
Records

Record of Policy Actions of the Board of Governors

Regulation A

Extensions of Credit by
Federal Reserve Banks

[Docket No. R-1304]

On December 10, 2007, the Board approved amendments establishing a temporary term auction facility (TAF), with the intention of permitting depository institutions to obtain credit from the Federal Reserve on a secured basis at rates that meet the market demand for credit of relatively short terms. The TAF allows depository institutions to obtain advances from their local Federal Reserve Banks at interest rates determined through auctions. The amendments are effective December 12, 2007.

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

Regulation B

Equal Credit Opportunity

Regulation E

Electronic Fund Transfers

Regulation M

Consumer Leasing

Regulation Z

Truth in Lending

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 DD

Truth in Savings

[Docket Nos. R-1281 through R-1285]

On October 23, 2007, the Board approved amendments to the requirements in several regulations and official staff commentaries for electronic disclosures to consumers concerning consumer financial services and fair lending. The amendments simplify and clarify the requirements by withdrawing unnecessary or unduly burdensome provisions in the interim final rules approved in March 2001 and by providing guidance on using electronic disclosures. The amendments are effective December 10, 2007, and compliance is mandatory by October 1, 2008.

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

On December 11, 2007, technical amendments were approved, under delegated authority, to clarify certain amendments to the official staff commentaries to Regulations B and Z that were approved by the Board on October 23. The technical amendments are effective January 14, 2008, and compliance is mandatory by October 1, 2008.

Regulation D

Reserve Requirements of
Depository Institutions

[Docket No. R-1262]

On April 2, 2007, the Board approved revisions to its 1980 interpretation of the

regulation, which sets forth criteria for the exemption of bankers' banks from reserve requirements. The revisions allow the Board to make case-by-case determinations as to whether a bankers' bank may, to a limited extent, have as customers certain entities that are not specified in the interpretation without losing its exemption. The revised interpretation is effective May 7, 2007.

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

[Docket No. R-1297]

On September 24, 2007, the Board approved amendments to reflect the annual indexing of the reserve requirement exemption amount and the low reserve tranche. For 2008, the reserve requirement exemption amount is \$9.3 million, an increase from \$8.5 million in 2007, and the low reserve tranche is \$43.9 million, a decrease from \$45.8 million in 2007. The Board also adjusted the non-exempt deposit cutoff level (\$216.2 million for 2008) and the reduced reporting limit (\$1.211 billion for 2008), which are used to determine the frequency of reporting by depository institutions.

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

Regulation E Electronic Fund Transfers

[Docket No. R-1270]

On June 25, 2007, the Board approved amendments to the regulation and official staff commentary to exempt electronic fund transfers of \$15 or less from the requirement to make paper receipts available to consumers for transactions initiated at electronic terminals. The

amendments are effective August 6, 2007.

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

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

Regulation K International Banking Operations

[Docket No. R-1279]

On September 14, 2007, the Board, acting with the other federal bank and thrift regulatory agencies, approved final rules to extend, from twelve to eighteen months, the on-site examination cycle for certain state member banks and U.S. offices of foreign banks. The extended schedule applies to (1) insured institutions that have up to \$500 million in total assets, are well capitalized and well managed, and receive a composite CAMELS rating of 1 or 2 and (2) U.S. branches and agencies of foreign banks that have up to \$500 million in total assets and meet comparable criteria. The final rules, which implement the Financial Services Regulatory Relief Act of 2006 and related legislation, are identical to interim final rules approved by the Board on March 16, 2007, and are effective September 25, 2007.

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

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-1261]

On November 2, 2007, the Board, acting with the other federal bank and thrift regulatory agencies, approved a new risk-based capital adequacy framework for banking organizations (which include thrifts), popularly known as Basel II. The new framework requires some banking organizations, and permits other qualifying banking organizations, to calculate their regulatory capital requirements using an internal ratings-based approach for credit risk and advanced measurement approaches for operational risks. Basel II, which modernizes the Basel Capital Accord of 1988, consists of three components, or pillars: minimum regulatory capital requirements (pillar 1), supervisory review of capital adequacy (pillar 2), and market discipline through enhanced disclosure (pillar 3). The final rules set forth the qualifying criteria and applicable risk-based capital requirements for banking organizations operating under the new framework. They are effective April 1, 2008.

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

Regulation L Management Official Interlocks

[Docket No. R-1272]

On July 9, 2007, the Board, acting with the other federal bank and thrift regulatory agencies, approved a final rule to permit management interlocks between unaffiliated depository institutions that have offices in the same relevant metropolitan statistical area if one of the institutions has less than \$50 million (previously \$20 million) in total assets. The final rule, which implements provisions of the Financial Services Regulatory Re-

lief Act of 2006, is identical to an interim final rule approved in December 2006 and is effective July 16, 2007.

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

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

[Docket No. R-1271]

On May 23, 2007, the Board approved a final rule to eliminate certain reporting requirements that have not contributed significantly to effective monitoring or to prevention of insider lending abuse. The final rule, which implements provisions of the Financial Services Regulatory Relief Act of 2006, is identical to an interim final rule approved in December 2006 and is effective July 2, 2007.

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

Regulation R Exceptions for Banks from the Definition of Broker in the Securities Exchange Act of 1934

[Docket No. R-1274]

On September 24, 2007, the Board, acting with the Securities and Exchange Commission (SEC), approved a single set of joint final rules to implement certain exceptions for banks from the definition of *broker* under section 3(a)(4) of the Securities Exchange Act of 1934 (Exchange Act), as amended by the so-called push-out provisions of the Gramm-Leach-Bliley Act of 1999. The final rules help define the scope of securities activities that banks may conduct in providing banking services to their

customers without registering with the SEC as a securities broker or complying with the SEC's rules. Some portions of the final rules are effective September 28, 2007; the remaining portions are effective December 3, 2007. However, banks are exempt from complying with the final rules and the broker exceptions in section 3(a)(4)(B) of the Exchange Act until the first day of their first fiscal year that begins after September 30, 2008.

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

Regulation V

Fair Credit Reporting

[Docket No. R-1203]

On October 17, 2007, the Board, acting with the other federal financial institutions regulatory agencies, approved final rules requiring that a financial institution provide notice and a reasonable opportunity to opt out before using information from an affiliate to market its own products and services to a consumer. The final rules, which implement the affiliate-marketing provisions of the Fair and Accurate Credit Transactions Act of 2003, are effective January 1, 2008, and compliance is mandatory by October 1, 2008.

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

[Docket No. R-1255]

On October 23, 2007, the Board, acting with the other federal financial institutions regulatory agencies and the Federal Trade Commission, approved final rules requiring financial institutions and creditors that open or hold certain accounts to develop and implement a writ-

ten identity theft prevention program that includes reasonable policies and procedures for detecting, preventing, and mitigating identity theft. The final rules provide guidelines for developing and implementing those programs and examples of "red flags" signaling possible identity theft. In addition, the final rules require (1) debit and credit card issuers to assess the validity of change-of-address notifications under certain circumstances and (2) users of consumer reports to establish and maintain reasonable policies and procedures regarding notifications of address discrepancies they receive from consumer reporting agencies. The final rules and guidelines, which implement provisions of the Fair and Accurate Credit Transactions Act of 2003, are effective January 1, 2008, and compliance is mandatory by November 1, 2008.

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

Policy Statements and Other Actions

Policy on Payments System Risk

[Docket No. OP-1259]

On January 11, 2007, the Board approved revisions to part 1 of its Policy on Payments System Risk to address risk management in payments and settlement systems. The revisions establish an expectation that payments and settlement systems under the Board's authority that are systemically important will publicly disclose self-assessments of their compliance with the relevant principles or minimum standards set forth in the policy. Self-assessments should be updated after any material change and should be reviewed at least every two years. In addition, the revisions incorpo-

rate the Recommendations for Central Counterparties, which were developed jointly by international committees of central banks and securities commissions, as the Board's minimum standards for central counterparties. The revisions also clarify the purpose of and revise the scope of part 1 relating to central counterparties. The revisions are effective January 19, 2007, and the initial self-assessments are expected to be completed and published by December 31, 2007.

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

Illustrations of Consumer Information for Nontraditional Mortgage Products

[Docket No. OP-1267]

On May 25, 2007, the Board, acting with the other federal financial institutions regulatory agencies, approved final illustrations of consumer information for nontraditional mortgage products to assist financial institutions in implementing the consumer protection provisions of the Interagency Guidance on Nontraditional Mortgage Product Risks issued in October 2006. Financial institutions may use the illustrations as provided, change their format, or tailor the information to specific transactions or products. The illustrations are effective June 8, 2007.

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

Statement on Subprime Mortgage Lending

[Docket No. OP-1278]

On June 27, 2007, the Board, acting with the other federal financial institu-

tions regulatory agencies, approved interagency guidance intended to clarify how financial institutions may offer certain adjustable-rate mortgages in a manner that is safe and sound and also allows for clear disclosure of the risks assumed by the borrower. The guidance is effective July 10, 2007.

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

Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages

On August 29, 2007, the Board, acting with the other federal financial institutions regulatory agencies and the Conference of State Bank Supervisors, approved guidance to encourage federally regulated and state-regulated financial institutions and state-supervised servicers of residential mortgages to pursue strategies to mitigate losses while preserving home ownership to the extent possible and appropriate.

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

Permissible Complementary Activities for Financial Holding Companies

On September 6, 2007, the Board determined under the Gramm-Leach-Bliley Act of 1999 that, subject to certain limitations, disease management and mail-order pharmacy services are complementary activities permissible for financial holding companies. To qualify, an activity must complement a financial activity and not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. The Board concluded that disease management and mail-order pharmacy

services complement the financial activity of underwriting and selling health insurance and do not pose a substantial risk. The determination is effective September 7, 2007.

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

On December 3, 2007, the Board similarly determined that, subject to certain limitations, energy management activities are permissible activities for financial holding companies because they complement the financial activities of engaging as principal in commodity derivatives activities and providing advisory services for derivatives transactions and do not pose a substantial risk. The determination is effective December 4, 2007.

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

Permissible Financial Activities for Financial Holding Companies

On October 10, 2007, the Board determined under the Gramm-Leach-Bliley Act of 1999 and after consultation with the Secretary of the Treasury that, subject to certain limitations, the acquisition, management, and operation in the United Kingdom of certain third-party defined benefit pension plans are financial activities permissible for financial holding companies. The determination is effective October 12, 2007.

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

Discount Rates in 2007

Under the Federal Reserve Act, the boards of directors of the Federal Reserve Banks must establish rates on dis-

count window loans to depository institutions at least every fourteen days, subject to review and determination by the Board of Governors.

Primary Credit

Primary credit, the Federal Reserve's main lending program, is extended at a rate above the federal funds rate target set by the Federal Open Market Committee (FOMC). It is typically 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.

During 2007, acting on recommendations of the Reserve Bank boards of directors, the Board approved four reductions in the primary credit rate, bringing the rate from 6¼ percent to 4¾ percent. The first of these reductions came on August 17 in response to the emergence of severe financial market strains in previous weeks. The Board approved a temporary narrowing of the spread of the primary credit rate over the FOMC's target rate to 50 basis points, from 100 basis points, and announced a temporary change to the Reserve Banks' discount window lending practices to allow the provision of term financing for as long as thirty days, renewable by the borrower. These changes remained in effect at the end of 2007. In the remaining three instances, the Board reached its determinations on the primary credit rate in conjunction with the FOMC's decisions to lower the target federal funds rate by a cumulative 1 percentage point, from 5¼ percent to 4¼ percent. Monetary policy developments are reviewed more fully in other parts of this report (see the section "Monetary Policy and Economic Developments" and the minutes of FOMC meetings held in 2007).

Secondary and Seasonal Credit

Secondary credit is available in appropriate circumstances to depository institutions that do not qualify for primary credit. The secondary credit rate is set at a spread above the primary credit rate. Throughout 2007, the spread was set at 50 basis points.

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

At year-end, the secondary and seasonal credit rates were 5¼ percent and 4.70 percent, respectively.

Term Auction Facility Credit

In December, the Federal Reserve established a temporary Term Auction Facility (TAF). Under the TAF, the Federal Reserve auctions term funds to depository institutions that are in generally sound financial condition and are eligible to borrow under the primary credit program. The amount of each auction is determined in advance by the Federal Reserve, and the interest rate on TAF credit is determined by the bidding process as the rate at which all bids can be fulfilled, up to the maximum auction amount and subject to a minimum bid rate. The Federal Reserve conducted two TAF auctions in 2007—on December 17 and December 20; the resulting rates were 4.65 percent and 4.67 percent, respectively.

Votes on Discount Rate Changes

About every two weeks during 2007, the Board approved proposals by the twelve Reserve Banks to maintain the formulas for computing the secondary and sea-

sonal credit rates. In December, the Board approved proposals by the twelve Reserve Banks to establish the auction method by which the TAF credit rate is set. Details on the four actions by the Board to approve changes in the primary credit rate are provided below.

August 16, 2007. The Board approved actions taken by the directors of the Federal Reserve Banks of New York and San Francisco to lower the rate on discounts and advances under the primary credit program by ½ percentage point, to 5¾ percent, effective August 17, 2007. The Board also approved an identical action subsequently taken by the directors of the Federal Reserve Banks of Boston, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, and Dallas, effective August 17, 2007, and the Federal Reserve Bank of St. Louis, effective August 20, 2007.

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

September 18, 2007. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Cleveland, Minneapolis, Kansas City, and San Francisco to lower the rate on discounts and advances under the primary credit program by ½ percentage point, to 5¼ percent. The same change was approved for the Federal Reserve Bank of St. Louis, effective September 19, 2007. The Board also approved an identical action subsequently taken by the directors of the Federal Reserve Banks of Richmond, Atlanta, and Dallas, effective September 19, 2007, and the Federal Reserve Banks of Philadelphia and Chicago, effective September 20, 2007.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors

Warsh, Kroszner, and Mishkin. Votes against this action: None.

October 31, 2007. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of New York, Richmond, Atlanta, Chicago, and San Francisco to lower the rate on discounts and advances under the primary credit program by $\frac{1}{4}$ percentage point, to 5 percent. The same change was approved for the Federal Reserve Bank of St. Louis, effective November 1, 2007. The Board also approved an identical action subsequently taken by the directors of the Federal Reserve Banks of Boston, Philadelphia, Cleveland, Minneapolis, Kansas City, and Dallas effective November 1, 2007.

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

December 11, 2007. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of New York, Philadelphia, Cleveland, Richmond, Atlanta, and Chicago to lower the rate on discounts and advances under the primary credit program by $\frac{1}{4}$ percentage point, to $4\frac{3}{4}$ percent. The same change was approved for the Federal Reserve Bank of St. Louis, effective December 12, 2007. The Board also approved identical actions subsequently taken by the directors of the Federal Reserve Banks of San Francisco, effective December 11, 2007; Boston, Minneapolis, and Dallas, effective December 12, 2007; and Kansas City, effective December 13, 2007.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Warsh, Kroszner, and Mishkin. 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 Congress a full account of such actions.

The minutes of the meetings contain the votes on the policy decisions made at those meetings as well as a summary of the information and discussions that led to the decisions. In addition, four times a year, starting with the October 2007 Committee meeting, a Summary of Economic Projections is published as an addendum to the minutes. The descriptions of economic and financial conditions in the minutes and the Summary of Economic Projections are based solely on the information that was available to the Committee at the time of the meetings.

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

are identified in the minutes and a summary of the reasons for their dissent is provided.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market operations, the Federal Reserve Bank of New York operates under instructions from the Federal Open Market Committee that take the form of an Authorization for Domestic Open Market Operations and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Federal Reserve Bank of New York operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations.¹ Changes in the instruments during the year are reported in the minutes for the individual meetings.

1. As of January 1, 2007, the Federal Reserve Bank of New York was operating under the Domestic Policy Directive approved at the December 12, 2006, Committee meeting. The other policy instruments (the Authorization for Domestic Open Market Operations, the Authorization for Foreign Currency Operations, the Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations) in effect as of January 1, 2007, were approved at the January 31, 2006, meeting.

Meeting Held on January 30–31, 2007

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, January 30, 2007 at 2:00 p.m., and continued on Wednesday, January 31, 2007 at 9:00 a.m.

Present:

- Mr. Bernanke, Chairman
- Mr. Geithner, Vice Chairman
- Ms. Bies
- Mr. Hoenig
- Mr. Kohn
- Mr. Kroszner
- Ms. Minehan
- Mr. Mishkin
- Mr. Moskow
- Mr. Poole
- Mr. Warsh

- Mr. Fisher, Ms. Pianalto, and Messrs. Plosser and Stern, Alternate Members of the Federal Open Market Committee

- Mr. Lacker and Ms. Yellen, Presidents of the Federal Reserve Banks of Richmond and San Francisco, respectively

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

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

- Messrs. Connors, Evans, Fuhrer, Kamin, Madigan, Rasche, Sellon, Slifman, Tracy, and Wilcox, Associate Economists

- Mr. Dudley, Manager, System Open Market Account

- Messrs. Clouse and English, Associate Directors, Division of Monetary Affairs, Board of Governors

- Ms. Liang and Mr. Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

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

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

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

- Ms. Kole² and Mr. Lebow,² Section Chiefs, Divisions of International Finance, and Research and Statistics, respectively, Board of Governors

- Messrs. Doyle,² Schindler,³ and Wood,² Senior Economists, Division of International Finance, Board of Governors

- Messrs. Engen³ and Tetlow,² Senior Economists, Division of Research and Statistics, Board of Governors

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

- Ms. Roush,³ Economist, Division of Monetary Affairs, Board of Governors

- Mr. Hambley,² Assistant to the Board, Office of Board Members, Board of Governors

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

2. Attended portion of the meeting relating to the role of economic forecasts in policy communications.

3. Attended portion of the meeting relating to the economic outlook and monetary policy discussion.

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

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

Messrs. Judd and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of San Francisco and Dallas

Mses. Mester and Mosser and Messrs. Sniderman and Weinberg, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, New York, Cleveland, and Richmond, respectively

Mr. Cunningham, Vice President, Federal Reserve Bank of Atlanta

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

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for a term beginning January 30, 2007 had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

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

Cathy E. Minehan, President of the Federal Reserve Bank of Boston, with Charles I. Plosser, President of the Federal Reserve Bank of Philadelphia, as alternate.

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

William Poole, President of the Federal Reserve Bank of St. Louis, with Richard

W. Fisher, President of the Federal Reserve Bank of Dallas, as alternate.

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

By unanimous vote, the following officers of the Federal Open Market Committee were selected to serve until the selection of their successors at the first regularly scheduled meeting of the Committee in 2008, 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:

Ben S. Bernanke	Chairman
Timothy F. Geithner	Vice Chairman
Vincent R. Reinhart	Secretary and Economist
Deborah J. Danker	Deputy Secretary
Michelle A. Smith	Assistant Secretary
David W. Skidmore	Assistant Secretary
Scott G. Alvarez	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Karen H. Johnson	Economist
David J. Stockton	Economist

Thomas A. Connors, Charles L. Evans, Jeffrey C. Fuhrer, Steven B. Kamin, Brian F. Madigan, Robert H. Rasche, Gordon H. Sellon, Lawrence Slifman, Joseph S. Tracy, and David W. Wilcox, Associate Economists

By unanimous vote, the Committee amended its Rules of Organization by making a provision for a backup to the Manager of the System Open Market Account should he/she be unable to serve, and it made several technical changes to its Program for Security of FOMC Information.

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

By unanimous vote, William C. Dudley 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

By unanimous vote, the Committee approved the Authorization for domestic Open Market Operations with an amendment to paragraph 1(b) that brings the language for repurchase agreements into conformity with the authorization's existing language for outright purchases and reverse repurchase agreements. Accordingly, the Authorization for Domestic Open Market Operations was adopted, effective January 30, 2007, as shown below.

Authorization for Domestic Open Market Operations (Amended January 30, 2007)

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;

(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 System Open Market Account 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.

(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

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

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.

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

Authorization for Foreign Currency Operations (Reaffirmed January 30, 2007)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out

the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

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

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

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

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

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

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the

Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

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

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

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

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

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). Such investments may include buying or selling outright obligations of, or fully guaranteed as to principal and interest by, a

foreign government or agency thereof; buying such securities under agreements for repurchase of such securities; selling such securities under agreements for the resale of such securities; and holding various time and other deposit accounts at foreign institutions. In addition, when appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

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

7. The Chairman is authorized:

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

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

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

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

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

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

Foreign Currency Directive (Reaffirmed January 30, 2007)

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 Interna-

tional 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 (Reaffirmed January 30, 2007)

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.

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

The information reviewed at the January meeting, which included the advance data on the national income and product accounts for the fourth quarter, showed that economic expansion had picked up in the fourth quarter of 2006, but was uneven across sectors. Considerable vigor in consumer spending late last year boosted economic growth in the fourth quarter, supported by further increases in employment and income. A surge in net exports and a pickup in defense spending also raised output growth last quarter, but these factors

were expected to prove largely transitory. The decline in residential construction continued to weigh on overall activity, but some indications of stabilization in the demand for homes had emerged. Outlays for business fixed investment softened in the fourth quarter. Although a spike in energy prices lifted total consumer price inflation in December, readings on core inflation had edged lower in recent months.

The labor market exhibited continued strength through year-end. Nonfarm payrolls rose robustly again in December, driven by further gains in the service-producing sectors. Employment in the manufacturing and construction industries declined further, but by less than in the previous several months. Aggregate hours of private production or nonsupervisory workers edged up further. The unemployment rate held steady at 4.5 percent.

Industrial production firmed in December after having softened in the preceding three months. Output of manufacturing industries rose noticeably in December after being flat in November; the increase was associated with sizable gains in the production of semiconductors, computers, and commercial aircraft. Motor vehicle output turned up in November and December, but remained low compared with earlier in the year as vehicle makers continued their efforts to pare inventories. After contracting in November, output in the mining sector increased in December, boosted by a rise in the production of crude oil. In contrast, unseasonably warm weather caused a sharp cutback in the output of utilities in December.

Real consumer spending rose briskly in November and December, buoyed by sizable increases in outlays for non-auto consumer goods. Spending on services, in contrast, appeared to be expanding only moderately toward year-end, as

warmer-than-usual temperatures led to a drop in real outlays for energy services in November and probably damped expenditures in that category again in December. Real disposable income posted solid gains in October and November and likely rose further in December, reflecting increases in wages and salaries and further declines in energy prices. Although house-price appreciation appeared to have slowed further since the end of the third quarter, robust gains in equity prices likely resulted in a small rise in the ratio of household wealth to disposable income last quarter. Readings on consumer sentiment moved up at the end of last year and held steady in early 2007.

Residential construction activity remained quite weak late last year, but home sales showed some tentative signs of stabilization. Single-family housing starts declined modestly in December, reversing about half of November's gain. However, new permit issuance edged up in December after having moved down steadily for nearly a year. Construction in the multifamily sector, which accounts for a much smaller share of new home construction, rose sharply in December to the upper end of the range that has prevailed over the past decade. Sales of existing single-family homes held steady in November and rose in December, while sales of new homes inched up in both months. Inventories of unsold homes remained considerable although they ticked down in December for the second straight month. The most timely indicators of home prices, which are not adjusted for changes in quality or the mix of homes sold, pointed to small declines.

After having risen at a solid average pace in the first three quarters of last year, real investment in equipment and software fell in the fourth quarter. Business outlays on transportation equip-

ment, a volatile spending category, dropped considerably. Sales of light vehicles to business customers declined to their lowest level in two years, which more than offset a surge in sales of medium and heavy trucks ahead of stricter regulations on truck engine emissions that went into effect this year. Spending on high-tech capital goods moderated. Outside of the transportation and high-tech sectors, real spending declined last quarter. That weakness appeared to be concentrated in equipment related to construction and motor vehicle manufacturing. Nonresidential construction activity decelerated late last quarter; however, indicators of future expenditures in this sector remained firm, with office and industrial vacancy rates somewhat below their historical averages. Overall, prospects for business spending continued to be supported by robust corporate cash flow and a low cost of capital.

Business inventories remained elevated in the fourth quarter. In November, the book-value ratio of inventories to sales for the manufacturing and trade sectors (excluding motor vehicles) stood near its highest level since early 2005. Although relatively high ratios of inventories to sales appeared to be associated in part with developments in the homebuilding and motor vehicle sectors, some indications of inventory imbalances in other sectors had recently become evident.

The U.S. international trade deficit narrowed again in October, primarily reflecting declines in both the price and volume of imported oil. In addition, imports of non-oil industrial supplies, capital goods, and automotive products fell, offsetting small increases in imports of consumer goods, food, and services. In November, the trade deficit edged down further—to its smallest level since mid-2005—as export growth outpaced a

modest increase in non-oil imports, and oil imports remained flat.

Economic activity in the advanced foreign economies appeared to have accelerated in the fourth quarter, supported by a broad-based firming of domestic demand and strong employment gains. In the euro area, consumer sentiment was lifted by lower unemployment, and economic growth continued at a solid pace. After contracting in the third quarter, consumption spending in Japan apparently rebounded last quarter, providing significant support to economic activity. The expansion in the United Kingdom's economy strengthened, likely reflecting a pickup in consumption growth. Output growth in Canada seemed to have firmed but likely remained below trend. Recent economic data for the emerging-market economies pointed to some moderation in the pace of growth in the fourth quarter. In China, the most recent evidence suggested that growth had remained strong.

While large fluctuations in energy prices continued to cause swings in overall consumer price inflation in recent months, readings on core inflation improved. Overall consumer prices were flat in November, but turned up in December because of a surge in retail energy prices that month. Still, the rise in the price index for personal consumption expenditures over the twelve months ending in December was estimated to have been noticeably less than that of the year-earlier period. Prices for personal consumption expenditures other than those for food and energy were estimated to have increased slightly faster over the twelve months of 2006 than they did a year earlier. However, the three-month change in core prices in December likely was down considerably from its peak in May. Year-over-year increases in average hourly earnings late last year continued to run

ahead of those a year earlier. However, hourly compensation of private industry workers, as measured by the employment cost index, rose at a moderate rate in the three months ending in December, a touch below the pace registered in the previous quarter. Survey measures of households' year-ahead inflation expectations held steady through January at levels that were below those reported in the second and third quarters of last year, and respondents' longer-term inflation expectations had been unchanged since ticking down in the middle of 2006.

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

The FOMC's decision at the December meeting to leave its target for the federal funds rate unchanged and to retain the language in the statement re-

garding the risks to inflation appeared to match investors' expectations. However, the characterization of recent economic growth was reportedly interpreted by market participants as suggesting a slight softening in the Committee's outlook for the expansion. As a result, the expected path of the federal funds rate beyond the near term edged down. The subsequent release of the minutes from the meeting elicited little market reaction. Investors' outlook for economic activity firmed over the intermeeting period, as economic data releases came in stronger than expected and oil prices declined notably. As a result, investors markedly reduced the extent of policy easing anticipated over coming quarters, and yields on nominal and inflation-indexed Treasury coupon securities rose. Measures of inflation compensation were little changed on net. Spreads of investment-grade corporate bond yields over those of comparable-maturity Treasury securities moved down a bit, while those of speculative-grade issues declined significantly more. Broad equity indexes edged higher. The foreign exchange value of the dollar against other major currencies rose, on balance, particularly versus the yen.

Debt of the domestic nonfinancial sectors was estimated to have expanded in the fourth quarter at a pace that was close to that registered over the first three quarters of the year. A pickup in merger-related borrowing appeared to boost business debt growth last quarter, and a sharp rise in the issuance of bonds and commercial paper more than offset a moderation in bank loans. In the household sector, the ongoing deceleration in house prices further restrained the growth of home mortgage debt. M2 continued to expand briskly in December and January, primarily reflecting strength in its liquid deposit component.

In its forecast prepared ahead of the meeting, the staff had revised up its estimate of growth of aggregate economic activity in the fourth quarter. Nonetheless, real GDP in the second half of last year was still projected to have increased at a pace that was a bit below the economy's long-run potential, primarily because of the ongoing adjustment in the housing sector and the lower level of motor vehicle production. Looking ahead, the staff expected the rate of increase in real GDP to be little changed in 2007 relative to the projected pace for the second half of 2006. However, with the contraction in housing activity expected to abate this year, the pace of economic growth was anticipated to edge back up to a level that was close to the staff's estimate of potential output growth by the end of 2007 and to remain in that same range throughout 2008. In light of developments in futures markets, the paths of both energy and import prices were projected to be lower than was previously thought. Against this background and with the rate of increase of shelter prices slowing down, the staff expected core inflation to edge down in 2007 and 2008. The advance data on the national income and product accounts for the fourth quarter that were released on the morning of the second day of the FOMC meeting showed stronger-than-expected net exports and a larger-than-anticipated accumulation of inventories. The staff interpreted this information as suggesting some upward revision to its estimate of output growth in the fourth quarter and perhaps a slight downward revision to its forecast for the current quarter.

In their discussion of the economic situation and outlook, meeting participants noted that the economic information received since the last meeting pointed to a somewhat more favorable outlook regarding both inflation and

economic growth than they had earlier anticipated. Incoming data suggesting a leveling out in housing demand and strength in consumer spending outside the housing sector supported the view that the expansion remained resilient despite the appreciable decline in housing activity and recent weakness in the manufacturing sector. Over the next several quarters, economic activity would likely advance at a pace at or modestly below the economy's trend rate of growth. Thereafter, growth was likely to return to around its trend rate, which several participants viewed as likely to be higher than the staff's estimate. Favorable readings on core inflation and lower energy prices had also improved the odds that inflation pressures would diminish. However, it was noted that the prevailing level of inflation was uncomfortably high, and resource utilization was elevated. The upside risks to inflation remained the Committee's predominant concern.

In preparation for the Federal Reserve's semiannual report to the Congress on the economy and monetary policy, the members of the Board of Governors and the presidents of the Federal Reserve Banks submitted individual projections of the growth of nominal and real GDP, the rate of unemployment, and core consumer price inflation for the years 2007 and 2008, conditioned on their views of the appropriate path for monetary policy. The projections of the growth of nominal GDP were in the range of $4\frac{3}{4}$ to $5\frac{1}{2}$ percent for both years, with a central tendency of 5 to $5\frac{1}{2}$ percent for 2007 and $4\frac{3}{4}$ to $5\frac{1}{4}$ percent for 2008. Projections of the rate of expansion in real GDP for 2007 were in the $2\frac{1}{4}$ to $3\frac{1}{4}$ percent range, with a central tendency of $2\frac{1}{2}$ to 3 percent; for 2008 the forecasts were in the slightly higher range of $2\frac{1}{2}$ to $3\frac{1}{4}$ percent, with a central tendency of $2\frac{3}{4}$ to 3 percent.

These rates of growth were associated with a civilian unemployment rate in the range of $4\frac{1}{2}$ to $4\frac{3}{4}$ percent in the fourth quarter of 2007 and $4\frac{1}{2}$ to 5 percent in the fourth quarter of 2008; the central tendency of these projections was $4\frac{1}{2}$ to $4\frac{3}{4}$ percent for both years. The rate of inflation, as measured by the core PCE price index, was projected to edge down from a range of 2 to $2\frac{1}{4}$ percent in 2007, with the central tendency being the same, to a range of $1\frac{1}{2}$ to $2\frac{1}{4}$ percent in 2008, centered on $1\frac{3}{4}$ to 2 percent.

In their discussion of the major sectors of the economy, participants noted that the housing market showed tentative signs of stabilization in most regions. Anecdotal reports presented a mixed picture, with fairly firm home sales in some areas but continuing decline in others. But aggregate data indicated that home sales, which had been essentially flat since mid-year, had risen a bit during the fourth quarter. Mortgage applications for home purchases had risen from their low levels of last summer. Sentiment among homebuilders reportedly had improved in the past few months, and the inventory of new homes for sale had fallen. Nonetheless, participants noted that inventories remained elevated and needed to be worked down before growth in this sector resumed. Unseasonably warm weather so far this winter complicated the interpretation of recent data, but participants were optimistic that the risk of a much larger contraction in housing had diminished and that the drag on growth from the housing sector would ease later this year.

Participants saw continued gains in employment and incomes and lower energy prices as sustaining solid growth in consumer spending. Contacts reported healthy holiday sales in many regions, particularly late in the Christmas season. In addition, the growth of gift cards was

mentioned as a factor that likely boosted retail sales in January. To date, weakness in the housing market had not appeared to have spilled over to aggregate consumption, although some such effect could not be ruled out as the growth in households' home equity slowed. The recent strength of consumption spending, together with favorable readings from consumer sentiment surveys, suggested that households were optimistic about prospects for employment and income. Indeed, the possibility that the personal saving rate would fail to rise as in the staff forecast was cited by some participants as posing a significant upside risk to the outlook.

Meeting participants noted that continued gains in nonresidential construction spending were offsetting some of the weakness on the residential side. Further advances in nonresidential investment were likely. Office vacancy rates were reported as declining in some areas. However, the recent decrease in energy prices had already led to a reduction in drilling activity and was likely to reduce some investment in alternative fuels. Participants noted that business fixed investment overall continued to be weaker than anticipated, suggesting some caution on the part of businesses in expanding capacity. Nonetheless, participants expected that, going forward, favorable financial conditions, strong corporate balance sheets, high profitability, and growth in sales would support a firming of investment spending.

Net exports were unexpectedly strong in the fourth quarter. In part, this development could be attributed to a temporary reduction in petroleum imports as a result of the unseasonably warm weather. Although imports were likely to pick up again, global economic growth, which had been strong of late, was expected to continue to provide ongoing support for growth in exports.

The more favorable budget positions of the state and local governments were seen as permitting additional spending by such governmental units and hence as an additional source of stimulus to the economy. Strong federal tax receipts suggested that personal incomes were expanding vigorously.

Participants reported some continuing softness in manufacturing, primarily in industries related to housing or automobiles. The recent slackness in manufacturing activity appeared to be largely an inventory correction, which participants expected would be completed this year. Participants noted that the tone of contacts in the industrial sector was generally more positive than at the time of the December meeting, and some survey information pointed to expectations of a rebound in manufacturing activity later this year. However, the recent declines in energy prices were likely to restrain energy extraction as well as activity in associated energy-producing sectors.

Many participants observed that labor markets remained relatively taut, with significant wage pressures being reported in some occupations. In addition to the continuing shortages of skilled workers in technical and professional fields, recent reports suggested a scarcity of less skilled and unskilled workers in some areas of the country. One participant observed that some of the sluggishness in manufacturing job growth could be due to difficulties in hiring rather than indicating weakness in demand. So far, aggregate measures of labor compensation were showing only moderate increases, but looking ahead, the possibility that labor costs might rise more rapidly as a result of the tightness in labor market was seen as an upside risk to inflation.

All meeting participants expressed some concern about the outlook for inflation. To be sure, incoming data had

suggested some improvement in core inflation, and a further gradual decline was seen as the most likely outcome, fostered in part by the continued stability of inflation expectations. However, participants did not yet see a downtrend in core inflation as definitively established. Although lower energy prices, declining core import prices, and a deceleration in owners' equivalent rent were expected to contribute to slower core inflation in coming months, the effects of some of these factors on inflation could well be temporary. The influence of more enduring factors, importantly including pressures in labor and product markets and the behavior of inflation expectations, would primarily determine the extent of more persistent progress. In light of the apparent underlying strength in aggregate demand, risks around the desired path of a further gradual decline in core inflation remained mainly to the upside. Participants emphasized that a failure of inflation to moderate as expected could impair the long-term performance of the economy.

In the Committee's discussion of monetary policy for the intermeeting period, all members favored keeping the target federal funds rate at $5\frac{1}{4}$ percent at this meeting. The confluence of better-than-expected news on economic activity and inflation suggested somewhat smaller downside risks to economic growth as well as improved prospects for core inflation. Recent developments were seen as supporting the Committee's view that maintaining the current target was likely to foster moderate economic growth and to further the gradual reduction of core inflation from its elevated level over the past year. Nonetheless, Committee members saw continued risks to the economic outlook. The ongoing contraction in the housing

sector and the potential for spillovers to other sectors remained notable downside risks to economic activity, although those risks had diminished somewhat, and continuing strength in consumption suggested upside risks as well. All members agreed that the predominant concern remained the risk that inflation would fail to moderate as desired.

In light of the recent economic data and anecdotal information, the Committee agreed that the statement to be released after the meeting should acknowledge evidence of somewhat firmer economic growth and tentative signs of stabilization in the housing market. They further agreed that the statement should reiterate that the economy seemed likely to expand at a moderate pace over coming quarters. The statement would also note the modest improvement in readings on core inflation and the Committee's view that inflation pressures seemed likely to moderate over time. The members discussed whether the balance of risks language in its recent statements still was the best way to represent the views of the Committee and decided that a change was not warranted at this time. All members agreed that the statement should continue to stress that some inflation risks remained and note that additional policy firming was possible.

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve

markets consistent with maintaining the federal funds rate at an average of around 5¼ percent.

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

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

Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Hoenig, Kohn, and Kroszner, Ms. Minehan, Messrs. Mishkin, Moskow, Poole, and Warsh. Votes against this action: None.

The Committee then moved on to a discussion of the role of economic projections in policy communications. Meeting participants reviewed the objectives, advantages, and disadvantages of potential changes to the production and communication of policymakers' forecasts of key economic variables. They expressed support for continuing to report summaries of their individual forecasts, which they now make twice a year and which are included in the Monetary Policy Report. Participants agreed to explore whether changes to current practices might facilitate improved communication internally among themselves during the policy debate and externally by providing the public with additional context for understanding the Committee's policy decisions. No decisions on any such changes were made at this meeting, and a further discussion of communications topics was planned for the next FOMC meeting, confirmed for March 20–21, 2007.

The meeting adjourned at 2:45 p.m.

Notation Votes

By notation vote completed on December 29, 2006, the Committee unani-

mously approved the minutes of the FOMC meeting held on December 12, 2006.

By notation vote completed on January 5, 2007, the Committee unanimously selected William C. Dudley to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.

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

Vincent R. Reinhart
Secretary

Meeting Held on March 20–21, 2007

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 20, 2007 at 2:30 p.m., and continued on Wednesday, March 21, 2007 at 9:00 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Mr. Hoenig
Mr. Kohn
Mr. Kroszner
Ms. Minehan
Mr. Mishkin
Mr. Moskow
Mr. Poole
Mr. Warsh

Ms. Cumming, Mr. Fisher, Ms. Pianalto, and Messrs. Plosser and Stern, Alternate Members of the Federal Open Market Committee

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

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

Messrs. Connors, Evans, Fuhrer, Kamin, Madigan, Rasche, Slifman, and Wilcox, Associate Economists

Mr. Dudley, Manager, System Open Market Account

Messrs. Clouse and English,⁵ Associate Directors, Division of Monetary Affairs, Board of Governors

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

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

Messrs. Dale⁶ and Oliner, Senior Advisers, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

Mr. Hambley,⁶ Assistant to the Board, Office of Board Members, Board of Governors

Mr. Meyer, Visiting Reserve Bank Officer, Division of Monetary Affairs, Board of Governors

Mr. Small,⁵ Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Kiley⁶ and Ms. Kole,⁶ Section Chiefs, Divisions of International Finance and Research and Statistics, respectively, Board of Governors

Mr. Doyle,⁶ Ms. Mauskopf,⁶ and Mr. Wood,⁶ Senior Economists, Divisions of International Finance, Research and Statistics, and International Finance, respectively, Board of Governors

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

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

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

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

Mr. Rosenblum, Executive Vice President, Federal Reserve Bank of Dallas

Mr. Hakkio, Ms. Mester, Messrs. Rolnick, Rudebusch, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Kansas City, Philadelphia, Minneapolis, San Francisco, and Cleveland, respectively

Messrs. Cunningham and Hilton, Vice Presidents, Federal Reserve Banks of Atlanta and New York, respectively

Ms. Sbordone, Research Officer, Federal Reserve Bank of New York

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

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

The information reviewed at the March meeting indicated that the economy appeared to be expanding at a

5. Attended Wednesday's session.

6. Attended portion of the meeting relating to the discussion of communications issues.

modest pace in the first quarter. Declines in residential construction activity continued to weigh on overall activity, and business investment had softened considerably over the preceding several months, especially in equipment used in the construction and motor vehicle industries. However, consumer spending had increased appreciably in the early part of the year, and labor demand continued to expand, albeit at a somewhat slower pace than last year. Meanwhile, the twelve-month increase in core consumer prices remained elevated relative to its pace one year earlier.

Employment gains moderated in early 2007. In February, employment in the construction industry contracted considerably, in part because of severe winter storms; manufacturing employment also declined, but hiring in service-producing sectors remained solid. A decline in the average workweek led to a contraction in aggregate hours. At the same time, the unemployment rate edged down from 4.6 percent in January to 4.5 percent in February.

Industrial production rose strongly in February and was revised up for both December and January. In February, production was boosted by a rebound in motor vehicle assemblies and by a temporary surge in output at utilities that reflected a swing from unseasonably warm temperatures in January to colder weather in February. Production rose at a solid pace in all major high-tech categories. Output of materials and defense and space equipment expanded as well. In contrast, production of consumer goods and business equipment changed little, while output of construction supplies declined.

Real consumer spending appeared on track to rise at a robust pace in the first quarter, buoyed in part by a weather-related surge in spending on energy services and by a jump in sales of light

motor vehicles. Outside of these areas, however, real consumer spending moderated. The determinants of household spending were mixed. Disposable personal income was estimated to have risen sharply in January, but the increase was partly the result of special factors, such as pay raises for federal and military personnel and cost-of-living adjustments to Social Security payments. Meanwhile, readings on consumer sentiment, which had been favorable in recent months, edged down in early March. The boost to consumer spending from earlier gains in wealth was likely being muted by the lagged effects of the upward trend in borrowing costs. In addition, recent declines in equity prices and slowing house price appreciation pointed to a modest reduction in households' wealth-to-income ratio in the first quarter.

Housing starts declined in January, extending the downward trend that had been in place since early 2006, but bounced back in February. However, adjusted permit issuance in the single-family sector continued to step down, suggesting that builders were still slowing the pace of new construction to work off elevated inventories. The inventory of new homes for sale remained high, although cuts in residential construction in the last few months had reduced the number of unsold homes. As at the time of the January meeting, available data suggested that housing demand was stabilizing. Sales of both new and existing single-family homes in recent months were, on balance, in line with the pace seen since mid-2006. However, a tightening of standards for subprime borrowers in recent weeks seemed likely to restrain home sales. House price appreciation had slowed further, with some measures showing outright declines in home values.

Business fixed investment had been sluggish in recent months. Real spending on equipment and software fell in the fourth quarter, and nominal orders for and shipments of nondefense capital goods excluding aircraft posted widespread declines in January, with transportation equipment showing a very large drop. Business purchases of light vehicles remained low, and new orders for and deliveries of medium and heavy trucks plunged in the last few months after a surge in 2006. Investment in goods and services other than transportation and high-tech equipment softened more than fundamentals had suggested. Declines in spending for capital equipment that is used heavily in the construction and motor vehicle industries accounted for an outsized share of the drop in orders and shipments at manufacturers outside high-tech and transportation in January. Investment in categories such as industrial equipment; electromedical, measuring, and controlling devices; and other electrical equipment also softened. In contrast, computer imports surged in January, suggesting rising domestic purchases, and computer sales appeared to have picked up in February. The ample cash reserves held by firms and ongoing reductions in the user cost of high-tech capital goods remained supportive of investment going forward.

Businesses accumulated inventories of items other than motor vehicles at a slower pace in January than in the previous two quarters. Even so, the ratio of inventories to sales for manufacturing and trade excluding motor vehicles remained elevated. In addition, purchasing managers at manufacturing firms, on net, continued to view their customers' inventory levels as too high.

The U.S. international trade deficit narrowed considerably in the fourth quarter. Exports rose, partly reflecting a

robust increase in deliveries of civilian aircraft to foreign buyers, while imports were pushed down by a fall in the volume and price of imported oil. In January, the trade deficit was little changed.

Economic activity in the advanced foreign economies accelerated in the fourth quarter. In Japan, private consumption rebounded strongly, and private investment and net exports continued to boost growth. The pace of economic expansion in the euro area picked up as investment and exports rose. Growth in the United Kingdom firmed because of brisk investment spending and a rebound in consumption growth. In contrast, output in Canada decelerated in the fourth quarter as inventory accumulation turned down sharply. Recent data for the emerging-market economies pointed to continued strength in activity, although there were signs that growth was moderating in some countries. Growth remained solid in China but decelerated in several other Asian economies and Mexico.

In January, the overall PCE price index rose moderately as a decline in energy prices helped to offset a jump in food prices. Meanwhile, the PCE price index excluding food and energy rose at a faster pace than in the previous two months. Increases in consumer energy prices and higher prices for fruits and vegetables in February reflected a period of unusually cold weather and contributed to an acceleration in that month's CPI. Excluding food and energy, core CPI inflation slowed slightly in February but remained elevated. In recent months, prices had risen across a broad range of core goods. On a twelve-month-change basis, core CPI inflation in February was considerably above its pace a year earlier, largely because of a sharp acceleration in shelter rents over the past year. Average hourly earnings also rose at a noticeably faster pace dur-

ing the year ending in February than during the preceding twelve-month period. Surveys indicated that households' expectations of inflation over the next year were little changed in February while households' and professional forecasters' longer-term inflation expectations edged lower.

At its January meeting, the Federal Open Market Committee maintained its target for the federal funds rate at 5¼ percent. The Committee's accompanying statement noted that recent indicators had suggested somewhat firmer economic growth and that some tentative signs of stabilization had appeared in the housing market. Overall, the economy seemed likely to expand at a moderate pace over coming quarters. Readings on core inflation had improved in recent months, and inflation pressures seemed likely to moderate over time, but the high level of resource utilization had the potential to sustain inflation pressures. The Committee judged that some inflation risks remained. The extent and timing of any additional firming that might be needed to address these risks would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

The FOMC's decision at its January meeting was in accord with market expectations, but the accompanying statement reportedly was read as a sign that the Committee was more sanguine about inflation prospects than in December, and the expected path for monetary policy beyond 2007 edged lower. Policy expectations declined a bit more in the wake of the Chairman's semiannual monetary policy testimony, which apparently reinforced investors' beliefs that the FOMC anticipated gradually diminishing inflation pressures. Economic data releases were somewhat weaker than expected on balance over the first

few weeks of the intermeeting period, and policy expectations moved appreciably lower on net by mid-February. Financial market volatility increased sharply in the second half of the intermeeting period amid an apparent pull-back from risk-taking that was reportedly spurred by mixed news on domestic economic activity, mounting concerns about the subprime mortgage sector, and significant declines in foreign equity prices. On net over the intermeeting period, investors tilted their anticipated path for monetary policy beyond mid-2007 down substantially, and yields on two- and ten-year nominal Treasury securities fell 30 to 40 basis points. Yields on inflation-indexed Treasury securities generally declined somewhat less than their nominal counterparts, leaving inflation compensation slightly lower across the term structure. Broad stock price indexes dropped several percent on net over the period. Yields on investment-grade corporate bonds fell about in line with those on Treasury securities of comparable maturity. In contrast, yields on speculative-grade bonds declined only modestly, leaving risk spreads noticeably wider, albeit still narrow by historical standards.

Domestic nonfinancial sector debt appeared to be continuing to rise at a relatively brisk rate in the first quarter. Despite the recent volatility in financial markets, funding in the bond and syndicated loan markets appeared to remain readily available. However, borrowing by nonfinancial corporations was estimated to be moderating somewhat in the first quarter, with a step-down in bond issuance associated with merger and acquisition activity. Indicators pointed to a continuing deceleration in house prices this quarter, and home mortgage borrowing probably continued to slow. M2 increased more moderately in February than at the end of 2006 as the expansion

of liquid deposits slowed from its outsized fourth-quarter rate.

In its forecast prepared for this meeting, the staff marked down the projected increase in real GDP in the first quarter in response to weaker-than-expected incoming data on business equipment spending and federal defense purchases. The recent increase in oil prices and decline in equity prices, along with increased strains in the subprime mortgage sector, were expected to exert some drag on real activity over the remainder of the year. Even so, real GDP growth was expected to pick up to a rate a little below that of the economy's long-run potential for the remainder of 2007, as declines in residential construction activity lessened, and to remain at a similar rate in 2008. The increase in energy prices over the intermeeting period led the staff to revise up its forecast for headline PCE inflation during the first half of this year, but the staff continued to expect that core PCE inflation would edge down over the remainder of this year and next.

In their discussion of the economic situation and outlook, meeting participants agreed that, while recent economic data had been mixed, the economy was likely to expand at a moderate pace in coming quarters. Although the housing sector adjustment continued, accumulating data suggested that the demand for homes was leveling out. Business fixed investment had been soft in recent months, but financing conditions and other fundamentals remained favorable for a pickup in capital spending. Moreover, continuing gains in personal income could be expected to support growth in consumer spending. Thus economic growth likely would increase in coming quarters to a pace close to or modestly below the economy's trend growth rate. However, additional evidence of sluggish business investment

and recent developments in the subprime mortgage market suggested that the downside risks relative to the expectation of moderate growth had increased in the weeks since the January FOMC meeting. At the same time, the prevailing level of inflation remained uncomfortably high, and the latest information cast some doubt on whether core inflation was on the expected downward path. Most participants continued to expect that core inflation would slow gradually, but the recent readings on inflation and productivity growth, along with higher energy prices, had increased the odds that inflation would fail to moderate as expected; that risk remained the Committee's predominant concern.

Participants reported signs of stabilization in housing demand in most regions of the country. At the national level, sales of new and existing homes, while fluctuating in recent months, did not display declining trends. The inventory of new homes for sale reportedly had fallen further from its recently elevated level. Participants noted, however, that such inventories likely would need to be worked down appreciably more before growth in housing construction would resume. The increase in delinquencies on subprime adjustable-rate mortgage loans and the ensuing increase in interest rates and tightening of credit standards in the subprime mortgage market likely would constrain home purchases by some borrowers, perhaps retarding the recovery in the housing sector. However, there was no sign of spillovers from the subprime market to the overall mortgage market; indeed, interest rates on prime mortgage loans had declined somewhat in recent weeks, along with yields on U.S. Treasury securities. Moreover, home-buying attitudes had improved and continuing job growth could be expected to support home sales.

Business fixed investment spending had been surprisingly weak of late, given strong corporate balance sheets, high profitability, anticipated growth in sales, and favorable financial conditions. Participants continued to expect these fundamentals to support a firming of investment spending going forward, and they saw no indication that recent market volatility had prompted a reduction in the availability of financing for business investment. Also, declining office vacancy rates in some areas were spurring gains in nonresidential construction activity, and further advances in commercial construction were seen as likely. Energy prices were high enough to encourage continued investment in alternative fuels. However, the relatively slow pace of investment in recent months might be signaling that business executives had become less certain about the outlook, and perhaps that they expected quite modest gains in sales. Participants agreed that the possibility of persistently sluggish investment spending was an important downside risk to the outlook for economic growth.

Growth in consumer spending would likely continue to be supported by gains in employment and incomes. Meeting participants noted that weakness in the housing market had not spilled over to aggregate consumption—though the flattening out in house prices likely would contribute to an increase in the personal saving rate—and turmoil in the subprime mortgage market did not appear to be generating any diminution in the availability of other types of household credit. The recent increase in oil prices and the reduction in household net worth resulting from the small net declines in equity prices during the intermeeting period warranted a modest downward adjustment in projected growth of consumer spending. Even so, the possibility that the personal saving

rate would fail to rise as projected in the staff forecast remained an upside risk to the outlook.

Growth in federal as well as state and local government spending probably would remain a source of stimulus to the economy. Moreover, continued expansion in domestic demand in our major trading partners could be expected to sustain solid growth in U.S. exports.

Many participants again reported softness in manufacturing, primarily but not exclusively in industries related to housing or automobiles. However, a number of firms outside of the housing sector—including auto companies—appeared to have made progress in reducing inventories to more comfortable levels, and contacts in the industrial sector were generally optimistic about future growth. Such attitudes were consistent with national and regional surveys that pointed to a rebound in manufacturing activity later this year.

Anecdotal and statistical evidence suggested that labor markets remained relatively tight. Business contacts continued to report shortages of skilled workers in technical and professional fields, with significant wage pressures in some occupations, as well as a scarcity of less skilled and unskilled workers in some areas of the country. So far, aggregate measures of labor compensation were showing only moderate increases, but, looking ahead, the possibility that labor costs might rise more rapidly was seen as an upside risk to inflation. It was noted, however, that increases in compensation that exceeded productivity gains might be absorbed to some extent by a narrowing of firms' high profit margins. Participants expected that productivity growth would pick up as firms slowed hiring to a pace more in line with output growth but acknowledged that the improvement might

be limited, particularly if business investment spending were to remain soft.

Most participants continued to expect a gradual decline in core inflation over the next year or two, fostered by stable inflation expectations, a likely deceleration in shelter costs, and a slight easing of pressures on resources. Nonetheless, all meeting participants expressed concern about the risks to this outlook. The latest readings on core inflation were higher than expected, and it was difficult to discern whether the apparent downward trend in core inflation during the past few quarters was continuing. Also, the recent increases in prices for energy and some non-energy imports likely would boost overall inflation in the near term and might put upward pressure on prices of some core goods and services. Moreover, rates of resource utilization that were near the high end of historical experience suggested a possibility that inflation pressures could build. Participants agreed that risks around the expected and desired path of a gradual decline in core inflation remained mainly to the upside; some noted that upside risks to inflation appeared to have increased slightly in recent months.

In the Committee's discussion of monetary policy for the period between its March and May meetings, all members favored keeping the target federal funds rate at 5¼ percent. Recent developments were seen as supporting the Committee's view that maintaining the current target was likely to foster moderate economic growth and to further the gradual reduction of core inflation from its elevated level. Nonetheless, the combination of generally weaker-than-expected economic indicators and uncomfortably high readings on inflation suggested increased downside risks to economic growth and greater uncer-

tainty that the expected gradual decline in core inflation would materialize.

In light of the recent economic data and anecdotal information, the Committee agreed that the statement to be released after the meeting should note that economic indicators had been mixed, that the adjustment in the housing market was ongoing, and that the economy seemed likely to expand at a moderate pace over coming quarters. Members agreed the statement also should indicate that inflation pressures seemed likely to moderate over time, but that recent readings on core inflation had been somewhat elevated and the high level of resource utilization had the potential to sustain inflation pressures. A persistence of inflation at recent rates could eventually have adverse consequences for economic performance. All members agreed the statement should indicate that the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. The Committee agreed that further policy firming might prove necessary to foster lower inflation, but in light of the increased uncertainty about the outlook for both growth and inflation, the Committee also agreed that the statement should no longer cite only the possibility of further firming. Instead, the statement should indicate that future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

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

The Federal Open Market Committee seeks monetary and financial conditions that

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

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

In these circumstances, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Votes for this action: Messrs. Bernanke, Geithner, Hoenig, Kohn, and Kroszner, Ms. Minehan, Messrs. Mishkin, Moskowitz, Poole, and Warsh. Votes against this action: None.

The Committee then returned to the topic of improving policy communications. Participants expressed a range of views on the possible advantages and disadvantages of specifying a numerical price objective for monetary policy and on technical aspects of a quantification. Participants emphasized that any such move would need to be consistent with the Committee's statutory objectives for promoting maximum employment as well as price stability. The Committee made no decisions on this issue. Participants also discussed the communications role of the economic projections that are made periodically by the members of the Board of Governors and the Reserve Bank presidents. A number of substantive and practical issues would still need to be evaluated before the Committee could make decisions about an enhanced role for projections in explaining policy. The Committee planned to continue its review of communication issues at the FOMC meeting in June 2007.

It was agreed that the next meeting of the Committee would be held on Wednesday, May 9, 2007.

The meeting adjourned at 1:30 p.m.

Notation Vote

By notation vote completed on February 20, 2007, the Committee unanimously approved the minutes of the FOMC meeting held on January 30–31, 2007.

Vincent R. Reinhart
Secretary

Meeting Held on May 9, 2007

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, May 9, 2007 at 8:30 a.m.

Present:

- Mr. Bernanke, Chairman
- Mr. Geithner, Vice Chairman
- Mr. Hoenig
- Mr. Kohn
- Mr. Kroszner
- Ms. Minehan
- Mr. Mishkin
- Mr. Moskowitz
- Mr. Poole
- Mr. Warsh

- Mr. Fisher, Ms. Pianalto, and Messrs. Plosser and Stern, Alternate Members of the Federal Open Market Committee

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

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

Messrs. Connors, Evans, Kamin, Madigan, Rasche, Slifman, Tracy, and Wilcox, Associate Economists

Mr. Dudley, Manager, System Open Market Account

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

Ms. Liang and Mr. Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Leahy and Wascher, Deputy Associate Directors, Divisions of International Finance and Research and Statistics, respectively

Mr. Dale, Senior Adviser, Division of Monetary Affairs

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

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

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

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

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

Ms. Green, First Vice President, Federal Reserve Bank of Richmond

Mr. Rosenblum, Executive Vice President, Federal Reserve Bank of Dallas

Mr. Hakkio, Ms. Perelmuter, Messrs. Rolnick, Rudebusch, Sniderman, and Weinberg, Senior Vice Presidents, Federal Reserve Banks of Kansas City, New York, Minneapolis, San Francisco, Cleveland, and Richmond, respectively

Messrs. Dotsey, Tallman, and Tootell, Vice Presidents, Federal Reserve

Banks of Philadelphia, Atlanta, and Boston, respectively

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

By unanimous vote, the Committee extended for one year beginning in mid-December 2007 the reciprocal currency ("swap") arrangements with the Bank of Canada and the Banco de Mexico. The arrangement with the Bank of Canada is in the amount of \$2 billion equivalent and that with the Banco de Mexico is in the amount of \$3 billion equivalent. Both arrangements are associated with the Federal Reserve's participation in the North American Framework Agreement of 1994. The vote to renew the System's participation in the swap arrangements maturing in December was taken at this meeting because of the provision that each party must provide six months' prior notice of an intention to terminate its participation.

The information reviewed at the May meeting suggested that economic activity had expanded at a below-trend pace in recent months. Gains in payroll employment had moderated, and the unemployment rate appeared to have stabilized after a period of decline. Housing construction remained under pressure from weak demand and large inventories of unsold homes, and consumer spending appeared to have slowed in recent months. Business fixed investment

remained subdued. Manufacturing production, however, showed signs of strengthening after a period of considerable softness. Rising energy prices pushed up total PCE price inflation in March, while the twelve-month increase in core PCE prices was just slightly above its year-earlier pace.

The average monthly increase in payroll employment through the first four months of this year was well below the relatively strong pace recorded in the fourth quarter of 2006. In April, the construction industry continued to shed jobs, manufacturing employment declined further, and retailers reduced hiring after a large gain in March. The unemployment rate stood at 4.5 percent in April, similar to its average in the first quarter, and the labor force participation rate moved down.

Industrial production increased at a modest annual rate of 1.4 percent in the first quarter, with the monthly pattern reflecting fluctuations in the output of utilities, which was influenced importantly by swings in weather conditions. Manufacturing output declined, on net, over the six months ending in February as a result of inventory-related adjustments in a number of industries. However, factory production turned up in March. The output of high-tech industries rose briskly; the production of consumer goods increased; and the output of business equipment, construction supplies, and materials picked up. The limited information available on industrial production for April suggested that output had been boosted by the scheduled pickup in motor vehicle assemblies.

Real consumer expenditures increased at a brisk pace in the first quarter, although monthly gains in spending slowed over the course of the quarter, in part because of swings in weather-related outlays on energy goods and energy services. Retail sales of both autos

and light trucks moved up in the first quarter, but eased a bit in April. Real spending on goods other than motor vehicles, which had shown exceptional vigor late last year, was broadly flat between December and March. However, outlays on non-energy services were reported to have posted solid gains, especially in March. Real disposable personal income rose smartly in the first quarter. Wages and salaries increased solidly, on average, and the Bureau of Economic Analysis estimated that income in January was boosted by unusually large bonus payments and stock option exercises. The household wealth-to-income ratio likely ticked down in the first quarter, as the stock market rose only a little and house prices remained soft. However, given the surge in stock prices in April, much of the lost ground had probably since been made up.

Residential construction activity remained soft as builders attempted to work off elevated inventories of unsold new homes. Single-family housing starts moved up in March, almost certainly boosted by unusually warm and dry weather; single-family permit issuance also increased. Although existing home sales declined in March, the level of sales was only slightly below the steady pace that had prevailed in the second half of 2006. By contrast, new home sales fell sharply in the first two months of the year and had recovered only a bit in March. All told, recent readings on home sales suggested that housing demand had weakened further. House-price appreciation continued to slow, and some measures were again showing declines in home values.

Real spending on equipment and software rose modestly in the first quarter after having fallen in the fourth quarter of 2006. Spending on high-tech equipment, boosted by a surge in outlays on computers, posted a substantial increase

in the first quarter. In addition, purchases of communications equipment—which tend to be volatile quarter to quarter—rebounded strongly after a fourth-quarter dip. By contrast, spending on transportation equipment declined significantly: Although domestic spending on aircraft jumped after three weak quarters, purchases of medium and heavy trucks dropped sharply, largely as a consequence of a pull-forward of truck purchases in the latter part of last year in anticipation of the tighter emissions standards that took effect in January. Business investment in equipment other than high-tech and transportation dropped in the first quarter, although the weakness in this broad category appeared to have been especially pronounced around the turn of the year and to have lessened somewhat over the course of the quarter. Robust corporate cash reserves and continuing declines in the user cost of high-tech goods remained supportive of equipment and software spending going forward. Real outlays for nonresidential construction regained some momentum in the first quarter of this year after having hit a lull in late 2006.

Real nonfarm inventory investment excluding motor vehicles increased at a slower pace in the first quarter of 2007 than in the previous quarter. The downshift in inventory investment had helped to reduce the apparent overhangs that had emerged in late 2006. In the motor vehicle sector, the sharp decline in the pace of assemblies over the past few quarters appeared to have brought inventories back into line with sales. In April, surveys indicated that the net number of firms who viewed their customers' inventory levels as too high had dropped back from elevated readings over the previous two quarters.

The U.S. international trade deficit narrowed in February, reflecting a steep

drop in imports, which more than offset a sizable decline in exports. Within imports, the value of oil imports plunged, reflecting decreases in both prices and quantities, and imports of industrial supplies, capital goods, and automotive parts also fell. The lion's share of the February decline in exports was of capital goods. Smaller decreases occurred in exports of industrial supplies, consumer goods, and services.

Economic activity in advanced foreign economies appeared to have grown at a steady rate in the first part of the year. Canada's growth seemed to have rebounded from a disappointing fourth quarter. Renewed household demand in Japan pointed to further strong growth in the first quarter, while investment demand seemed to be underpinning growth in the United Kingdom. Although euro-area exports had slowed from the rapid pace set in the fourth quarter and the hike in the German value-added tax likely depressed consumption, overall economic conditions remained solid. Economic activity in the emerging market countries appeared to have continued to advance at a robust pace in the first quarter. Surging growth in China was a highlight of the strong performance of most countries in Asia. In Latin America, indicators pointed to further lackluster growth in Mexico and some weakening in Argentina, but in other countries, especially Brazil, conditions appeared more positive.

The total PCE price index rose substantially in both February and March. The advance in February was distributed across a broad range of categories, while the March increase was driven largely by a jump in the index for energy. Core PCE prices were unchanged in March after an upswing in February. Smoothing through the high-frequency movements, the twelve-month change in the core PCE price index in March was

just a touch higher than the increase over the year-earlier period. Accelerations in the costs of housing and medical services were major contributors to both core CPI and core PCE inflation over the past year. Household surveys conducted in April indicated that the median expectation for year-ahead inflation had moved up, consistent with the recent pickup in headline CPI inflation. Median expectations of longer-term inflation had edged higher but were still in the narrow range seen over the past few years. Average hourly earnings for production or nonsupervisory workers, which had accelerated noticeably over the past couple of years, posted moderate increases in March and April.

At its March meeting, the Federal Open Market Committee (FOMC) maintained its target for the federal funds rate at 5¼ percent. The Committee's accompanying statement noted that recent economic indicators had been mixed and that the adjustment in the housing sector was ongoing. Nevertheless, the economy seemed likely to expand at a moderate pace over coming quarters. Recent readings on core inflation had been somewhat elevated. Although inflation pressures seemed likely to moderate over time, the high level of resource utilization had the potential to sustain those pressures. The Committee's predominant policy concern remained the risk that inflation would fail to moderate as expected. Future policy adjustments would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Market participants had largely anticipated the FOMC's decision at its March meeting to leave the target federal funds rate unchanged. Nevertheless, the expected path for monetary policy moved lower on the announcement, as investors apparently interpreted the accompany-

ing statement as suggesting that the Committee's economic outlook had become somewhat more balanced. However, subsequent FOMC communications—including the Chairman's testimony before the Joint Economic Committee, speeches by various FOMC members, and the minutes from the March meeting—were generally seen as emphasizing the Committee's concern about upside risks to inflation. Over the intermeeting period, yields on nominal Treasury securities edged up at all maturities. Measures of inflation compensation based on inflation-indexed Treasury securities were little changed despite a significant rise in oil prices. Yields on investment-grade corporate bonds rose in line with those on comparable-maturity Treasury securities, leaving their spreads little changed at fairly low levels. Spreads on speculative-grade corporate bonds narrowed. Equity prices climbed steeply amid solid earnings reports and improved sentiment, more than reversing the declines in the previous intermeeting period. The foreign exchange value of the dollar against other major currencies moved lower, on balance.

Gross bond issuance by nonfinancial businesses slowed from its torrid first-quarter pace in April, but acquisition-related financing continued to fuel the issuance of both investment- and speculative-grade corporate bonds. Commercial paper outstanding declined, but bank lending accelerated. In the household sector, the rise in home mortgage debt likely slowed a bit further in the first quarter, as home-price appreciation appeared to have remained sluggish. Consumer credit continued to expand at a moderate pace early in the year. M2 accelerated during March and April, primarily reflecting faster growth in liquid deposits, which were likely boosted in April by tax-related flows.

In its forecast prepared for this meeting, the staff expected the pace of economic activity to pick up from weak first-quarter growth to a rate a little below that of the economy's long-run potential for the remainder of this year and to increase at a pace broadly in line with potential output in 2008. The projected gradual acceleration in economic activity largely reflected the expected waning of the drag from residential investment, although recent readings on sales and inventories of new homes had been interpreted by the staff as suggesting that the ongoing contraction in residential investment would continue for longer than previously expected. In response to data received over the past year, the staff had marked down slightly its estimate of structural productivity growth and nudged up its estimate for the increase in labor supply—leaving its estimate of the overall growth of potential GDP broadly unchanged. The increases in energy and other commodity prices over the intermeeting period had led the staff to revise up its forecast for headline PCE inflation during the first half of the year. Nonetheless, the staff continued to expect core inflation to edge lower over the course of the next two years.

In their discussion of the economic situation and outlook, participants noted that their assessments of the medium-term prospects for economic growth and inflation had not changed materially from the previous meeting. The pace of economic expansion had slowed in the first part of this year, but the recent subpar performance probably exaggerated the weakness of underlying demand, and the rate of economic growth was expected to pick up in coming quarters. Meeting participants anticipated that real GDP would advance at a pace a little below the economy's trend rate of growth through the remainder of this year and then pick up to a rate broadly

in line with the economy's trend rate in 2008. Most participants continued to expect core inflation to slow gradually, although considerable uncertainty surrounded that judgment and the Committee's predominant concern remained the risk that inflation would fail to moderate as expected.

The incoming data on new home sales and inventories suggested that the ongoing adjustment in the housing market would probably persist for longer than previously anticipated. In particular, the demand for new homes appeared to have weakened further in recent months, and the stock of unsold homes relative to sales had increased sharply. That said, participants also noted that sales of existing homes appeared to have held up somewhat better since the beginning of the year. Moreover, the turmoil in the subprime market evidently had not spread to the rest of the mortgage market; indeed, mortgage rates available to prime borrowers remained well below their levels of last summer. Nevertheless, most participants agreed that, although the level of inventories of unsold homes that homebuilders desired was uncertain, the correction of the housing sector was likely to continue to weigh heavily on economic activity through most of this year—somewhat longer than previously expected.

Growth in consumer spending appeared to have slowed over the past few months. Real spending on goods had flattened out, and contacts in both the retail sector and the consumer credit sector reported a softening in the expansion of demand. In contrast to the rapid gains of recent years, meeting participants expected household expenditure to grow at a more moderate pace in coming quarters. Consumption was likely to be supported by continued advances in employment and incomes, as well as gains in stock prices; but the recent increases

in gasoline prices probably would damp households' spending power in the near term, and the effect of the anticipated leveling out in home-price appreciation on household wealth was expected to contribute to a gradual increase in the personal saving rate over the medium run. Participants remained concerned that the housing market correction could have a more pronounced impact on consumer spending than currently expected, especially if house prices were to decline significantly.

The growth of business fixed investment seemed most likely to move higher in coming quarters, supported by strong corporate balance sheets and profits, favorable financial conditions, and a gradual strengthening in business output. The downside risks to business capital spending appeared to have diminished somewhat since the previous meeting. In particular, participants took note of the upturn in orders and shipments of capital goods, and of more upbeat surveys of business conditions. However, participants cautioned against drawing too much comfort from the most recent few data observations, and recognized that the current sluggishness of equipment outlays could persist for longer than currently anticipated, especially if financial market conditions became less supportive. Participants were also encouraged that, outside of the construction sector, the correction of inventories to more comfortable levels appeared well advanced, thus reducing the possibility that going forward this adjustment process could trigger shortfalls in business spending and output.

Economic activity in the rest of the world continued to advance briskly. Participants noted that strong foreign expansion should help to underpin demand for U.S. exports, but expressed some concern that the strength of global demand could contribute to price pressures

at home. Prices of non-energy commodities, especially metals, had moved up markedly since the previous meeting. Moreover, inflationary pressures in a number of overseas economies appeared to have increased of late, perhaps partly in response to heightened levels of capacity utilization in those countries, and this development had the potential to add to the prices of U.S. imports. In that regard, several participants noted that the decline in the foreign exchange value of the dollar over the intermeeting period could reinforce the upward pressure on import prices.

Participants discussed how best to reconcile the slowdown in output growth over the past year with the relatively strong performance of the labor market. This apparent tension could partly reflect measurement issues; in particular, participants noted that the more-rapid gains in estimates of gross domestic income over this period might better capture the pace of activity than the modest advances in measured GDP. Aside from measurement problems, a possible explanation was that these differing trends largely related to the lagged adjustment of employment to the slowing pace of expansion. In that regard, several participants observed that the recent moderation in economic growth had been concentrated in the construction sector, but that measured employment in construction had not yet declined by a corresponding amount. This suggested that increases in overall employment in coming quarters may possibly be held down by notable declines in construction employment as the adjustment of the labor force in that sector played out. A slowing in employment could then occur in conjunction with a strengthening in productivity growth. Alternatively, some of the recent weakness in measured productivity growth could reflect a decline in the un-

derlying trend in productivity and so might persist. Although this explanation might help account for some of the downshift in measured productivity growth, participants agreed that there appeared to be little other evidence pointing to a significant slowing of advances in structural productivity. In the context of this discussion, many participants commented that their view of potential output growth was somewhat more optimistic than that of the staff.

Labor markets appeared to remain relatively tight. Unemployment continued around the low levels seen since last fall, and many business contacts reported difficulties in recruiting suitably qualified workers, especially for certain types of professional and skilled positions. However, several participants observed that aggregate measures of labor compensation had so far increased only modestly, perhaps suggesting that the labor market might be less stretched than it appeared. Moreover, even if wages and salaries did accelerate, the resulting cost pressures might be absorbed by a narrowing in firms' profit margins from current elevated levels, rather than being passed on in the form of higher prices. On the other hand, some participants reported that their business contacts appeared very resistant to any squeeze in profit margins. All told, for most participants, the apparent tightness of the labor market remained a significant source of upside risk to inflation.

Nearly all participants viewed core inflation as remaining uncomfortably high and stressed the importance of further moderation. Although readings on core inflation in March had been more favorable, this followed several months of elevated inflation data and price pressures were not yet viewed as convincingly on a downward trend. Most participants expected core inflation to moderate gradually, fostered in part by stable inflation

expectations and a likely deceleration in shelter costs. Some participants also expected the anticipated slight easing of pressures on resources to help nudge inflation lower, although others felt that small movements in resource utilization were unlikely to have discernible effects on inflation. All participants agreed that the risks around the anticipated moderation in inflation were to the upside; and some noted that a failure of inflation to moderate could entail significant costs particularly if it led to an upward drift in inflation expectations.

In the Committee's discussion of monetary policy for the intermeeting period, all members favored keeping the target federal funds rate at 5¼ percent. Recent developments were seen as supporting the Committee's view that maintaining the current target rate was likely to foster moderate economic growth and a gradual ebbing in core inflation. Members continued to view the risks to economic activity as weighted to the downside, although with turmoil in the subprime market appearing to have remained relatively well contained and business spending indicators suggesting a more encouraging outlook, these downside risks were judged to have diminished slightly. Members agreed that considerable uncertainty attended the prospects for inflation, and the risk that inflation would fail to moderate as desired remained the Committee's predominant concern.

In light of the recent economic data and anecdotal information, the Committee agreed that the statement to be released after the meeting should acknowledge that economic growth had slowed in the first part of the year. The Committee thought that the statement should reiterate the view that the adjustment in the housing market was ongoing, but that nevertheless the economy seemed likely to expand at a moderate

pace over coming quarters. While readings on core inflation were lower in March, members felt that it was appropriate to emphasize that core inflation remained somewhat elevated. The Committee agreed that the statement should continue to note that their predominant policy concern was the risk that inflation would fail to moderate as expected, and that future policy adjustments would depend on the evolution of the outlook for both inflation and economic growth.

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

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

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

In these circumstances, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Votes for this action: Messrs. Bernanke, Geithner, Hoenig, Kohn, and Kroszner, Ms. Minehan, Messrs. Mishkin, Moskowitz, Poole, and Warsh. Votes against this action: None.

Meeting participants briefly discussed the next steps in their review of communication issues and agreed to consider them at the next FOMC meeting, confirmed for June 27–28, 2007.

The meeting adjourned at 1:15 p.m.

Notation Vote

By notation vote completed on April 10, 2007, the Committee unanimously approved the minutes of the FOMC meeting held on March 20–21, 2007.

Vincent R. Reinhart
Secretary

Meeting Held on June 27–28, 2007

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, June 27, 2007 at 2:00 p.m. and continued on Thursday, June 28, 2007 at 9:00 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Mr. Hoenig
Mr. Kohn
Mr. Kroszner
Ms. Minehan
Mr. Mishkin
Mr. Moskowitz
Mr. Poole
Mr. Warsh

Mr. Fisher, Ms. Pianalto, and Messrs. Plosser and Stern, Alternate Members of the Federal Open Market Committee

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

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

Messrs. Connors, Evans, Fuhrer, Madigan, Rasche, Sellon, Slifman, and Wilcox, Associate Economists

- Mr. Dudley, Manager, System Open Market Account
- Messrs. Clouse and English, Associate Directors, Division of Monetary Affairs, Board of Governors
- Ms. Liang and Mr. Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors
- Messrs. Leahy and Wascher, Deputy Associate Directors, Divisions of International Finance and Research and Statistics, respectively, Board of Governors
- Mr. Dale, Senior Adviser, Division of Monetary Affairs, Board of Governors
- Mr. Blanchard, Assistant to the Board, Office of Board Members, Board of Governors
- Mr. Gross,⁷ Special Assistant to the Board, Office of Board Members, Board of Governors
- Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors
- Mr. Ahmed⁸ and Ms. Kusko,⁸ Senior Economists, Divisions of International Finance and Research and Statistics, respectively, Board of Governors
- Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors
- Ms. Beechey and Mr. Natalucci,⁸ Economists, Division of Monetary Affairs, Board of Governors
- Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors
- Mr. Moore, First Vice President, Federal Reserve Bank of Cleveland
- Mr. Rosenblum, Executive Vice President, Federal Reserve Bank of Dallas
- Ms. Mester, Messrs. Sniderman, Weinberg, and Williams, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Cleveland, Richmond, and San Francisco, respectively
- Ms. McLaughlin and Mr. Tallman, Vice Presidents, Federal Reserve Banks of New York and Atlanta, respectively
- Ms. McConnell, Assistant Vice President, Federal Reserve Bank of New York
- Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

The information reviewed at the June meeting suggested that the expansion of economic activity rebounded in the second quarter from its subpar pace in the first quarter. Upswings in net exports and inventory investment were expected to contribute importantly to the rise in real GDP. Consumer spending appeared to have slowed from its rapid pace earlier in the year, while business fixed investment continued to rise at a modest rate. Residential construction remained weak as builders worked further to clear high inventories of unsold homes. Sharp increases in energy prices drove up overall inflation in April and appeared to have done so again in May; core inflation seemed to have remained subdued.

Employment continued to rise at a moderate pace; the average monthly increase in payroll employment in April and May was a little below that of the first quarter. In May, employment was boosted by strong hiring in the service sector, but the manufacturing and retail sectors continued to shed jobs. Larger payrolls and a slightly longer average workweek in May led to an increase in

7. Attended portion of the meeting relating to monetary policy communications.

8. Attended portion of the meeting relating to the economic outlook and monetary policy discussion.

aggregate hours; the unemployment rate held steady at 4.5 percent.

Industrial production increased modestly in April and May after having been little changed in the first quarter when some manufacturers restrained production to cope with a buildup in inventories. Manufacturing output edged up in recent months, reflecting increases in the output of light motor vehicles, other consumer durable goods, construction supplies, and durable materials. The production of high-tech industries also rose, albeit at a relatively sluggish pace compared with the brisk expansion seen around the turn of the year. Capacity utilization in the manufacturing sector in May was close to its long-run average and slightly below its level one year earlier.

The pace of real consumer spending appeared to have slowed somewhat in the second quarter after substantial increases late last year and early this year. The deceleration primarily reflected a flattening out of outlays for goods in recent months; spending on services continued to rise at a solid pace for the quarter as a whole, although the monthly pattern was affected by weather-related swings in outlays on energy services. The determinants of household spending were broadly supportive. Real disposable personal income rose at a moderate pace, on average, in the first four months of the year, boosted not only by ongoing gains in wages and salaries, but also by unusually large bonus payments and stock option exercises in the first quarter. Although the household wealth-to-income ratio ticked down in the first quarter with the stock market up only a little and house prices remaining soft, the increase in stock prices in the second quarter likely made up much of the lost ground.

Elevated inventories of unsold new homes continued to weigh on residential

construction activity. In May, single-family housing starts declined, and adjusted permit issuance for the single-family sector stepped down further, indicating that builders were intending to slow further the pace of new construction. The monthly readings on sales of new and existing homes through May had fluctuated around levels lower than the average over the second half of 2006. Some, though not all, of this weakening in home sales was likely related to the tightening of lending standards for nonprime borrowers that began in February. Even though the inventory of new homes for sale ticked down in May, the months' supply in May remained noticeably above its level in late 2006. According to OFHEO's purchase-only price index for existing homes, house-price appreciation continued to slow in the first quarter.

Outlays for nonresidential construction appeared to have remained robust early in the second quarter. Business spending on equipment and software in recent months appeared to be about unchanged from the first quarter, although the softness was largely confined to outlays for transportation equipment. Shipments and orders for items other than transportation moved up markedly in March and April after weakness in earlier months, and, even with the small declines in May, the data pointed to a healthy rise in outlays in the second quarter. In particular, real spending on equipment other than high-tech and transportation seemed to be rebounding after sizable declines over the previous two quarters. After a surge in outlays on computers in the first quarter, spending on high-tech equipment appeared to be rising at a more modest pace in April and May. In contrast, spending on transportation equipment declined significantly. Purchases of medium and heavy trucks dropped further in May, continu-

ing to reflect the payback from sales that were pulled forward into 2005 and 2006 in anticipation of tighter emissions standards that took effect in January. New orders for trucks picked up in May, albeit from very low levels. Shipments data indicated that spending on aircraft dropped back from the elevated level in the first quarter. The downtrend in the cost of capital was likely curtailed in recent weeks by the rise in corporate bond rates. Nonetheless, firms retained ample cash in reserve to finance investment.

Real nonfarm inventory investment excluding motor vehicles slowed appreciably in the first quarter of 2007, as firms in most industries appeared to have made considerable progress in addressing the inventory overhangs that developed in 2006. The adjustment apparently continued into the second quarter, as the ratio of inventories to sales for manufacturing and trade excluding motor vehicles ticked down further in April after a March decline. Inventories of light motor vehicles, which were pared down to more comfortable levels during the first quarter, continued to edge lower through May. Indeed, the inventory adjustment reached the point that, for the third month in a row, the May survey of purchasing managers indicated that, on net, more firms viewed their customers' inventory levels as too low rather than too high.

After no change between the fourth quarter and first quarter, the U.S. international trade deficit narrowed in April from its March level. The recent narrowing reflected a steep decline in many categories of goods imports and a modest increase in exports, especially of agricultural products. Nominal imports of petroleum were flat in April after surging in March despite steady increases in the price of imported oil.

Economic activity in advanced foreign economies appeared to have grown at a solid rate in the first quarter. Economic growth in Canada rebounded sharply from a disappointing fourth quarter, and growth picked up in the United Kingdom, owing primarily to a robust expansion in the service sector. In the euro area, export growth in the first quarter slowed from its rapid fourth-quarter pace, and the hike in the German value-added tax likely temporarily depressed first-quarter consumption growth. Consumer spending showed signs of recovering in recent months, and overall, economic conditions in the euro area remained solid. In Japan, recent data suggested that growth in the second quarter had moderated from the vigorous first-quarter pace, with public spending and net exports likely sources of weakness. Recent data indicated that economic activity in emerging-market economies remained strong. Growth in China and India appeared to have moderated somewhat from the very high rates of the first quarter. In Latin America, indicators for Mexico suggested some recovery from the marked slowdown of the previous few quarters, while growth in Argentina and Brazil appeared to pick up as well.

Headline consumer price inflation stepped up in recent months, driven by large increases in the index for energy. However, readings on core inflation had declined. Core PCE prices rose 0.1 percent in April and were estimated to have posted a similar, modest increase in May. The recent readings had been held down, in part, by declines in volatile categories such as apparel and tobacco products that were likely to prove transitory; the rent components had also decelerated. The twelve-month change in core PCE prices in May was expected to be lower than the increase over the year-earlier period; however, over that longer

period, the decline in core PCE inflation was almost entirely the result of a slowing in its nonmarket component. Household surveys conducted in early June indicated that the median expectation for year-ahead inflation increased further, consistent with the energy-driven acceleration in overall consumer prices in recent months. After edging higher in April and May, median expectations of longer-term inflation fell back in June and remained in the narrow range seen over the past two years. The twelve-month change in average hourly earnings for production or nonsupervisory workers edged lower in recent months.

At its May meeting, the Federal Open Market Committee (FOMC) maintained its target for the federal funds rate at 5¼ percent. The Committee's accompanying statement noted that economic growth slowed in the first part of the year and that the adjustment in the housing sector was ongoing. Nevertheless, the economy seemed likely to expand at a moderate pace over coming quarters. Core inflation remained somewhat elevated. Although inflation pressures seemed likely to moderate over time, the high level of resource utilization had the potential to sustain those pressures. The Committee's predominant policy concern remained the risk that inflation would fail to moderate as expected. Future policy adjustments would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Market participants had largely anticipated the FOMC's decision at its May meeting to leave the target federal funds rate unchanged, but some market participants were reportedly surprised by the retention of the assessment that inflation was "somewhat elevated." The publication of the minutes of the May meeting elicited little market response. Over the intermeeting period, however,

investors seemed to reappraise their beliefs that the economic expansion would slow and that monetary policy easing would be forthcoming. This reappraisal seemed to be based in part on the release of some economic data in the United States and abroad that were more favorable than expected. As a result, the expected path of the federal funds rate over the coming year was marked up sharply in financial markets. Yields on nominal Treasury securities at all maturities also rose over the intermeeting period, with the most pronounced gains in forward rates three to five years ahead. Measures of long-horizon inflation compensation based on inflation-indexed Treasury securities edged slightly higher. Yields on investment-grade corporate bonds rose in line with those on comparable-maturity Treasury securities, leaving their spreads little changed. In contrast, spreads on speculative-grade corporate bonds narrowed. Equity prices were volatile at times during the intermeeting period, but broad stock price indexes advanced modestly, on net, as favorable news on the economy and announcements of mergers and acquisitions outweighed the drag of higher bond yields. The foreign exchange value of the dollar against other major currencies was little changed, on balance.

Gross bond issuance by nonfinancial businesses surged in May from the already robust pace of earlier in the year. Acquisition-related financing continued to support corporate bond issuance, but a significant share of recent issues was reportedly designated for capital expenditures. Commercial paper outstanding was unchanged in May, but bank lending maintained a strong pace. In the household sector, mortgage debt expanded at a slower pace in the first quarter, reflecting the slowdown in home-price appreciation over the past year and the lower pace of home sales. Interest

rates available to prime borrowers on both fixed-rate and variable-rate mortgages increased along with other market interest rates. Consumer credit continued to expand at a moderate pace in the first quarter. After rising at a particularly rapid rate in the first quarter, M2 increased at a more moderate pace in April and May.

In preparation for this meeting, the staff reduced its estimate of the increase in real GDP in the first quarter and marked up its forecast of the rebound in economic activity in the second quarter, in large part because of a more substantial swing in inventory investment than previously expected. The revisions, however, left the projection of economic growth over the first half of the year unchanged. As was the case in May, economic activity was expected to increase at a rate a little below that of the economy's long-run potential for the remainder of the year and to rise at a pace broadly in line with potential output growth in 2008. The projected gradual acceleration in economic activity in coming quarters largely reflected the expected waning of the drag from residential investment and improvements in the pace of business fixed investment. Increases in energy and food prices over the intermeeting period led the staff to revise up its forecast for headline PCE inflation during the second quarter, but its projection of core PCE inflation was revised down. Although some of the recent slowing in readings on core PCE inflation was likely due to transitory factors, the staff took some signal from the data and trimmed its forecast for core PCE inflation slightly in coming quarters. Over the next several quarters, total PCE inflation was projected to moderate to a pace close to core PCE inflation.

In their discussion of the economic situation and outlook, participants noted that economic activity appeared to have

expanded at a moderate pace on balance over the first half of the year. In view of incoming data and anecdotal information, participants continued to anticipate moderate economic growth in coming quarters, with growth rising gradually to a pace close to that of potential output. Participants interpreted the most recent information on business spending, business sentiment, and the labor market as suggesting that the risks to growth were more balanced than at the time of the May meeting, despite the ongoing adjustment in the housing sector and the significant recent increases in longer-term interest rates. Participants generally expected that inflation would probably edge lower over the next two years, reflecting the waning of temporary factors that had boosted prices last year and a slight easing of pressures on resources. Recent data on core consumer prices were encouraging in this regard, but participants were wary of drawing any firm conclusions about future trends from a few monthly readings that could reflect transitory influences and remained concerned about forces that could contribute to inflation pressures. Against this backdrop, participants agreed that the risk that inflation would fail to moderate as expected remained their predominant concern.

In preparation for the Federal Reserve's semiannual report to the Congress on the economy and monetary policy, the members of the Board of Governors and the presidents of the Federal Reserve Banks submitted individual projections of the growth of nominal and real GDP, the rate of unemployment, and core consumer price inflation for the years 2007 and 2008, conditioned on their views of the appropriate path for monetary policy. The projections for the growth of nominal GDP were in the range of 4½ to 5½ percent, with a central tendency of 4½ to 5 percent for

2007; for 2008, the projections for nominal GDP growth ranged between $4\frac{1}{2}$ to $5\frac{1}{2}$ with a central tendency of $4\frac{3}{4}$ to 5 percent. Projections for the rate of expansion in real GDP in 2007 were in a range from 2 to $2\frac{3}{4}$ percent in 2007, with a central tendency of $2\frac{1}{4}$ to $2\frac{1}{2}$ percent; for 2008, the projections ranged between $2\frac{1}{2}$ to 3 percent, with a central tendency of $2\frac{1}{2}$ to $2\frac{3}{4}$ percent. These rates of growth were associated with civilian unemployment rates in the range of $4\frac{1}{2}$ to $4\frac{3}{4}$ percent in the fourth quarter of 2007 and $4\frac{1}{2}$ to 5 percent in the fourth quarter of 2008; the central tendency of these projections was $4\frac{1}{2}$ to $4\frac{3}{4}$ percent in 2007 and about $4\frac{3}{4}$ percent in 2008. Projections for the rate of inflation, as measured by the core PCE price index, in 2007 were in a range of 2 to $2\frac{1}{4}$ percent in 2007 and $1\frac{3}{4}$ to 2 percent in 2008. The central tendencies of these projections in 2007 and 2008 were identical to the ranges for those years.

Participants generally agreed that the housing sector was likely to remain a drag on growth for some time yet and represented the most significant downside risk to the economic outlook. Although starts of single-family homes had moved up, on balance, over recent months, permits for new construction continued to decline. A number of participants noted that inventories of new homes for sale remained quite elevated. Housing activity was seen as likely to continue to contract for several more quarters. Participants also identified a number of downside risks associated with their outlook for residential construction. The recent increase in interest rates for prime mortgages could further dampen the demand for housing. Moreover, a number of participants pointed to rising mortgage delinquency rates and related difficulties in the subprime mortgage market as factors that could crimp

the availability of mortgage credit and the demand for housing.

Spillovers from the strains in the housing market to consumption spending had apparently been quite limited to date. To be sure, personal consumption expenditures appeared to be rising more slowly in recent months than earlier in the year, but that development was probably, at least in part, a result of the rise in gasoline prices, which was not expected to be extended. Participants generally anticipated moderate gains in consumption spending over coming months, supported by the strong labor market and solid growth in personal income. Still, the advance in spending was expected to fall short of income growth, and the saving rate was anticipated to trend higher over coming quarters from the unusually low levels of recent years. Some participants noted a risk that the saving rate could rise more than currently foreseen, particularly if household wealth were depressed by a further softening in house prices or by a less buoyant equity market that might accompany a potential slowing in the growth of corporate earnings. Several participants noted that higher interest rates and a potential tightening in credit availability might also be factors that could contribute to a rise in the personal saving rate. At the same time, participants recognized that consumption growth had held up to date and saw a risk that the saving rate could fail to rise as much as currently expected, particularly if equity markets continued to register significant gains.

A number of participants remarked that the recent data on business spending were more encouraging than those available at the time of the May meeting. In particular, orders and shipments for nondefense capital goods had stepped up, on balance, from March through May, and survey indicators of

business conditions had improved of late. Strength in foreign demand for U.S. goods and services was another factor that seemed likely to contribute to the firming of business spending. Participants noted that inventories appeared to be better aligned with sales, boding well for a resumption of inventory accumulation and a pickup in manufacturing activity. At the same time, some recognized the possibility that downside risks to investment spending persisted. Longer-term interest rates and the cost of credit generally had moved higher of late, the growth of business profits seemed to be moderating, and measured productivity growth had been slower. Although credit market conditions seemed to remain generally quite accommodative, in the days just prior to the meeting, the availability of credit to some highly leveraged and other lower-rated borrowers appeared to be tightening a bit and investors seemed to re-evaluate the risks associated with investments in complex and illiquid financial instruments.

Strength in spending abroad and the decline in the exchange value of the dollar were seen as factors boosting U.S. exports. The rise in global interest rates was cited as evidence of increasing global demand, and some participants pointed to strength of aggregate demand worldwide and its potential effect on the prices of imports and globally traded commodities as contributing to upside risks to U.S. inflation.

Most participants judged labor market conditions to remain rather tight, particularly for the most skilled workers. The continued tautness of labor markets was something of a puzzle in light of below-trend economic growth over recent quarters, and this development seemed to be connected with slower productivity growth lately. In their discussion of this issue, partici-

pants noted that employment data for 2006 could ultimately be revised down, resulting in a corresponding upward revision to productivity. Some participants also pointed to evidence of lags in employment adjustments, particularly in the construction industry, as a factor depressing productivity in recent quarters. These observations suggested that the recent decline in productivity growth might prove smaller than now estimated and largely transitory. Still, some decline in the pace of trend productivity growth could not be ruled out—a development that could have implications for business costs and price pressures. Some participants further noted that the level of the unemployment rate consistent with stable inflation could be lower than previously thought—a possibility that would help to explain the absence of outsized wage pressures in the current environment.

The incoming data on core consumer prices were viewed as favorable, but were not seen as convincing evidence that the recent moderation of core inflation would be sustained. Participants noted that monthly data on consumer prices are noisy, and recent readings on core inflation seemed to have been depressed by transitory factors. Moreover, a number of forces could sustain inflation pressures, including the generally high level of resource utilization, elevated energy and commodity prices, the decline in the exchange value of the dollar over recent quarters, and slower productivity growth. In addition, while core consumer price inflation had moderated of late, total consumer price inflation had moved substantially higher, boosted by rising energy and food prices. While total inflation was expected to slow toward the pace of core inflation over time, a number of participants noted that recent elevated readings posed some risk of a deterioration in

inflation expectations. On this point, several participants cited the uptick in forward measures of inflation compensation over the intermeeting period derived from Treasury inflation-indexed securities. However, a portion of this increase might be attributed to technical factors, and survey measures of long-term inflation expectations had held steady over recent weeks. Nonetheless, several participants emphasized that holding long-run inflation expectations at or below current levels would likely be necessary for core inflation to moderate as expected over coming quarters.

In their discussion of monetary policy for the intermeeting period, members generally regarded the risks to economic growth as more balanced than at the time of the May meeting. Although the housing market remained a key source of uncertainty about the outlook, members thought it most likely that the overall economy would expand at a moderate pace over coming quarters. Members generally anticipated that core inflation would remain relatively subdued but concurred that a sustained moderation in inflation had not yet been convincingly demonstrated. In these circumstances, members agreed that maintaining the target federal funds rate at 5¼ percent for this meeting was appropriate and that future policy adjustments would depend on the outlook for economic growth and inflation, as implied by incoming information.

In light of the recent economic data and anecdotal information, the Committee agreed that the statement to be released after the meeting should indicate that the economy seemed to be expanding at a moderate pace over the first half of the year. Members agreed that while measures of core inflation had improved lately, the statement should indicate that a sustained moderation of inflation remained in question and that high levels

of resource utilization had the potential to fuel inflation pressures. Against this backdrop, members judged that the risk that inflation would fail to moderate as expected remained their predominant concern.

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

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

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

In these circumstances, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Votes for this action: Messrs. Bernanke, Geithner, Hoenig, Kohn, and Kroszner, Ms. Minehan, Messrs. Mishkin, Moskowitz, Poole, and Warsh. Votes against this action: None.

The Committee then again took up the topic of monetary policy communications. The discussion at this meeting focused on several key elements of the Committee's communications vehicles: the statement released after each FOMC meeting; the minutes of FOMC meetings; and the projections of FOMC participants that are summarized in the Federal Reserve's semiannual monetary policy reports to the Congress. The

Committee made no decisions at this meeting, and it was understood that the subcommittee on communications issues would review the Committee's discussions to date on these matters.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 7, 2007.

The meeting adjourned at 2:20 p.m.

Notation Vote

By notation vote completed on May 29, 2007, the Committee unanimously approved the minutes of the FOMC meeting held on May 9, 2007.

Vincent R. Reinhart
Secretary

Meeting Held on August 7, 2007

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 7, 2007 at 8:30 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Mr. Hoenig
Mr. Kohn
Mr. Kroszner
Mr. Mishkin
Mr. Moskow
Mr. Poole
Mr. Rosengren
Mr. Warsh

Ms. Cumming, Mr. Fisher, Ms. Pianalto, and Messrs. Plosser and Stern, Alternate Members of the Federal Open Market Committee

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

Mr. Madigan, Secretary and Economist
Ms. Danker, Deputy Secretary

Ms. Smith, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist

Messrs. Connors, Evans, Fuhrer, Kamin, Rasche, Sellon, Slifman, Tracy, and Wilcox, Associate Economists

Mr. Dudley, Manager, System Open Market Account

Mr. Struckmeyer, Deputy Staff Director, Office of Staff Director for Management, Board of Governors

Messrs. Clouse and English, Senior Associate Directors, Division of Monetary Affairs, Board of Governors

Ms. Liang and Mr. Reifschneider, Associate Directors, Division of Research and Statistics, Board of Governors

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

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

Mr. Meyer, Visiting Reserve Bank Officer, Division of Monetary Affairs, Board of Governors

Ms. Dykes, Project Manager, Division of Monetary Affairs, Board of Governors

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

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

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

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

Messrs. Judd and Rosenblum, Executive Vice Presidents, Federal Re-

serve Banks of San Francisco and Dallas, respectively

Ms. Mosser and Mr. Sniderman, Senior Vice Presidents, Federal Reserve Banks of New York and Cleveland, respectively

Mr. Cunningham, Vice President, Federal Reserve Bank of Atlanta

Mr. Chatterjee, Senior Economic Adviser, Federal Reserve Bank of Philadelphia

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

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

In the agenda for this meeting, it was reported that advices of the election of Eric S. Rosengren as a member of the Federal Open Market Committee had been received and that he had executed his oath of office.

By unanimous vote, the Federal Open Market Committee selected Brian F. Madigan to serve as Secretary and Economist until the selection of a successor at the first regularly scheduled meeting of the Committee in 2008.

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 operations in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at the August meeting suggested that economic activity picked up in the second quarter from the slow pace in the first quarter. On average, the economy expanded at a

moderate pace during the first half of the year despite the ongoing drag from the housing sector. While the growth of consumer spending slowed in the second quarter from its rapid pace in prior quarters, wages and salaries increased solidly and household sentiment appeared supportive of further gains in spending. Business fixed investment picked up in the second quarter after little net change in the preceding two quarters. Inventories generally appeared to be well aligned with sales at midyear. Overall inflation receded in June because of a decline in energy prices, while the core personal consumption expenditure (PCE) price index rose a bit less than its average pace over the past year.

Private nonfarm payroll employment continued to increase at a healthy pace; the rise in July was about equal to the average increase over the first half of the year. Solid hiring in the service sector was partly offset by declines in construction and manufacturing employment. Most of the drop in construction employment occurred in jobs typically associated with nonresidential construction. Both the average workweek and aggregate hours ticked down in July. The unemployment rate edged up to 4.6 percent; it had remained between 4.4 percent and 4.6 percent since September 2006.

Industrial production picked up in the second quarter after little net change over the preceding two quarters. The increase was largely attributable to a smaller drag from inventory liquidation and a modest improvement in net exports. Manufacturing production rose solidly in the second quarter because of substantial increases in the output of light motor vehicles, other durable consumer goods, business equipment, construction supplies, and materials. Production in high-tech industries rose

relatively modestly in comparison to its longer-run growth.

The growth of real consumer spending slowed considerably in the second quarter after substantial increases earlier in the year. The deceleration primarily reflected sharply slower growth in outlays for goods as purchases of motor vehicles decreased noticeably. Although a spike in energy prices eroded real income growth in the second quarter, there were solid gains in wages and salaries. Despite continued softness in house prices, household wealth moved markedly higher in the second quarter, mostly reflecting rising equity prices.

Demand for housing in the second quarter was restrained by higher interest rates and by tightening credit conditions in the subprime mortgage market. Sales of new and existing homes in the second quarter were down substantially from their average levels in the second half of 2006. In June, single-family housing starts held steady at their May rate, although adjusted permit issuance slipped further. The combination of decreased sales and unchanged production left inventories of new homes for sale still elevated. House-price appreciation continued to slow, with some measures again showing declines in home values.

Outlays for nonresidential construction rose rapidly in the second quarter. Business spending on equipment and software, other than transportation equipment, posted a solid increase after being flat, on net, in the preceding two quarters. The rise was led by a rebound in purchases of industrial machinery. Expenditures for computers, software, and communications equipment grew moderately in the second quarter after a brisk first-quarter increase. Spending on transportation equipment again declined sharply. The drop was largely a continuation of the payback from exceptionally strong purchases of heavy trucks in 2005

and 2006 in anticipation of tighter emissions standards on diesel engines. New orders for medium and heavy trucks edged up in the second quarter, though they remained at low levels, suggesting that the downturn in business spending on motor vehicles may be ending.

Real nonfarm inventory investment was a roughly neutral influence on real GDP growth in the second quarter after having held down the growth rate by an average of 1 percentage point in the previous two quarters. Businesses made considerable progress in reducing the apparent inventory overhangs that had emerged at the end of 2006. In the motor vehicle sector, low rates of assemblies in the first half of this year left inventories of domestic light vehicles at the end of the second quarter fairly well aligned with sales; however, inventories rose again in July as production accelerated and sales remained weak. More broadly, the number of purchasing managers who viewed their customers' inventory levels as too high in July only slightly exceeded the number who saw them as too low.

The U.S. international trade deficit widened in May, as a rise in imports more than offset an increase in exports. Within imports, most categories of goods recorded an increase, as did services. The value of oil imports rose sharply, boosted by a jump in the price of imported oil. The increase in exports was largely attributable to capital goods, including aircraft, computers and semiconductors, and industrial supplies.

Economic activity in advanced foreign economies expanded somewhat less rapidly in the second quarter than in the prior quarter, but nonetheless appeared to have grown faster than trend, reflecting upbeat business and consumer confidence as well as favorable labor market conditions. Although many of those economies recently experienced

sharp declines in equity prices and widening credit spreads amid deepening concerns about credit quality, these developments occurred too late in the intermeeting period to have any apparent effect on incoming data. In Japan, survey evidence suggested that its economy expanded moderately. Survey evidence indicated high levels of economic sentiment and strong capital spending plans among large manufacturers. In the euro area, survey measures of business and consumer confidence remained near record highs in July, and labor market conditions generally continued to improve in May and June. In the United Kingdom, real GDP growth rose in the second quarter, an increase driven mainly by robust expansion in the service sector. Canada's growth seemed to continue to pick up from its disappointing rate posted in much of last year.

Recent data indicated that economic activity in emerging-market economies remained generally strong. The Chinese economy continued to expand at a rapid pace, and activity elsewhere in emerging Asia appeared to have accelerated. In Latin America, Mexican indicators pointed to a weaker-than-expected rebound in the second quarter, whereas Brazil and Argentina appeared to have experienced solid growth. While equity prices fell and bond spreads widened in several emerging-market economies, particularly in Latin America, there was no evidence that this increased volatility had yet weighed on economic activity.

U.S. headline consumer price inflation slowed in June as energy prices flattened out after a rapid increase over the preceding three months. Core PCE prices rose 0.1 percent in June, as a decline in the price index for core goods nearly offset a rise in the index for core services. The readings on core PCE price inflation in recent months had been held down, in part, by declines in prices

of some categories of goods, such as apparel, that tend to be volatile on a monthly basis. Household surveys conducted in early July indicated that the median expectation for inflation over the next year remained unchanged from June's elevated level despite declines in gasoline prices in both months. Median expectations of longer-term inflation ticked up and were near the top of the narrow range that had prevailed over the past few years. The employment cost index rose somewhat faster in the second quarter than over the preceding three months, and the twelve-month change was slightly higher than that of a year ago.

At its June meeting, the Federal Open Market Committee (FOMC) maintained its target for the federal funds rate at 5¼ percent. The statement announcing the policy decision noted that economic growth appeared to have been moderate during the first half of the year, despite the ongoing adjustment in the housing sector. The economy seemed likely to continue to expand at a moderate pace over coming quarters. Readings on core inflation had improved modestly in recent months. However, a sustained moderation in inflation pressures had yet to be convincingly demonstrated. Moreover, the high level of resource utilization had the potential to sustain those pressures. The Committee's predominant policy concern remained the risk that inflation would fail to moderate as expected. Future policy adjustments would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Market participants had largely anticipated the FOMC's decision at its June meeting to leave the target for the federal funds rate unchanged, although the accompanying statement expressed greater concern about inflation than in-

vestors reportedly had foreseen and caused the expected path for the federal funds rate to edge higher. Expectations for a policy easing diminished somewhat more in the wake of favorable economic news early in the period. Subsequently, the semiannual *Monetary Policy Report to the Congress* and the accompanying testimony, which reported lower projections for real GDP growth than investors apparently expected, appeared to prompt a downward shift in investors' expected path for the federal funds rate. Later in the intermeeting period, growing apprehension that turmoil in markets for subprime mortgages and some low-rated corporate debt might have adverse effects on economic growth led investors to mark down their expectations for the future path of policy considerably further. At the same time, measures of long-horizon inflation compensation based on inflation-indexed Treasury securities edged down.

Financial market conditions were volatile during the intermeeting period, particularly over the last few weeks of the interval. Yields on nominal Treasury securities fell on balance, possibly reflecting an increased preference by investors for safe assets as well as revisions in policy expectations. Conditions in markets for subprime mortgages and related instruments, including segments of the asset-backed commercial paper market, deteriorated sharply toward the end of the period. Credit conditions for speculative-grade corporate borrowers tightened substantially, as investors pulled back from higher-risk assets. Spreads on speculative-grade bonds increased to near their highest levels in the past four years. A number of high-yield bond and leveraged loan deals intended to finance leveraged buyouts were delayed or restructured, though other high-yield bonds were issued. In contrast,

credit conditions for investment-grade businesses and prime households were relatively little affected by the market turbulence. Issuance of investment-grade bonds continued. Yields on investment-grade corporate issues rose relative to yields on Treasury securities, but because yields on Treasuries declined, yields on investment-grade bonds were about unchanged on net. Nonfinancial commercial paper outstanding posted a modest gain in July, while the pace of bank lending to businesses picked up from an already solid clip. Mortgage loans and consumer credit appeared to remain readily available to households with strong balance sheets, although late in the period some evidence pointed to diminishing availability of jumbo mortgages.

Broad stock price indexes declined substantially, on net, over the intermeeting period despite generally solid second-quarter earnings reports. Share prices of financial firms fell especially sharply, reportedly a reflection, in part, of concerns about exposures to subprime mortgages and about the effect of a potential slowdown in merger activity on operating profits. The foreign exchange value of the dollar against other major currencies fell, on balance.

Growth of home mortgage debt likely slowed again in the second quarter, mainly reflecting the decline in home-price appreciation over the past year and the drop in home sales. Overall consumer credit expanded moderately through the year ending in May. The debt of nonfinancial businesses expanded at a robust pace in the second quarter but slowed in July. After rising at a rapid pace in the first half of the year, M2 grew at a more moderate rate in July.

In preparation for this meeting, the staff lowered somewhat its forecast of real GDP growth in the second half of

2007 and in 2008. The reduction was in part due to the annual revision of national income and product accounts (NIPA), which revealed somewhat less rapid growth in output and productivity during the past three years than previously reported and led the staff to trim its estimates of the growth rates of structural productivity and potential GDP; the reduction also reflected less accommodative financial conditions and the softer tone of some near-term indicators. The near-parallel revisions to the forecasts for potential and actual GDP left the staff's projections for resource utilization about unchanged. Although part of the recent favorable monthly readings on core PCE price changes was expected to be transitory, the staff revised down slightly its forecast for core PCE price inflation in the second half of 2007; however, in light of slower growth in structural productivity and prospects of somewhat greater pressure from import prices, the staff left its projection for core PCE inflation unchanged for 2008. Overall PCE inflation was expected to slow in the second half of 2007 from the elevated pace of the first half, as the effects of the sizable increases in food and energy prices earlier this year abated, and then to move down a bit further in 2008.

In their discussion of the economic situation and outlook, meeting participants indicated that they still saw moderate economic expansion in coming quarters as the most likely outcome but that the downside risks to growth had increased. Participants reported that economic expansion had continued at a moderate pace in many regions of the country despite further weakness in the housing sector. Going forward, most participants anticipated that growth in aggregate demand would be supported by rising employment, incomes, and exports, with the result that growth in ac-

tual output probably would remain close to growth of potential GDP despite the ongoing adjustment in the housing sector. Several mentioned that the revisions to the NIPA pointed to a modest downward adjustment in projected growth of actual and potential GDP, but thought that potential output growth was likely to be a bit higher than forecast by the staff. However, recent spending indicators had been mixed, and credit conditions had become tighter, suggesting greater downside risks to growth. Participants generally expected that core inflation would edge lower over the next two years, reflecting a slight easing of pressures on resources, well-anchored inflation expectations, and the waning of temporary factors that had boosted prices last year and early this year. Participants anticipated that total inflation would slow as well, particularly if market expectations of a modest decline in energy prices in coming quarters were to prove correct. But they were concerned that the high level of resource utilization and slower productivity growth could augment inflation pressures. Against this backdrop, the Committee agreed that the risk that inflation would fail to moderate as expected remained its predominant policy concern.

Participants agreed that the housing sector was apt to remain a drag on growth for some time and represented a significant downside risk to the economic outlook. Indeed, developments in mortgage markets during the intermeeting period suggested that the adjustment in the housing sector could well prove to be both deeper and more prolonged than had seemed likely earlier this year. Participants noted that investors had become much more uncertain about the likely future cash flows from subprime and certain other nontraditional mortgages, and thus about the valuation of securities backed by such mortgages.

Consequently, the markets for securities backed by subprime and other non-traditional mortgages had become illiquid, and originations of new subprime mortgages had dropped sharply. While these markets were expected to recover over time, it was anticipated that credit standards for these types of mortgages would be tighter, and interest rates higher relative to rates on conforming mortgages, in the future than in recent years. However, participants also observed that mortgage loans remained readily available to most potential borrowers, and that interest rates on conforming, conventional mortgage loans had declined in recent weeks, providing some support to the housing sector.

Participants thought that consumer expenditures likely would expand at a moderate pace in coming quarters, supported by solid gains in employment and real income. Though growth in consumer spending had slowed in the second quarter, the slowing likely reflected temporary factors in part, including some payback from unusually strong growth in prior quarters and the surge in gasoline prices. Several participants noted the risks that house prices could decline significantly and that credit standards for home equity loans could be tightened substantially as factors that could weigh on consumer spending. However, the sizable upward revision—from negative to positive—in estimates of the personal saving rate during the past three years suggested somewhat less need for households to rebuild their savings.

Participants expected that business investment would be supported by solid fundamentals, including high profits, strong business balance sheets, and moderate growth in output. Recent financial market developments were thought unlikely to have an appreciable adverse effect on capital spending. Al-

though lenders recently appeared to be less willing to extend credit for financial restructuring, the supply of credit to finance real investment did not appear significantly diminished. Funding had become more costly and difficult to obtain for riskier corporate borrowers, but there had been little net change in the cost of credit for investment-grade businesses. Also, businesses in the aggregate continued to have sufficient internally generated funds to finance the expected level of real investment. Nonetheless, participants recognized that conditions in corporate credit markets could change rapidly, and that adverse effects on business spending were possible. Moreover, heightened asset market volatility and the associated increase in uncertainty, if they were to persist for long, could lead businesses to pare capital spending plans. Still, participants judged that continued growth of investment outlays going forward was the most likely outcome.

Rapid economic growth abroad and the decline in the foreign exchange value of the dollar in recent quarters were seen as likely to boost U.S. exports and thus support the economic expansion. Some participants also anticipated that growth in government purchases of goods and services would support continued growth in output.

The data on core inflation received during the intermeeting period were favorable, but meeting participants believed that the readings for the past few months likely had been damped by transitory factors and did not provide reliable evidence that the recent level would be sustained. Still, participants thought that a slight decrease in pressures on resources and the stability of inflation expectations likely would foster over time a gradual moderation in core inflation. Participants anticipated that total inflation would slow as well, particu-

larly if market expectations for a modest decline in energy prices in coming quarters were to prove correct. Participants remained concerned about factors that could augment inflation pressures, including the continuing high level of resource utilization and slower trend growth in productivity. Some also pointed to the strength of aggregate demand worldwide and the depreciation of the dollar, and their potential effects on the prices of imports and globally traded commodities, as contributing to upside risks to U.S. inflation. Several participants noted significant increases in wages in their Districts, particularly in the service sector, but it was also observed that overall gains in labor compensation had remained moderate, suggesting that sustainable rates of resource utilization could be slightly higher than typically estimated. On balance, participants continued to agree that risks to the outlook for sustained moderation in inflation pressures remained tilted to the upside.

In their discussion of monetary policy for the intermeeting period, Committee members again agreed that maintaining the existing stance of policy at this meeting was likely to be consistent with the overall economy expanding at a moderate pace over coming quarters and inflation pressures moderating over time. The expansion would be supported by solid job gains and rising real incomes that would bolster consumption, and by increasing foreign demand for goods and services produced in the United States. The ongoing adjustment in housing markets likely would exert a restraining influence on overall growth for several more quarters and remained a key source of uncertainty about the outlook. The recent strains in financial markets posed additional downside risks to economic growth. Members expected a return to more normal market condi-

tions, but recognized that the process likely would take some time, particularly in markets related to subprime mortgages. However, a further deterioration in financial conditions could not be ruled out and, to the extent such a development could have an adverse effect on growth prospects, might require a policy response. Policymakers would need to watch the situation carefully. For the present, however, given expectations that the most likely outcome for the economy was continued moderate growth, the upside risks to inflation remained the most significant policy concern. In these circumstances, members agreed that maintaining the target federal funds rate at $5\frac{1}{4}$ percent at this meeting was appropriate.

In light of the recent economic data, anecdotal information, and financial market developments, the Committee agreed that the statement to be released after the meeting should indicate that economic growth was moderate during the first half of the year and that the economy seemed likely to continue to expand moderately in coming quarters, supported by solid growth in employment and incomes and by robust economic growth abroad. Members also agreed that the statement should incorporate their view that downside risks to growth had increased somewhat, and should mention volatile financial markets, tighter credit conditions for some households and businesses, and the ongoing correction in the housing market. In addition, the Committee agreed that the statement should again note that readings on core inflation had improved modestly in recent months but did not yet convincingly demonstrate a sustained moderation of inflation pressures, and that the high level of resource utilization had the potential to sustain inflation pressures. Against this backdrop, members judged that the risk that infla-

tion would fail to moderate as expected continued to outweigh other policy concerns.

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

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

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

Although the downside risks to growth have increased somewhat, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the outlook for both inflation and economic growth, as implied by incoming information.

Votes for this action: Messrs. Bernanke, Geithner, Hoenig, Kohn, Kroszner, Mishkin, Moskow, Poole, Rosengren, and Warsh. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 18, 2007.

The meeting adjourned at 1:25 p.m.

Notation Vote

By notation vote completed on July 18, 2007, the Committee unanimously approved the minutes of the FOMC meeting held on June 27–28, 2007.

Brian F. Madigan
Secretary

Meeting Held on September 18, 2007

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 18, 2007 at 8:30 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Mr. Evans
Mr. Hoenig
Mr. Kohn
Mr. Kroszner
Mr. Mishkin
Mr. Poole
Mr. Rosengren
Mr. Warsh

Mr. Fisher, Ms. Pianalto, and Messrs. Plosser and Stern, Alternate Members of the Federal Open Market Committee

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

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

Messrs. Clouse, Connors, Fuhrer, Kamin, Rasche, Slifman, and Wilcox, Associate Economists

Mr. Dudley, Manager, System Open Market Account

Ms. J. Johnson,⁹ Secretary, Office of the Secretary, Board of Governors

9. Attended portion of the meeting relating to the discussion of approaches to stabilizing money markets.

Mr. Frierson,⁹ Deputy Secretary, Office of the Secretary, Board of Governors

Ms. Bailey⁹ and Mr. Roberts,⁹ Deputy Directors, Division of Banking Supervision and Regulation, Board of Governors

Mr. English, Senior Associate Director, Division of Monetary Affairs, Board of Governors

Ms. Liang and Mr. Reifschneider, Associate Directors, Division of Research and Statistics, Board of Governors

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

Mr. G. Evans,⁹ Assistant Director, Division of Reserve Bank Operations and Payment Systems, Board of Governors

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

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

Mr. Meyer, Visiting Reserve Bank Officer, Division of Monetary Affairs, Board of Governors

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

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

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

Ms. Beattie,⁹ Assistant to the Secretary, Office of the Secretary, Board of Governors

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

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

Messrs. Judd, Rosenblum, and Sniderman, Executive Vice Presidents, Federal Reserve Banks of San Francisco, Dallas, and Cleveland, respectively

Messrs. Dzina and Hakkio, Meses. Krieger⁹ and Mester, and Messrs. Rolnick and Weinberg, Senior Vice Presidents, Federal Reserve Banks of New York, Kansas City, New York, Philadelphia, Minneapolis, and Richmond, respectively

Messrs. Krane, Peach, and Robertson, Vice Presidents, Federal Reserve Banks of Chicago, New York, and Atlanta, respectively

In the agenda for this meeting, it was reported that advices of the election of Charles L. Evans as a member of the Federal Open Market Committee had been received and that he had executed his oath of office.

By unanimous vote, the Federal Open Market Committee selected James A. Clouse and Daniel G. Sullivan to serve as Associate Economists until the selection of their successors at the first regularly scheduled meeting of the Committee in 2008.

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

The information reviewed at the September meeting suggested that economic activity advanced at a moderate rate early in the third quarter. After expand-

ing at a robust pace in July, retail sales rose at a somewhat slower rate in August. Orders and shipments of capital goods posted solid gains in July. However, residential investment weakened further, even before the recent disruptions in mortgage markets. In addition, private payrolls posted only a small gain in August, and manufacturing production decreased after gains in the previous two months. Meanwhile, core inflation rose a bit from the low rates observed in the spring but remained moderate through July.

Private nonfarm payroll employment rose only modestly in August, and the levels of employment in June and July were revised down. The weakness in employment was spread fairly widely across industries. Residential construction and manufacturing posted noticeable declines in jobs, employment in wholesale trade and transportation was little changed, and hiring at business services was well below recent trends. Both the average workweek and aggregate hours were unchanged in August. The unemployment rate held steady at 4.6 percent, 0.1 percentage point above its second-quarter level and equal to its 2006 average.

After posting solid gains in June and July, total industrial production edged up only a bit in August. This increase was attributable to a surge in electricity generation, as temperatures swung from mild in July to very warm in August. After large gains in the preceding two months, manufacturing output declined in August, held down by a decrease in the production of motor vehicles and parts. High-tech output rose only modestly in August, but production gains in June and July were revised up considerably.

Consumer spending appeared to have strengthened early in the summer from its subdued second-quarter pace. Al-

though auto sales were weak in July, real outlays for other goods rose briskly. At the same time, spending on services was up moderately despite a drop in outlays for energy associated with relatively cool weather in the eastern part of the United States. In August, consumption appeared to have posted another solid gain. Although nominal retail sales outside the motor vehicle sector were about flat (abstracting from a drop in nominal sales at gasoline stations associated with falling gas prices), vehicle sales stepped up and warmer weather likely caused an increase in energy usage. Real disposable income rose further in July, as wages and salaries posted a strong gain and energy prices came down. However, household wealth likely was providing a diminishing impetus to the pace of spending, reflecting recent declines in stock market wealth and an apparent further deceleration in house prices. Readings on consumer sentiment turned down in August after having risen in July, and the Reuters/Michigan index remained near its relatively low August level in early September.

The housing sector remained exceptionally weak. Home sales had dropped considerably this year: Sales of new and existing single-family homes in July were down substantially from their averages over the second half of last year. Demand was restrained by deteriorating conditions in the subprime mortgage market and by an increase in rates for thirty-year fixed-rate conforming mortgages. In the nonconforming mortgage market, the availability of financing to borrowers recently appeared to have been crimped even further. Most forward-looking indicators of housing demand, including an index of pending home sales, pointed to a further deterioration in sales in the near term. Single-family starts slid in July to their lowest

reading since 1996, and adjusted permit issuance continued on a downward trajectory. Although single-family housing starts had come down substantially from their peak, the drop had lagged the decline in demand, and as a result, inventories of new homes had risen considerably. In the multifamily sector, starts in July were in line with readings thus far this year and at the low end of the fairly narrow range seen since 1997. Meanwhile, house prices generally continued to decelerate.

Orders and shipments of capital goods posted a strong gain early in the third quarter. In particular, orders and shipments of equipment outside the high-tech and transportation sector registered a robust increase in July, and data on computer production and shipments of high-tech goods pointed to solid increases in business demand for high-tech. In contrast, indicators of spending for transportation equipment were mixed. Aircraft shipments in July and public information on Boeing's deliveries suggested that domestic spending on aircraft was retreating somewhat in the current quarter. While fleet sales of light vehicles appeared to have moved up in July and August, sales of medium and heavy trucks remained below the second-quarter average. More generally, surveys of business conditions suggested that increases in business activity were somewhat slower in August than in the second quarter.

Book-value data for the manufacturing and trade sectors excluding motor vehicles and parts suggested that inventory accumulation stepped down noticeably in July from the second-quarter pace. Inventories of light motor vehicles rose again in July and August. The number of manufacturing purchasing managers who viewed their customers' inventory levels as too low in August slightly

exceeded the number who saw them as too high.

The U.S. international trade deficit narrowed slightly in July, as exports increased more than imports. Sharp increases in exports of both aircraft and automobiles contributed importantly to the overall gain. Exports of agricultural products and consumer goods were also strong. In contrast, exports of industrial supplies and semiconductors exhibited declines. The value of imported goods and services was boosted by a large increase in imports of automotive products. Higher imports of capital goods excluding aircraft, computers, and semiconductors and of oil also contributed to the overall gain in imports.

Economic growth slowed in the second quarter in most advanced foreign economies, except the United Kingdom. The step-down was most pronounced in Japan, where GDP contracted, but was also substantial in the euro area, where total domestic demand rose only slightly. Although growth remained robust in Canada, data late in the quarter, including retail sales, indicated a more significant weakening in activity. This softness appeared to have continued into the third quarter in some economies. In July, indicators for Europe generally moderated, on balance, from their second-quarter levels; those for Canada and Japan, however, slowed more notably. Most of the readings available on economic developments after August 9, when financial turmoil intensified, were measures of confidence. They dropped, on average, but otherwise were consistent with the indicators reported for July.

Data through July suggested that economic activity in emerging-market countries remained robust. Output in the Asian economies soared in the second quarter, and several countries posted growth at or near double-digit rates. In Latin America, output in Mexico and

Venezuela rebounded sharply from earlier weakness. Indicators for China in July pointed to only a modest slowing of output growth from its torrid pace in the first half of the year. The scant data for August received thus far provided little indication that the turmoil in financial markets had a significant negative impact on real economic activity in emerging-market economies.

After rapid price increases earlier this year, U.S. headline consumer price inflation was moderate in both June and July. Although food prices continued their string of sizable increases, energy prices fell in June and July and gasoline prices appear to have dropped further in August. Core PCE prices rose 0.2 percent in June and 0.1 percent in July. On a twelve-month-change basis, core PCE inflation in July was below the comparable rate twelve months earlier. Step-downs in price inflation for prescription drugs, motor vehicles, and nonmarket services accounted for nearly all of the deceleration in core PCE prices. Although owners' equivalent rent decelerated over the past year, this change was largely offset by an acceleration in tenants' rent and lodging away from home. Household surveys indicated that the median expectation for year-ahead inflation declined in August and edged down further in early September to a level only slightly above the reading at the turn of the year; the median expectation of longer-term inflation in early September remained in the range seen over the past couple of years. The producer price index for core intermediate materials rose only modestly in July. Compensation per hour decelerated in the second quarter. Nonetheless, the increase over the four quarters ending in the second quarter was noticeably above the increase in the preceding four quarters and well above the rise in the employment cost index over the same period.

At its August meeting, the FOMC decided to maintain its target for the federal funds rate at 5¼ percent. In the statement, the Committee acknowledged that financial markets had been volatile in recent weeks, credit conditions had become tighter for some households and businesses, and the housing correction was ongoing. The Committee reiterated its view that the economy seemed likely to continue to expand at a moderate pace over coming quarters, supported by solid growth in employment and incomes and a robust global economy. Readings on core inflation had improved modestly in recent months. However, a sustained moderation in inflation pressures had yet to be convincingly demonstrated. Moreover, the high level of resource utilization had the potential to sustain these pressures. Although the downside risks to growth had increased somewhat, the Committee repeated that its predominant policy concern remained the risk that inflation would fail to moderate as expected. Future policy adjustments would depend on the outlook for both inflation and economic growth, as implied by incoming information. The FOMC's policy decision and the accompanying statement were about in line with market expectations, and reactions in financial markets were muted.

In the days after the August FOMC meeting, financial market participants appeared to become more concerned about liquidity and counterparty credit risk. Unsecured bank funding markets showed signs of stress, including volatility in overnight lending rates, elevated term rates, and illiquidity in term funding markets. On August 10, the Federal Reserve issued a statement announcing that it was providing liquidity to facilitate the orderly functioning of financial markets. The Federal Reserve indicated that it would provide reserves as neces-

sary through open market operations to promote trading in the federal funds market at rates close to the target rate of 5¼ percent. The Federal Reserve also noted that the discount window was available as a source of funding.

On August 17, the FOMC issued a statement noting that financial market conditions had deteriorated and that tighter credit conditions and increased uncertainty had the potential to restrain economic growth going forward. The FOMC judged that the downside risks to growth had increased appreciably, indicated that it was monitoring the situation, and stated that it was prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets. Simultaneously, the Federal Reserve Board announced that, to promote the restoration of orderly conditions in financial markets, it had approved a 50 basis point reduction in the primary credit rate to 5¾ percent. The Board also announced a change to the Reserve Banks' usual practices to allow the provision of term financing for as long as thirty days, renewable by the borrower. In addition, the Board noted that the Federal Reserve would continue to accept a broad range of collateral for discount window loans, including home mortgages and related assets, while maintaining existing collateral margins. On August 21, the Federal Reserve Bank of New York announced some temporary changes to the terms and conditions of the SOMA securities lending program, including a reduction in the minimum fee. The effective federal funds rate was somewhat below the target rate for a time over the intermeeting period, as efforts to keep the funds rate near the target were hampered by technical factors and financial market volatility. In the days leading up to the FOMC meeting, however, the funds rate traded closer to the target.

Short-term financial markets came under pressure over the intermeeting period amid heightened investor unease about exposures to subprime mortgages and to structured credit products more generally. Rates on asset-backed commercial paper and on low-rated unsecured commercial paper soared, and some issuers, particularly asset-backed commercial paper programs with investments in subprime mortgages, found it difficult to roll over maturing paper. These developments led several programs to draw on backup lines, exercise options to extend the maturity of outstanding paper, or even default. As a result, asset-backed commercial paper outstanding contracted substantially. Investors sought the safety and liquidity of Treasury securities, and yields on Treasury bills dropped sharply for a period; trading conditions in the bill market were impaired at times. Meanwhile, banks took measures to conserve their liquidity and were cautious about counterparties' exposures to asset-backed commercial paper. Term interbank funding markets were significantly impaired, with rates rising well above expected future overnight rates and traders reporting a substantial drop in the availability of term funding. Pressures eased a bit in mid-September, but short-term financial markets remained strained.

Conditions in corporate credit markets were mixed. Investment- and speculative-grade corporate bond spreads edged up; they were near their highest levels in four years, although they remained far below the peaks seen in mid-2002. Investment-grade bond issuance was strong in August as yields declined, but issuance of speculative-grade bonds was scant. Speculative-grade bond deals and leveraged loans slated to finance leveraged buyouts continued to be delayed or restructured. Bank lending to businesses surged in

August, apparently because some banks funded leveraged loans that they had intended to syndicate to institutional investors and perhaps because some firms substituted bank credit for commercial paper. Although markets for nonconforming mortgages were impaired over the intermeeting period, the supply of conforming mortgages seemed to have been largely unaffected by recent developments. Broad stock price indexes were volatile but about unchanged, on net, over the intermeeting period. The foreign exchange value of the dollar against other major currencies fell, on balance.

Investors appeared to mark down significantly their expected path for the federal funds rate during the intermeeting period, evidently in response to the strains in money and credit markets and a few key data releases, including weaker-than-expected reports on housing activity and employment. Yields on nominal Treasury securities fell appreciably across the term structure. TIPS-based inflation compensation at the five-year horizon was about unchanged, while inflation compensation at longer horizons crept higher.

Growth of nonfinancial domestic debt was estimated to have slowed a little in the third quarter from the average pace in the first half of the year. The deceleration in total nonfinancial debt reflected a projected slowdown in borrowing across all major sectors of the economy excluding the federal government. Although it decelerated in the third quarter, business-sector debt continued to advance at a solid pace, boosted by a surge in business loans. In the household sector, mortgage borrowing was estimated to have slowed notably, as mortgage interest rates moved up, nonconforming mortgages became harder to obtain, and as home sales slowed and house prices decelerated. M2 increased

at a brisk pace in August. The rise was led by a surge in liquid deposits and in retail money funds as investors adjusted their portfolios in response to the turmoil in financial markets.

In preparation for this meeting, the staff continued to estimate that real GDP increased at a moderate rate in the third quarter. However, the staff marked down the fourth-quarter forecast, reflecting a judgment that the recent financial turbulence would impose restraint on economic activity in coming months, particularly in the housing sector. The staff also trimmed its forecast of real GDP growth in 2008 and anticipated a modest increase in unemployment. Softer demand for homes amid a reduction in the availability of mortgage credit would likely curtail construction activity through the middle of next year. Moreover, lower housing wealth, slower gains in employment and income, and reduced confidence seemed likely to restrain consumer spending in 2008. Despite the recent difficulties in some corporate credit markets, financial conditions confronting most nonfinancial businesses did not appear to have tightened appreciably to date. But going forward, the staff anticipated that businesses would scale back their capital spending a touch in response to financing conditions that were likely to become a little less accommodative and to more modest gains in sales. With credit markets expected to largely recover over coming quarters, growth of real GDP was projected to firm in 2009 to a pace a bit above the rate of growth of its potential. Incoming data on consumer price inflation that were slightly to the low side of the previous forecast, in combination with the easing of pressures on resource utilization in the current forecast, led the staff to trim slightly its forecast for core PCE inflation. Headline PCE inflation, which was boosted by sizable increases in en-

ergy and food prices earlier in the year, was expected to slow in 2008 and 2009.

In their discussion of the economic situation and outlook, meeting participants focused on the potential for recent credit market developments to restrain aggregate demand in coming quarters. The disruptions to the market for non-conforming mortgages were likely to reduce further the demand for housing, and recent financial developments could well lead to a more general tightening of credit availability. Moreover, some recent data and anecdotal information pointed to a possible nascent slowdown in the pace of expansion. Given the unusual nature of the current financial shock, participants regarded the outlook for economic activity as characterized by particularly high uncertainty, with the risks to growth skewed to the downside. Some participants cited concerns that a weaker economy could lead to a further tightening of financial conditions, which in turn could reinforce the economic slowdown. But participants also noted that the resilience of the economy in the face of a number of previous periods of financial market disruptions left open the possibility that the macroeconomic effects of the financial market turbulence would prove limited.

Although financial markets were expected to stabilize over time, participants judged that credit markets were likely to restrain economic growth in the period ahead. Given existing commitments to customers and the increased resistance of investors to purchasing some securitized products, banks might need to take a large volume of assets onto their balance sheets over coming weeks, including leveraged loans, asset-backed commercial paper, and some types of mortgages. Banks' concerns about the implications of rapid growth in their balance sheets for their capital ratios and for their liquidity, as well as

the recent deterioration in various term funding markets, might well lead banks to tighten the availability of credit to households and firms. Tighter credit conditions were likely to weigh particularly on residential investment and to a lesser extent on other components of aggregate demand in coming quarters. Meeting participants also noted that financial market conditions, while seeming to have improved somewhat in the most recent days, were still fragile and that further adverse credit market developments could well increase the downside risks to the economy. Even after market volatility subsided and the recent strains eased, risk spreads probably would be wider and credit terms tighter than they had been a few months ago. Although these developments would likely be consistent with longer-term financial stability, they were likely to exert some restraint on aggregate demand.

In their discussion of individual sectors of the economy, participants noted that recent data suggested greater weakness in the housing market than had previously been expected. Furthermore, recent financial developments had the potential to deepen further and prolong the downturn in the housing market, as subprime mortgages remained essentially unavailable, little activity was evident in the markets for other nonprime mortgages, and prime jumbo mortgage borrowers faced higher rates and tighter lending standards. The faster pace of foreclosures as subprime mortgage rates reset was also seen as posing a downside risk to the housing market. Nonetheless, participants observed that conforming mortgages remained readily available to creditworthy borrowers and that rates on these mortgages had declined in recent weeks. Moreover, conditions in the jumbo mortgage market were expected to improve gradually over time.

Although employment probably was not as weak as the most recent monthly data had suggested, trend growth in jobs had fallen off even prior to the recent financial market strains, and participants judged that some further slowing of employment growth was likely. Indeed, financial services firms had already announced layoffs, largely reflecting mortgage market developments, the demand for temporary workers appeared to have softened, and the most recent weakening in construction employment was likely to continue for a while. Moreover, if declines in house prices were to damp consumption, that could feed back on employment and income, exerting additional restraint on the demand for housing. Nonetheless, to date, initial claims for unemployment insurance did not indicate a substantial and widespread weakening in labor demand, and labor markets across the country generally remained fairly tight, with several participants citing continued reports of shortages of labor from their contacts in some sectors.

Participants thought that the most likely prospect was for consumer expenditures to continue to expand at a moderate pace on average over coming quarters, supported by growth in employment and income. However, some participants saw indications of a possible weakening of consumer spending. Sales of automobiles and building materials had flagged of late, and survey measures suggested that consumer confidence had been adversely affected by the recent financial market developments. Also, a further tightening of terms for home equity lines of credit and second mortgages seemed possible, which could weigh on consumer spending, especially for consumer durables.

Participants reported that recent financial market developments generally appeared to have had limited effects to

date on business capital spending plans and expected that business investment was likely to remain healthy in coming quarters. The access of investment-grade corporate borrowers to credit so far remained unimpeded, and rates on investment-grade bonds had declined in recent weeks. Moreover, participants noted that many capital expenditures were internally financed, making them less sensitive to credit market conditions. Nonetheless, the pace of financing for lower-rated firms—including issuance of both speculative-grade bonds and leveraged loans—had slowed sharply over the summer. Participants also noted that standards and terms for commercial real estate credit reportedly had tightened, and that credit availability for homebuilders could be trimmed going forward. In addition, contacts indicated that business executives in parts of the country had apparently become somewhat more cautious and that some were delaying investment outlays in view of heightened economic and financial uncertainty.

Some participants noted that foreign demand remained robust and net exports appeared strong. Port utilization rates reportedly remained high. Participants discussed the turbulence in foreign financial markets and noted that unusually high precautionary demand for dollar-denominated term funding in Europe had added to strains in U.S. interbank markets and contributed to a wide spread between libor and federal funds rates.

Participants made only modest revisions to their outlook for inflation in the period since the Committee's last regular meeting. Still, they recognized that incoming data on core inflation continued to be favorable, and they generally were a little more confident that the decline in inflation earlier this year would be sustained. Inflation expectations

seemed to be contained, and the less robust economic outlook implied somewhat less pressure on resources going forward. Participants nonetheless remained concerned about possible upside risks to inflation. Higher benefit costs, rising unit labor costs more generally, reduced markups, and levels of resource utilization both in the United States and abroad that remained relatively high were all cited as factors that could contribute to inflationary pressures. Inflation risks could be heightened if the dollar were to continue to depreciate significantly.

In the Committee's discussion of policy for the intermeeting period, all members favored an easing of the stance of monetary policy. Members emphasized that because of the recent sharp change in credit market conditions, the incoming data in many cases were of limited value in assessing the likely evolution of economic activity and prices, on which the Committee's policy decision must be based. Members judged that a lowering of the target funds rate was appropriate to help offset the effects of tighter financial conditions on the economic outlook. Without such policy action, members saw a risk that tightening credit conditions and an intensifying housing correction would lead to significant broader weakness in output and employment. Similarly, the impaired functioning of financial markets might persist for some time or possibly worsen, with negative implications for economic activity. In order to help forestall some of the adverse effects on the economy that might otherwise arise, all members agreed that a rate cut of 50 basis points at this meeting was the most prudent course of action. Such a measure should not interfere with an adjustment to more realistic pricing of risk or with the gains and losses that implied for participants in financial markets.

With economic growth likely to run below its potential for a while and with incoming inflation data to the favorable side, the easing of policy seemed unlikely to affect adversely the outlook for inflation.

The Committee agreed that the statement to be released after the meeting should indicate that the outlook for economic growth had shifted appreciably since the Committee's last regular meeting but that the 50 basis point easing in policy should help to promote moderate growth over time. They also agreed that the inflation situation seemed to have improved slightly and judged that it was no longer appropriate to indicate that a sustained moderation in inflation pressures had yet to be shown. Nonetheless, all agreed that some inflation risks remained and that the statement should indicate that the Committee would continue to monitor inflation developments carefully. Given the heightened uncertainty about the economic outlook, the Committee decided to refrain from providing an explicit assessment of the balance of risks, as such a characterization could give the mistaken impression that the Committee was more certain about the economic outlook than was in fact the case. Future actions would depend on how economic prospects were affected by evolving market developments and by other factors.

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve

markets consistent with reducing the federal funds rate to an average of around 4¾ percent.

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

Developments in financial markets since the Committee's last regular meeting have increased the uncertainty surrounding the economic outlook. The Committee will continue to assess the effects of these and other developments on economic prospects and will act as needed to foster price stability and sustainable economic growth.

Votes for this action: Messrs. Bernanke, Geithner, Evans, Hoenig, Kohn, Kroszner, Mishkin, Poole, Rosengren, and Warsh. Votes against this action: None.

The Committee then resumed its discussion of monetary policy communication issues. Subsequently, in a joint session of the Federal Open Market Committee and the Board of Governors, Board members and Reserve Bank presidents discussed additional policy options to address strains in money markets. No decisions were made in this session, but it was agreed that policymakers should continue to consider such options carefully.

It was agreed that the next meeting of the Committee would be held on Tuesday-Wednesday, October 30–31, 2007.

The meeting adjourned at 3:55 p.m.

Notation Vote

By notation vote completed on August 27, 2007, the Committee unanimously approved the minutes of the FOMC meeting held on August 7, 2007.

Conference Calls

On August 10, 2007, the Committee reviewed developments in money and credit markets, where strains had wors-

ened in the days since its last meeting. Participants discussed the condition of domestic and foreign financial markets, the Open Market Desk's approach to open market operations, possible adjustments to the discount rate, and the statement to be issued immediately after the conference call.

On August 16, 2007, the Committee again met by conference call. With financial market conditions having deteriorated further, meeting participants discussed the potential usefulness of various policy responses. The discussion focused primarily on changes associated with the discount window that would be directed at improving the functioning of the money markets. Most participants expressed strong support for taking such steps, although some concern was noted about the likely effectiveness of these measures and one participant also questioned their appropriateness. In light of the risks posed to the economic outlook by the tighter credit conditions and the increased uncertainty in financial markets, the Committee felt that the downside risks to growth had increased appreciably, but that a change in the federal funds rate target was not yet warranted. However, the situation bore close watching.

At the conclusion of the discussion, the Committee voted to approve the text below to be released the following morning:

Financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward. In these circumstances, although recent data suggest that the economy has continued to expand at a moderate pace, the Federal Open Market Committee judges that the downside risks to growth have increased appreciably. The Committee is monitoring the situation and is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets.

Votes for: Messrs. Bernanke, Geithner, Fisher, Hoenig, Kohn, Kroszner, Mishkin, Moskow, Rosengren, and Warsh. Votes against: None. Mr. Fisher voted as alternate member.

Brian F. Madigan
Secretary

Meeting Held on October 30–31, 2007

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, October 30, 2007 at 2:00 p.m. and continued on Wednesday, October 31, 2007 at 9:00 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Mr. Evans
Mr. Hoenig
Mr. Kohn
Mr. Kroszner
Mr. Mishkin
Mr. Poole
Mr. Rosengren
Mr. Warsh

Ms. Cumming, Mr. Fisher, Ms. Pianalto, and Messrs. Plosser and Stern, Alternate Members of the Federal Open Market Committee

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

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

Messrs. Clouse, Connors, Fuhrer, Kamin, Rasche, Slifman, Sullivan, and Wilcox, Associate Economists

Mr. Dudley, Manager, System Open Market Account

Mr. Struckmeyer, Deputy Staff Director, Office of Staff Director for Management

Mr. English, Senior Associate Director, Division of Monetary Affairs, Board of Governors

Messrs. Reifschneider¹⁰ and Wascher, Associate Directors, Division of Research and Statistics, Board of Governors

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

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

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

Ms. K. Johnson, Senior Adviser, Division of International Finance, Board of Governors

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

Mr. Dale,¹⁰ Senior Adviser, Division of Monetary Affairs, Board of Governors

Mr. Gross,¹⁰ Special Assistant to the Board, Office of Board Members, Board of Governors

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

Messrs. Kumasaka¹¹ and Luecke,¹² Senior Financial Analysts, Division of Monetary Affairs, Board of Governors

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

10. Attended portion of meeting relating to the discussion of communication issues.

11. Attended Tuesday session.

12. Attended Wednesday session.

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

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

Messrs. Judd and Sniderman, Executive Vice Presidents, Federal Reserve Banks of San Francisco and Cleveland, respectively

Mr. Altig and Ms. Mester, Senior Vice Presidents, Federal Reserve Banks of Atlanta and Philadelphia, respectively

Mr. Hakkio, Special Adviser, Federal Reserve Bank of Kansas City

Messrs. Hilton, Koenig, and Potter, Vice Presidents, Federal Reserve Banks of New York, Dallas, and New York, respectively

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

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

By unanimous vote, the Federal Open Market Committee selected D. Nathan Sheets to serve as Economist until the selection of his successor at the first regularly scheduled meeting of the Committee in 2008.

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 operations in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information provided to the Committee on the first day of the meeting, prior to the release of the advance esti-

mates of the third-quarter national income and product accounts, indicated that economic activity expanded at a solid pace in the third quarter. Consumer spending rose more strongly after a tepid increase in the second quarter, and the pace of expansion of business outlays for equipment and structures remained reasonably solid. Manufacturing posted a sizable gain for the third quarter as a whole. In contrast, the slump in residential investment intensified during the third quarter, at least partly because of ongoing disruptions in the markets for nonconforming mortgages. The average monthly gain in private employment also slowed significantly. Headline inflation eased during the third quarter, reflecting a decline in energy prices; core inflation continued to be moderate.

Employment increased more slowly in the third quarter than in the first half of the year. Private payroll employment registered a considerably smaller average monthly gain; employment in residential construction, manufacturing, and industries related to mortgage lending continued to decline, but most service-producing industries added jobs at a moderate pace. With gains in employment smaller and the workweek flat, the growth of aggregate hours of private production or nonsupervisory workers stepped down from its second-quarter pace. The labor force participation rate was unchanged, on average, in the third quarter, and the unemployment rate ticked up to 4.7 percent in September.

Industrial production changed little in August and September after having posted solid advances in June and July. Manufacturing output expanded in the third quarter overall at about the same pace as in the second quarter but declined modestly on net in August and September. During those two months, production was damped by declines in the output of motor vehicles and parts.

In addition, output of construction supplies and products fell, likely reflecting the ongoing decline in residential investment. Meanwhile, production in the high-tech sector rose at a moderate rate.

Consumer spending was well maintained in August and September. Motor vehicle sales improved, and real spending on other goods posted solid gains in both months. Real outlays on consumer services were strong in August because of a weather-induced jump in energy services. Solid increases in nominal wages and salaries and lower headline inflation led to robust gains in real income over the summer. However, other factors affecting consumer spending were mixed. Short-term interest rates dropped and stock prices rose, on balance, after August. By contrast, house prices continued to decelerate, standards on consumer and mortgage credit tightened after midsummer, and the turmoil in financial markets that started in the summer likely exerted some restraint on consumer spending. Moreover, measures of consumer confidence had declined in recent months.

The housing downturn deepened as sales of new and existing single-family homes continued to fall. Deterioration in nonprime mortgage markets as well as higher mortgage interest rates and tighter lending conditions for prime jumbo loans since earlier in the year appeared to be restraining housing demand. Forward-looking indicators, including an index of pending home sales and adjusted single-family permit issuance, continued to point to a further slowing in housing activity over the near term. Single-family housing starts declined significantly over August and September. Nonetheless, with single-family home sales continuing to sag, inventories of unsold homes remained quite elevated. In the multifamily sector, starts declined sharply in September;

however, the third-quarter reading remained within the fairly narrow range observed over the past decade.

Orders and shipments of nondefense capital goods excluding aircraft rose on average over August and September. In the high-tech category, orders and shipments of computers and peripherals posted robust gains over the same period. Shipments of communication equipment also rose in August and September, but orders were little changed on balance over the same period. Outside the technology sector, shipments of nondefense capital goods excluding aircraft increased at a solid rate over August and September but orders declined in August and were flat in September. Sales of medium and heavy trucks leveled off in the third quarter after a sharp drop in the first half of the year. Domestic outlays for aircraft likely stepped down somewhat in the third quarter. Nonresidential building activity remained vigorous through August after having posted very strong gains in the second quarter; anecdotal evidence through early October indicated that the recent turbulence in commercial credit markets had done little to slow the pace of commercial construction. More generally, surveys of business conditions continued to point to further near-term gains in spending, although reports from business contacts indicated that some firms had marked down their capital spending plans.

Data on the book value of business inventories through August suggested that real nonfarm inventory investment excluding motor vehicles moved down in the third quarter after having risen at a moderate pace in the second quarter. The ratio of book-value inventories to sales in the manufacturing and trade sector excluding motor vehicles, which was available through August, remained well below the elevated values seen around

the turn of the year. Purchasing managers, on average, viewed the level of their customers' inventories as about right in September.

The U.S. international trade deficit narrowed in August as exports increased and imports decreased. Goods exports were boosted by a jump in exports of agricultural products and of gold, which more than offset a decline in exports of other goods. Exports of automotive products fell back sharply after a surge in July. Exports of capital goods contracted slightly, led by a drop in aircraft exports. Exports of semiconductors declined, while exports of computers were about flat. On the import side, the decline was concentrated in goods; service imports were flat. Higher imports of oil and of capital goods, particularly computers and semiconductors, were more than offset by lower imports of automotive products, consumer goods, and industrial supplies excluding oil.

Indicators of economic activity in the third quarter for advanced foreign economies were solid on balance. In the euro area, production and sales picked up in the third quarter from their second-quarter levels. However, recent survey data, including the purchasing managers' index for the service sector in the euro area, pointed to a possible slowing in the pace of growth. Likewise, notwithstanding a strong preliminary estimate of third-quarter GDP growth in the United Kingdom, more recent surveys pointed to some softening. Recent Canadian data were mixed, with relatively strong employment growth and some weakness in retail sales. In contrast, Japan's retail sales and exports rebounded in August, and the October Tankan survey seemed to suggest that the second quarter's sharp contraction in investment was temporary.

In emerging-market economies, recent information, mostly through Au-

gust, gave no signs that the turmoil in financial markets was having a significant negative effect on real economic activity. In emerging Asia, activity appeared to have remained robust, although growth slowed from its elevated second-quarter pace. Economic indicators for Mexico pointed to moderate growth in the third quarter. In South America, activity was strong, boosted by high prices for commodities and, in Argentina and Venezuela, by expansionary macroeconomic policies. Food prices continued to be a major source of inflationary pressures in emerging-market economies, and Chinese authorities took several steps aimed at quelling rising prices.

After having risen rapidly in the first half of the year, headline consumer prices decelerated considerably over the summer, largely because of a fall in energy prices. Over September and October, gasoline prices appeared to have risen only moderately despite a jump in crude oil costs. Consumer food prices posted further sizable increases in August and September and continued to run well above the change in core prices. Core consumer price inflation remained moderate in August and September and, on a twelve-month change basis, was down noticeably from a year earlier. Core goods prices fell over the year ending in September after having risen little over the preceding year; noticeable decelerations occurred in the prices of apparel, prescription drugs, and motor vehicles. In addition, increases in owners' equivalent rent slowed noticeably, while rent inflation remained about the same as a year earlier. The producer price index for core intermediate materials edged up in September. The twelve-month change in that index stepped down considerably from last year, in part because of softer prices for a variety of energy-intensive and

construction-related items. Household surveys indicated that median year-ahead inflation expectations inched down in September and October to about the level observed in the first quarter, and longer-term inflation expectations slipped to their lowest level in two years. Average hourly earnings posted a moderate increase over the twelve months ending in September.

At its September meeting, the FOMC lowered its target for the federal funds rate 50 basis points, to 4¾ percent. The Board of Governors also approved a 50 basis point decrease in the discount rate, to 5¼ percent, leaving the gap between the federal funds rate target and the discount rate at 50 basis points. The Committee's statement noted that, while economic growth had been moderate during the first half of the year, the tightening of credit conditions had the potential to intensify the housing correction and to restrain economic growth more generally. The Committee indicated that its action was intended to help forestall some of the adverse effects on the broader economy that could otherwise arise from the disruptions in financial markets and to promote moderate growth over time. Readings on core inflation had improved modestly during the year, but the Committee judged that some inflation risks remained, and the Committee planned to continue to monitor inflation developments carefully. The Committee further noted that developments in financial markets since the last regular FOMC meeting had increased the uncertainty surrounding the economic outlook. Accordingly, the Committee would continue to assess the effects of these and other developments on economic prospects and remained ready to act as needed to foster price stability and sustainable economic growth.

The expected path for monetary policy as inferred from futures markets

declined in the wake of the September policy action, as many investors were surprised by the magnitude of the reduction in the target rate. Over the intermeeting period, many investors came to expect that the Committee would reduce the target federal funds rate at its October meeting; in addition, the anticipated policy path further ahead moved down a bit more, on net, over the remainder of the intermeeting period, apparently in response to heightened concerns among investors about economic growth.

Early in the intermeeting period, the functioning of short-term funding markets improved somewhat, but conditions in these markets remained strained. The effective federal funds rate was very close to the target, on average, but the average absolute daily deviation of the effective rate from the target and the intraday standard deviation remained elevated. Credit spreads declined in the commercial paper and term interbank funding markets but stayed well above longer-term norms. Liquidity in the Treasury bill market was poor at times. Corporate bond spreads narrowed somewhat, leaving private yields a little lower. Nonfinancial bond issuance was robust; speculative-grade offerings increased markedly. The credit quality of most households remained strong, but delinquency rates on subprime mortgages climbed further. Securitization of nonconforming mortgages remained limited, and spreads on jumbo mortgages relative to conforming mortgages stayed high. Two-year Treasury yields declined roughly in line with the lower expected policy path, while yields on ten-year Treasuries were little changed, on net. TIPS-based inflation compensation was about unchanged on balance over the intermeeting period despite a sharp rise in spot oil prices. Stock prices jumped early in the intermeeting period in response to the cut in the target fed-

eral funds rate and some favorable economic news but later dropped back, leaving broad indexes up only a bit on net. The foreign exchange value of the dollar against other major currencies declined notably.

Debt of the domestic nonfinancial sectors was estimated to have expanded slightly more quickly in the third quarter than in the previous quarter. Despite evidence that bank lending standards and terms had tightened over the previous three months, business debt was still rising strongly, reflecting a continued surge in commercial and industrial (C&I) lending by banks and robust issuance of investment-grade bonds. The expansion of business loans was apparently due in part to financings for leveraged buyouts that underwriters could not syndicate to institutional investors. Household mortgage borrowing was estimated to have decelerated again in the third quarter. M2 increased significantly more slowly in September and October than the rapid pace observed in August, when the financial market turmoil apparently drove investors to the safety of M2 assets. Inflows to retail money market funds and small time deposits were especially strong in September and October; small time deposits were apparently boosted by the attractive rates that banks were offering in order to help fund their expanding loan portfolios.

In the forecast prepared for this meeting, which was formulated prior to the release of the advance estimates of the third-quarter national income and product accounts, the staff revised up its estimate of aggregate economic activity in the third quarter from its forecast presented at the September meeting in light of available indicators that suggested that consumer spending, business investment, and exports were stronger than previously expected. Nonetheless, the

staff expected real GDP growth to be considerably slower in the fourth quarter, reflecting steepening declines in residential construction, reductions in the pace of motor vehicle production, and a smaller contribution from net exports. Looking forward, the staff expected residential investment to remain weak in 2008 with modest declines in house prices. In addition, the staff continued to expect the stress in credit markets and the appreciably higher oil prices indicated by futures markets to restrain spending by businesses and consumers, although the lower foreign exchange value of the dollar suggested some boost to net exports. On balance, real GDP growth for 2008 was projected to slow to a pace a bit below that of its potential, and unemployment was expected to creep up slightly. For 2009, the forecast called for real output growth to step up to a pace slightly above potential as the drags on economic activity exerted by the contraction in residential investment and financial strains were expected to abate. The staff's forecast for core PCE inflation was little changed from that presented at the September meeting because favorable incoming figures on core PCE inflation were offset by expectations for some limited feed-through into retail prices of recent increases in energy prices and for slightly less easing in resource utilization. The forecast for headline inflation was in the same range as that for core inflation in 2008 and 2009, reflecting expectations that energy prices would level off and then turn down and that increases in food prices would slow to a pace more in line with core inflation.

The advance data on the national income and product accounts for the third quarter, which were released on the morning of the second day of the FOMC meeting, indicated a stronger increase in real GDP than the staff had forecast,

mostly because inventory investment was estimated to be higher than projected by the staff. The staff interpreted this information as suggesting some upward revision to its estimate of output growth in the third quarter, a small downward revision to its forecast of growth in the current quarter, and no significant change to its forecast for coming quarters.

In conjunction with the FOMC meeting in October, all meeting participants (Federal Reserve Board members and Reserve Bank presidents) provided annual projections for economic growth, unemployment, and inflation for the period 2007 through 2010. The projections are described in the *Summary of Economic Projections*, which is attached as an addendum to these minutes.

In their discussion of the economic outlook and situation, and in the projections that they had submitted for this meeting, participants noted that economic activity had expanded at a somewhat faster pace in the third quarter than previously anticipated and that there was scant evidence of negative spillovers from the ongoing housing correction to other sectors of the economy. Conditions in financial markets had improved since the September FOMC meeting, but functioning in a number of markets remained strained. Even with some further easing of monetary policy, participants expected economic growth to slow over the next few quarters, reflecting continued sharp declines in the housing sector and tighter lending standards and terms across a broad range of credit products. The slowing of growth was likely to produce a modest increase in the unemployment rate from its recent levels, leading to the emergence of a little slack in labor markets. Looking further ahead, participants noted that economic growth should increase gradually to around its trend rate by 2009 as

weakness in the housing sector abated and stresses in financial markets subsided. With aggregate demand showing somewhat greater than expected strength in the third quarter and little evidence of significant spillovers from the housing sector to other components of spending, participants viewed the downside risks to growth as somewhat smaller than at the time of the September meeting, but those risks were still seen as significant. Participants generally expected that inflation would edge down over the next few years, a projection consistent with the recent string of encouraging releases on core consumer prices, futures prices pointing to a flattening of energy costs, and the anticipated easing of pressures on resources. Nonetheless, some upside risks to inflation remained, reflecting in part the potential feed-through to inflation expectations of increases in energy and import prices.

Financial market functioning was judged to have improved somewhat since the previous FOMC meeting, but the situation in a number of markets remained strained, and credit market conditions were thought likely to weigh on economic growth over coming quarters. In light of some improvement in the commercial paper and leveraged loan markets over the intermeeting period, participants were somewhat less concerned that banks would not have sufficient balance-sheet capacity to absorb large volumes of assets. Conditions in corporate credit markets also had improved in recent weeks, and most businesses were apparently having little difficulty raising external funds, as evidenced by strong issuance of investment-grade corporate bonds, a pickup in speculative-grade issuance, and surging C&I loans. Markets for non-conforming mortgages, by contrast, remained disrupted. Meeting participants also mentioned that while financial

market conditions had improved, the functioning of some markets remained somewhat impaired. Indeed, several participants noted some relapse in financial conditions late in the inter-meeting period. Moreover, unusual pressures in funding markets persisted. Participants generally viewed financial markets as still fragile and were concerned that an adverse shock—such as a sharp deterioration in credit quality or disclosure of unusually large and unanticipated losses—could further dent investor confidence and significantly increase the downside risks to the economy. Participants were also concerned about a potential scenario in which unexpected economic weakness could cause a further tightening of credit conditions that could in turn reinforce weakness in aggregate demand.

In their discussion of individual sectors of the economy, participants noted that the recent declines in housing activity—while substantial—had largely been anticipated. Nonetheless, the potential for significant further weakening in housing activity and home prices represented a downside risk to the economic outlook. Most participants pointed to the deterioration in non-prime mortgage markets as well as higher interest rates and tighter credit standards for prime nonconforming mortgages as factors that had exacerbated the deterioration in housing markets, and they noted that these developments could further limit the availability of mortgage credit and depress the demand for housing. Some participants also pointed to downside risks to the housing market stemming from the large volume of substantial upward interest-rate resets that were likely on subprime mortgages in coming quarters, which could lead to a faster pace of foreclosures in the near term, thereby intensify-

ing the downward pressure on house prices.

Participants generally agreed that the available data suggested that consumer spending had been well maintained over the past several months and that spillovers from the strains in the housing market had apparently been quite limited to date. Nevertheless, a number of participants cited notable declines in survey measures of consumer confidence since the onset of financial turbulence in midsummer, along with sharply higher oil prices, declines in house prices, and tighter underwriting standards for home equity loans and some types of consumer loans, as factors likely to restrain consumer spending going forward. Moreover, anecdotal reports by business contacts suggested a softening in retail sales in some regions of the country. Participants expressed a concern that larger-than-expected declines in house prices could further sap consumer confidence as well as net worth, causing a pullback in consumer spending. All told, however, participants envisioned that the most likely scenario was for consumer spending to continue to advance at a moderate rate in coming quarters, supported by the generally strong labor market and further gains in real personal income.

Meeting participants noted that capital expenditures had grown at a solid pace in recent months and that the financial turmoil generally appeared to have had a limited effect on business capital spending plans to date. Nevertheless, business sentiment appeared to have eroded somewhat amid heightened economic and financial uncertainty, potentially restraining investment outlays in some industries. However, participants noted that conditions in corporate bond markets had improved since the September FOMC meeting, and that credit availability generally appeared to be

ample, albeit on somewhat tighter terms. Participants judged that moderate growth of investment outlays going forward was the most likely outcome. A number of participants saw downside risk to the outlook for nonresidential building activity, reflecting elevated spreads on commercial-mortgage-backed securities and a further tightening of banks' lending standards for commercial real estate loans.

Data on economic growth outside the United States indicated that the global expansion, though likely to slow somewhat in coming quarters, was nevertheless on a firm footing. The continued strength of global growth and the recent decline in the foreign exchange value of the dollar were seen as likely to support U.S. exports going forward.

Readings on core inflation received during the intermeeting period continued to be generally favorable, and meeting participants agreed that the recent moderation in core inflation would likely be sustained. The slower pace of economic expansion anticipated for the next few quarters would help ease inflationary pressures. Nonetheless, participants expressed concern about the upside risks to the outlook for inflation. The recent increases in the prices of energy and other commodities, along with the significant decline in the foreign exchange value of the dollar, were cited as factors that could exert upward pressure on prices of some core goods and services in the near term. Increases in unit labor costs also could add to inflationary pressures. Moreover, participants expressed concern that some measures of inflation compensation calculated from TIPS securities had risen this year, although they viewed inflation expectations generally as remaining contained. Participants were concerned that if headline inflation remained above core measures for a sustained period, then longer-

term inflation expectations could move higher, a development that could lead to greater inflation pressures over the longer term and be costly to reverse.

In the Committee's discussion of policy for the intermeeting period, members discussed the relative merits of lowering the target federal funds rate 25 basis points, to 4½ percent, at this meeting or awaiting additional information on prospects for economic activity and inflation before assessing whether a further adjustment in the stance of monetary policy was necessary. Many members noted that this policy decision was a close call. However, on balance, nearly all members supported a 25 basis point reduction in the target federal funds rate. The stance of monetary policy appeared still to be somewhat restrictive, partly because of the effects of tighter credit conditions on aggregate demand. Moreover, most members saw substantial downside risks to the economic outlook and judged that a rate reduction at this meeting would provide valuable additional insurance against an unexpectedly severe weakening in economic activity. Many members were concerned about the still-sensitive state of financial markets and thought that an easing of policy would help to support improvements in market functioning, thereby mitigating some of the downside risks to economic growth. With real GDP likely to expand below its potential over coming quarters, recent price trends favorable, and inflation expectations appearing reasonably well anchored, the easing of policy at this meeting seemed unlikely to affect adversely the outlook for inflation. A number of members noted that the recent policy moves could readily be reversed if circumstances evolved in a manner that would warrant such action.

The Committee agreed that the statement to be released at this meeting

should indicate that economic growth was solid in the third quarter and that strains in financial markets had eased somewhat on balance. Members also agreed that economic growth seemed likely to slow over coming quarters, but that the easing action taken at the meeting—combined with the 50 basis point cut in the target federal funds rate at the September meeting—should help to promote moderate growth over time, although some downside risks to growth would remain. Members felt that it was appropriate to underscore the upside risks to inflation stemming from the recent increases in the prices of energy and other commodities, even though recent readings on core inflation had been favorable. While the Committee saw uncertainty regarding the economic outlook as still elevated, it judged that, after this action, the upside risks to inflation roughly balanced the downside risks to growth.

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

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

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

The Federal Open Market Committee decided today to lower its target for the Federal funds rate 25 basis points to 4½ percent.

Economic growth was solid in the third quarter, and strains in financial markets have

eased somewhat on balance. However, the pace of economic expansion will likely slow in the near term, partly reflecting the intensification of the housing correction. Today's action, combined with the policy action taken in September, should help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and promote moderate growth over time.

Readings on core inflation have improved modestly this year, but recent increases in energy and commodity prices, among other factors, may put renewed upward pressure on inflation. In this context, the Committee judges that some inflation risks remain, and it will continue to monitor inflation developments carefully.

The Committee judges that, after this action, the upside risks to inflation roughly balance the downside risks to growth. The Committee will continue to assess the effects of financial and other developments on economic prospects and will act as needed to foster price stability and sustainable economic growth.

Votes for this action: Messrs. Bernanke, Geithner, Evans, Kohn, Kroszner, Mishkin, Poole, Rosengren, and Warsh.

Votes against this action: Mr. Hoenig.

Mr. Hoenig dissented because he believed that policy should remain unchanged at this meeting. Projections for the U.S. and global economies suggested that growth was likely to proceed at a reasonable pace over the outlook period. To better assure that outcome, the FOMC had moved rates down significantly at its September meeting. At this meeting, inflation risks appeared elevated and Mr. Hoenig felt that the target federal funds rate was currently close to neutral. In these circumstances, he judged that policy needed to be slightly firm to better hold inflation in check. Going forward, if the data suggested the Committee needed to ease further, it could do so. He also recognized that liquidity remains a near-term challenge and that the Federal Reserve would be prepared to act if needed. Mr.

Hoening saw the risks to both economic growth and inflation to be elevated and preferred to wait, watch, and be ready to act depending on how events developed.

The Committee then resumed its discussion of an enhanced role for the economic projections that are made periodically by the members of the Board of Governors and the Reserve Bank presidents. At this meeting, participants reached a consensus on increasing the frequency and expanding the content of the projections that in the past have been released to the public in summary form twice a year. They agreed to publish with the minutes a summary of participants' economic projections made for this meeting and to release a press statement describing the plan for the future. The release of more frequent forecasts

covering longer time spans and accompanied by explanations of those forecasts was seen as providing the public with more context for understanding the Committee's monetary policy decisions.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 11, 2007.

The meeting adjourned at 12:00 noon.

Notation Vote

By notation vote completed on October 5, 2007, the Committee unanimously approved the minutes of the FOMC meeting held on September 18, 2007 and of the conference calls on August 10, 2007 and August 16, 2007.

Brian F. Madigan
Secretary

Summary of Economic Projections

In conjunction with the October 2007 FOMC meeting, the members of the Board of Governors and the presidents of the Federal Reserve Banks, all of whom participate in the deliberations of the FOMC, provided projections for economic growth, unemployment, and inflation in 2007, 2008, 2009, and 2010. Projections were based on information available through the conclusion of the October meeting, on each participant's assumptions regarding a range of factors likely to affect economic outcomes, and his or her assessment of appropriate monetary policy. "Appropriate monetary policy" is defined as the future policy most likely to foster outcomes for economic activity and inflation that best satisfy the participant's interpretation of the Federal Reserve's dual objectives of maximum employment and price stability.

The projections, which are summarized in table 1 and chart 1, suggest that FOMC participants expected that, in the near term, output will grow at a pace somewhat below its trend rate and the unemployment rate will edge higher, owing primarily to weakness in housing markets and to the tightening in the availability of credit resulting from recent strains in financial markets. Further ahead, output was projected to expand at a pace close to its long-run trend. Total inflation was expected to be lower in 2008 than in 2007, and then to edge down further in subsequent years.

The Outlook

Data available at the time of the October FOMC meeting indicated that economic growth had been solid during the second and third quarters, and evidence that the contraction in the housing sector had begun to spill over substantially to other sectors of the economy remained scant. Consequently, despite the recent finan-

1. Economic Projections of Federal Reserve Governors and Reserve Bank Presidents¹

	2007	2008	2009	2010
Central Tendencies				
Real GDP Growth	2.4 to 2.5	1.8 to 2.5	2.3 to 2.7	2.5 to 2.6
<i>June Projections</i>	2 ¹ / ₄ to 2 ¹ / ₂	2 ¹ / ₂ to 2 ³ / ₄		
Unemployment Rate	4.7 to 4.8	4.8 to 4.9	4.8 to 4.9	4.7 to 4.9
<i>June Projections</i>	4 ¹ / ₂ to 4 ³ / ₄	about 4 ³ / ₄		
PCE Inflation	2.9 to 3.0	1.8 to 2.1	1.7 to 2.0	1.6 to 1.9
Core PCE Inflation	1.8 to 1.9	1.7 to 1.9	1.7 to 1.9	1.6 to 1.9
<i>June Projections</i>	2 to 2 ¹ / ₄	1 ³ / ₄ to 2		
Ranges				
Real GDP Growth	2.2 to 2.7	1.6 to 2.6	2.0 to 2.8	2.2 to 2.7
<i>June Projections</i>	2 to 2 ³ / ₄	2 ¹ / ₂ to 3		
Unemployment Rate	4.7 to 4.8	4.6 to 5.0	4.6 to 5.0	4.6 to 5.0
<i>June Projections</i>	4 ¹ / ₂ to 4 ³ / ₄	4 ¹ / ₂ to 5		
PCE Inflation	2.7 to 3.2	1.7 to 2.3	1.5 to 2.2	1.5 to 2.0
Core PCE Inflation	1.8 to 2.1	1.7 to 2.0	1.5 to 2.0	1.5 to 2.0
<i>June Projections</i>	2 to 2 ¹ / ₄	1 ³ / ₄ to 2		

1. Projections of real GDP growth, PCE inflation, and core PCE inflation are fourth-quarter-to-fourth-quarter growth rates, that is, percentage changes from the fourth quarter of the prior year to the fourth quarter of the indicated year. PCE inflation and core PCE inflation are the percentage rates of change in the price index for personal consumption expenditures and the price index for personal consumption expenditures excluding food and energy, respectively. Projections for the unemploy-

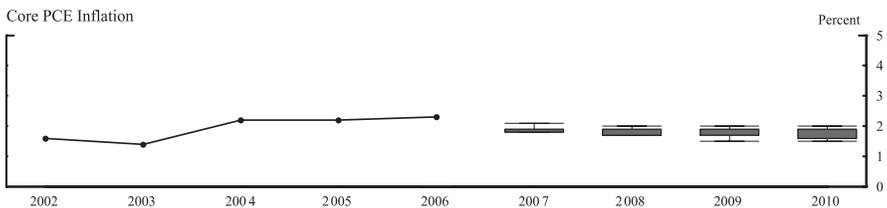
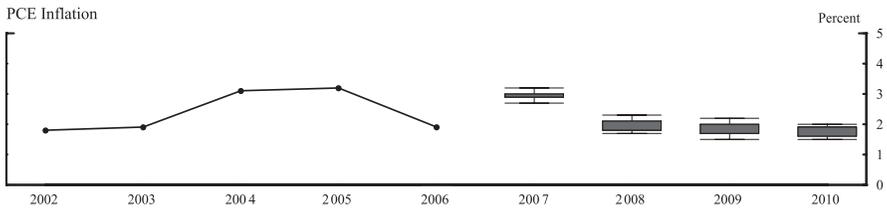
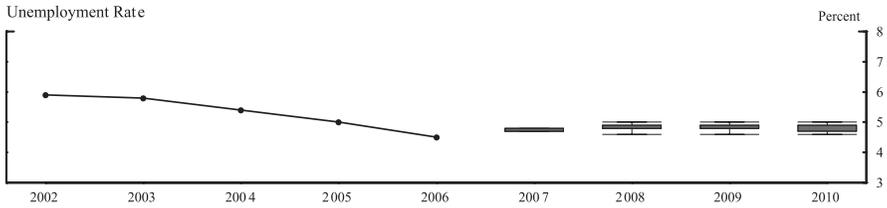
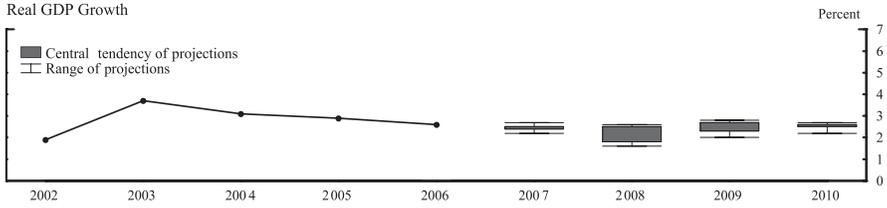
ment rate are for the average civilian unemployment rate in the fourth quarter of each year. Each participant's projections are based on his or her assessment of appropriate monetary policy. The range for each variable in a given year includes all participants' projections, from lowest to highest, for that variable in the given year; the central tendencies exclude the three highest and three lowest projections for each variable in each year.

cial market turmoil, the central tendency of participants' projections for real GDP growth in 2007, at 2.4 to 2.5 percent, was little changed from the central tendency of the projections provided in conjunction with the June FOMC meeting and included in the Board's *Monetary Policy Report to the Congress* in July. However, the central tendency of participants' projections for real GDP growth in 2008 was revised down to 1.8 to 2.5 percent, notably below the 2¹/₂ to 2³/₄ percent central tendency in June. These revisions to the 2008 outlook since June stemmed from a number of factors, including the tightened terms and reduced availability of subprime and jumbo mortgages, weaker-than-expected housing data, and rising oil prices. Partly in response to declining housing wealth, the personal saving rate was expected to rise over the next few years, contributing to restraint on the growth of personal consumption expenditures. How-

ever, net exports were expected to provide some support to growth. The subpar economic growth projected in the near term was not anticipated to persist. Growth was expected to pick up as the adjustment in housing markets ran its course, financial markets gradually resumed more-normal functioning, and as the monetary policy easing at the September and October FOMC meetings provided support to aggregate demand. Economic activity was projected to expand at a pace broadly in line with participants' estimates of the rate of expansion of the economy's productive potential in 2009 and to continue at much the same pace in 2010. Participants read last summer's benchmark revisions to the national income and product accounts as suggesting a somewhat slower rate of trend growth than previously thought.

Most participants expected that, with output growth running somewhat below

1. Central Tendencies and Ranges of Economic Projections*



* See notes to table 1 for variable definitions.

trend over the next year or so, the unemployment rate would increase modestly. The central tendency of participants' projections for the average rate of unemployment in the fourth quarter of 2008 was 4.8 to 4.9 percent, slightly above the 4¾ percent unemployment rate forecasted in June; these projections suggested the emergence of a little slack in

labor markets. The central tendency of participants' projections was for the unemployment rate to stabilize in 2009 and to fall back a bit in 2010 as output and employment growth pick up.

Overall inflation was expected to edge down over the next few years, fostered by an assumed flattening of energy prices about in line with futures markets

quotes, a modest easing of pressures on resource utilization, and fairly well anchored inflation expectations. Participants' projections for core inflation this year and next were marked down from those provided at the time of the June FOMC meeting, partly in light of recent generally favorable core inflation data that pointed to some reduction in underlying inflation pressures. The central tendency of projections for core PCE inflation in 2007 was 1.8 to 1.9 percent, down from 2 to 2¼ percent in June. The central tendency of core inflation projections for 2008 was 1.7 to 1.9 percent. Participants' projections for PCE inflation in 2009 and 2010 were importantly influenced by their judgments about the measured rates of inflation consistent with the Federal Reserve's dual mandate to promote maximum employment and price stability and about the time frame over which policy should aim to attain those rates given current economic conditions. The central tendency of participants' projections for both core and total inflation in 2010 ranged from 1.6 to 1.9 percent.

Risks to the Outlook

Most participants viewed the risks to their GDP projections as weighted to the downside and the associated risks to their projections of unemployment as tilted to the upside. Financial market conditions had deteriorated sharply in August, and although there had been some signs of improvement since then, markets remained strained. The possibilities that markets could relapse or that current tighter credit conditions could exert unexpectedly large restraint on household and business spending were viewed as downside risks to economic activity. Participants were concerned about the possibility for adverse feedbacks in which economic weakness could lead to further tightening in credit

conditions, which could in turn slow the economy further. The potential for a more severe contraction in the housing sector and a substantial decline in house prices was also perceived as a risk to the central outlook for economic growth. But participants also noted that in recent decades, the U.S. economy had proved quite resilient to episodes of financial distress, suggesting that the adverse effects of financial developments on economic activity outside of the housing sector could prove to be more modest than anticipated.

Participants were more persuaded than they had been in June that the decline in core inflation readings this year represented a sustained albeit modest step-down rather than the effect of transitory influences. Nonetheless, participants saw some upside risks to their inflation projections. Recent increases in energy and commodity prices and the pass-through of dollar depreciation into import prices would raise inflation over the medium term. That increase could lead to an upward drift in inflation expectations that would add to price pressures and could be costly to reverse.

The possibility that financial market turbulence could have larger-than-anticipated adverse effects on household and business spending heightened participants' uncertainty about the outlook for economic activity. Most participants judged that the uncertainty attending their October projections for real GDP growth was above typical levels seen in the past. (Table 2 provides an estimate of average ranges of forecast uncertainty for GDP growth, unemployment, and inflation over the past twenty years.¹³) In

13. The box "Forecast Uncertainty" at the end of this summary discusses the sources and interpretation of uncertainty in economic forecasts and explains the approach used to assess the uncertainty and risks attending participants' projections.

2. Average Historical Projection Error Ranges¹

	2007	2008	2009	2010
Real GDP ²	±0.6	±1.3	±1.4	±1.4
Unemployment rate ³	±0.2	±0.6	±0.9	±1.1
Total consumer prices ² ...	±0.3	±1.0	±1.0	±1.0

1. “Average historical projection error ranges” for the years 2007 through 2010 are measured as plus or minus the root mean squared error of projections that were released in the autumn from 1986 through 2006 for the current and following three years by various private and government forecasters. As described in the forecast uncertainty box, under certain assumptions, there is about a 70 percent probability that actual outcomes for real activity, unemployment, and inflation will fall in ranges implied by the average size of projection errors made in the past. For further information, see David Reifschneider and Peter Tulip, “Gauging the Uncertainty of the Economic Outlook from Historical Forecast Errors,” Federal Reserve Board Financial and Economics Discussion Series #2007-60 (November 2007).

2. Overall consumer price index, as this is the price measure that has been most widely used in government and private economic forecasts. Percent change, fourth quarter of year relative to fourth quarter of preceding year.

3. Percent, fourth-quarter average.

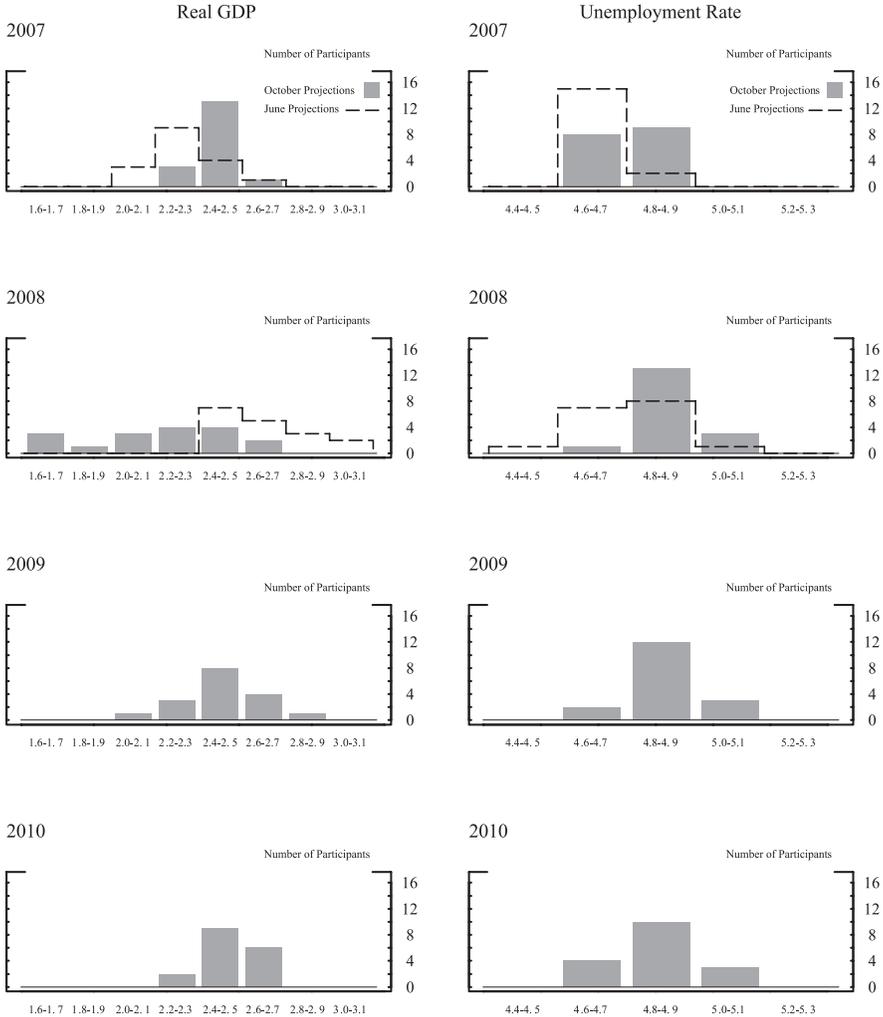
contrast, the uncertainty attached to participants’ inflation projections was generally viewed as being broadly in line with past experience, although several participants judged that the degree of uncertainty about total inflation was higher than usual, reflecting the possibility that the recent volatility in food and energy prices might persist.

Diversity of Participants’ Views

Charts 2(a) and 2(b) provide more detail on the diversity of participants’ views. The dispersion of participants’ projec-

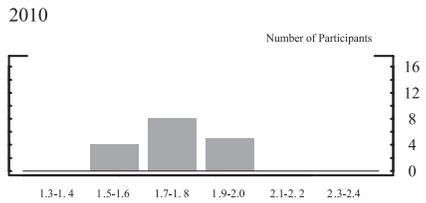
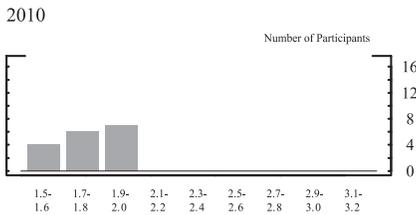
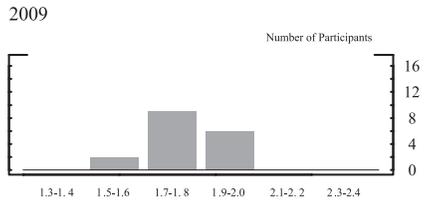
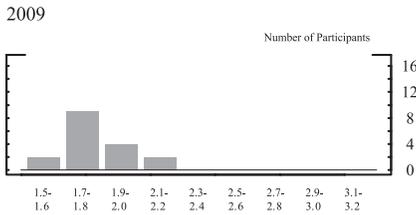
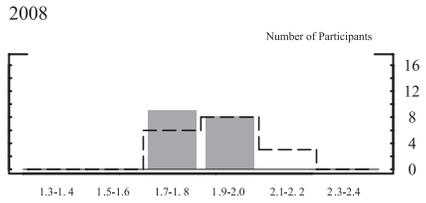
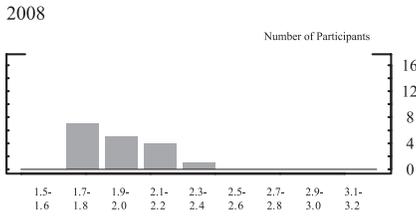
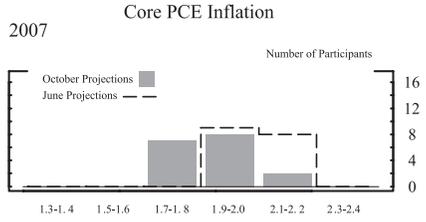
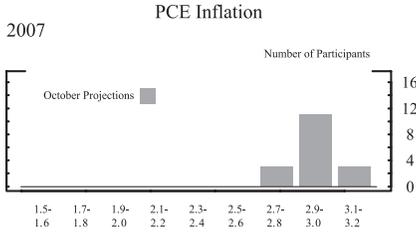
tions for real GDP growth in 2008 was markedly wider than in June. The dispersion of participants’ projections for growth next year seemed largely to reflect differing assessments of the likely depth and duration of the correction in the housing market, the effect of financial market disruptions on real activity outside of the housing sector, and the speed with which financial markets will return to more normal functioning. The dispersion of participants’ projections for the rate of unemployment over the next year or so had changed little. Participants’ longer-term projections for real GDP growth and for the rate of unemployment were more heavily influenced by their views about, respectively, the economy’s trend growth rate and the unemployment rate that would be consistent over time with maximum employment. The dispersion of the projections for PCE inflation in the near term partly reflected different weights attached to the various factors expected to foster a moderation of inflation. Some participants judged that the anticipated modest easing in resource pressures was unlikely to have a marked effect on inflation. Similarly, views differed about the influence that inflation expectations would exert on inflation over the short and medium run. Participants’ projections further out were also influenced by their views about the rate of inflation consistent with the Federal Reserve’s dual mandate.

2(a). Distribution of Participants' Projections (percent)*



* See notes to table 1 for variable definitions. Those participants' June projections that were provided in quarter points have been rounded to the nearest tenth for the construction of these histograms.

2(b). Distribution of Participants' Projections (percent)*



* See notes to table 1 for variable definitions. Those participants' June projections that were provided in quarter points have been rounded to the nearest tenth for the construction of these histograms.

Forecast Uncertainty

The economic projections provided by the members of the Board of Governors and the presidents of the Federal Reserve Banks help shape monetary policy and can aid public understanding of the basis for policy actions. Considerable uncertainty attends these projections, however. The economic and statistical models and relationships used to help produce economic forecasts are necessarily imperfect descriptions of the real world. And the future path of the economy can be affected by myriad unforeseen developments and events. Thus, in setting the stance of monetary policy, participants consider not only what appears to be the most likely economic outcome as embodied in their projections, but also the range of alternative possibilities, the likelihood of their occurring, and the potential costs to the economy should they occur.

Table 2 summarizes the average historical accuracy of a range of forecasts, including those reported in past Monetary Policy Reports and those prepared by Federal Reserve Board staff in advance of meetings of the Federal Open Market Committee. The projection error ranges shown in the table illustrate the considerable uncertainty associated with economic forecasts. For example, suppose a participant projects that real GDP and total consumer prices will rise steadily at annual rates of, respectively, 3 percent and 2 percent. If the uncertainty attending those projections is similar to that experienced in the past and the risks around the projections are broadly balanced, the

numbers reported in table 2 might imply a probability of about 70 percent that actual GDP would expand 2.4 percent to 3.6 percent in the current year, 1.7 percent to 4.3 percent next year, and 1.6 percent to 4.4 percent in the third and fourth years. The corresponding 70 percent confidence intervals for overall inflation would be 1.7 percent to 2.3 percent in the current year and 1.0 percent to 3.0 percent in the second, third, and fourth years.

Because current conditions may differ from those that prevailed on average over history, participants provide judgments as to whether the uncertainty attached to their projections of each variable is greater than, smaller than, or broadly similar to typical levels of forecast uncertainty in the past as shown in table 2. Participants also provide judgments as to whether the risks to their projections are weighted to the upside, downside, or are broadly balanced. That is, participants judge whether each variable is more likely to be above or below their projections of the most likely outcome. These judgments about the uncertainty and the risks attending each participant's projections are distinct from the diversity of participants' views about the most likely outcomes. Forecast uncertainty is concerned with the risks associated with a particular projection, rather than with divergences across a number of different projections.

Meeting Held on December 11, 2007

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 11, 2007, at 8:00 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Mr. Evans
Mr. Hoenig
Mr. Kohn
Mr. Kroszner
Mr. Mishkin
Mr. Poole
Mr. Rosengren
Mr. Warsh

Ms. Cumming, Mr. Fisher, Ms. Pianalto, and Messrs. Plosser and Stern, Alternate Members of the Federal Open Market Committee

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

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

Messrs. Clouse, Connors, Fuhrer, Kamin, Rasche, Sellon, Slifman, Sullivan, and Wilcox, Associate Economists

Mr. Dudley, Manager, System Open Market Account

Mr. Struckmeyer, Deputy Staff Director, Office of Staff Director for Management

Mr. English, Senior Associate Director, Division of Monetary Affairs, Board of Governors

Ms. Liang and Mr. Wascher, Associate Directors, Division of Research and Statistics, Board of Governors

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

Mr. Meyer, Visiting Reserve Bank Officer, 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 Specialist, Division of Monetary Affairs, Board of Governors

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

Mr. Rosenblum, Executive Vice President, Federal Reserve Bank of Dallas

Mr. Altig, Ms. Perelmuter, Messrs. Rolnick, Weinberg, and Williams, Senior Vice Presidents, Federal Reserve Banks of Atlanta, New York, Minneapolis, Richmond, and San Francisco, respectively

Messrs. Bryan and Yi, Vice Presidents, Federal Reserve Banks of Cleveland and Philadelphia, respectively

Mr. McCarthy, Research Officer, Federal Reserve Bank of New York

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

The Committee approved a foreign currency swap arrangement with the Swiss National Bank that paralleled the arrangement with the European Central Bank approved during the Committee's conference call on December 6, 2007. With Mr. Poole dissenting, the Committee voted to direct the Federal Reserve Bank of New York to establish and maintain a reciprocal currency (swap) arrangement for the System Open Market Account with the Swiss National Bank in an amount not to exceed \$4 billion. The Committee authorized associated draws of up to the full amount of \$4 billion, and the arrangement itself was authorized for a period of up to 180 days unless extended by the FOMC. Mr. Poole dissented because he viewed the swap agreement as unnecessary in light of the size of the Swiss National Bank's dollar-denominated foreign exchange reserves.

The information reviewed at the December meeting indicated that, after the robust gains of the summer, economic activity decelerated significantly in the fourth quarter. Consumption growth slowed, and survey measures of sentiment dropped further. Many readings from the business sector were also softer: Industrial production fell in October, as did orders and shipments of capital goods. Employment gains stepped down during the four months ending in November from their pace earlier in the year. Headline consumer price inflation moved higher in September and October as energy prices increased significantly; core inflation also rose but remained moderate.

The slowing in private employment gains was due in large part to the ongoing weakness in the housing market. Employment in residential construction posted its fourth month of sizable declines in November, and employment in housing-related sectors such as finance,

real estate, and building-material and garden-supply retailers continued to trend down. Elsewhere, factory jobs declined again, while employment in most service-producing industries continued to move up. Aggregate hours of production or nonsupervisory workers edged up in October and November. Some indicators from the household survey also suggested softening in the labor market, but the unemployment rate held steady at 4.7 percent through November.

Industrial production fell in October after small increases in the previous two months. The index for motor vehicles and parts fell for the third consecutive month, and the index for construction supplies moved down for the fourth straight month. Materials output also declined in October, with production likely curbed by weak demand from the construction and motor vehicle sectors. Production in high-tech industries, however, increased modestly, and commercial aircraft production registered another solid gain. In November, output appeared to have edged up in manufacturing sectors (with the exception of the motor vehicles sector) for which weekly physical product data were available.

After posting notable gains in the summer, real consumer spending was nearly flat in September and October. Spending on goods excluding motor vehicles was little changed on net over that period. Spending on services edged down, reflecting an extraordinarily large drop in securities commissions in September. The most recent readings on weekly chain store sales as well as industry reports and surveys suggested subdued gains in November and an uneven start to the holiday shopping season. Sales of light motor vehicles in November remained close to the pace that had prevailed since the second quarter. Real disposable income was about unchanged in September and October. The

Reuters/University of Michigan index of consumer sentiment ticked down further in early December as respondents took a more pessimistic view of the outlook for their personal finances and for business conditions in the year ahead.

In the housing market, new home sales were below their third-quarter pace, and sales of existing homes were flat in October following sharp declines in August and September. These declines likely were exacerbated by the deterioration in nonprime mortgage markets and by the higher interest rates and tighter lending conditions for jumbo loans. Single-family housing starts stepped down again in October after substantial declines in the June-September period. Yet, because of sagging sales, builders made only limited progress in paring down their substantial inventories. Single-family permit issuance continued along the steep downward trajectory that had begun two years earlier, which pointed toward further slowing in homebuilding over the near term. Multifamily starts rebounded in October from an unusually low reading in September, and the level of multifamily starts was near the midpoint of the range in which this series had fluctuated over the past ten years.

Real spending on equipment and software posted a solid increase in the third quarter. In October, however, orders and shipments of nondefense capital goods excluding aircraft declined, suggesting that some deceleration in spending was under way in the fourth quarter. The October decline in orders and shipments was led by weakness in the high-tech sector: Shipments of computers and peripheral equipment declined while the industrial production index for computers was flat; orders and shipments for communications equipment plunged. Some of that weakness may have been attributable to temporary production dis-

ruptions stemming from the wildfires in Southern California; cutbacks in demand from large financial institutions affected by market turmoil may have contributed as well. In the transportation equipment category, purchases of medium and heavy trucks changed little, and orders data suggested that sales would remain near their current levels in the coming months. Orders for equipment outside high-tech and transportation rose in October, but shipments were about flat, pointing to a weaker fourth quarter for business spending after two quarters of brisk increases. Some prominent surveys of business conditions remained consistent with modest gains in spending on equipment and software during the fourth quarter, but other surveys were less sanguine. In addition, although the cost of capital was little changed for borrowers in the investment-grade corporate bond market, costs for borrowers in the high-yield corporate bond market were up significantly. In the third quarter, corporate cash flows appeared to have dropped off, leaving firms with diminished internally generated funds for financing investment. Data available through October suggested that nonresidential building activity remained vigorous.

Real nonfarm inventory investment excluding motor vehicles increased slightly faster in the third quarter than in the second quarter. Outside of motor vehicles, the ratio of book-value inventories to sales had ticked up slightly in September but remained near the low end of its range in recent years. Book-value estimates of the inventory investment of manufacturers—the only inventory data available beyond the third quarter—were up in October at about the third-quarter pace.

The U.S. international trade deficit narrowed slightly in September as an increase in exports more than offset

higher imports. The September gain in exports primarily reflected higher exports of goods; services exports recorded moderate growth. Exports of agricultural products exhibited particularly robust growth, with both higher prices and greater volumes. Exports of industrial supplies and consumer goods also moved up smartly in September. Automotive products exports, in contrast, were flat, and capital goods exports fell, led by a decline in aircraft. The increase in imports primarily reflected higher imports of capital goods, with imports of computers showing particularly strong growth. Imports of automotive products, consumer goods, and services also increased. Imports of petroleum, however, were flat, and imports of industrial supplies fell.

Output growth in the advanced foreign economies picked up in the third quarter. In Japan, real output rebounded, led by exports. In the euro area, GDP growth returned to a solid pace in the third quarter on the back of a strong recovery in investment. In Canada and the United Kingdom, output growth moderated but remained robust, as vigorous domestic demand was partly offset by rapid growth of imports. Indicators of fourth-quarter activity in the advanced foreign economies were less robust on net. Confidence indicators had deteriorated in most major economies in the wake of the financial turmoil and remained relatively weak. In November, the euro-area and U.K. purchasing managers indexes for services were well below their level over the first half of the year; nevertheless they pointed to moderate expansion. Labor market conditions generally remained relatively strong in recent months. Incoming data on emerging-market economies were positive on balance. Overall, growth in emerging Asia moderated somewhat in the third quarter from its double-digit

pace in the second quarter, but remained strong. Economic growth was also solid in Latin America, largely reflecting stronger-than-expected activity in Mexico.

In the United States, headline consumer price inflation increased in September and October from its low rates in the summer as the surge in crude oil prices began to be reflected in retail energy prices. In addition, though the rise in food prices in October was slower than in August and September, it remained above that of core consumer prices. Excluding food and energy, inflation was moderate, although it was up from its low rates in the spring. The pickup in core consumer inflation over this period reflected an acceleration in some prices that were unusually soft last spring, such as those for apparel, prescription drugs, and medical services, as well as nonmarket prices. On a twelve-month-change basis, core consumer price inflation was down noticeably from a year earlier. In October, the producer price index for core intermediate materials moved up only slightly for a second month, and the twelve-month increase in these prices was considerably below that of the year-earlier period. This pattern reflected, in part, a deceleration in the prices of a wide variety of construction materials, such as cement and gypsum, and in the prices of some metal products. In response to rising energy prices, household survey measures of expectations for year-ahead inflation picked up in November and then edged higher in December. Households' longer-term inflation expectations also edged up in both November and December. Average hourly earnings increased faster in November than in the previous two months. Over the twelve months that ended in November, however, this wage measure rose a bit more slowly than over the previous twelve months.

At its October meeting, the FOMC lowered its target for the federal funds rate 25 basis points, to 4½ percent. The Board of Governors also approved a 25 basis point decrease in the discount rate, to 5 percent, leaving the gap between the federal funds rate target and the discount rate at 50 basis points. The Committee's statement noted that, while economic growth was solid in the third quarter and strains in financial markets had eased somewhat on balance, the pace of economic expansion would likely slow in the near term, partly reflecting the intensification of the housing correction. The Committee indicated that its action, combined with the policy action taken in September, should help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and should promote moderate growth over time. Readings on core inflation had improved modestly during the year, but the statement noted that recent increases in energy and commodity prices, among other factors, may put renewed upward pressure on inflation. In this context, the Committee judged that some inflation risks remained and indicated that it would continue to monitor inflation developments carefully. The Committee also judged that, after this action, the upside risks to inflation roughly balanced the downside risks to growth. The Committee said that it would continue to assess the effects of financial and other developments on economic prospects and would act as needed to foster price stability and sustainable economic growth.

The Committee's action at its October meeting was largely expected by market participants, although the assessment that the upside risks to inflation balanced the downside risks to growth was not fully anticipated and apparently led investors to revise up slightly the

expected path for policy. During the intermeeting period, the release of the FOMC minutes and associated summary of economic projections, as well as various data releases, elicited only modest market reaction. In contrast, markets were buffeted by concerns about the potential adverse effects on credit availability and economic growth of sizable losses at large financial institutions and of financial market strains in general. Market participants marked down their expected path for policy substantially, and by the time of the December meeting, investors were virtually certain of a rate cut. Two-year Treasury yields fell on net over the intermeeting period by an amount about in line with revisions to policy expectations. Ten-year Treasury yields also declined, but less than shorter-term yields. The steepening of the yield curve was due mostly to sharply lower short- and intermediate-term forward rates, consistent with investors' apparently more pessimistic outlook for economic growth. TIPS yields fell less than their nominal counterparts, implying modest declines in inflation compensation both at the five-year and longer horizons.

After showing some signs of improvement in late September and October, conditions in financial markets worsened over the intermeeting period. Heightened worries about counterparty credit risk, balance sheet constraints, and liquidity pressures affected interbank funding markets and commercial paper markets, where spreads over risk-free rates rose to levels that were, in some cases, higher than those seen in August. Strains in those markets were exacerbated by concerns related to year-end pressures. In longer-term corporate markets, both investment- and speculative-grade credit spreads widened considerably; issuance slowed but remained strong. In housing finance,

subprime mortgage markets stayed virtually shut, and spreads on jumbo loans apparently widened further. Spreads on conforming mortgage products also widened after reports of losses and reduced capital ratios at the housing-related government-sponsored enterprises. Broad-based equity indexes were volatile and ended the period down noticeably. Financial stocks were especially hard hit, dropping substantially more than the broad indexes. Similar stresses were evident in the financial markets of major foreign economies. The trade-weighted foreign exchange value of the dollar against major currencies moved up, on balance, over the intermeeting period.

Debt in the domestic nonfinancial sector was estimated to be increasing somewhat more slowly in the fourth quarter than in the third quarter. Nonfinancial business debt continued to expand strongly, supported by solid bond issuance and by a small rebound in the issuance of commercial paper. Bank loans outstanding also continued to rise rapidly. Household mortgage debt was expected to expand at a reduced rate in the fourth quarter, reflecting softer home prices and declining home sales, as well as a tightening in credit conditions for some borrowers. Nonmortgage consumer credit in the fourth quarter appeared to be expanding at a moderate pace. In November, M2 growth picked up slightly from its October rate. While liquid deposits continued to grow slowly, heightened demand for safety and liquidity appeared to boost holdings of retail money market mutual funds. Small time deposits continued to expand, likely in part due to high rates offered by some depository institutions to attract retail deposits. Currency outstanding was about flat in November.

In the forecast prepared for this meeting, the staff revised down its estimate

of growth in aggregate economic activity in the fourth quarter. Although third-quarter real GDP was revised up sharply, most available indicators of activity in the fourth quarter were more downbeat than had previously been expected. Faster inventory investment contributed importantly to the upward revision to third-quarter real GDP, but part of that upswing was expected to be unwound in the fourth quarter. The available data for domestic final sales also suggested a weaker fourth quarter than had been anticipated. In particular, real personal consumption expenditures had been about unchanged in September and October, and the contraction in single-family construction had intensified. Providing a bit of an offset to these factors, however, was further improvement in the external sector. The staff also marked down its projection for the rise in real GDP over the remainder of the forecast period. Real GDP was anticipated to increase at a rate noticeably below its potential in 2008. Conditions in financial markets had deteriorated over the intermeeting period and were expected to impose more restraint on residential construction as well as consumer and business spending in 2008 than previously expected. In addition, compared with the previous forecast, higher oil prices and lower real income were expected to weigh on the pace of real activity throughout 2008 and 2009. By 2009, however, the staff projected that the drag from those factors would lessen and that an improvement in mortgage credit availability would lead to a gradual recovery in the housing market. Accordingly, economic activity was expected to increase at its potential rate in 2009. The external sector was projected to continue to support domestic economic activity throughout the forecast period. Reflecting upward revisions to previously published data, the forecast

for core PCE price inflation for 2007 was a bit higher than in the preceding forecast; core inflation was projected to hold steady during 2008 as the indirect effects of higher energy prices on prices of core consumer goods and services were offset by the slight easing of resource pressures and the expected deceleration in the prices of nonfuel imported goods. The forecast for headline PCE inflation anticipated that retail energy prices would rise sharply in the first quarter of 2008 and that food price inflation would outpace core price inflation in the beginning of the year. As pressures from these sources lessened over the remainder of 2008 and in 2009, both core and headline price inflation were projected to edge down, and headline inflation was expected to moderate to a pace slightly below core inflation.

In their discussion of the economic situation and outlook, participants generally noted that incoming information pointed to a somewhat weaker outlook for spending than at the time of the October meeting. The decline in housing had steepened, and consumer outlays appeared to be softening more than anticipated, perhaps indicating some spillover from the housing correction to other components of spending. These developments, together with renewed strains in financial markets, suggested that growth in late 2007 and during 2008 was likely to be somewhat more sluggish than participants had indicated in their October projections. Still, looking further ahead, participants continued to expect that, aided by an easing in the stance of monetary policy, economic growth would gradually recover as weakness in the housing sector abated and financial conditions improved, allowing the economy to expand at about its trend rate in 2009. Participants thought that recent increases in energy prices likely would boost headline infla-

tion temporarily, but with futures prices pointing to a gradual decline in oil prices and with pressures on resource utilization seen as likely to ease a bit, most participants continued to anticipate some moderation in core and especially headline inflation over the next few years.

Participants discussed in detail the resurgence of stresses in financial markets in November. The renewed stresses reflected evidence that the performance of mortgage-related assets was deteriorating further, potentially increasing the losses that were being borne in part by a number of major financial firms, including money-center banks, housing-related government-sponsored enterprises, investment banks, and financial guarantors. Moreover, participants recognized that some lenders might be exposed to additional losses: Delinquency rates on credit card loans, auto loans, and other forms of consumer credit, while still moderate, had increased somewhat, particularly in areas hard hit by house price declines and mortgage defaults. Past and prospective losses appeared to be spurring lenders to tighten further the terms on new extensions of credit, not just in the troubled markets for nonconforming mortgages but, in some cases, for other forms of credit as well. In addition, participants noted that some intermediaries were facing balance sheet pressures and could become constrained by concerns about rating-agency or regulatory capital requirements. Among other factors, banks were experiencing unanticipated growth in loans as a result of continuing illiquidity in the market for leveraged loans, persisting problems in the commercial paper market that had sparked draws on back-up lines of credit, and more recently, consolidation of assets of off-balance-sheet affiliates onto banks' balance sheets.

Concerns about credit risk and the pressures on banks' balance sheet capacity appeared to be contributing to diminished liquidity in interbank markets and to a pronounced widening in term spreads for periods extending through year-end. A number of participants noted some potential for the Federal Reserve's new Term Auction Facility and accompanying actions by other central banks to ameliorate pressures in term funding markets. Participants recognized, however, that uncertainties about values of mortgage-related assets and related losses, and consequently strains in financial markets, could persist for quite some time.

Some participants cited more-positive aspects of recent financial developments. A number of large financial intermediaries had been able to raise substantial amounts of new capital. Moreover, credit losses and asset write-downs at regional and community banks had generally been modest; these institutions typically were not facing balance sheet pressures and reportedly had not tightened lending standards appreciably, except for those on real estate loans. And, although spreads on corporate bonds had widened over the intermeeting period, especially for speculative-grade issues, the cost of credit to most nonfinancial firms remained relatively low; nonfinancial firms outside of the real estate and construction sectors generally reported that credit conditions, while somewhat tighter, were not restricting planned investment spending; and consumer credit remained readily available for most households. Nonetheless, participants agreed that heightened financial stress posed increased downside risks to growth and made the outlook for the economy considerably more uncertain.

Participants noted the marked deceleration in consumer spending in the na-

tional data. Real personal consumption expenditures had shown essentially no growth in September and October, suggesting that tighter credit conditions, higher gasoline prices, and the continuing housing correction might be restraining growth in real consumer spending. Retailers reported weaker results in many regions of the country, but in some, retailers saw solid growth. Job growth rebounded somewhat in October and November, and participants expected continuing gains in employment and income to support rising consumer spending, though they anticipated slower growth of jobs, income, and spending than in recent years. However, consumer confidence recently had dropped by a sizable amount, leading some participants to voice concerns that household spending might increase less than currently anticipated.

Recent data and anecdotal information indicated that the housing sector was weaker than participants had expected at the time of the Committee's previous meeting. In light of elevated inventories of unsold homes and the higher cost and reduced availability of nonconforming mortgage loans, participants agreed that the housing correction was likely to be both deeper and more prolonged than they had anticipated in October. Moreover, rising foreclosures and the resulting increase in the supply of homes for sale could put additional downward pressure on prices, leading to a greater decline in household wealth and potentially to further disruptions in the financial markets.

Indicators of capital investment for the nation as a whole suggested solid but appreciably less rapid growth in business fixed investment during the fourth quarter than the third. Participants reported that firms in some regions and industries had indicated they would scale back capital spending, while con-

tacts in other parts of the country or industries reported no such change. Similarly, business sentiment had deteriorated in many parts of the country, but in other areas firms remained cautiously optimistic. Anecdotal evidence generally suggested that inventories were not out of line with desired levels. Even so, participants expected that inventory accumulation would slow from its elevated third-quarter pace. Several participants remarked that, unlike residential real estate, commercial and industrial real estate activity remained solid in their Districts. But participants also noted the deterioration in the secondary market for commercial real estate loans and the possible effects of that development, should it persist, on building activity.

The available data showed strong growth abroad and solid gains in U.S. exports. Participants noted that rising foreign demand was benefiting U.S. producers of manufactured goods and agricultural products, in particular. Exports were unlikely to continue growing at the robust rate reported for the third quarter, but participants anticipated that the combination of the weaker dollar and still-strong, though perhaps less-rapid, growth abroad would mean continued firm growth in U.S. exports. Several participants observed, however, that strong growth in foreign economies and U.S. exports might not persist if global financial conditions were to deteriorate further.

Recent readings on inflation generally were seen as slightly less favorable than in earlier months, partly due to upward revisions to previously published data. Moreover, earlier increases in energy and food prices likely would imply higher headline inflation in the next few months, and past declines in the dollar would put upward pressure on import prices. Some participants said that

higher input costs and rising prices of imports were leading more firms to seek price increases for goods and services. However, few business contacts had reported unusually large wage increases. Downward revisions to earlier compensation data, along with the latest readings on compensation and productivity, indicated only moderate pressure on unit labor costs. With futures prices pointing to a gradual decline in oil prices and with an anticipation of some easing of pressures on resource utilization, participants generally continued to see core PCE inflation as likely to trend down a bit over the next few years, as in their October projections, and headline inflation as likely to slow more substantially from its currently elevated level. Nonetheless, participants remained concerned about upside risks to inflation stemming from elevated prices of energy and non-energy commodities; some also cited the weaker dollar. Participants agreed that continued stable inflation expectations would be essential to achieving and sustaining a downward trend to inflation, that well-anchored expectations couldn't be taken for granted, and that policymakers would need to continue to watch inflation expectations closely.

In the Committee's discussion of monetary policy for the intermeeting period, members judged that the softening in the outlook for economic growth warranted an easing of the stance of policy at this meeting. In view of the further tightening of credit and deterioration of financial market conditions, the stance of monetary policy now appeared to be somewhat restrictive. Moreover, the downside risks to the expansion, resulting particularly from the weakening of the housing sector and the deterioration in credit market conditions, had risen. In these circumstances, policy easing would help foster maximum sustainable growth and provide some additional in-

insurance against risks. At the same time, members noted that policy had already been eased by 75 basis points and that the effects of those actions on the real economy would be evident only with a lag. And some data, including readings on the labor market, suggested that the economy retained forward momentum. Members generally saw overall inflation as likely to be lower next year, and core inflation as likely to be stable, even if policy were eased somewhat at this meeting; but they judged that some inflation pressures and risks remained, including pressures from elevated commodity and energy prices and the possibility of upward drift in the public's expectations of inflation. Weighing these considerations, nearly all members judged that a 25 basis point reduction in the Committee's target for the federal funds rate would be appropriate at this meeting. Although members agreed that the stance of policy should be eased, they also recognized that the situation was quite fluid and the economic outlook unusually uncertain. Financial stresses could increase further, intensifying the contraction in housing markets and restraining other forms of spending. Some members noted the risk of an unfavorable feedback loop in which credit market conditions restrained economic growth further, leading to additional tightening of credit; such an adverse development could require a substantial further easing of policy. Members also recognized that financial market conditions might improve more rapidly than members expected, in which case a reversal of some of the rate cuts might become appropriate.

The Committee agreed that the statement to be released after this meeting should indicate that economic growth appeared to be slowing, reflecting the intensification of the housing correction and some softening in business and con-

sumer spending, and that strains in financial markets had increased. The characterization of the inflation situation could be largely unchanged from that of the previous meeting. Members agreed that the resurgence of financial stresses in November had increased uncertainty about the outlook. Given the heightened uncertainty, the Committee decided to refrain from providing an explicit assessment of the balance of risks. The Committee agreed on the need to remain exceptionally alert to economic and financial developments and their effects on the outlook, and members would be prepared to adjust the stance of monetary policy if prospects for economic growth or inflation were to worsen.

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

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

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

The Federal Open Market Committee decided today to lower its target for the federal funds rate 25 basis points to 4¼ percent.

Incoming information suggests that economic growth is slowing, reflecting the intensification of the housing correction and some softening in business and consumer spending. Moreover, strains in financial markets have increased in recent weeks. Today's action, combined with the policy actions taken earlier, should help promote moderate growth over time.

Readings on core inflation have improved modestly this year, but elevated energy and commodity prices, among other factors, may put upward pressure on inflation. In this context, the Committee judges that some inflation risks remain, and it will continue to monitor inflation developments carefully.

Recent developments, including the deterioration in financial market conditions, have increased the uncertainty surrounding the outlook for economic growth and inflation. The Committee will continue to assess the effects of financial and other developments on economic prospects and will act as needed to foster price stability and sustainable economic growth.

Votes for this action: Messrs. Bernanke, Geithner, Evans, Hoenig, Kohn, Kroszner, Mishkin, Poole, and Warsh.

Votes against this action: Mr. Rosengren.

Mr. Rosengren dissented because he regarded the weakness in the incoming economic data and in the outlook for the economy as warranting a more aggressive policy response. In his view, the combination of a deteriorating housing sector, slowing consumer and business spending, high energy prices, and ill-functioning financial markets suggested heightened risk of continued economic weakness. In light of that possibility, a more decisive policy response was called for to minimize that risk. In any case, he felt that well-anchored inflation expectations and the Committee's ability to reverse course on policy would limit the inflation risks of a larger easing move, should the economy instead prove significantly stronger than anticipated.

It was agreed that the next meeting of the Committee would be held on Tuesday-Wednesday, January 29–30, 2008.

The meeting adjourned at 1:15 p.m.

Notation Vote

By notation vote completed on November 19, 2007, the Committee unani-

mously approved the minutes of the FOMC meeting held on October 30–31, 2007.

Conference Call

On December 6, 2007, in a joint session of the Federal Open Market Committee and the Board of Governors, Board members and Reserve Bank presidents reviewed conditions in domestic and foreign financial markets and discussed two proposals aimed at improving market functioning. The first proposal was for the establishment of a temporary Term Auction Facility (TAF), which would provide term funding to eligible depository institutions through an auction mechanism beginning in mid-December. Meeting participants recognized that a TAF would not address all of the factors giving rise to stresses in money and credit markets, notably the ongoing concerns about credit quality and balance sheet pressures. Nonetheless, most participants viewed the TAF, which would provide liquidity to more counterparties and against a broader range of collateral than used for open market operations, as a potentially useful tool. Some mentioned that a TAF could help alleviate year-end pressures in money markets. A few participants, however, questioned the need for and the likely efficacy of the proposal, expressed concerns about the longer-run incentive effects of a TAF, and felt that the possible drawbacks could well outweigh any benefits.¹⁴ Participants generally regarded the second proposal, to set up a foreign exchange swap arrangement with the European Central Bank, as a positive step in international coop-

14. Secretary's Note: The Board of Governors approved the TAF via notation vote on December 10, 2007 after the staff finalized its proposal for specifications of the TAF.

eration to address elevated pressures in short-term dollar funding markets.

At the conclusion of the discussion, with Mr. Poole dissenting, the Committee voted to direct the Federal Reserve Bank of New York to establish and maintain a reciprocal currency (swap) arrangement for the System Open Market Account with the European Central Bank in an amount not to exceed \$20 billion. Within that aggregate limit, draws of up to \$10 billion were autho-

rized, and the arrangement itself was authorized for a period of up to 180 days, unless extended by the FOMC. Mr. Poole dissented because he viewed the swap agreement as unnecessary in light of the size of the European Central Bank's dollar-denominated foreign exchange reserves.

Brian F. Madigan
Secretary

Litigation

During 2007, the Board of Governors was a party in one lawsuit and one appeal filed that year and in six other cases pending from previous years, for a total of eight cases; in 2006, the Board had been a party in a total of seven cases. As of December 31, 2007, six cases were pending.

Interactive Media Entertainment and Gaming Association, Inc. v. Federal Reserve System, No. 07-2625 (D. New Jersey, filed June 5, 2007), is an action challenging the implementation of the Unlawful Internet Gambling Enforcement Act of 2006.

Smith v. Bernanke, No. 07-1710 (Sixth Circuit, filed June 4, 2007), is an appeal of the dismissal of a district court action (No. 07-10453 (E.D. Michigan)) challenging the Federal Reserve's handling of appellant's consumer complaint.

Chandler v. Bernanke, No. 06-2082 (D. District of Columbia, filed December 6, 2006), is an employment discrimination action.

Price v. Bernanke, No. 06-1569 (D. District of Columbia, filed September 8, 2006), was an employment discrimination action. The action was dismissed voluntarily on November 20, 2007.

Inner City Press/Community on the Move v. Board of Governors, No. 05-6162 (Second Circuit, filed November 21, 2005), was an appeal of the district court's order (No. 04-CV-8337, 380 F. Supp. 2d 211 (S.D.N.Y. 2005)) granting in part and denying in part the Board's

motion for summary judgment in a Freedom of Information Act case. On September 11, 2006, the court of appeals affirmed in part and reversed in part the ruling of the district court, and remanded the case. 463 F.3d 239. On March 20, 2007, the case was dismissed by stipulation of the parties.

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

Jones v. Greenspan, No. 04-CV-1696 (RMU) (D. District of Columbia, filed October 4, 2004), is an employment discrimination action. On December 13, 2005, the district court granted in part and denied in part the Board's motion to dismiss and for summary judgment. 402 F. Supp. 2d 294. On June 11, 2007, the court granted the Board's motion for summary judgment as to Counts I and II of the plaintiff's First Amended Complaint. 493 F. Supp. 2d 18.

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. On January 31, 2007, the District Court granted the Board's renewed motion to dismiss the action. 474 F. Supp. 2d 16. The plaintiffs' motion to alter or amend judgment is pending. ■