The Federal Reserve Board

Minutes of the Federal Open Market Committee

December 13, 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, December 13, 2005 at 9:00 a.m.

Present:

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

Ms. Cumming, Messrs. Guynn and 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

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, Freeman, and Madigan, Ms. Mester, Messrs. Oliner, Rosenblum, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

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

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

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

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

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

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

Mr. Kumasaka, 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

Messrs. Fuhrer, Hakkio, Rasche, Sniderman, Weinberg, and Williams, Senior Vice Presidents, Federal Reserve Banks of Boston, Kansas City, St. Louis, Cleveland, Richmond, and San Francisco, respectively

Mr. Cunningham, Ms. Mosser, and Mr. Sullivan, Vice Presidents, Federal Reserve Banks of Atlanta, New York, and Chicago, respectively

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

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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.

The information reviewed at this meeting suggested that the economy continued to expand at a solid rate in the fourth quarter. Industrial production rebounded, and employment growth appeared to have recovered smartly from the depressing effects of recent hurricanes. Although some scattered signs of cooling of the housing sector had emerged, the pace of construction activity and sales remained brisk. More broadly, spending by consumers and businesses was well maintained. Core consumer price inflation remained subdued, even though some of the increase in energy costs had apparently passed through to prices of final goods and services.

Private nonfarm payrolls grew rapidly in November after a small gain in October. Construction employment posted another large increase, probably owing in part to hurricane-related activity. Broad-based gains in durable goods industries augmented manufacturing employment, and employment in the related industries of temporary help services and wholesale trade increased as well. With employment rising but the average workweek of production or nonsupervisory workers falling slightly, aggregate hours slipped in November--

albeit to a level above that of their third-quarter average. The unemployment rate held steady at 5 percent, and the labor force participation rate was also unchanged. Survey measures of individuals' expectations of future labor market conditions improved in November, largely reversing post-Katrina declines.

Industrial production rebounded in October after having been held down in September by hurricanes and by a strike at Boeing. The resumption of commercial aircraft production boosted manufacturing output and more than offset a fall in the production of motor vehicles and parts. Large output gains in hurricane-affected industries--such as segments of the food, rubber and plastics, and paper industries--also contributed to the increase in manufacturing output. The growth of high-tech output slowed slightly in October, mainly as a result of smaller increases in the production of semiconductors. In contrast, production of communication equipment--particularly data networking equipment--accelerated. With many energy facilities in the Gulf region still closed, output at mines, which is defined to include oil and gas extraction, slipped further in October. Manufacturing capacity utilization moved up again in October and was only a touch below its long-run average.

Real personal consumption expenditures appeared to be increasing solidly over the course of the fourth quarter, led by improvements in the fundamental determinants of consumer spending. Real disposable personal income was bolstered by gains in employment and falling retail energy prices, while continued brisk advances in house prices and the recent strengthening of equity prices contributed importantly to increases in household wealth. Consumer sentiment picked up in November and early December; some survey measures of confidence returned to the range seen during the first half of the year. The personal saving rate--while still slightly negative--moved up in October.

Activity in the housing market remained brisk despite a rise in mortgage interest rates. Starts of new single-family homes dropped back somewhat in October from September's very strong pace, but permit issuance remained elevated. New home sales reached a new high in October, and existing home sales eased off only a little from the high levels recorded during the summer. Other available indicators of housing activity were on the soft side: An index of mortgage applications for purchases of homes declined in November, and builders' ratings of new home sales had fallen off in recent months. In addition, survey measures of homebuying attitudes had declined to levels last observed in the early 1990s.

Real outlays for equipment and software posted a solid gain in the third quarter. Although business purchases of motor vehicles declined in October and November, growth in investment in nontransportation equipment appeared to have been well maintained in the fourth quarter. Rising business sales, a declining cost of capital, and ample financial resources in the corporate sector continued to foster a favorable environment for capital spending, a sentiment echoed in executive surveys, which generally pointed to widespread increases in planned capital outlays. Real spending on nonresidential construction improved materially in the third quarter, boosted by substantial gains in drilling and mining expenditures.

Real nonfarm inventories ran off in the third quarter as automakers pared their motor vehicle stocks. But even outside the motor vehicle sector, inventory investment was relatively restrained, and partial data for October suggested that real stockbuilding continued to be subdued. The level of stocks appeared reasonably well aligned with sales.

The U.S. international trade deficit reached a new record in September. A surge in imports was accompanied by a fairly sizable drop in exports, part of which was due to a steep falloff in aircraft exports as a result of the strike at Boeing. The jump in the value of imports was driven by strong growth in most categories of goods and, to a lesser extent, growth in services; increases in the dollar value of imports of oil and of industrial supplies--especially natural gas--were particularly strong, a reflection of higher prices. Foreign industrialized economies expanded robustly in the third quarter, and available indicators for the fourth quarter appeared promising, on balance.

Core consumer price inflation was moderate in recent months, although some signs of pass-through of higher energy costs were evident, especially in transportation services. Consumer energy prices had retreated notably from their elevated post-hurricane levels. Wholesale and retail gasoline prices dropped as gasoline inventories rebounded. And spot prices for natural gas fell sharply through mid-November amidst unusually temperate weather, plentiful inventories, and declining prices of competing fuels; unusually cold weather in early December, however, caused spot prices to move back up to their October levels. Presumably in response to falling retail energy prices, one survey of households in November and early December showed a marked retreat in expectations for inflation over the coming year. Longer-term inflation expectations also edged down, but stayed a touch above the narrow range observed in recent years. Although recent increases in energy costs had pushed up producer prices in some sectors, overall producer price inflation remained subdued. With regard to labor costs, the twelve-month change in the employment cost index for private industry workers in September was well below its year-ago increase. Hourly compensation in the nonfarm business sector also appeared to have slowed a bit recently.

At its November meeting, the Federal Open Market Committee decided to increase the target level of the federal funds rate 25 basis points, to 4 percent. In its accompanying statement, the Committee indicated that, with appropriate monetary policy action, the upside and downside risks to the attainment of sustainable growth and price stability should be kept roughly equal. The Committee also noted that elevated energy prices and hurricane-related disruptions in economic activity had temporarily depressed output and employment. However, monetary policy accommodation, coupled with robust underlying growth in productivity, was providing ongoing support to economic activity. And although the cumulative rise in energy and other costs had the potential to add to inflation pressures, core inflation had been relatively low in recent months, and longer-term inflation expectations remained contained. In these circumstances, the Committee believed that policy accommodation could be removed at a pace that was likely to be measured but noted that it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Market participants widely anticipated the Committee's decision at its November meeting, and the policy announcement evoked little reaction in financial markets. Over the intermeeting period, investors marked up slightly their expectations for the path of monetary policy in light of stronger-than-expected data on spending and production. Nominal Treasury yields changed little, on net, but measures of inflation compensation at longer horizons--which are calculated using yields on nominal and inflation-protected securities--declined somewhat. Credit spreads on both investment- and speculative-grade corporate bonds were about unchanged over the intermeeting period. Major equity price indexes posted substantial gains, spurred by the perception that the economy had retained considerable momentum with limited inflation pressures. In foreign exchange markets, the trade-weighted value of the dollar was about unchanged over the intermeeting period.

The expansion of domestic nonfinancial debt appeared to have moderated a little from its brisk third-quarter pace. Consumer credit dipped in October, and nonfinancial firms' net borrowing in the form of bank loans, commercial paper, and bonds was a bit below the third-quarter pace. Household bankruptcies hovered at very low levels in recent weeks after soaring to unprecedented heights just before the implementation of more-stringent bankruptcy rules in mid-October. Hurricane relief payments apparently boosted M2 in October, but that aggregate decelerated in November, partly reflecting the continued rise in the opportunity cost of holding liquid deposits.

The staff forecast prepared for this meeting suggested that growth of economic activity would slow from this year's pace, but remain solid, with output staying near the economy's potential over the next two years. Although hurricane-related rebuilding would boost activity, especially in the near term, this stimulus increasingly would be countered by higher interest rates, the anticipated waning of the positive wealth effect associated with large earlier gains in equity and house prices, and reduced impetus from fiscal policy. Both overall and core consumer price inflation were projected to move higher in the first half of next year, reflecting the effects of higher energy prices, but then to trend lower as those effects ebb.

In their discussion of the economic situation and outlook, meeting participants noted that incoming data over the intermeeting period had been encouraging with regard to both economic growth and inflation. The economic expansion had shown considerable resilience in the face of higher energy prices and hurricane-related disruptions, suggesting greater underlying strength than had been apparent at the time of the November meeting. At the same time, incoming inflation data had been benign, indicating relatively modest pass-through of higher energy prices to core inflation to date; subdued gains in compensation and strong growth in productivity were holding down business costs; and inflation expectations, which had jumped after the hurricanes, had fallen back. Nonetheless, with growth solid and prices of energy products still well above levels earlier in the year, possible increases in resource utilization had the potential to add to pressures on prices, especially in the absence of some further firming of policy.

In their discussion of major sectors of the economy, meeting participants noted that, while light vehicle sales had slowed in the fall, consumer spending outside the auto sector appeared to have remained vigorous. Holiday sales were said to be off to a good start in many parts of the country. The substantial recovery in measures of consumer confidence after their sharp declines in the aftermath of the hurricanes had reduced meeting participants' concerns about a significant pull-back in spending. Going forward, consumer outlays were expected to be supported by further advances in employment and income.

Meeting participants discussed tentative signs that activity was beginning to slow in the housing sector. Reports from contacts in many parts of the country suggested somewhat less ebullient market conditions, and measures of confidence of homebuyers and builders had fallen back noticeably. A downshift in attitudes regarding the outlook for the housing sector could have significant market effects, in part by damping the demand for houses by investors and speculators. A slowing of house price increases, by restraining the expansion of consumption, and a moderation in the pace of new building were expected to reduce the growth of aggregate demand somewhat in coming quarters. To date, however, the national data on home prices, sales, and construction activity did not suggest a significant weakening in the sector.

Business investment spending had accelerated some since midyear. In part, the pickup may have reflected an increase in business confidence as the economy proved resilient in the face of this year's substantial adverse shocks. Participants noted that the improved performance of investment suggested that the expansion was becoming more balanced, with strengthening business spending potentially offsetting some moderation in the growth of household spending from the elevated rates of recent years.

Economic activity also could be buoyed by developments in other sectors of the economy. Increased federal government outlays were expected to boost output a little next year. Supportive financial conditions and an apparent increase in confidence had contributed to a pickup in growth abroad. Despite possible firming of monetary policy by some foreign central banks and the rise in the foreign exchange value of the dollar owing to global demands for dollar assets, a good portion of the recent strength in foreign economic growth was expected to persist and provide support for U.S. exports.

In their discussion of prices, participants indicated that their concerns about near-term inflation pressures had eased somewhat over the intermeeting period. Recent data suggested that, thus far, indirect effects of elevated energy prices on core inflation had been muted. Moreover, energy prices generally had fallen back on balance since earlier in the fall, and much of the increases in inflation expectations posted in the aftermath of the hurricanes had reversed. Participants noted that robust competition--including that from foreign producers--and further substantial gains in productivity were helping to contain cost and price pressures. Moreover, measures of labor compensation showed only moderate gains while relatively wide profit margins could allow firms to absorb somewhat larger increases in labor and other costs without boosting prices. Nonetheless, surveys and anecdotal reports suggested that some firms were successfully passing at least a portion of their increased costs on to customers, and many participants remained concerned that elevated energy prices could put pressure on core inflation. Also, in the view of a number of participants, the economy was possibly producing in the neighborhood of its potential, and the persistent strength in spending of late suggested that resource markets could tighten further and inflation pressures build. Under these circumstances, and with policy having been accommodative for some time, inflation expectations could rise if monetary policy were not seen as responding to contain such risks.

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 4-1/4 percent. With spending apparently retaining considerable momentum, and with the indirect effects of increased energy prices still threatening to raise core inflation at least for a time, the Committee thought that additional policy firming at this meeting was appropriate to keep inflation and inflation expectations in check. Committee members generally anticipated that policy would likely need to be firmed further going forward. In that process, the Committee would need to be mindful of the lags in the effect of policy firming on the economy. However, it would also have to take account of the effects of the sustained period of favorable financial conditions on asset prices and aggregate demand as well as the resulting possibility of further increases in resource utilization and pressures on prices. Views differed on how much further tightening might be required. Because the Committee's actions over the past eighteen months had significantly reduced the degree of monetary policy accommodation, members thought that the policy outlook was becoming considerably less certain and that policy decisions going forward would depend to an increased extent on the implications of incoming economic data for future growth and inflation.

The Committee agreed that several changes in the wording of the announcement to be released after today's meeting would be appropriate. The federal funds rate had been boosted substantially, and, in the view of some members, it was now likely within a broad range of values that might turn out to be consistent with output remaining close to potential. In these circumstances, the Committee thought that policy should no longer be characterized as accommodative. Members concurred that the statement should note that the expansion remained solid despite elevated energy prices and hurricane-related disruptions. While inflation and long-term inflation expectations remained contained, the Committee agreed that the announcement should indicate that possible increases in resource utilization, as well as elevated energy prices, had the potential to add to inflation pressures and that "some further measured policy firming is likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance." Although future action would depend on the incoming data, this characterization of the outlook for policy was seen by most members as indicating that, given the information now in hand, the number of additional firming steps required probably would not be large. Some members thought that the word "measured" was no longer necessary, but its retention for this meeting was seen as potentially useful to preclude a possible misinterpretation that the Committee now saw a significant possibility of adjusting policy in larger increments in the near future. Wording of the announcement along these lines was not expected to have a substantial effect on market expectations for policy, though such effects were especially difficult to judge given the extensive changes being made to the statement. The members agreed that the announcement should end by noting that policy will respond to changes in economic prospects as needed to foster the Committee's objectives.

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 4-1/4 percent."

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

> "The Committee judges that some further measured policy firming is likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. In any event, the Committee will respond to changes in economic prospects as needed to foster these objectives."

Votes for this action: Messrs. Greenspan and Geithner, Ms. Bies, Messrs. Ferguson, Fisher, Kohn, Olson, Moskow, Santomero, and Stern.

Votes against this action: None

It was agreed that the next meeting of the Committee would be held on Tuesday, January 31, 2006.

The meeting adjourned at 1:00 p.m.

Notation Vote
By notation vote completed on November 21, 2005, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on November 1, 2005.

Vincent R. Reinhart
Secretary

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