



## The Federal Reserve Board

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### Minutes of the Federal Open Market Committee

May 3, 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, May 3, 2005 at 9:00 a.m.

**Present:**

Mr. Greenspan, Chairman  
Mr. Geithner, Vice Chairman  
Ms. Bies  
Mr. Ferguson  
Mr. Fisher<sup>1</sup>  
Mr. Gramlich  
Mr. Kohn  
Mr. Moskow  
Mr. Olson  
Mr. Santomero  
Mr. Stern

Messrs. Guynn and Lacker, Ms. 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

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

Messrs. Connors, Evans, and Madigan, Ms. Mester, Messrs. Oliner, Rosenblum, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

Messrs. Freeman, Slifman, and Struckmeyer, Associate Directors, Divisions of International Finance, Research and Statistics, and Research and Statistics, respectively, Board of Governors

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

Affairs, Board of Governors

Messrs. English and Leahy, Assistant Directors, Divisions of Monetary Affairs and International Finance, respectively, Board of Governors

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

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

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

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

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

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

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

Messrs. Eisenbeis, Goodfriend, Hakkio, Rasche, Rudebusch, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Richmond, Kansas City, St. Louis, San Francisco, and Cleveland, respectively

Mr. Elsasser, Ms. Little, and Messrs. Peach and Todd, Vice Presidents, Federal Reserve Banks of New York, Boston, New York, and Minneapolis, respectively

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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 voted to extend for one year beginning in mid-December 2005 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 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 received at this meeting suggested that the growth of economic activity had unexpectedly moderated during the first quarter from the rapid pace seen during the second half of 2004. Gains in private payroll employment over the first quarter were similar to the average for the second half of 2004 but weakened in March, and manufacturing production rose only a little, on balance, over February and March. Consumers appeared to have turned

somewhat cautious in their spending, likely a reflection of higher energy prices. Housing starts fell in March after a sustained stretch of very high readings, but home sales continued at a rapid rate throughout the quarter. Growth of capital spending, while strong in the first quarter, was down from the brisk rates of previous quarters. Sharp increases in energy prices pushed up headline inflation, and core measures were also somewhat elevated. Labor costs, however, advanced at a moderate rate. Employment continued to expand in March, although the increase was less than the strong advance in February. Employment declined in manufacturing, retail trade, and temporary help services, but most other sectors registered gains. The average workweek remained at its recent level, and aggregate hours posted a small gain. The unemployment rate moved down to 5.2 percent in March. Also suggesting a gradual erosion of slack in labor markets were surveys indicating that some employers were finding some jobs requiring special skills harder to fill and that households were experiencing increases in job availability. Nevertheless, survey measures of expected conditions in labor markets softened somewhat in the early months of the year, and the labor market participation rate remained low in March.

Industrial production continued to expand in the first quarter, but the pace was slower than in the final months of 2004. Gains were restrained by a decline in manufacturing output, particularly for motor vehicles and parts, and by a reduction in energy generation at utilities, which was held down by unseasonably warm weather early in the year. Mining output, however, accelerated, as did production in the business equipment and defense and space equipment industries. Capacity utilization in manufacturing edged up on average in the first quarter, but moved down in March and remained a bit below its thirty-year average.

Consumer spending advanced solidly in the first quarter despite some slowing in automobile sales. However, much of that strength was registered early in the quarter, and spending in March was subdued. Measures of consumer confidence declined in the early months of the year but remained well above the lows of two years ago. Other factors underlying consumer spending also remained favorable: Real wages and salaries continued to rise, and the ratio of wealth to income remained high, although it was down a bit because of a decline in equity prices. The personal saving rate stayed low over the first quarter of the year.

Housing starts slowed in March, after exceptional strength in the prior two months. However, a substantial increase in the level of permits in March suggested that starts likely turned back up in April. A similar pattern was observed in the multifamily sector. The thirty-year mortgage rate in the first quarter stayed in a range around its average level for the past two years. Sales of existing homes were rapid throughout the quarter, and sales of new homes rose to another record level in March. House prices continued to rise rapidly over the first quarter, although recent data suggested some slowing.

Growth of business spending on equipment and software moderated substantially in the first quarter from the very high rates of last year, but appeared to retain considerable momentum; strong gains occurred in all major categories except motor vehicles. This performance reflected favorable underlying fundamentals, including solid growth in business output, strong retained earnings, high levels of liquid assets, and favorable borrowing conditions in the form of low interest rates and narrow risk spreads in bond and loan markets. At the same time, construction of nonresidential structures remained quite subdued. Over the first quarter, outlays for manufacturing facilities picked up a bit, but those for office buildings stayed low despite some declines in the office vacancy rate, and spending on commercial structures fell.

Nonfarm inventories accumulated in the first two months of the year at a much faster rate than in the preceding quarter, prompting a small increase in inventory-sales ratios. Inventory gains were especially strong early in the quarter and were concentrated in the manufacturing sector.

The U.S. international trade deficit widened in February as exports held steady. The value of imported oil jumped sharply, and nonoil imports also rose. Economic indicators for major foreign industrial countries suggested some slowing of growth late in the quarter after a pickup earlier in the year. In Japan, industrial production rose briskly in January before falling back; the euro-area industrial sector evidenced a similar pattern. By contrast, economic activity in China and other developing countries showed greater buoyancy. Consumer price inflation abroad remained subdued.

U.S. consumer price inflation firmed in recent months as energy prices rose sharply. Core consumer prices also rose a bit more rapidly recently, but the increase over the twelve months ending in March was little different than over the year-earlier period. According to survey information, expectations of near-term inflation picked up in March, consistent with the increase in energy prices. As for labor costs, the employment cost index for private industry decelerated over the first quarter from an already moderate pace. The slowing occurred in both the wages and salaries component and the benefits component and was fairly widespread across industry groups.

At its March meeting, the Federal Open Market Committee decided to increase the target level of the federal funds rate 25 basis points, to 2-3/4 percent. In its accompanying statement, the Committee expressed its perception that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. The Committee also noted that economic output continued to grow at a solid pace despite the rise in energy prices and that labor market conditions continued to improve gradually. While pressures on inflation had picked up in recent months and pricing power was more evident, longer-term inflation expectations remained well contained. In these circumstances, the Committee believed that policy accommodation could be removed at a pace that would likely be measured but noted that it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

The FOMC's decision in March to raise the intended level of the federal funds rate 25 basis points was fully anticipated by the market, as were its retention in the accompanying statement of the "measured pace" language and its assessment that the risks to price stability and sustainable economic growth were balanced. Interest rates, however, rose, reportedly in response to the statement's references to increased price pressures and to more evident pricing power as well as to the Committee's conditioning of its risk assessment on "appropriate monetary policy action." Interest rates rose further the next day following the release of a larger-than-expected increase in the CPI for February. Over subsequent weeks, however, these increases were more than reversed by weaker-than-expected data on consumer spending, consumer sentiment, and output. Further downward pressure on interest rates was exerted by the market's response to the release of the minutes of the March meeting, as attention focused on the reference to Committee members' judgment that an accelerated path of policy tightening was not necessary at that time. Despite generally good first-quarter earnings reports, equity indexes moved down considerably in response to the

signs of weaker economic growth. In foreign exchange markets, the dollar rose on balance, apparently due, in part, to disappointing news on employment and output abroad.

M2 expanded in March and April at about the same sluggish pace as it did earlier in the year. The growth of M2 continued to be restrained by increases in its opportunity cost resulting from rising short-term interest rates. Rates paid on its liquid components particularly lagged increases in market rates.

Partly in response to the receipt of weaker-than-expected data for spending and output in the first quarter, the staff marked down somewhat its forecast of economic growth for 2005 and 2006. Even so, the economy was seen as retaining considerable momentum, and growth was expected to pick up some after the first quarter, paced by business spending on equipment and software. Consumption expenditures were seen as likely to expand at a moderate rate and residential investment to slow. With exports forecast to expand a bit more rapidly than imports, the arithmetic net drag on the economy from trade was expected to lessen. Fiscal policy was expected to provide a more moderate impetus to growth this year and next, following the substantial boost estimated for earlier years. Although economic growth was projected to run a bit above the staff's estimate of the economy's potential, the unemployment rate was projected to hold around its current level with improvements in job prospects expected to lure more workers back into the labor force. Inflation was projected to edge lower over the rest of the year and into 2006, reflecting the attenuation of the impact of higher energy prices and the effects of a slowed rate of growth of import prices and remaining slack in resource markets.

In their discussion of current conditions and the economic outlook, meeting participants observed that incoming data over the intermeeting period hinted at possible upside risks for inflation and downside risks for economic growth. Earlier increases in energy prices seemed to be an important factor contributing to an uptick in core inflation and a slower pace of economic activity. With energy prices leveling out more recently, however, and the behavior of compensation suggesting a lack of pressure in labor markets, underlying inflation appeared to remain contained. The weakness in spending was widespread and could not be completely dismissed, but it had appeared only very recently and could be a product of the inherent noisiness of high-frequency economic data. On balance, economic fundamentals including low interest rates, robust underlying productivity growth, and strengthened business balance sheets were expected to support economic growth at a pace sufficient to gradually eliminate remaining slack in resource utilization. Although the economic outlook generally seemed favorable, there was also broad recognition of greater uncertainty attending the outlook for both inflation and output growth.

Capital expenditures advanced briskly over the first quarter, but at a pace significantly below that registered over the latter half of last year. To some extent, businesses probably had pulled capital outlays forward from this year into 2004 to benefit from the partial-expensing tax provision that expired at year-end, but the unexpected weakness in capital goods orders for February and March seemed hard to attribute to this factor alone. In addition, the prolonged period of elevated spot energy prices, the sense supported by futures markets that these higher prices may persist for some time, and the heightened uncertainty about energy prices going forward, together may have left businesses less confident about the future and wary of longer-term commitments such as expanding plant capacity or taking on new workers. A less buoyant and less certain economic outlook seemed apparent in financial markets as well, where equity prices had fallen and risk spreads had widened. On balance,

though, these financial developments did not appear to signal the onset of a sharp retrenchment in investors' willingness to bear risk, and capital expenditures were seen as likely to remain quite robust, spurred by strong economic fundamentals that included elevated profits, opportunities to raise efficiency by utilizing new technologies, a low cost of capital, and strong corporate balance sheets. Indeed, a substantial weakening in business investment in an environment with such favorable fundamentals would be at odds with the historical record.

Incoming data for the household sector were viewed as mixed. Higher gasoline prices seemed to be sapping consumer confidence and consumer spending. The pace of consumption growth had fallen off appreciably toward the end of the first quarter, and some participants worried about the potential for continued sluggishness in consumer spending if increasingly cautious households sought to raise their saving rate rapidly. On balance, though, strong income growth and low interest rates augured well for household spending. Although housing starts had dropped of late, home sales and other indicators of activity in the residential real estate market remained at very high levels. House price appreciation was expected to moderate over coming quarters, but a number of local real estate markets were still regarded as "hot," with signs of possible speculative excesses in some areas.

The deceleration in final sales over the first quarter had been accompanied by a sizable accumulation of businesses inventories. The available data suggested that stocks had accumulated in a variety of industries, but particularly in the motor vehicle sector where the inventory of new autos had moved appreciably higher. Although difficult to judge, the inventory buildup was not regarded as likely to have major implications for aggregate manufacturing beyond some modest production cutbacks in the current quarter.

A relatively high proportion of demand had continued to be met by imports. Some concern was expressed that incoming data suggested weaker growth in some of our major trading partners, which posed a downside risk to forecasts for U.S. exports. Moreover, advances in domestic income were expected to contribute to brisk growth in imports. Looking ahead, the U.S. economy was expected to continue to run quite substantial current account deficits, although the impact of past dollar depreciation should work to boost exports and slow the rise in imports to some extent.

Recent energy price developments garnered considerable attention. Declines in energy prices in recent weeks were viewed as welcome, but participants noted that far-dated futures prices for oil remained quite elevated and that persistently high energy prices could trigger a range of deleterious effects on the economy. High energy prices appeared to be taking a toll on household and business confidence and might be beginning to crimp corporate profits. In some cases, firms seemed to be more successfully passing on energy costs to their customers. Indeed, some portion of recent elevated inflation readings probably represented, at least partly, such pass-through effects from higher energy costs. However, while pass-through effects could leave the overall price level higher, their impact on inflation should fade over time, as long as inflation expectations remain well contained. Still, considerable uncertainty surrounded the degree of pass-through from energy prices to core consumer prices, and pass-through effects might be more pronounced when energy price increases were perceived as more likely to be permanent. Persistently high energy prices were mentioned as a factor that could trim the level of potential output to a small degree over time, possibly contributing to additional upward pressure on consumer prices at the margin.

Participants voiced concerns about recent price trends; they expected inflation to remain contained but also perceived that the risks to that inflation outlook now might be skewed somewhat to the upside. Core measures of price inflation had moved up over recent quarters and particularly so over the last few months. A discernable upcreep was apparent in survey measures of short- and, to a limited extent, long-term inflation expectations over recent months. Moreover, there were risks that the relative stability of long-term survey measures of inflation expectations could simply reflect lags in households' perceptions of changing economic prospects. The success that some businesses seemed to be encountering in passing through cost increases raised the possibility that competitive pressures and resource slack were exerting somewhat less restraint on inflation than had been anticipated.

However, available indicators of wages and benefits had registered only modest growth, suggesting to many that some slack in labor markets persisted. Moreover, market measures of inflation compensation had ebbed in recent weeks, and survey measures of long-term inflation expectations, albeit a touch higher of late, remained in the broad range of recent years. Along with energy prices, import and materials prices apparently had contributed to the recent uptick in inflation, and pressures on inflation stemming from these three sources were expected to lessen over coming quarters. On balance, measures of core inflation were thought likely to remain in check over the remainder of this year and next.

In the Committee's discussion of monetary policy for the intermeeting period, all members favored raising the target federal funds rate 25 basis points to 3 percent at this meeting. Although downside risks to sustainable growth had become more evident, most members regarded the recent slower growth of economic activity as likely to be transitory. In this regard, the ability of the U.S. economy to withstand significant shocks over recent years buttressed the view that policymakers should not overreact to a comparatively small number of disappointing indicators, especially when economic fundamentals appeared to remain quite supportive of continued solid expansion. To be sure, the Committee had raised its federal funds rate target appreciably over the past year, and, in the view of a few members, a larger-than-expected moderation of aggregate demand in response to this cumulative policy action could not be ruled out. However, all members regarded the stance of policy as accommodative and judged that the current level of short-term rates remained too low to be consistent with sustainable growth and stable prices in the long run. Against the backdrop of the recent uptick in core inflation and in some measures of inflation expectations, members agreed that they should continue along the course of removing policy accommodation at a measured pace conditional on the outlook for inflation and economic growth.

In discussing the statement to be released after the meeting, members agreed that it was appropriate to acknowledge that rising energy prices seemed to have spurred an increase in core measures of inflation by dropping the reference from the March statement indicating that "The rise in energy prices, however, has not notably fed through to core consumer prices." They likewise all agreed that mention should be made that, on balance, longer-term inflation expectations remained well contained. Regarding the risks to sustainable growth and price stability, some members noted that the risk assessment conditioned on "appropriate policy" no longer seemed to convey useful information regarding the Committee's economic and policy outlook. Although some members noted that a case could be made that the risks to inflation were now somewhat skewed to the upside and those to sustainable economic growth perhaps to the downside, the most likely outcome remained one of stable prices and sustainable growth, and the Committee agreed that it should retain a balanced assessment of

risks conditional on appropriate policy.

For many, heightened economic uncertainty in the current environment implied greater uncertainty about the range of possible policy outcomes and placed a premium on flexibility in setting policy at upcoming meetings. Some members commented that this greater uncertainty called for eliminating or paring back forward-looking language from the statement--if not at this meeting, then fairly soon. In the event, most members viewed the forward-looking language in the statement--including the characterization of the stance of policy as accommodative as well as the judgment that policy accommodation could be removed at a pace that is "likely to be measured"--as a reasonable characterization of the policy stance and its likely evolution over time. Moreover, a number remarked that the language in its current form was clearly conditioned on economic developments and therefore would not stand in the way of either a pause or a step-up in policy firming depending on events. In the end, all members agreed to retain the forward-looking language.

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

"The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 3 percent."

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

"The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, 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 and Geithner, Ms. Bies, Messrs. Ferguson, Fisher, Gramlich, Kohn, Moskow, Olson, Santomero, and Stern.

**Votes against this action:** None.

**Absent and not voting:** Mr. Bernanke

It was agreed that the next meeting of the Committee would be held on Wednesday-Thursday, June 29-30, 2005.

The meeting adjourned at 1:25 p.m.

#### **Notation Vote**

By notation vote completed on April 11, 2005, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on March 22, 2005.



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

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**Footnote**

1. Secretary's note: Advice had been received that Richard W. Fisher had been elected by the directors of the Federal Reserve Banks of Atlanta, Dallas, and St. Louis, as a member of the Federal Open Market Committee for the period commencing April 4, 2005, and that he had executed his oath of office. [Return to text](#)

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