter stemmed in part from the temporary effects of mortgage refinancing, which boosted liquid deposits over this period, though M2 was also buoyed by strong gains in nominal income. In recent months, a rebound in currency growth and reduced portfolio shifts by households from monetary assets to equities and bonds also supported the expansion of M2. The growth of M2 slowed appreciably during the first half of June. Commercial bank credit decelerated in May, reflecting a contraction in bank holdings of securities and a slowdown in the growth of loans. The slowing in loan growth was concentrated mainly in real estate credits and was due partly to heavy securitizations.

The staff forecast prepared for this meeting suggested that the economy would continue to expand at a solid pace through 2005. Monetary policy was expected to support economic activity over the projection period, and fiscal policy was anticipated to remain accommodative through 2004. Moreover, persisting strong gains in structural productivity would likely continue to provide significant impetus to spending. With firms shedding their unusual caution of the past few years, further large additions to payrolls over the next several quarters were anticipated, followed by a gradual moderation in the rate of increase in employment. Strong profits, sustained increases in aggregate demand, and a favorable financing environment were expected to keep business spending on equipment and software on a healthy upward trajectory over the forecast period. The impending expiration of the partial-expensing tax provision was likely to provide an additional boost to capital spending later this year, although the shifting forward of some investment was expected to dampen capital spending in early 2005. In addition, inventory investment was forecast to increase gradually in order to bring changes in stocks closer in line with rising sales. Robust employment growth and the cumulative productivity gains of recent years were expected to contribute to strong advances in real disposable income, sustaining the expansion of consumption spending over the forecast period. Core inflation was projected to fall back later this year from its pace in the first five months and to remain low in 2005, as the transitory effects of higher energy and non-oil import prices waned.

In the Committee's discussion of current and prospective economic conditions, members commented that the evidence accumulated over the intermeeting period continued to portray an economy that was expanding briskly and was likely to continue to do so for some time. Business and consumer expenditures were on a strong uptrend, and related growth in output was associated with notable improvement in labor market conditions and in manufacturing activity. Members saw the persistence of a relatively vigorous expansion in overall economic activity as a likely prospect in the context of continuing stimulus from fiscal and monetary policies, accommodative financial conditions, growing business optimism, favorable consumer sentiment, and robust increases in productivity. Solid increases in economic activity and employment should in turn provide ongoing support to business and consumer spending. Members acknowledged that their favorable outlook for economic activity was based on the assumption that major terrorist disruptions would be averted.

In light of the strength of economic activity and recent indications of somewhat increased price pressures, the members focused particular attention on the outlook for inflation. They referred to statistical and anecdotal evidence that on the whole pointed to some recent acceleration of consumer prices and to some increase in near-term inflation expectations. Factors cited in this regard included large increases in prices of energy and intermediate materials, both of which appeared to be passing through at least in part to core consumer prices. Members referred to some limited inflationary impetus as well from the depreciation of the dollar and larger increases in labor compensation. Considerable uncertainty still surrounded the overall extent to which competitive pressures would allow producers to pass through rising costs to prices of finished goods; anecdotal reports suggested that the ability of many producers to do so was increasing but was far from universal at this point. With regard to the prospective course of inflation, members suggested that some of the rise in core inflation in recent months appeared to have resulted from what might well prove to be transitory factors, notably including increases in energy and other import prices, which were not seen as likely to persist and indeed might be partially reversed. Just how much slowing of price increases was likely after some relatively elevated readings was difficult to forecast. Those who anticipated a noticeable deceleration emphasized the contribution of the one-time price increases that had boosted inflation recently, persisting, albeit diminishing, margins of unemployed labor and other productive resources, the anticipation of strong further gains in productivity and declines in markups of goods prices over costs, and steady long-term inflation expectations. Others tended to emphasize the changes in business attitudes and expectations, the strength in labor compensation, and the tendency for underlying inflation trends to be subject to considerable momentum that was unlikely to be reversed quickly. Whatever their inflation forecasts, several noted that they now had less confidence in those forecasts than earlier. A number of members qualified their inflation outlook by noting that its realization likely would require an adjustment to monetary policy over time that brought the latter to a neutral stance as the economy continued to move toward full utilization of its resources.

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 2004 and 2005. The forecasts of the rate of expansion in real GDP were concentrated in the upper part of a 4 to 4¾ percent range for 2004, implying expectations by most members of a pickup over the second half of the year; for 2005 the forecasts were in a reduced range of 3½ to 4 percent. These rates of growth were associated with ranges for the civilian rate of unemployment of 5¼ to 5½ percent in the fourth quarter of 2004 and 5 to 5½ percent in the fourth quarter of 2005. Forecasts of the rate of inflation, as measured by the core PCE price index, pointed to marginally higher rates of inflation encompassed by ranges of 1½ to 2 percent for this year and 1½ to 2½ percent for 2005.

In their comments about developments in key sectors of the economy, many of the members emphasized the strength in business capital spending. Explanatory factors included the sustained demand for business output, strong profit margins and cash flow, low capital costs, and the partial-expensing tax provision. Weakness persisted, however, in the nonresidential construction sector, though signs of improvement were emerging in some areas. Many business contacts were expressing a marked degree of optimism about the outlook for business activity in the second half of the year. Currently low inventory-to-sales ratios, indeed reports of emerging bottlenecks in some markets, were expected to foster efforts to rebuild inventories and thus add support to the expansion going forward.

Consumer outlays were rising more moderately in the second quarter and somewhat below expectations. The slowing was not universal, however. Some members reported a continuation of robust consumer expenditures in various parts of the country. Looking ahead, members, in part echoing the sentiment of contacts among retailers, anticipated renewed strength in consumer spending in the context of sizable further growth in employment and disposable incomes and a generally high level of consumer confidence. In housing markets, activity had remained at generally high levels, with only a few signs that rising mortgage rates were beginning to hold down sales and construction. There was evidence in some areas that inventories of unsold homes had risen. Members noted that persisting overall strength in housing might to some extent be a response to expectations of further increases in mortgage rates, implying that a slowdown might be likely later in the year.

Members commented that fiscal policy was continuing to provide appreciable impetus to the economy, in part because of the incentives for business investment associated with the partial-expensing tax legislation. Following the scheduled expiration of that legislation at the end of this year and with more moderate gains in federal spending forecast in the absence of new legislation, the federal budget was expected to become mildly contractionary in 2005, although a marked degree of uncertainty surrounded this outlook. Many state and local governments were increasing their spending more rapidly in response to brightening budget situations.

Expanding foreign economies and the depreciation of the dollar were expected to foster appreciable growth in U.S. exports, but with imports still considerably larger than exports, the external sector was likely to make a measurable negative contribution to U.S. GDP growth this year and next. On the inflation side, higher import prices and, importantly, the rise in domestic and imported oil prices were adding to domestic inflationary pressures, although improving oil supplies had recently contributed to somewhat lower domestic gasoline prices.

In the Committee's discussion of policy for the intermeeting period, all of the members indicated that they could support an upward adjustment in the target for the federal funds rate from a level of 1 percent to 1¼ percent. Recent developments, notably the persistence of solid gains in output and employment along with indications of some increase in inflation, were seen as warranting a first step in the process of removing policy accommodation. The timing and pace of further policy moves would depend, of course, on the members' reading of the incoming economic information and their interpretation of its implications for economic activity and inflation. In this regard, members commented that they could envision a series of gradual or "measured" policy moves as likely to be consistent with the attainment of the Committee's objectives for sustaining progress toward higher levels of resource utilization and maintaining price stability. A few indicated, however, that their preference would be to remove any characterization of possible future policy actions from the Committee's statements. Partly reflecting anticipated monetary policy actions, financial market conditions had tightened in recent months, but short-term interest rates were quite low, especially when judged against the recent level of inflation. Depending on the rate at which resource utilization increased and the level and trend of inflation, a more aggressive pace toward reaching a neutral policy stance might be called for so as to provide assurance of containing emerging inflationary pressures and averting the potential need for greater overall tightening over time.

In the Committee's review of the announcement to be released shortly after this meeting, members agreed that an updating of the reasons for its policy decision was desirable, specifically by adding a reference to the possibility that some of the recent acceleration in inflation might reflect transitory factors. The members also decided to modify the reference to labor market conditions by referring in general terms to improved conditions rather than more narrowly to a pickup in hiring to acknowledge the broad range of labor market indicators considered by the Committee. They agreed to retain the assessments adopted at the May meeting indicating that they viewed the upside and downside risks to both the attainment of sustainable economic growth and to the goal of price stability as roughly in balance for the next few quarters. However, with regard to the outlook for inflation, a number of members emphasized that they would view the risks as tilted to the upside in the absence of further policy tightening actions that would bring the stance of policy to a more neutral setting. Many members also underscored their view that the statement should make clear that the Committee would be prepared to respond to significant changes in economic prospects and take actions that were deemed necessary to meet the Committee's commitment to maintain price stability.

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

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

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

> The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters are roughly equal. With underlying inflation still expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

The next meeting of the Committee was scheduled to be held on Tuesday, August 10, 2004.

The meeting adjourned at 1:35 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on August 10, 2004

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 10, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Messrs. McTeer, Moskow, Santomero, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Guynn, Lacker, and Ms. Yellen, Presidents of the Federal Reserve Banks of Atlanta, Richmond, and San Francisco respectively

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

Messrs. Connors, Hakkio, Howard, Madigan, Rasche, Sniderman, Slifman, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Oliner 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. English, Assistant Director, Division of Monetary Affairs, Board of Governors

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

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

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

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

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

Messrs. Goodfriend and Rudesbusch and Ms. Mester, Senior Vice Presidents, Federal Reserve Banks of Richmond, San Francisco, and Philadelphia respectively

Messrs. Cunningham, Hilton, Marshall, Tootell, and Wynne, Vice Presidents, Federal Reserve Banks of Atlanta, New York, Chicago, Boston, and Dallas respectively

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 June 29–30, 2004, were approved.

By unanimous vote, the Federal Open Market Committee approved the election of Scott G. Alvarez as General Counsel of the Committee to serve until the election of a successor at the first regularly scheduled meeting after December 31, 2004.

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 June 29, 2004, through August 9, 2004. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that economic growth softened somewhat in recent months. While strength in the housing market persisted and business outlays remained healthy, growth in consumer spending fell off significantly. Additionally, gains in employment, which were robust in earlier months, slowed sharply in June and July. Industrial production also decelerated modestly in June, but available indicators suggested a bounce-back in July. Core consumer price inflation moderated in May and June, despite further increases in energy prices.

Growth in employment slowed in June and July after displaying significant improvement in preceding months. The weakness was reported to be widespread, with the retail trade, information, financial activities, and government sectors registering declines on average over the two months. The construction and services sectors posted gains, but at a pace well below those of previous months. In contrast, after little change in June, payrolls in manufacturing rose appreciably in July. The average workweek declined in June but edged up in July, and aggregate hours of private production workers showed a similar pattern. Labor force participation moved up slightly in recent months, and the unemployment rate, which was unchanged in June, edged down to 5½ percent in July.

After rising rapidly in April and May, industrial production declined modestly in June, although manufacturing output, excluding motor vehicles and parts, increased a bit. Production of motor vehicles and parts declined noticeably, as automakers scaled back assemblies in response to elevated inventories. Output at utilities also fell in June as temperatures returned to more normal levels after an unseasonably warm May. Activity in the mining sector changed little. Overall capacity utilization was off slightly in June, but utilization on average over the quarter was above that of the first quarter. However, data on the growth in production-worker hours and other indicators of production suggested that manufacturing output bounced back in July.

Growth in consumer spending slowed sharply in the second quarter, posting only a small increase after a robust expansion in the first quarter. Although gains in outlays for services continued at a solid rate in the second quarter, expenditures for goods declined markedly. Data on consumer expenditures showed particular weakness in June, with either declines or no growth in purchases across most categories of goods and services. Purchases of cars and trucks contracted in that month but rebounded in July. Real disposable income was unchanged in June, held back by increases in prices of food and, especially, energy.

Activity in the housing market remained strong in June despite some variation across segments. Single-family housing starts fell back from very high levels in April and May. Multifamily housing starts also declined in June, though only a bit. Sales of existing homes jumped again in June to set a new record, and sales of new homes came in just below the record pace posted in May.

Business investment spending on equipment and software was solid in the second quarter, posting growth a little above the pace of the first quarter. Performance across categories, however, was uneven. Spending in the transportation equipment sector bounced back from a first-quarter decline, and outlays in the high-tech sector grew twice as fast as overall equipment and software spending in the quarter. Excluding transportation and high-tech equipment, however, gains were minimal. Real business investment in nonresidential structures turned up in the second quarter, albeit to a still-depressed level. Increased spending on office buildings, commercial structures, and various other types of buildings more than offset a sizable decline in the power generation component.

Real nonfarm inventories excluding motor vehicles picked up in the second quarter as the manufacturing, merchant wholesalers, and retail trade segments all boosted stocks. Book-value inventory–sales ratios edged up, but remained at fairly low levels.

The U.S. international trade deficit declined somewhat in May after reaching a record high in April. The value of exports of goods and services climbed substantially, with exports of goods more than accounting for the entire rise, as exports of services edged down. The value of imports of goods and services also increased in the month, but by less than exports. Available data indicated that major foreign industrial economies continued to expand at a solid pace in recent months. In Japan, gains in exports and household expenditures fueled the advance in output, and surveys of business and consumer confidence were also favorable. Real GDP accelerated in the United Kingdom, and economic activity grew at a solid pace in Canada, led by a surge in investment. Indicators for the euro area suggested that activity decelerated a bit in the second quarter. Growth of real GDP in China slowed significantly in the spring.

Core consumer price inflation moderated substantially in May and June, though sizable increases in food and energy prices continued to push up overall consumer price inflation. Increases in the food and energy components of the CPI were smaller in June than in May, and further deceleration was expected as gasoline and natural gas prices eased in July and supply conditions in a number of agricultural segments improved. In July, households' expectations for consumer inflation in the year ahead fell somewhat. Overall producer prices for finished goods were down in June, as declines in prices for food and energy were only partially offset by modest growth in the core components of the index. With regard to labor costs, the employment cost index for hourly compensation of private workers for the three months ending in June advanced at about the same rate as it had over the previous year-and-a-half. Unit labor costs, however, increased faster in the second quarter than in the first.

At its meeting on June 29–30, 2004, the Federal Open Market Committee adopted a directive that called for conditions in reserve markets consistent with increasing the federal funds rate to an average of around 1¼ percent. The Committee continued to perceive that the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters were roughly equal. In its public statement, the Committee noted that, with underlying inflation still expected to be relatively low, it believed that policy accommodation could be removed at a pace that was likely to be measured, but that, nonetheless, it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

This decision to raise the intended level of the federal funds rate by 25 basis points was anticipated in the financial markets, yet investors revised down their expectations for the path of policy upon the release of the accompanying statement. In particular, investors noted that the Committee attributed some of the recent increase in inflation to transitory factors, retained its earlier balance of risks assessment, and reiterated its belief that policy accommodation could be removed at a pace that would likely be measured. Subsequently, the Chairman's Congressional testimony on monetary policy, which suggested that recent softness in consumer spending should prove short-lived and emphasized the FOMC's commitment to price stability, spurred an upward tilt in the market's expected path of monetary policy. Over the remainder of the intermeeting period, though, expectations of policy tightening were revised down somewhat, on balance, as incoming data pointed to weaker-than-anticipated spending and employment and more subdued core inflation. Yields on intermediate- and long-term nominal Treasury securities dropped significantly over the intermeeting period. Available data suggested that corporate credit quality remained strong, and yields on investment-grade bonds moved roughly in line with those on Treasury securities. Speculative-grade yields, however, fell by less. In equity markets, broad indexes declined appreciably, reflecting the soft economic data, concerns about energy prices, and guidance from corporations pointing to a less-optimistic trajectory for earnings than investors apparently had been expecting. In foreign exchange markets, the dollar's trade-weighted value against other major currencies ended the period little changed, on net.

Following several months of robust expansion, M2 grew at a slower pace in June and available data implied a slight contraction in July. Most of the weakness owed to a slowdown in liquid deposit growth that was related in part to the decline in mortgage refinancing activity. In addition, retail money market funds resumed their earlier decline. Currency growth, however, strengthened over the two months, partly as a result of a pickup in foreign demand.

The staff forecast prepared for this meeting suggested that the economy would continue to expand at a solid pace through 2005, supported by a relatively accommodative monetary policy over the projection period and by stimulative fiscal policy through 2004. Consumer spending was expected to strengthen in the near term, boosted by strong consumer confidence and rising disposable income, which would likely continue to be propelled by robust growth in structural productivity. Favorable financial conditions, higher profits, and the partial-expensing tax incentives over the remainder of this year were projected to lead to a near-term acceleration in business fixed investment. Subsequently, growth in capital spending was expected to moderate somewhat but still to remain on a healthy upward trajectory. Despite recent weakness in employment growth, the waning of firms' unusual caution of recent years was expected to foster a pickup in hiring over the next several quarters. Consumer price inflation was projected to remain low over the forecast period as the sharp increases in energy and import prices experienced earlier in the year partially unwound. Slack resource utilization through 2005 was also expected to help hold down inflation.

In the Committee's discussion of current and prospective economic developments, members noted that the pace of the expansion had moderated. In particular, consumer spending, which had previously provided considerable support to aggregate demand, had slowed sharply in the second quarter. At the same time, growth in payrolls had fallen back in June and July after posting significant gains in the spring. While the recent moderation in growth might portend a substantially slower expansion going forward than had previously been expected, the Committee did not see such a sizable shortfall as the most likely outcome. Activity in the housing sector remained strong, and investment outlays continued to advance at a good pace. With economic growth buoyed by accommodative monetary policy and supportive credit conditions more generally as well as by robust underlying growth in productivity, the Committee believed that conditions were in place for the pace of expansion to strengthen enough to continue to trim margins of slack in resource utilization. Indeed, the limited available evidence pointed to a rebound in household spending, especially on motor vehicles, in July and early August, and some indicators suggested continued improvement in labor market conditions. Regarding the outlook for inflation, the most recent data were seen as consistent with an assessment that a portion of the higher rates of price increases recorded earlier in the year had reflected transitory factors.

Committee members generally agreed that higher energy prices had played an important role in the recent moderation of economic growth. While the direct effect of higher energy prices on real disposable income could account for only a relatively small part of the reduction in the growth of consumer spending, some members suggested that those effects may have been exacerbated by substantial increases in expected future energy costs as well as greater uncertainty about those costs. Moreover, the economy seemed to have responded in some past episodes to sharp increases in energy costs by much more than could be explained by most models. Still, some Committee members doubted that higher energy prices were sufficient to explain all of the recent slowdown in spending. Effects of increased energy prices on consumer and business confidence, which might have led to a larger spending response, had not been evident, and the consequences for growth in other industrialized countries dependent on imported oil appeared to have been fairly modest thus far. Informed in part by prices in futures markets, Committee members anticipated that energy costs would level out and perhaps fall back from their recent highs, but they noted that there was considerable uncertainty about that outlook.

Policymakers focused their comments about key sectors of the economy on the slowdown in consumer spending toward the end of the second quarter. Business contacts in some parts of the country suggested that, in addition to higher energy prices, unseasonable weather may have limited spending for a time. The Committee discussed a number of other factors that may have contributed to the slowdown, including a waning of the stimulus from last year's tax cuts, which had previously provided considerable impetus to spending, and the possibility that, with stock prices down, saving rates near historic lows, and the outlook more uncertain, households may have felt the need to boost saving. Although a complete accounting for the moderation in growth was not possible, the Committee agreed that a resumption of faster growth in consumer spending was very likely. Continued strength in home construction did not suggest that households were in the process of retrenching, and gains in income, low interest rates, and robust consumer confidence were seen as undergirding further gains in household spending going forward. Members noted that reports of rising motor vehicle sales in July and early August and a firming of chain store sales in recent weeks provided some limited evidence that consumption spending was picking up.

Investment spending had continued to advance, though perhaps at a somewhat slower pace than some members had anticipated. Several policymakers noted that businesses remained cautious about capital spending and hiring and were attempting to boost production as much as possible with existing capacity and payrolls. Indeed, some members suggested that heightened uncertainty, reflecting the effects of higher energy prices and increased concerns about geopolitical risks, might have contributed to greater business caution of late. Nonetheless, business confidence generally remained high, and the fundamentals for investment—including solid growth in productivity, robust profits and cash flow, and accommodative financial markets—pointed to continued healthy gains in business outlays. A few members also noted that the commercial real estate sector, which had been weak for some time, was showing signs of improvement.

In their remarks regarding the external sector of the economy, members noted that on average growth abroad had remained reasonably robust, which should support U.S. exports. However, the U.S. trade deficit was expected to remain large as imports increased in response to solid growth in the United States.

In their discussion of recent labor market trends, Committee members noted the slowing of job growth reported in June and July. Committee members pointed to several factors that that might have contributed to the recent weakness. Firms' focus on controlling costs and implementing further productivity improvements were doubtless continuing to play a role. Higher labor costs, particularly those related to health benefits, were also reportedly weighing on some firms' hiring decisions. However, policymakers noted that the monthly payrolls data might be providing an incomplete picture of expansion in economic activity because of near-term variation in the rate of growth of productivity. In addition, many members pointed to data from the survey of households, which showed both a rise in labor force participation and a decline in the unemployment rate in July, as well as to initial claims for unemployment compensation, which remained near recent lows. Moreover, survey data on labor market attitudes of both consumers and businesses had not signaled a significant deterioration in employment prospects. All things considered, the Committee expected the pace of employment gains to improve in coming months.

In their review of the outlook for prices, members noted that incoming data over the intermeeting period had shown a slowing in core inflation from the high levels posted earlier in the year, consistent with the Committee's view that a portion of the earlier increase had reflected transitory factors. Information from business contacts suggested that a number of firms had been able to pass on at least some of their higher energy and other costs to customers, but few signs of more widespread price increases were apparent. Some members expressed concern about developments in the transportation sector, where trucking costs were reportedly on the rise and bottlenecks in the railroad industry were triggering delivery delays. Looking forward, however, most members thought that rapid productivity growth and flat or declining energy prices would limit increases in the overall unit costs of businesses. Despite the higher rates of headline inflation earlier in the year, longer-term inflation expectations remained well contained and slack in resource markets was seen as persisting, leading the Committee to expect underlying inflation to be relatively low.

In the Committee's discussion of policy for the intermeeting period, all the members favored an increase in the target for the federal funds rate from 1¼ to 1½ percent. Although the pace of economic growth had moderated in the second quarter, the Committee believed that the softness would prove short-lived and that the economy was poised to resume a stronger rate of expansion going forward. Given the current quite low level of short-term rates, especially when judged against the recent level of inflation, members noted that significant cumulative policy tightening likely would be needed to foster conditions consistent with the Committee's objectives for price stability and sustainable economic growth. In this context, a relatively small tightening move at this meeting would help to limit the risk of a rise in inflation expectations and reduce the likelihood that policy might need to be adjusted more sharply in the future, thereby lowering the attendant risks to financial markets and the economy. The members thought that policy accommodation probably could be removed gradually—a view that had been reinforced by the slower pace of growth and more moderate rates of price increase that had become evident over the intermeeting period. However, members also recognized that the timing and pace of additional policy tightening would depend importantly on incoming economic data and the Committee's assessment of their implications for economic activity and inflation.

With regard to the Committee's announcement to be released after the meeting, members agreed that the description of recent economic circumstances should acknowledge the slowing in output and employment growth, as well as highlight the role of higher energy prices in those developments. They also agreed to retain the assessments adopted at the June meeting that the risks to the Committee's goals of sustainable economic growth and price stability were balanced over the next few quarters. While a more persistent slowing of household spending was possible, and more subdued inflation readings over the intermeeting period had eased concerns about a potential increase in underlying inflation, policymakers continued to judge the risks to sustainable growth and the inflation outlook as roughly balanced. The Committee chose to reiterate its belief that policy accommodation could be removed at a pace that is likely to be measured as well as its intention to respond to changes in economic prospects as needed to fulfill its obligation to achieve its goal of price stability.

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

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 1½ percent.

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

> The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters are roughly equal. With underlying inflation still expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 21, 2004.

The meeting adjourned at 1:00 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on September 21, 2004

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 21, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Messrs. McTeer, Moskow, Santomero, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Guynn and Lacker, and Ms. Yellen, Presidents of the Federal Reserve Banks of Atlanta, Richmond, and San Francisco respectively

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

Messrs. Connors, Fuhrer, Hakkio, Howard, Madigan, Slifman, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

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

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

Ms. Danker, Special Assistant to the Board, Division of Monetary Affairs, Board of Governors

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

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

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

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

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

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

Mr. Judd, Executive Vice President, Federal Reserve Bank of San Francisco

Messrs. Eisenbeis, Evans, and Goodfriend, Mses. Mester and Perelmuter, and Messrs. Rolnick and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Chicago, Richmond, Philadelphia, New York, Minneapolis, and Dallas respectively

Messrs. Bryan and Gavin, 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 August 10, 2004, 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 August 10, 2004, through September 20, 2004. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that economic growth regained some vigor in recent months after having slowed in late spring. The August labor market report showed a moderate gain in payrolls. After contracting in June, industrial production strengthened modestly on average in July and August, and the increases were widespread across sectors. Consumer spending rose sharply in July, housing activity increased further in August, and business outlays picked up last month. Core consumer price inflation moderated in June and July, and a decline in energy prices further damped overall inflation in July.

The labor market improved in August, and the unemployment rate edged down to 5.4 percent. Private nonfarm payrolls grew moderately, with gains registered in the manufacturing, construction, financial activities, and nonbusiness services categories. In addition, the figures for June and July were revised upward and suggested that the deceleration in hiring over that period was not as abrupt as had been previously thought. The average workweek was unchanged in August from the upward-revised July level and was a bit higher than its second-quarter average. The labor force participation rate edged down in August.

Total industrial production advanced modestly on average in July and August, down slightly from its second-quarter pace. The increases in manufacturing production since the end of the second quarter were widespread. Output of motor vehicles and parts jumped in August. Excluding motor vehicles and parts, the expansion in manufacturing output was brisk in July but more subdued in August. In the high-tech sector, computer production continued to rise in August, and the output of communications equipment posted its fourth consecutive monthly increase. In contrast, output at utilities declined further in July and August, while mining-related production was about flat on average over those same months. The rate of capacity utilization ticked up in July from its average over the first half of the year and remained steady in August.

Real consumer spending grew sharply in July after having slowed in the second quarter, and the available indicators suggest that spending held fairly steady in August. Expenditures on goods jumped in July and moderated in August, while spending on services moved up somewhat in July. Purchases of motor vehicles surged in July and fell back in August. For the two months together, the average pace of these outlays exceeded that seen in the first half of the year, reflecting in part a further sweetening of incentives. Real disposable income was up slightly in July, as increases in compensation were largely offset by declines in other income categories. The latest readings on consumer confidence showed a drop in August amid labor market slack and near-record gasoline prices, and a further slight decline in September, but the readings for the third quarter averaged above those for the second quarter.

Housing activity increased further in August. Housing starts for new single-family homes bounced up in July and remained about unchanged in August, and starts of multi-family homes rose somewhat each month. Taken together, total housing starts in August reached the highest level in five months. Home sales remained robust in July for both existing and new homes, although sales were below the monthly peaks recorded earlier in the year. Interest rates on thirty-year conventional mortgages receded over the past couple of months, retracing much of the runup in rates that occurred earlier in the year. Weekly data on mortgage applications to purchase homes continued to move up, on average, through mid-September.

Business outlays for equipment and software increased at a significant pace in the second quarter, and the available data pointed to a similar advance more recently. Spending was being supported by the continued gains in business output, low financing costs, ongoing price declines for high-tech capital, and the corporate sector's large cushion of liquid assets. Spending on transportation equipment and other capital goods was brisk in the second quarter, although expenditures in the high-tech sector decelerated. In July, shipments of capital goods excluding aircraft fell substantially from the rate seen in the first half of the year, but orders were relatively strong. Real business investment in nonresidential structures remained depressed, but the most recent data provided a sign of some improvement. In the office sector, the vacancy rate came in only a little below its recent peak, although property values had inched up, and the vacancy rate for industrial space also remained near its high. The retail sector, in contrast, continued to fare better.

Excluding motor vehicles, the pace of inventory accumulation in July continued at its second-quarter rate. A decline in stocks in the retail trade segment was more than offset by stockbuilding in the manufacturing and wholesale trade segments. Although the book value of manufacturing and trade inventories rose appreciably in July, these gains were again inflated by price increases in the petroleum sector. Inventory–sales ratios in the manufacturing sector, as in the retail and wholesale trade sectors (excluding motor vehicles and parts), remained about flat in July.

The U.S. international trade deficit reached a record high in June, bringing it to a new high in the second quarter as a percentage of nominal GDP. While the deficit fell back in July, it remained much above May's reading. In June, exports fell sharply, with declines widespread, while imports rose, owing in part to a surge in petroleum imports. In July, exports registered a modest recovery, driven by capital goods, industrial supplies, and automotive products, while the value of imports fell with the sharp decline in oil imports. Economic activity in the major foreign industrial countries continued to expand in the second quarter, although growth slowed in Japan and in the euro area. Indicators to date for the third quarter were mixed.

Core consumer prices edged up slightly over the months of June and July, as inflation in both goods and services moderated. The core PCE price index was flat in July but, like the core CPI, was up a bit on balance over June and July. The twelve-month change in core consumer prices based on either measure was somewhat higher this July than for the same period last year. Retail energy prices fell in July, led by a drop in gasoline prices after large gains in a number of earlier months. During the summer, gasoline inventories climbed above seasonal norms because of lower demand and increased imports, and the resulting downward pressure on margins led gasoline prices to fall even as crude oil prices moved higher. Owing to the decline in energy prices in July, inflation in overall consumer prices slowed that month. In August, households' expectations for consumer inflation in the year ahead edged lower for the second consecutive month. Meanwhile, after a small rise in July, the prices of finished goods faced by producers moved down a bit in August. Turning to labor costs, hourly compensation in the nonfarm business sector rose at a faster pace in the second quarter than it did in the first, but the advance was in line with the average rate of increase over the preceding four quarters. Unit labor costs measured at nonfinancial corporations also registered an increase in the second quarter.

At its meeting on August 10, 2004, the Federal Open Market Committee decided to increase the target federal funds rate by 25 basis points, to 1½ percent, and to retain its assessment of balanced risks with respect to sustainable economic growth and price stability. In its announcement, the Committee noted that output growth had moderated in recent months and that the pace of improvement in labor market conditions had slowed, but that the softness likely owed importantly to the substantial rise in energy prices. It also noted that while inflation was somewhat elevated this year, a portion of the pickup seemed to reflect transitory factors. The Committee went on to comment that the economy appeared poised to resume a stronger pace of expansion going forward, that it continued to believe that policy accommodation could be removed at a pace that was likely to be measured, and that it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Although the Committee's decision to raise the intended level of the federal funds rate by 25 basis points was widely anticipated in financial markets, the accompanying statement was read as setting a more optimistic tone about economic prospects than had been anticipated and prompted investors to mark up their expectations for the near-term path of policy. That sentiment was apparently reinforced over the remainder of the period by the comments of several Federal Reserve officials and the release of the August employment report, which seemed to convey the view that the economy was emerging from its "soft patch." As a result, policy rate expectations for the next two quarters ended the intermeeting period slightly firmer. Longer-term policy expectations, however, moved noticeably lower, reflecting the release of relatively benign readings on inflation and the Chairman's comments on the inflation outlook in testimony to the House Budget Committee. In line with these revised expectations for the path of policy, the term structure of interest rates flattened over the intermeeting period, as the two-year Treasury yield ended about unchanged and the ten-year Treasury yield dropped somewhat. While credit spreads on investment-grade corporate bonds narrowed a bit, spreads on speculative-grade issues fell significantly more, particularly in riskier segments of the market, probably reflecting greater confidence about prospects in the business sector. Further evidence of such confidence was visible in equity markets, where broad indexes advanced 5½ to 7½ percent. The exchange value of the dollar against other major currencies was about unchanged over the intermeeting period.

M2 balances were about flat on average over the previous two months: After contracting a bit in July, M2 expanded slightly in August. Money growth was damped by a rise in the opportunity cost of holding M2 assets (as typically occurs in periods of policy tightening). In addition, the lift to M2 from mortgage refinancings in evidence during the spring was likely still unwinding over the past couple of months, depressing the growth of liquid deposits. Business loans at banks expanded in August for the third consecutive month.

The staff forecast prepared for this meeting suggested that the economy would continue expanding at a solid pace through the end of 2006. Labor market improvements and accommodative monetary policy were seen as counterbalancing the drag from the swing in fiscal policy from considerable stimulus this year to modest restraint next year. Consumer spending was expected to pick up in conjunction with the strengthening labor market and associated gains in wages and salaries that would offset the effects of an anticipated rise in the savings rate from its recent low level. The contour of business spending was expected to be affected by the expiration of the partial-expensing tax provisions at year-end, which gave an incentive for businesses to invest more heavily this year. Supported by a favorable financing environment, ample stocks of liquid assets, and the ongoing need to replace aging or obsolete equipment and software, investment outlays were expected to grow robustly once the tax-related swings were completed. After the current period of below-average employment gains, employers were expected to hire at a relatively robust pace next year. At the same time, as labor market conditions improved, individuals who had withdrawn from the labor force were thought likely to return, so that job gains were expected to have a muted effect on the unemployment rate. Consumer price inflation was projected to remain at or below its current level. Slack in resource utilization, continued rapid growth in structural productivity, and the pass-through of declining energy prices were expected to contribute to the restraint on inflation.

In the Committee's discussion of current and prospective developments, the members agreed that the economy had strengthened somewhat after going through a "soft patch" in late spring and early summer. Recent data and anecdotal information suggested solid growth ahead, but at a pace that could well be less brisk than previously anticipated. Consumer spending appeared to have rebounded in the third quarter. Business investment also was robust, but executives, especially those at larger firms, seemed more cautious about the outlook than they had been several months ago. Although higher energy prices had played an important role in damping growth, questions remained about the reasons for the shortfall from expectations held this spring, and several policymakers remarked that their uncertainty about the likely pace of the expansion going forward had risen. Members commented that the benign incoming data on prices tended to confirm their previous judgment that the increase in inflation earlier in the year had importantly reflected temporary factors and that core inflation would probably remain relatively low.

In their discussion of developments in key sectors of the economy, policymakers agreed that business investment would most likely continue to provide considerable impetus to the overall economic expansion going forward. The anticipated further expansion of aggregate demand should boost investment. Also, low real interest rates, strong business balance sheets, and high levels of profits and cash flow were expected to support capital spending. However, the extent to which the federal tax provision permitting partial expensing of most investment expenditures had been boosting capital expenditures was difficult to discern, and it was possible that the expiration of that provision at year-end could result in a fairly sharp slowing in investment, at least for a time. In addition, recent discussions with business contacts, as well as a range of statistical information, suggested a persisting tendency for corporate executives to limit capital spending commitments. The reasons for this tendency were unclear, but a continuing focus on corporate governance issues might still be playing a role, and business concerns about terrorism and other geopolitical risks might have risen this year. Some members also noted that the pace of technological advance could be slowing a bit, trimming the rate of decline in the cost of capital for high-tech equipment and software. High vacancy rates for office buildings and industrial structures would likely continue to weigh on nonresidential investment, although activity in that sector was showing some signs of revival.

Committee members interpreted recent data and anecdotal information as indicating that growth in consumer spending was rebounding from its relatively slow rate of late spring. They saw household spending as most likely continuing to expand at a solid pace going forward. Gains in nominal income, partly resulting from gradual increases in employment, were expected to continue to support consumer spending and low interest rates to buoy residential investment. However, members perceived several possible sources of downside risk to household spending. In particular, households might hold back on spending in an attempt to increase their saving, which had fallen to a very low level relative to income. The ebbing of stimulus from last year's tax cuts also could tend to slow growth in consumer spending. And a failure of employment to accelerate as expected could undermine consumer confidence as well as hold down the growth in personal income.

With regard to the external sector, foreign economies were seen as generally expanding steadily, with the high level of crude oil prices apparently having restrained growth abroad somewhat less than in the United States. Still, expectations for foreign economic growth had been marked down somewhat, with adverse implications for U.S. exports and for overall U.S. growth. Indeed, some policymakers noted that domestic demand in several major U.S.

trading partners was relatively weak and that aggregate demand in those economies was being sustained importantly by exports to the United States. That pattern was contributing to a worrisome further widening of the U.S. trade and current account balances, and the Committee discussed the significance of wide external deficits and various adjustments that might occur in the process of their return to more sustainable levels.

Committee members generally viewed labor market conditions as having improved modestly of late. Although payroll growth had been weak in June and July, it registered a somewhat better performance in August, and initial claims for unemployment insurance continued to hover around relatively low levels. Some members noted a mismatch between demand and supply for certain types of labor. In particular, unskilled workers were said to be having considerable difficulty finding jobs, while firms were facing challenges in hiring workers with some specific skills, including truck drivers and heavy-equipment operators. Partly as a result, businesses in a few sectors, such as transportation and construction, reportedly were experiencing constraints on their output. Overall, however, some slack appeared to remain in labor markets. Looking forward, policymakers expected gradual improvement in labor market conditions as the economy expanded. However, anecdotal information suggested that many firms remained quite cautious about expanding payrolls, citing, among other factors, continued uncertainty about economic prospects and the high cost of providing health care benefits.

Partly reflecting the likely persistence of some economic slack, members expected inflation to stay low. Although non-energy commodity prices remained relatively high, energy prices had declined noticeably from record levels in recent weeks, and the effects of the energy price shock on inflation were expected to wane. In this regard, a number of policymakers commented that data on consumer and producer inflation had generally come in at or below expectations over the intermeeting period, tending to confirm the Committee's judgment that the upturn in inflation earlier in the year had owed importantly to temporary factors. Moreover, inflation expectations appeared to be well-contained, although those expectations probably were conditioned in part on investors' anticipation that the stance of monetary policy would likely be tightened over time.

In the Committee's discussion of policy for the intermeeting period, all of the members favored raising the target for the federal funds rate by 25 basis points to 1¾ percent at this meeting. The expansion evidently was resilient and self-sustaining and appeared no longer to require the unusual degree of monetary stimulus that had previously been necessary. A gradual increase in interest rates seemed likely to be consistent with continued solid economic growth that would be sufficient to erode remaining margins of slack in resource utilization over time. In view of these considerations, the Committee believed that another modest reduction in the degree of monetary policy accommodation at today's meeting was warranted. With today's action, the real federal funds rate—measured as the difference between the nominal funds rate and a moving average of core PCE inflation—would move slightly into positive territory.

With regard to the Committee's announcement to be released after the meeting, the members agreed that the statement should indicate that, after moderating earlier in the year, partly in response to the substantial rise in energy prices, output growth appeared to have regained some traction and that labor market conditions had improved modestly. In addition, policymakers concurred that the statement should indicate that inflation and inflation expectations had eased in recent months. They also agreed again to characterize the risks to sustainable growth and price stability as balanced. Members commented that recent evidence had boosted their confidence that moderate economic growth would continue and that inflation would be contained. With aggregate demand probably expanding at least as rapidly as the economy's potential to produce over the next several quarters, policymakers continued to see economic conditions as likely to warrant a further reduction in policy accommodation in coming quarters. However, in the view of many members, policy actions would need to be increasingly keyed to incoming data. Indeed, it was noted that market participants now appeared to anticipate some slowing in the pace of policy firming before long and did not interpret the removal of policy accommodation at a measured rate as necessarily involving the same policy action at each meeting.

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

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

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

> The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal. With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

> Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

The Committee noted that Deputy Secretary Normand R.V. Bernard had announced his intention to retire in the period before the next FOMC meeting, following more than four decades at the Federal Reserve. The Committee thanked Mr. Bernard for his dedication, integrity, and steadfast support through the more than 345 FOMC meetings he attended during his career.

It was agreed that the next meeting of the Committee would be held on Wednesday, November 10, 2004.

The meeting adjourned at 1:15 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on November 10, 2004

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 10, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Messrs. Moskow, Santomero, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Guynn, Lacker, and Ms. Yellen, Presidents of the Federal Reserve Banks of Atlanta, Richmond, and San Francisco respectively

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

Messrs. Connors, Fuhrer, Hakkio, Howard, Madigan, Slifman, Sniderman, Rasche, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

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

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

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

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

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

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

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

Ms. Holcomb and Mr. Rasdall, First Vice Presidents, Federal Reserve Banks of Dallas and Kansas City respectively

Messrs. Eisenbeis, Estrella, Evans, and Goodfriend, Ms. Mester, Messrs. Rosenblum and Williams, Senior Vice Presidents, Federal Reserve Banks of Atlanta, New York, Chicago, Richmond, Philadelphia, Dallas, and San Francisco respectively

Mr. Hilton, 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 21, 2004, were approved.

By unanimous vote, the Federal Open Market Committee approved the selection of Deborah J. Danker as Deputy Secretary of the Committee to serve until the selection of a successor at the first regularly scheduled meeting after December 31, 2004.

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 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 September 21, 2004, through November 9, 2004. By unanimous vote, the Committee ratified these transactions.

The Manager also discussed the pressures on the federal funds rate prior to, and volatility in the rate that has ensued at times after, recent FOMC meetings as depository institutions sought to satisfy a larger portion of their reserve requirements before anticipated increases in the FOMC's target funds rate. The Committee agreed that the Desk would continue to conduct open market operations as it has in such situations—leaning against anticipatory pressures in the funds market while taking account of the reserve management implications of such operations for the remainder of the reserve maintenance period.

The information received at this meeting suggested that the economy expanded at a moderate pace over the third quarter. Low interest rates helped to maintain a buoyant housing market and spending by both consumers and businesses was firm. Available information suggested that the recent tempo of economic activity continued into the current quarter despite the restraint imparted on real incomes and consumer confidence from higher oil prices. However, industrial production was flat in recent months, and hiring activity was lackluster through September before advancing sharply in October. Inflation measures continued at low levels through September.

Employment gains were subdued in the third quarter, but showed substantial strength in October. Job growth last month was fairly widespread, although heavy hiring in the construction sector was due partly to efforts to repair damage from the four hurricanes that hit the southeastern states. Employment increases were particularly large in the financial and services sectors. However, a small decline was registered in employment in the manufacturing sector. The average workweek held steady in October at its third-quarter level and was a bit above the average for the second quarter. Despite the strong increase in payroll employment, the household survey indicated a slight increase in the unemployment rate to 5.5 percent in October.

Industrial production was about unchanged in September, likely restrained by the hurricanes that month. A decline in manufacturing was about offset by a jump in utilities output and expansion in high-tech industries. The available data suggested that industrial production rebounded in October. Capacity utilization was unchanged in September at about the third-quarter average but was up from its level earlier in the year.

Consumer spending advanced strongly in the third quarter from the sluggish pace of the second quarter. The acceleration reflected a surge in expenditures on motor vehicles that owed partly to attractive incentives, but spending on other durables and nondurables was also up. Spending on services was steady for the third quarter on average, but advanced in September on a boost to electricity consumption related to unseasonably warm weather. Real disposable income slowed in the third quarter to a moderate pace and was flat in September, probably in part because of effects of the hurricanes. Measures of consumer confidence moved down in September and again in October. Activity in housing markets remained generally strong in September, supported by favorable mortgage rates. Although starts of single-family homes slowed to well below the level of preceding months, multifamily starts rose and sales of both existing and new homes were elevated.

Business investment spending on equipment and software continued to expand at a rapid pace in the third quarter, supported by positive fundamentals that included robust business output, low interest rates and readily available credit, and healthy business balance sheets. Outlays for high-tech equipment and software stepped down in the third quarter, but spending on other types of equipment, including transportation, was at a high level. At the same time, investment in nonresidential structures, which had turned up in the second quarter, softened in the third quarter. Construction spending for retail buildings and warehouses advanced, but high vacancy rates for office buildings held back investment in that sector.

Accumulation of nonfarm inventories excluding motor vehicles picked up smartly over the third quarter. The level of sales also rose, however, keeping inventory–sales ratios fairly steady at low levels.

The U.S. international trade deficit rose in the third quarter on average, reflecting some weakening in the growth of service exports and an increase in the price and quantity of petroleum imports. The deficit narrowed in September, however, as imports fell while exports expanded moderately. The lower level of imports in September mainly reflected declines in the petroleum and services categories. Economic expansion abroad on average appeared to slow in the third quarter, although it remained solid.

Consumer prices continued to advance at a moderate rate in recent months, although both overall and core consumer price measures rose a bit faster in the twelve months ending in September 2004 than in the year-earlier period. Expectations of near-term inflation picked up in October, consistent with the increase in energy prices. Labor costs continued to rise moderately. The increase in the employment cost index for private compensation over the third quarter was a bit below the average pace of the last two years.

At its meeting of September 21, 2004, the Federal Open Market Committee adopted a directive that called for conditions in reserves markets consistent with increasing the federal funds rate to an average of around 1¾ percent. In its public statement, the Committee expressed a belief that monetary policy remained accommodative even after this tightening, and judged the upside and downside risks to the attainment of both sustainable growth and price stability over the next few quarters to be roughly equal. The Committee noted its expectation that the underlying rate of inflation would continue to be low and that policy accommodation could be removed at a pace that is likely to be measured, but also stated that it would nonetheless respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

The FOMC's decision in September to raise the intended level of the federal funds rate 25 basis points and its attendant public statement were anticipated by the market, and the reaction was muted. Over subsequent weeks, however, a reference in the minutes of the August FOMC meeting to the need for "significant cumulative tightening" and comments by the Chairman and other FOMC members, which were read as minimizing the likely damping effect on the economy of higher energy prices, led markets to raise their expectations of forthcoming policy tightenings. These expectations were boosted further by the release of the strong employment data for October. The shift in the market's outlook for monetary policy contributed to noticeable upward pressure on short-term interest rates, and most long-term rates also moved up. Yields on investment-grade corporate bonds rose about in line with those on comparable-maturity Treasuries, but yields on speculative-grade bonds edged down and equity markets posted strong advances. In foreign exchange markets, the dollar declined appreciably, apparently in part on continuing market concerns about the financing of the U.S. current account deficit.

M2 expanded in October at about the sluggish pace of the third quarter. The growth of M2 was restrained in recent months by increases in its opportunity cost. Rates paid on its liquid asset components have lagged increases in market rates associated with the three monetary tightenings since midyear.

In the staff forecast prepared for this meeting, the economy was seen as likely to expand next year at around this year's solid pace under an assumption of generally accommodative financial conditions. Recent declines in the dollar were expected to support domestic economic activity by boosting net exports. Fiscal policy was expected to become much less stimulative after the current quarter, owing to the expiration of the temporary partial-expensing provisions of the tax code. Oil prices were anticipated to decline somewhat with the repair of hurricane-related damage to oil infrastructure in the Gulf of Mexico, leading to some slowing in inflation. With the economy expected to advance over the coming year at a rate a bit above its longer-run potential, the pace of hiring should firm and the unemployment rate should edge lower. In response to rising real incomes, consumer spending was forecast to strengthen after the early part of next year. The staff expected business investment spending to slow sharply early next year as partial-expensing provisions expired, but then to pick up noticeably in response to favorable financing conditions, ample business liquidity, and the need to replace or upgrade aging equipment and software.

In the Committee's discussion of current and prospective developments, the members generally expressed assessments that economic expansion in the neighborhood of the rate of growth of the economy's potential appeared to have become even more firmly established over recent months, despite the drag from higher energy prices. Recent data and anecdotal information suggested that spending by businesses and households had been reasonably robust of late, supported by accommodative financial conditions, continuing gains in productivity, and increasing employment. Looking forward, economic fundamentals appeared to be favorable for continued solid growth, and while fiscal stimulus would abate next year, a flattening out of energy prices, as markets seemed to anticipate, would bolster economic expansion. However, significant uncertainties surrounded the prospects for energy prices and fiscal policy, as well as the external sector. The Committee anticipated that underlying inflation pressures would remain contained as monetary accommodation was withdrawn. Core consumer price inflation had been quite damped on average in recent months and longer-term inflation expectations remained well anchored, despite further increases in energy prices and prospective increases in near-term headline inflation.

In their discussion of key sectors of the economy, policymakers noted that business investment had been expanding robustly and was likely to continue to be buoyed by the strength of productivity and profits. Some sectors, such as trucks and heavy equipment, had experienced rapid growth. However, even after taking account of likely effects of higher oil prices, the pace of overall business investment spending was still boosting GDP growth somewhat less than might have been expected given accommodative financial conditions and tax incentives. Some uncertainties, such as those associated with the election, had been resolved, but others persisted, including the prospects for oil prices and their consequences for the economy. Many business firms seemed hesitant about large-scale investment to increase productive capacity and hiring commitments, perhaps partly reflecting an environment of greater scrutiny regarding corporate governance and internal control systems. The high-tech sector, and investment in information technology more generally, had been growing less rapidly of late and was seen as posing a possible downside risk to the outlook. If the recent slower rate of price declines on high-tech products implied a softer underlying pace of technological change, both the outlook for investment demand and the prospects for persisting high trend growth in productivity could be damped relative to previous expectations.

While acknowledging data indicating a rebound in consumption spending in recent months, Committee members reported contacts with retail merchants that suggested mixed readings on the ongoing pace of consumer buying. The effect of higher energy prices on real incomes was likely still restraining consumer spending. Moreover, the stock of automobiles owned by households had risen substantially in recent years, and the willingness of households to purchase autos was seen as continuing to depend importantly on the provision of incentives by manufacturers. Home buying and residential construction generally remained robust, although a few members pointed to some moderation in activity in selected markets. It was noted that a slowdown in the rate of increase in home prices going forward might lead households to increase their desired saving. However, the risk of any significant drop-off in the growth of consumer spending would likely diminish with a sustained rebound in the pace of hiring.

In their comments on fiscal policy, Committee members indicated an expectation that the economic stimulus provided in recent years by discretionary fiscal measures was likely to fade next year. However, considerable uncertainty surrounded the likely evolution of the federal budget. Members stressed the importance of fiscal discipline to facilitate a better balance between net national saving and investment and thereby promote an adjustment of the imbalance in the current account of the balance of payments.

Committee members noted that the balance of trade had improved a little in September and commented that the decline in the value of the dollar over the past few years had been boosting demand seen by some exporting firms. However, with foreign economic growth moderating and the large excess of imports over exports, members generally viewed the prospects for net exports as likely to provide a continuing drag on U.S. economic expansion. One implication of this outlook was that U.S. external indebtedness relative to GDP would be increasing further.

Committee members remarked on signs of improvement in labor market conditions. While acknowledging the need to be cautious about readings from a single labor market report, members saw the increase in payroll employment in October and the upward revisions to previous months as encouraging. Furthermore, business contacts in several regions were indicating greater difficulty in filling some types of positions, both skilled and unskilled. Nevertheless, many firms evidently remained slow to expand hiring, in part because of rising benefit costs. One member commented on the performance of a few key industries, citing evidence that the job losses since the business cycle peak had been driven primarily by weak demand rather than productivity improvements. Although the extent of economic slack was uncertain, some members indicated a sense that the economy needed to grow faster than trend in order to take up remaining unused resources.

Wage and price pressures were generally still modest. While some firms reportedly were finding it easier to pass higher oil and other commodity costs on to their business customers, most business contacts indicated considerable difficulty in passing cost increases on to consumers. Longer-term inflation expectations had remained reasonably low, helping to restrain the spillover of elevated energy prices to the prices of other goods and services. Some members noted that any remaining resource slack would probably exert downward pressure on inflation and that the depreciation of the dollar seemed to be having a muted effect on import prices to date. However, upside risks to the inflation outlook included possible further depreciation of the dollar or increases in energy prices. In addition, a few members cited the possibility that the elevated pace of trend productivity growth experienced since the mid-1990s would begin to slow.

In the Committee's discussion of the setting of policy, all of the members favored raising the target for the federal funds rate by 25 basis points to 2 percent at this meeting. The economy appeared to be continuing to expand at a moderate pace that was likely to be rapid enough to gradually reduce margins of underutilized resources. In that regard, the Committee was encouraged by more evident signs of improvement in hiring. The Committee felt that the outlook justified the further removal of the policy accommodation that had been appropriate when the economic expansion was more tentative. Today's action would move the real funds rate, measured using core PCE inflation, toward a more positive setting.

In discussing the FOMC announcement for this meeting and going forward, several members commented that policy actions would likely become increasingly dependent on incoming data and their implications for future activity and prices. This might imply a more gradual path of tightening going forward than that of the last several months, as for example now seemed to be built into the term structure of interest rates, or it might mean that the Committee on occasion would need to firm policy more rapidly. A few members felt that, because of greater uncertainties, it might become appropriate eventually to move away from the recent practice of providing guidance about the likely future path of policy, while others emphasized the desirability of continuing to be as informative as possible about the Committee's perceived outlook. For now, most members agreed that the current statement language provided considerable flexibility with regard to the Committee's future actions and that market participants understood that flexibility. As regards the announcement to be released after the meeting, most members felt that little change in the statement language was required. Policymakers concurred that the statement should indicate that output appears to be growing at a moderate pace despite the rise in energy prices, that labor market conditions have improved, and that inflation and longer-term inflation expectations remain well contained. They agreed to characterize the risks to sustainable growth and price stability as balanced and to reiterate that policy accommodation could be removed at a pace that was likely to be measured but that the Committee will respond to changes in economic prospects as needed to maintain price stability.

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

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 2 percent.

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

> The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal. With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 14, 2004.

The meeting adjourned at 1:15 p.m.

Notation Vote

By notation vote completed on December 10, 2004, the Committee authorized Mr. Santomero, an alternate member of the Committee, to accept the honor of the title of "Cavaliere" to be awarded by the government of Italy.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

Vincent R. Reinhart
Secretary

Meeting Held on December 14, 2004

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 14, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Messrs. Moskow, Santomero, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Guynn, Lacker, and Ms. Yellen, Presidents of the Federal Reserve Banks of Atlanta, Richmond, and San Francisco, respectively

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

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

Messrs. Connors, Fuhrer, Hakkio, Howard, Madigan, Slifman, Sniderman, Rasche, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

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

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

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

Messrs. Brayton and Carpenter, Senior Economists, Divisions of Research and Statistics and Monetary Affairs, respectively, Board of Governors

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

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

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

Ms. Cumming, First Vice President, Federal Reserve Bank of New York

Messrs. Eisenbeis and Goodfriend, Ms. Mester, Messrs. Rosenblum and Williams, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Richmond, Philadelphia, Dallas and San Francisco, respectively

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

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 November 10, 2004, 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 November 10, 2004, through December 13, 2004. By unanimous vote, the Committee ratified these transactions.

The information received at this meeting suggested that the economy expanded at a moderate pace over the third quarter and into the current quarter. Consumer spending was solid, and investment spending remained strong. Manufacturing production increased at a modest pace, and employment gains in October and November indicated that the labor market continued to improve gradually. Core inflation measures remained subdued, albeit running at a slightly higher pace than last year, owing, in part, to the indirect effects of higher energy prices.

Gains in employment were moderate in November after a surge in October. Job growth was fairly widespread, with the exception of slightly weak seasonal hiring in the retail sector. Construction employment grew rapidly in November even after the outsized gains in October due to hurricane-related repair work. In contrast, employment in manufacturing edged lower. The average workweek in November was a touch below its level in October, but still a bit above the third-quarter average. The unemployment rate ticked down to 5.4 percent in November.

Industrial production expanded a little more slowly in November than it had in recent months. Output at mines increased noticeably for a second month, and manufacturing output posted a moderate gain. At utilities, output fell back in November after large increases in the preceding two months. Utilization rates moved higher in November.

Consumer spending appeared to be expanding at a more moderate pace in the fourth quarter, after growing at a robust rate in the third quarter. Although sales of motor vehicles declined in November, spending on other goods rose further after the large increase posted in October. Spending on services continued to register solid gains. Real disposable income, restrained by sharply higher energy prices, rose slightly. Even so, measures of consumer confidence were little changed and remained consistent with sustained increases in spending.

Activity in housing markets, buoyed by mortgage rates only modestly above their recent lows, remained strong in October. Starts of both single-family and multifamily homes increased and were above their third-quarter levels. Home sales remained at near-record levels.

Shipments of nondefense capital goods stepped up in October against the backdrop of solid expansion in business output, low user cost of capital, and an ample stock of liquid assets in the corporate sector. Shipments of computers jumped in October, while gains in the transportation sector were more modest. Outside the high-tech and transportation sectors, shipments moved up considerably in October from their robust third-quarter pace. Outlays on nonresidential construction edged down in October.

After a rapid rise in the third quarter, nonfarm inventories appeared to accumulate at a moderate pace in October. The book value of manufacturers' inventories increased notably; however, shipments also stepped up, an increase that left the inventory-shipments ratio in this sector unchanged.

The U.S. international trade deficit widened in October, primarily because of a surge in merchandise imports. Economic activity in most of the major foreign industrial countries slowed in the third quarter, and data for the fourth quarter pointed to continued subpar growth.

Consumer prices jumped in October, as hurricane damage contributed to higher prices for food and energy. For the twelve months ending in October, consumer prices rose considerably faster than they did in the year-earlier period. Core consumer prices increased much more modestly in October than did overall consumer prices, although the twelve-month change for core prices was also somewhat higher than it was a year before. The employment cost index for private compensation advanced moderately in the year ending the third quarter, and the markup of prices over labor costs remained somewhat elevated.

At its meeting on November 10, 2004, the Federal Open Market Committee (FOMC) adopted a directive that called for conditions in reserves markets consistent with increasing the federal funds rate to an average of around 2 percent. In its public statement, the Committee expressed a belief that monetary policy remained accommodative even after this tightening and judged that the upside and downside risks to the attainment of both sustainable growth and price stability over the next few quarters were roughly equal. The Committee noted its expectation that the underlying rate of inflation would continue to be low and that policy accommodation could be removed at a pace that is likely to be measured, but it also stated that it would nonetheless respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

The FOMC's decision in November to raise the intended federal funds rate 25 basis points and its attendant public statement were apparently anticipated by the market, so that the reaction was muted. Subsequently, higher-than-expected inflation data, remarks by the Chairman that were viewed as pointing to future rate increases, and the depreciation of the dollar all led market participants to price in a somewhat steeper path for future policy. The upward revision in policy expectations prompted modest increases in shorter-term Treasury coupon security yields. The yield on the ten-year Treasury note, however, was unchanged on net. Yields on both investment-grade and speculative-grade corporate bonds edged lower. The value of the dollar relative to other major currencies declined.

M2 accelerated a bit in November from its sluggish pace in October, but growth in money continued to be restrained by increases in its opportunity cost. Rates paid on the liquid components of M2 lagged increases in market rates associated with the monetary policy tightenings this year. Bank credit rebounded in November, with both securities and loans registering gains.

In the staff forecast prepared for this meeting, the economy was seen as likely to expand at a moderate pace, supported by accommodative monetary policy and financial conditions. Consistent with readings from futures markets, oil prices were anticipated to edge lower. With economic activity projected to expand at a pace a little above that of its longer-run potential over the coming year, hiring was projected to continue to firm, causing the unemployment rate to edge down next year. The steep run-up in housing prices, recent increases in equity prices, and anticipated gains in payrolls were viewed as likely to boost the growth of consumption spending next year to a pace somewhat above that recorded this year. Business investment was anticipated to decline a bit early next year in light of the expiration of the partial-expensing tax provision at the end of 2004 but was projected to resume vigorous growth in response to a favorable economic outlook, supportive financial conditions, ample liquid assets in the corporate sector, and an ongoing need to replace or upgrade aging equipment and software. Measures of total consumer price inflation were expected to decline from current levels reflecting the direct effect of the downturn in energy prices. By contrast, core inflation was seen in the staff forecast as remaining stable. The upward pressure on inflation from a slight step-down in structural productivity growth and a narrowing margin of resource slack was expected to be about counterbalanced by diminishing pressure from the pass-through of the earlier rise in energy prices and decline in the dollar.

In their discussion of the economic outlook, the participants at the meeting (the members of the Board of Governors and the Reserve Bank Presidents or those acting in their place) generally regarded incoming data since the prior meeting as consistent with an expectation that the economy would continue to expand at a pace that would likely prove sufficient to reduce margins of underutilized resources further. Recent data and anecdotal information indicated that the economic expansion was firmly established and had proven quite resilient in the face of rising oil prices and the reduction in policy accommodation. Although the November employment report had been disappointing, when viewed over several months, labor market conditions were generally seen as gradually improving. That improvement was expected to persist and, along with higher wealth and relatively low interest rates, would support further gains in spending by households. Rising demand, elevated underlying productivity growth, and accommodative financial conditions should keep business spending on a strong uptrend. With some economic slack persisting and longer-term inflation expectations well-anchored, inflation was anticipated to remain subdued. A number of participants cited the recent depreciation of the dollar on foreign exchange markets, elevated energy costs, and the possibility of a slowing in underlying productivity growth as factors tending to boost the upside risks to their inflation outlook, though, on net, they saw the risks to stable underlying inflation as still balanced.

In their discussion of important sectors of the economy, participants noted that increasing equity and home prices had boosted household net worth, leaving consumers well positioned to maintain a brisk pace of spending. Continued gains in employment were thought likely to provide additional support to spending by bolstering consumer confidence and income. Participants commented that real disposable incomes should receive a further lift from the recent drop in oil prices. Moreover, intermediate- and long-term interest rates remained low in both nominal and real terms despite the recent firming in the stance of policy, encouraging spending on consumer durables and housing.

Many of the fundamentals underlying the demand for capital goods—expanding output, a low cost of capital, strong profits, and ample liquid assets—appeared quite favorable, and participants generally were upbeat in their assessment of the prospects for investment. While some participants noted that their business contacts seemed more confident about the future and that the sense of caution previously evident in business spending and hiring behavior seemed to be waning, others believed that many businesses remained quite wary. Most participants acknowledged some significant uncertainties in their outlook, including the effects of the expiration of the partial-expensing provision for investment at the end of 2004 and recent indications of a softening in high-tech spending in the United States and elsewhere. The possible downshift in the pace of high-tech spending also raised the possibility of an erosion of profit margins that could result from a slackening in the pace of technology-led productivity growth and the associated increase in cost pressures.

A number of participants voiced concerns about domestic and global financial imbalances. On the domestic front, such concerns focused on the magnitude of current and projected fiscal deficits, which seemed likely to keep national saving low. Views about the prospects for fiscal restraint in the years ahead were mixed; some participants believed that the odds of significant deficit reduction over the next few years were remote while others were more optimistic. Regarding global imbalances and the current account deficit in the United States, a number of participants expressed doubts that such imbalances would be reduced in the near-term. Better global balance would require not only greater national saving in the United States but also a notable strengthening in domestic demand among major trading partners. Such a strengthening seemed unlikely in the near term given the recent softening in the economies of several important industrial countries.

In their discussion of financial market conditions, participants noted that investors anticipated further increases in the federal funds rate over the coming year, but intermediate- and long-term interest rates along with financial conditions more generally had remained quite supportive of growth. A few participants commented that the generally low level of interest rates across a wide range of maturities and the recent flattening of the slope of the yield curve (measured as the spread between ten- and two-year Treasury yields) might signal that expectations of longer-term growth had been marked down. Some participants believed that the prolonged period of policy accommodation had generated a significant degree of liquidity that might be contributing to signs of potentially excessive risk-taking in financial markets evidenced by quite narrow credit spreads, a pickup in initial public offerings, an upturn in mergers and acquisition activity, and anecdotal reports that speculative demands were becoming apparent in the markets for single-family homes and condominiums.

Although the November employment report had been disappointing and recent readings on initial claims for unemployment insurance had risen, participants viewed labor market conditions still as improving gradually. Averaging over recent months, or even the entire year, employment growth had been fast enough to absorb unutilized labor resources over time. Anecdotal information suggested a significant tightening in the market for skilled workers in some industries and regions, although demand for less skilled workers still appeared soft. Recent surveys of hiring plans by businesses were read as signaling future gains in employment. Despite the further improvement in labor markets, a number of participants noted that wage and compensation increases had not picked up materially and generally remained moderate.

In their discussion of the outlook for prices, a number of participants cited developments that could pose upside inflation risks. Although oil prices had fallen of late, they were still considerably higher than they had been in the spring, and the recent decline in the dollar would raise import prices and diminish competitive pressures on many industries. The pass-through from both sources should be limited, but they were still a potential source of upward pressure on prices that could get embedded in higher inflation under certain circumstances. In addition, productivity growth had slowed appreciably in the most recent quarter and unit labor costs had increased, raising questions about cost pressures going forward. A few participants also noted that uncertainty about the extent of resource slack in the economy was considerable and that it was quite possible that the economy could soon be operating close to potential, particularly if labor force participation rates did not turn up much while employment continued to register gains. The increase over the last few months in five-year measures of inflation compensation derived from Treasury nominal and inflation-indexed securities might be a warning sign that expectations were not as well anchored as they had been over the summer.

Despite these concerns, participants generally expected that inflation would remain low in the foreseeable future. While the depreciation of the dollar over recent months had been notable, some participants found persuasive the evidence from recent studies pointing to a decline over time and across countries in the pass-through of exchange rate movements into domestic prices. Forward market-based measures of inflation compensation beyond the next five years as well as survey measures of both short- and long-term inflation expectations had been quite stable of late, despite the previous rise in energy prices and the lower dollar. Moreover, several participants cited factors that likely would continue to provide a counterweight to any upside risks. Although participants generally acknowledged that the degree of economic slack was quite uncertain, the moderate pace of wage and compensation growth in recent months in the face of higher energy prices and several years of rapid productivity growth was consistent with an economy still operating somewhat below its potential. In a similar vein, the recent quarterly dip in productivity growth notwithstanding, there were no clear signs that underlying productivity had slowed appreciably of late, and a close reading of recent history suggested that upside risks to the outlook for productivity growth could be significant. Even if structural productivity growth were to slow, price markups remained quite elevated and some participants noted that further increases in unit labor costs could well be absorbed for some time by a return of markups to more normal levels.

In the Committee's discussion of policy for the intermeeting period, all of the members (the members of the Board of Governors and the five voting Reserve Bank Presidents) favored raising the target for the federal funds rate by 25 basis points to 2¼ percent at this meeting. All members judged that a further quarter-point tightening in the target federal funds rate at this meeting was appropriate in light of the prospects for solid growth and diminished slack. Even with this action, the current level of the real funds rate target remained below the level it most likely would need to reach to keep inflation stable and output at its potential. With the economic expansion more firmly entrenched, cost and price pressures were likely to become a clearer intermediate-term risk to sustained good economic performance absent further reduction of accommodation.

With regard to the Committee's announcement to be released after the meeting, members generally agreed that overall economic prospects were similar to those prevailing at the time of the November meeting and that consequently the statement should be altered only to the minor extent required to reflect recent economic developments. They concurred that the statement should note that output appears to be growing at a moderate pace despite the earlier rise in energy prices, that labor market conditions continue to improve gradually, and that inflation and longer-term inflation expectations remain well-contained. They also agreed again to characterize the risks to sustainable growth and price stability as balanced. A few members believed that the Committee's flexibility would be enhanced by eliminating the forward-looking elements of the Committee's statement referring to the pace of removal of policy accommodation. More of the members believed that this language was useful in conveying the Committee's sense of the outlook for the economy and the stance of monetary policy and was appropriately conditioned on economic developments. All members agreed that the FOMC statement for this meeting should again indicate that policy accommodation could be removed at a pace that was likely to be measured but that the Committee would respond to changes in economic prospects as needed to maintain price stability.

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

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 2¼ percent.

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

> The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal. With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

The meeting then turned to consideration of releasing FOMC minutes on an accelerated schedule. Meeting participants agreed that an experiment with accelerating the preparation of the minutes that had been conducted since early in the year had been successful in identifying the procedural changes that would be necessary if an accelerated schedule were to be followed going forward. Participants noted that the minutes contained a more complete and nuanced explanation of the reasons for the Committee's decisions and view of the risks to the outlook than was possible in the post-meeting announcement, and their earlier release would help markets interpret economic developments and predict the course of interest rates. They also would provide the public a more up-to-date context for individual policymakers' public remarks. Meeting participants supported the principle of openness and transparency, but debated the possibility that the markets would misinterpret the minutes and that the prospect of early release would lead to either less productive discussions at the meetings or to less comprehensive, and therefore less useful, minutes. A few participants expressed support for trimming the length and forward-looking elements of the post-meeting announcements, should the Committee decide to accelerate release of the minutes. Others, however, preferred not to link the two decisions or viewed the more extensive announcements as useful regardless of the minutes' publication schedule.

The clear consensus of the participants at the meeting was to release the minutes on an expedited schedule, and the Committee voted unanimously to begin publishing the minutes of regularly scheduled meetings three weeks after the day of the policy decision. The minutes of any other Committee meetings, such as conference calls, would be handled somewhat differently. In those cases, if a policy action were taken, an announcement of that action would be made as soon as practicably possible. If, however, no action were taken, the fact that the conference call took place would be reflected in the statement following the subsequent regular meeting, and, in any case, the minutes of the call would be released along with the minutes of the subsequent regular meeting.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, February 1–2, 2005.

The meeting adjourned at 1:25 p.m.

Vincent R. Reinhart
Secretary

Litigation

During 2004, the Board of Governors was a party in eight lawsuits or appeals filed that year and was a party in nine other cases pending from previous years, for a total of seventeen cases; in 2003, the Board had been a party in a total of twelve cases. Two of the lawsuits or appeals filed in 2004 raised questions under the Bank Holding Company Act. As of December 31, 2004, nine cases were pending.

Judicial Review of Board Orders under the Bank Holding Company Act

Haili et al. v. Greenspan et al., No. 04-00089 DAE-LEK (D. Hawaii, filed February 6, 2004), was an action seeking an order requiring the Board to enforce an alleged commitment made under the Community Reinvestment Act. The action also sought a declaratory judgment and an injunction preventing the approval of an application under the Bank Holding Company Act until the asserted commitment was fulfilled. On February 23, 2004, the district court granted the Board's motion to dismiss the action.

CB Bancshares, Inc. v. Board of Governors, No. 04-70229 (9th Circuit, filed January 14, 2004), was a petition for review of the Board order granting Central Pacific Financial Corp. of Honolulu, Hawaii, approval to acquire CB Bancshares, Inc., also of Honolulu. On June 3, 2004, the court dismissed the action on the motion of the petitioner.

Litigation under the Financial Institutions Supervisory Act

Board of Governors v. Thomas, et al., No. 1:04-CV-0777 (N.D. Georgia, filed March 19, 2004), is an injunctive action brought to compel eighteen individuals named in a separate Board administrative enforcement proceeding to deposit sufficient funds into the registry of the court to satisfy civil money penalties sought by the Board in the administrative action. On April 2, 2004, the court issued a temporary restraining order granting the relief sought by the Board, and on April 28, 2004, the court issued a preliminary injunction extending this relief until completion of the Board's enforcement proceeding.

Ulrich v. Board of Governors, No. 03-73854 (9th Circuit, filed October 24, 2003), and *Diehl McCarthy v. Board of Governors*, No. 03-73997 (9th Circuit, filed October 28, 2003), are petitions for review of orders of prohibition issued by the Board on October 15, 2003. On December 12, 2003, the court consolidated these cases with related petitions for review of orders issued by the Office of the Comptroller of the Currency imposing civil money penalties and restitution against the petitioners.

Other Actions

Inner City Press/Community on the Move v. Board of Governors, No. 04-CV-8337 (S.D. New York, filed October 21, 2004), is a case brought under the Freedom of Information Act.

Texas State Bank v. United States, No. 04-5126 (Federal Circuit, filed July 28, 2004), is an appeal of a decision of the United States Court of Federal Claims dismissing an action (*Community Bank & Trust v. United States*, No. 01-571C, 60 Fed. Cl. 815 (2004)) challenging on constitutional grounds the failure to pay interest on reserve accounts held at Federal Reserve Banks.

Sciba v. Board of Governors, No. 04-CV-1011 (D. District of Columbia, filed June 21, 2004), is a case brought under the Freedom of Information Act.

Price v. Greenspan, No. 04-CV-0973 (D. District of Columbia, filed June 14, 2004), is an employment discrimination action.

Thomas v. Board of Governors, No. 04-CV-1554 (N.D. Georgia, removed from Superior Court of Gwinnett County, Georgia, on May 28, 2004), was an action against the Board, its enforcement staff, and others by individuals involved in a pending enforcement action. On October 4, 2004, the court granted the Board's motion to dismiss the action.

Skanska USA Building, Inc. v. Board of Governors, No. 304CV00675 SRU (D. Connecticut, filed April 22, 2004), was a Freedom of Information Act case. The case was dismissed by stipulation of the parties on November 29, 2004.

Laigo v. Board of Governors, No. 03-CV-03576-MJP (W.D. Washington, filed November 19, 2003), was a claim regarding redemption of U.S. savings bonds. On June 9, 2004, the court granted the Board's motion to dismiss the action.

Apffel v. Board of Governors, No. 03-343 (S.D. Texas, filed May 20, 2003), was a case brought under the Freedom of Information Act. On January 9, 2004, the court granted the Board's motion to dismiss the case.

Carter v. Greenspan, No. 03-1026 (D. District of Columbia, filed May 9, 2003), was an employment discrimination action. On February 19, 2004, the court granted the Board's motion to dismiss the case.

Albrecht v. Board of Governors, No. 02-5235 (D.C. Circuit, filed October 18, 2002), was 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. The district court's dismissal was affirmed by the Court of Appeals on February 10, 2004.

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.

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