# Minutes of the Federal Open Market Committee

February 1-2, 2005

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, February 1, 2005, at 1:30 p.m. and continued on Wednesday, February 2, 2005, at 9:00 a.m.

**Present:**

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Guynn, Lacker, Mses. Pianalto and Yellen, Alternate Members of the Federal Open Market Committee

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

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

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, [1] Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Evans, Howard, Madigan, Oliner, Rolnick, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

Messrs. Clouse, Reifschneider, [2] and Whitesell, Deputy Associate Directors, Divisions of Monetary Affairs, Research and Statistics, and Monetary Affairs, respectively, Board of Governors

Messrs. Elmendorf, [2] English, Faust, [2] and Leahy, [2] Assistant Directors, Divisions of Research and Statistics, Monetary Affairs, International Finance, and International Finance, respectively, Board of Governors

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

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

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

Messrs. Bassett, Lebow, [3] Ms. Lindner, [2] Messrs. Rudd, [2] Tetlow, [2] and Wood, [3] Senior Economists, Divisions of Monetary Affairs, Research and Statistics, Research and Statistics, Research and Statistics, Research and Statistics, and International Finance, respectively, Board of Governors

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

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

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

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

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

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

Messrs. Altig, Dotsey, Ms. Hargraves, and Mr. Wynne, Vice Presidents, Federal Reserve Banks of Cleveland, Philadelphia, New York, and Dallas, respectively

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In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 2005 had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

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

Anthony M. Santomero, President of the Federal Reserve Bank of Philadelphia, with Jeffrey M. Lacker, President of the Federal Reserve Bank of Richmond, 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.

Jack Guynn, President of the Federal Reserve Bank of Atlanta as alternate, voting pending the election of the President of the Federal Reserve Bank of Dallas.

Gary H. Stern, President of the Federal Reserve Bank of Minneapolis, with Janet L. Yellen, President of the Federal Reserve Bank of San Francisco, 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 after December 31, 2005, 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:

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| Alan Greenspan | Chairman |
| Timothy F. Geithner | Vice Chairman |
| Vincent R. Reinhart | Secretary and Economist |
| Deborah J. Danker | Deputy Secretary |
| Michelle A. Smith | Assistant Secretary |
| Scott G. Alvarez | General Counsel |
| Thomas C. Baxter, Jr. | Deputy General Counsel |
| Karen H. Johnson | Economist |
| David J. Stockton | Economist |
| Thomas A. Connors, Charles L. Evans, David H. Howard, Brian F. Madigan, Loretta J. Mester, Stephen D. Oliner, Arthur J. Rolnick, Harvey Rosenblum, Joseph S. Tracy, and David W. Wilcox | Associate Economists |

As customarily occurs at the first regularly scheduled meeting of the year, the Committee reviewed a range of organizational items, covered below.

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

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

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

AUTHORIZATION FOR FOREIGN CURRENCY OPERATIONS
(Reaffirmed February 1, 2005)

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

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

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

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

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to

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

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

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

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

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

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

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

his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

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

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

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

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

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

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

FOREIGN CURRENCY DIRECTIVE
(Reaffirmed February 1, 2005)

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

2. To achieve this end the System shall:

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

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

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

3. Transactions may also be undertaken:

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

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

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

4. System foreign currency operations shall be conducted:

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

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

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

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

PROCEDURAL INSTRUCTIONS WITH RESPECT TO FOREIGN CURRENCY OPERATIONS
(Reaffirmed February 1, 2005)

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.

By unanimous vote, the Authorization for Domestic Open Market Operations was amended and approved in the form shown below. The amendment involved removing from paragraph 1(a) the reference to the limit on the amount by which the System Open Market Account holdings of securities can change between FOMC meetings. This limit had become outdated, as it had been superseded by other, more effective mechanisms for the Committee to oversee Desk operations.

AUTHORIZATION FOR DOMESTIC OPEN MARKET OPERATIONS
(Amended February 1, 2005)

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

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

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

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York and accounts maintained at the Federal Reserve Bank of New York as fiscal agent of the United States pursuant to Section 15 of the Federal Reserve Act, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such accounts on the bases set forth in paragraph l(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 l(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 Committee made several amendments to its rules, statements, and resolutions, including to align the starting dates of Committee membership terms of Presidents with those of Committee officers, and to authorize the Secretary of the Committee, with the concurrence of the General Counsel, to make technical changes to the rules in the future.

By unanimous vote, the Committee amended its Program for Security of FOMC Information on February 1, 2005, to reflect an updating and streamlining of the document.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period December 14, 2004 to February 1, 2005. By unanimous vote, the Committee ratified these transactions.

At this meeting the Committee engaged in a broad-ranging discussion of the pros and cons of formulating a numerical definition of the price-stability objective of monetary policy. A staff presentation on the topic included a review of the potential costs and benefits of introducing such a definition as well as of other countries' experiences. In the subsequent discussion, meeting participants uniformly agreed that price stability provided the best environment for maximizing sustainable economic growth in the long run, but expressed a range of views on whether it would be helpful for the Committee to articulate a specific numerical definition for the Federal Reserve's price-stability objective--either a single figure or a range. Those who believed such a move would be on balance beneficial cited, for example, its usefulness as an anchor for long-term inflation expectations, as a vehicle for enhanced clarity of Committee deliberations, and as an additional tool for communications. Several of those who saw greater potential drawbacks were concerned that such a shift might appear to be inconsistent with the Committee's dual mandate of fostering maximum employment as well as price stability or that it might inappropriately bias or constrain policy at times; in any case, with inflation expectations well-contained over recent years, the benefits of announcing a specific inflation objective were not likely to be large. The Committee decided to defer further discussion.

The information reviewed at this meeting suggested that the economy expanded at a solid pace in recent months. Consumer spending and the housing market continued to exhibit strength, and business fixed investment grew robustly in the fourth quarter. The pace of inventory accumulation picked up and industrial production accelerated. The labor market showed further signs of improvement. Core consumer prices rose moderately over the past few months, and measures of inflation expectations remained well-anchored.

Moderate increases in payroll employment during November and December pushed the average monthly advance in the quarter well above that of the third quarter. Employment gains were fairly widespread, with hiring in business services, health care, financial activities, and wholesale trade more than offsetting continued sluggishness in manufacturing and a seasonally adjusted decline in retail services during December. Surveys of employers' hiring plans and job openings pointed to continued moderate gains in employment early this year. The average workweek during the fourth quarter was unchanged from the third quarter, and as a result aggregate hours decelerated despite the pickup in employment growth. The unemployment rate held steady at 5.4 percent in December.

Industrial activity accelerated noticeably during the fourth quarter. The pickup of industrial production in December owed largely to increased motor vehicle assemblies and a turnaround in the output of utilities associated with cold weather across the northeast. Production of high-tech goods slowed slightly in the fourth quarter. Available weekly physical product data suggested that manufacturing production would increase moderately in January. Capacity utilization continued to climb through the end of the year but remained below its longer-run average.

Real consumer spending expanded briskly in December and in the fourth quarter as a whole, with retail sales exhibiting widespread strength across categories. Expenditures on consumer services also continued to post solid increases. A surge in light vehicle sales in December pulled the average rate of sales during the fourth quarter slightly above the third-quarter pace. Real disposable personal income increased at a rapid rate at the end of the year--boosted in part by the special dividend payment by Microsoft; excluding this payment, real disposable personal income rose at a more moderate rate. Measures of consumer confidence remained favorable and consistent with sustained increases in spending.

Residential housing activity remained buoyant in the fourth quarter. A rebound in single-family housing starts in December from a disappointing November brought the fourthquarter pace about in line with that earlier in the year. Sales of new and existing homes slipped some late in the year but remained robust. Mortgage rates had changed little since August and continued to support demand. Construction activity in the multifamily sector weakened a bit in November and December, but indicators of underlying demand pointed to a rebound in starts in January.

Business fixed investment continued to be bolstered by favorable fundamentals, including sustained expansion of business output, the flush cash position of many firms, readily available credit, and a still-favorable cost of capital. Equipment and software spending grew at a solid rate in the fourth quarter, though not quite as briskly as in the third quarter owing to a deceleration in spending outside the high-tech sector. By contrast, investment in nonresidential structures had edged down in recent months, with expenditures only for drilling and mining operations showing some strength amid flat outlays for manufacturing facilities and a decline in spending on office buildings.

Nonfarm inventories increased a bit more in the fourth quarter than they had in the third quarter. The buildup of inventories was widespread across manufacturers, wholesalers, and retailers as well as across stages of production. Motor vehicle inventories were an exception, as motor vehicle manufacturers sought to reduce stocks of unsold light vehicles. The aggregate inventory-sales ratio outside of motor vehicles likely edged up in the fourth quarter but remained within the range that had prevailed since the middle of last year.

The most recent data suggested that the U.S. international trade deficit widened in the fourth quarter as a result of a broad-based decline in exports of goods and increase in imports of oil and consumer goods. The expansion in economic activity in the major foreign industrialized economies appeared to remain sluggish in the fourth quarter, but the growth of real GDP in Latin America and emerging Asia likely stepped up.

Core consumer prices decelerated over the past few months, while overall consumer prices were buffeted by movements in energy prices. The rate of increase in core prices in the twelve months ending in December was somewhat higher than the very low rate that prevailed during the year-earlier period; the overall index also accelerated, with about half of its advance accounted for by a sharp rise in energy prices. Measures of inflation expectations were little changed over the intermeeting period. With regard to labor costs, the employment cost index decelerated in the fourth quarter; the slowdown was attributable to wages, which gained only slightly, while benefit costs rose a bit faster than in the third quarter.

At its meeting on December 14, 2004, the Federal Open Market Committee decided to increase its target for the federal funds rate 25 basis points to 2-1/4 percent. In its announcement of this decision, the Committee indicated that the upside and downside risks to the attainment of both sustainable growth and price stability were roughly equal. The Committee also noted that output appeared to be growing at a moderate pace and labor market conditions continued to improve gradually, while inflation and inflation expectations remained well-contained. As a result, the Committee again judged that policy accommodation could be removed at a pace that was likely to be measured, although the path of policy would depend importantly on evolving economic prospects.

The Committee's decision at its December meeting to increase the federal funds rate had been fully anticipated in financial markets, and reaction to the attendant statement was muted. The release of the minutes of the December meeting on January 4, however, triggered a significant upward revision in the anticipated path of monetary policy: Investors apparently read them as expressing more widespread concern among Committee members about inflation pressures than had been the case previously. Market participants viewed the generally favorable incoming data on economic activity as consistent with their expectations of firmer policy. Interest rates on intermediate-term Treasury securities rose in response to the revision to policy expectations, but longer-term yields were little changed over the intermeeting period. As yields on inflation-indexed Treasury securities rose roughly in line with their nominal counterparts, longer-term inflation compensation remained about unchanged. Risk spreads on corporate bonds were stable at relatively low levels, consistent with favorable indicators of corporate credit quality. Broad stock indexes declined a bit over the intermeeting period. In foreign exchange markets, the dollar ended the period little changed on a trade-weighted basis, appreciating against the major European currencies but falling vis-à-vis other important trading partners.

M2 grew moderately in recent months, its expansion restrained by rising opportunity costs associated with monetary policy tightening. Because changes in interest rates on liquid deposits typically lag those in market interest rates, the growth of that component slowed in the second half of 2004. By contrast, growth of small time deposits, whose yields closely track market rates, picked up. Currency growth was about flat in December.

In the staff forecast prepared for this meeting, the economy was seen as likely to expand at a pace a little above that of its longer-run potential over this year and next, while hiring was expected to firm some more, resulting in a further decrease in the unemployment rate. Household spending was projected to grow at a fairly solid rate, supported by higher employment and somewhat lower energy prices but damped somewhat by lessened stimulus from gains in wealth and the need for households to rebuild savings. After a temporary dip in the level of business investment this quarter related to the expiration of the partial-expensing tax provision, investment outlays were seen as likely to resume vigorous growth in response to steadily rising sales, strong corporate balance sheets, supportive financial conditions, and an ongoing need to replace or upgrade aging equipment and software. Real net exports were projected to be roughly stable for several quarters, held up by the lagged effect of the lower foreign exchange value of the dollar and some strengthening in foreign demand. Measures of total consumer price inflation were expected to decline over the forecast horizon as energy prices receded, while core inflation was seen as remaining stable in the staff forecast. Tendencies for core inflation to increase because of slightly higher trend unit labor costs and a narrowing margin of resource slack were expected to be offset by the waning contribution of elevated prices for energy and imported goods.

In their discussion of the economic outlook, the meeting participants regarded incoming data since the last meeting as supporting their expectations that, with the further removal of monetary accommodation, GDP would likely grow at a moderate pace consistent with a gradual reduction of remaining economic slack, and inflation would probably continue to be low. Domestic demand had stayed strong through the fourth quarter and should continue to be bolstered by favorable financial conditions. Recent data indicated low and stable rates of core consumer inflation and apparently well-anchored inflation expectations. Against this backdrop, the risks to the outlook for both output and inflation relative to the Committee's goals appeared to remain well-balanced.

In preparation for the Federal Reserve’s semi-annual report to the Congress on the economy and monetary policy, the members of the Board of Governors and the presidents of the Federal Reserve Banks submitted individual projections of the growth of GDP, the rate of unemployment, and core consumer price inflation for the years 2005 and 2006. As part of its continuing effort to improve its communications, the Committee had earlier decided to add one year to the forecast period so as to make the projections more useful to the public. The forecasts of the rate of expansion in real GDP were concentrated in the upper part of a 3-1/2 to 4 percent range for 2005; for 2006 the forecasts were in a slightly lower range of 3-1/4 to 3-3/4 percent, with a central tendency at 3-1/2 percent. These rates of growth were associated with a civilian unemployment rate in the range of 5 to 5-1/2 percent and a central tendency of 5-1/4 percent in the fourth quarter of 2005 and 5 to 5-1/4 percent in the fourth quarter of 2006. The rate of inflation, as measured by the core PCE price index, was expected to remain fairly stable, with forecasts concentrated in the lower portion of a 1-1/2 to 2 percent range for both this year and next.

In their comments about developments in key sectors of the economy, meeting participants noted that, relative to several months ago, many firms now seemed somewhat more confident about the economic outlook. The anticipation of increased sales relative to existing production capacity and also desires to upgrade technology and improve competitiveness were leading firms to increase spending on equipment and software. Gains in capital spending had been quite strong last year, and while some of that spending might have been motivated by the year-end expiration of the partial-expensing provisions of the tax code, participants had seen little evidence to date that there would be a significant slowdown in the growth of spending in the early part of 2005. Low longer-term interest rates on corporate borrowing--reflecting in part narrow credit risk spreads--along with strong corporate profitability and improved balance sheets were continuing to support fairly brisk growth of capital expenditures. Low longer-term nominal interest rates were partly attributable to well-contained inflation expectations, but low real interest rates, along with slight declines in equity prices so far this year, might reflect lingering caution on the part of businesses about the outlook. Nevertheless, narrow credit spreads and risk premiums, along with abundant liquidity in financing markets, suggested that markets now assigned fairly low odds to significant downside risks.

Solid income gains, low interest rates, and consumer confidence were seen by participants as helping to sustain strong growth of household spending. Some firms had reported that holiday sales were higher than a year earlier and better than expected, while auto sales had responded strongly to incentives in December. The current low measured saving rate seemed mostly explainable by the strength of expected income gains, low interest rates, and the increase in household wealth resulting from the rise in equity and housing prices. Although the saving rate might well drift up over the next couple of years, participants generally thought it likely that consumer spending would continue growing at a strong pace. However, a marked slowing in home price appreciation and possible increases in longer-term interest rates, which would raise financing costs and reduce opportunities to extract equity from homes through refinancings and home equity loans, were seen as downside risks to the prospects for consumption spending and for housing construction.

Several participants mentioned that the low level of measured national saving, which implied a continued need for foreign financing of U.S. investment, and imbalances in the external sector imparted additional uncertainty to the longer-term economic outlook. The extent to which the federal budget deficit would decline over coming years was an open question. As regards the current account balance, some participants noted that the sharp drop in net exports in November probably reflected transitory factors in large part, as well as reported measurement errors. However, there has been little hard evidence as yet of a strengthening in the growth of spending in our foreign trading partners or of substantial effects on net exports from previous dollar declines. As a result, the external imbalance seemed likely to remain elevated, with a high level of uncertainty surrounding the prospects for and path of adjustment.

A number of participants noted continued modest gains in employment, though some commented that, based on anecdotal information, job growth seemed to have picked up of late. The increase in aggregate demand was expected to be sufficient over coming quarters to allow the rate of unemployment to continue to edge lower even as more people return to the labor force. Participants noted considerable uncertainty about the sustainable rate of resource utilization and about structural productivity growth. One participant suggested that, given the range of uncertainty, output might already be at or close to potential. Others commented that recent studies did not on balance support a conclusion that structural labor market shifts had caused resource slack to be lower than commonly estimated and that the flat pattern of growth in wages and compensation suggested an absence of pressures in labor markets. However, unit labor costs had accelerated over 2004 owing to a tapering off in productivity growth. If that slowing reflected a moderation in structural productivity growth and if firms believed that the associated increases in the growth rate of labor costs were permanent, these cost pressures might be passed through to consumer prices fairly quickly to preserve profit margins. While participants generally felt that the pace of underlying productivity growth remained robust, careful attention would need to be paid to developments regarding unit labor costs and profit margins.

Despite some pickup in costs, participants thought that the rate of core inflation likely would remain low and stable, assuming further removal of policy accommodation. Elevated price markups and profits, as well as slack in resource use, had helped absorb cost increases and put downward pressure on inflation and would likely continue to do so. Indeed, core inflation measures had eased off, both in the latest readings and on balance over the second half of 2004 relative to the first half. However, several participants suggested the possibility of an upward skew to the distribution of inflation outcomes, especially if there were appreciable further declines in the foreign exchange value of the dollar or in structural productivity growth; already some participants were hearing anecdotal reports from firms of an increased ability to pass cost increases through to product prices, perhaps because of increasing confidence in the outlook for the economic expansion.

In the Committee's discussion of policy for the intermeeting period, all of the members favored raising the target for the federal funds rate by 25 basis points to 2-1/2 percent at this meeting. All members judged that a further quarter-point firming in the target federal funds rate was appropriate in light of current overall accommodative financial conditions and the continuing outlook for solid economic growth and diminished slack in resource utilization. A higher nominal federal funds rate was seen as needed to contain risks of increased cost and price pressures, but even with this action, the real federal funds rate was generally seen as remaining below levels that might reasonably be associated with maintaining a stable inflation rate over the medium run. The pace of policy moves at upcoming meetings, however, would depend on incoming data.

With regard to the Committee's announcement to be released after the meeting, members concurred that overall economic prospects were similar to those prevailing at the time of the December meeting and that consequently the statement should be altered only to the minor extent required to reflect recent economic developments. They concurred that the statement should note that output appeared to be growing at a moderate pace despite the rise in energy prices, that labor market conditions continued to improve gradually, and that inflation and longer-term inflation expectations remained well-contained. They also agreed again to characterize the risks to sustainable growth and price stability as balanced. All members agreed that the FOMC statement for this meeting should again indicate that policy accommodation could be removed at a pace that was likely to be measured but that the Committee would respond to changes in economic prospects as needed to maintain price stability.

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

> "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate at an average of around 2-1/2 percent."

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

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

in economic prospects as needed to fulfill its obligation to maintain price stability."

**Votes for this action:** Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Guynn, Kohn, Moskow, Olson, Santomero, and Stern.

**Vote against this action:** None.

Mr. Guynn voted as alternate member.

It was agreed that the next meeting of the Committee would be held on Tuesday, March 22, 2005.

The meeting adjourned at 12:35 p.m. on February 2, 2005.

Notation Vote
By notation vote completed on December 31, 2004, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on December 14, 2004.

**Vincent R. Reinhart**
**Secretary**

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**Footnotes**

1. Attended Tuesday’s session only.Return to text

2. Attended portion of meeting relating to special topic of a numerical definition of the price-stability objective for monetary policy.Return to text

3. Attended portion of meeting related to the economic outlook.Return to text

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