

Minutes of the Federal Open Market Committee August 11-12, 2009

A joint meeting of the Federal Open Market Committee and the Board of Governors of the Federal Reserve System was held in the offices of the Board of Governors in Washington, D.C., on Tuesday, August 11, 2009, at 2:00 p.m. and continued on Wednesday, August 12, 2009, at 9:00 a.m.

PRESENT:

Mr. Bernanke, Chairman
Mr. Dudley, Vice Chairman
Ms. Duke
Mr. Evans
Mr. Kohn
Mr. Lacker
Mr. Lockhart
Mr. Tarullo
Mr. Warsh
Ms. Yellen

Mr. Bullard, Ms. Cumming, Mr. Hoenig, Ms. Pinalto, and Mr. Rosengren, Alternate Members of the Federal Open Market Committee

Messrs. Fisher, Plosser, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis, respectively

Mr. Madigan, Secretary and Economist
Ms. Danker, Deputy Secretary
Mr. Luecke, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter,¹ Deputy General Counsel
Mr. Sheets, Economist
Mr. Stockton, Economist

Messrs. Altig, Clouse, Connors, Slifman, Sullivan, and Wilcox, Associate Economists

Mr. Sack, Manager, System Open Market Account

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

Ms. George, Acting Director, Division of Banking Supervision and Regulation, Board of Governors

Mr. Frierson,¹ Deputy Secretary, Office of the Secretary, Board of Governors

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

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

Ms. Robertson, Assistant to the Board, Office of Board Members, Board of Governors

Ms. Liang, Messrs. Reifschneider and Wascher, Senior Associate Directors, Division of Research and Statistics, Board of Governors

Mr. Meyer, Senior Adviser, Division of Monetary Affairs, Board of Governors

Messrs. Leahy and Nelson,¹ Associate Directors, Divisions of International Finance and Monetary Affairs, respectively, Board of Governors

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

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

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

Ms. Beattie,¹ Assistant to the Secretary, Office of the Secretary, Board of Governors

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

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

Mr. Sniderman, Executive Vice President, Federal Reserve Bank of Cleveland

¹ Attended Tuesday's session only.

Mr. McAndrews,¹ Ms. McLaughlin, Messrs. Rudebusch, Sellon, Tootell, and Waller, Senior Vice Presidents, Federal Reserve Banks of New York, New York, San Francisco, Kansas City, Boston, and St. Louis, respectively

Messrs. Burke, Dotsey, Koenig, and Pesenti, Vice Presidents, Federal Reserve Banks of New York, Philadelphia, Dallas, and New York, respectively

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

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

¹ Attended Tuesday's session only.

Developments in Financial Markets and the Federal Reserve's Balance Sheet

The Manager of the System Open Market Account reported on recent developments in domestic and foreign financial markets. The Manager also reported on System open market operations in Treasury securities, agency debt, and agency mortgage-backed securities (MBS) since the Committee's June 23-24 meeting. By unanimous vote, the Committee ratified those transactions. There were no open market operations in foreign currencies for the System's account during the intermeeting period. The Federal Reserve's total assets were about unchanged, on balance, since the Committee met in June, remaining at approximately \$2 trillion as the System's purchases of securities were essentially matched by a further decline in usage of the System's credit and liquidity facilities.

Meeting participants again discussed the merits of including agency MBS backed by adjustable-rate mortgages (ARMs) in the Committee's MBS purchase program: Some thought it would be useful to include agency ARM MBS, noting that doing so could reduce the unusually large spreads between ARM rates and yields on similar-duration Treasury securities—spreads that were far larger than the comparable spreads on fixed-rate mortgages; others saw little potential benefit, given the small stock and limited issuance of ARM MBS, and were hesitant to involve the Federal Reserve in another market segment. The Committee made no decision on purchasing ARM MBS at this meeting. Participants also discussed the merits of progressively reducing the pace at which the Federal Reserve buys

Treasury securities, agency debt, and agency MBS prior to the end of the asset purchase programs. They generally were of the view that gradually slowing the pace of the Committee's purchases of \$300 billion of Treasury securities and extending their completion to the end of October could help promote a smooth transition in markets. A number of participants noted that a similar tapering of agency debt and MBS purchases could be helpful in the future as those programs approach completion. The Committee made no decisions on tapering those purchases at this meeting.

The staff presented an update on the continuing development of several tools that could help support a smooth withdrawal of policy accommodation at the appropriate time. These measures include executing reverse repurchase agreements on a large scale, potentially with counterparties other than the primary dealers; implementing a term deposit facility that would be available to depository institutions in order to reduce the supply of excess reserves; and taking steps to tighten the link between the interest rate paid on reserve balances held at the Federal Reserve Banks and the federal funds rate. Several participants noted the need to continue refining the Committee's strategy for an eventual withdrawal of policy accommodation. The staff also updated the Committee on developments in the Term Asset-Backed Securities Loan Facility (TALF), summarized the pros and cons of expanding the range of collateral eligible for TALF loans, and recommended extending the final date for making new TALF loans into 2010. Participants generally supported the extension of TALF into 2010 but were skeptical about expanding the range of assets at this time.

Secretary's note: As announced on August 17, 2009, the Board of Governors subsequently approved an extension of the TALF while holding in abeyance any further expansion in the types of collateral eligible for the TALF.

Staff Review of the Economic Situation

The information reviewed at the August 11-12 meeting suggested that overall economic activity was stabilizing after a contraction in real gross domestic product (GDP) during 2008 and early 2009 that the Bureau of Economic Analysis recently reported to have been greater than it had previously estimated. Employment continued to move lower through July, but the pace of job losses had slowed noticeably in recent months. A sizable pickup in motor vehicle production appeared to be under way. Housing activity apparently was begin-

ning to turn up. Consumer spending dropped only a little further in the first half of this year, on balance, after falling sharply in the second half of last year. The decline in equipment and software (E&S) investment seemed to be moderating, although the incoming data did not point to an imminent recovery. The sharp cuts in production this year reduced inventory stocks significantly, though they remained high relative to the level of sales. A jump in gasoline prices pushed up overall consumer price inflation in June, but core consumer price inflation remained relatively stable in recent months.

Job losses continued to abate in July, and aggregate hours of production and nonsupervisory workers were unchanged. The step-up in motor vehicle assemblies boosted employment in that industry; job losses decreased in a number of other manufacturing industries, and factory workweeks generally rose. Employment declines in business and financial services in July were also smaller than those in recent months. Payrolls in nonbusiness services posted their third monthly gain, supported by the continued uptrend in health and education and a small gain in the leisure and hospitality industry. However, job losses in the construction industry continued at about the recent rate. In the household survey, the unemployment rate edged down in July to 9.4 percent, while the labor force participation rate fell back to its March level. Other indicators also suggested a reduced pace of deterioration in labor demand. Both initial claims for unemployment insurance and insured unemployment moved down since June. However, with labor markets still quite slack, year-over-year growth in average hourly earnings of production and nonsupervisory workers slowed further in July.

The contraction in industrial production slowed markedly in the second quarter, although the rate of decline remained rapid and the factory utilization rate recorded a new low in June. The moderation in the pace of decline in industrial production in the second quarter was widespread across industries and major market groups. Available indicators suggested that industrial production increased noticeably in July, led by motor vehicle assemblies; manufacturing output excluding motor vehicles likely also rose in July.

Real personal consumption expenditures (PCE) edged down in June after holding steady in May and declining in April. Apart from a jump in motor vehicle purchases, which were boosted appreciably by the government's "cash-for-clunkers" program, indicators of consumer spending in July were mixed. Most determinants

of spending remained weak on balance. In particular, the weak labor market continued to place significant strains on household income, and earlier declines in net worth were still holding back spending. However, household net worth received a boost from the rise in equity prices since their low in March. In addition, the July Senior Loan Officer Opinion Survey on Bank Lending Practices indicated that the fraction of banks tightening standards and terms for consumer credit had diminished further. Moreover, measures of consumer sentiment, though they recently retraced a portion of their earlier gains, remained well above levels seen at the turn of the year.

Data from the housing sector indicated that construction activity appeared to be emerging from its extended decline. Single-family housing starts registered a sizable increase in June, and the number of starts stood well above the record low recorded in the first quarter of this year. However, in the much smaller multifamily sector, starts continued to decline, on net, in 2009 after falling significantly in the second half of 2008 amid tight credit conditions and rapidly deteriorating demand fundamentals for apartment buildings. The latest sales data suggested that demand for new houses may be strengthening after stabilizing in the early portion of this year. Although sales remained quite modest, they were enough, given the very slow pace of production, to pare the overhang of unsold new single-family houses: In June, these inventories stood at about one-half of their peak in the summer of 2006, and the months' supply of new homes was down considerably from its record high in January. Sales of existing single-family houses, which were fairly flat early in the year, posted their third consecutive monthly increase in June, and pending home sales agreements through June suggested that resale activity would rise further in the months ahead. Sales of existing homes had been supported for much of the year by heightened volumes of transactions involving bank-owned and other distressed properties; the uptick in May and June, however, appeared to have been driven by an increase in transactions of non-distressed properties. The apparent stabilization in housing demand seen in recent months was likely due, in part, to improvements in housing affordability stemming from low interest rates for conforming mortgages and lower house prices.

Real investment in E&S continued to contract in the second quarter; however, the estimated rate of decline was substantially smaller than in the previous two quarters. Business outlays on motor vehicles leveled off in the second quarter after an extended period of steep

declines. Real spending in the high-tech sector declined, although real outlays for computing equipment posted their first gain in a year. Outside of high-tech and transportation, real spending on equipment dropped again in the second quarter but at a slower pace than in the previous quarter. Although the fundamental determinants of investment in E&S remained weak, conditions appeared less unfavorable, on balance, than earlier in the year. In particular, the decline in business output was less pronounced in the second quarter than in prior quarters, and estimates of the user cost of capital fell back somewhat in the second quarter after spiking last year. Other forward-looking indicators generally improved, but they remained at levels consistent with a weak outlook for E&S investment. Corporate bond spreads over Treasury securities continued to ease, and monthly surveys of business conditions and sentiment generally were less downbeat than earlier in the year. In addition, the July Senior Loan Officer Opinion Survey reported that the net percentage of banks that had tightened standards and terms on commercial and industrial (C&I) loans receded somewhat, although the July National Federation of Independent Business survey showed that the share of small businesses reporting increased difficulty in obtaining credit remained high. Conditions in the non-residential construction sector generally remained quite poor, with spending in most major categories staying on a downward trajectory through June. Vacancy rates continued to rise, property prices fell further, and, as indicated by the July Senior Loan Officer Opinion Survey, financing for nonresidential construction projects became even tighter.

In May, the U.S. international trade deficit narrowed to its lowest level since 1999, as exports increased moderately and imports declined. The increase in exports of goods and services was led by a climb in exports of industrial supplies, particularly of petroleum products, and reflected both higher prices and greater volumes. The value of imports of goods and services fell at a slower pace than in April. Imports of petroleum products exhibited the largest decline, with the fall wholly reflecting lower volumes, as petroleum prices rose. Imports of services and automotive products moved down somewhat, while non-oil industrial supplies were largely unchanged. Overall imports of consumer goods were also about unchanged, as a large decline in pharmaceuticals offset increases in a number of other goods. In contrast, imports of computers moved up strongly in May.

Recent indicators of economic activity in the advanced foreign economies suggested that the pace of contraction in those countries moderated further. Purchasing managers indexes continued to rebound but did not yet point to expansion for all countries. Industrial production, while remaining well below pre-crisis levels, moved up strongly in Japan and edged up in the euro area and in the United Kingdom. Indicators of economic sentiment also improved. However, labor market conditions continued to deteriorate, and credit standards remained generally tight. In emerging market economies, recent data showed that economic activity surged across emerging Asia in the second quarter. Real GDP rebounded sharply in China and South Korea, and the preliminary estimate in Singapore indicated a substantial increase. In China, policy stimulus lifted activity and thus helped boost China's imports, primarily from other countries in Asia. Indicators for these other countries also pointed to a strong rebound in the second quarter. Activity remained depressed in Mexico, partly reflecting the adverse effect of a swine flu outbreak. In contrast, activity in Brazil appeared to have begun to recover.

In the United States, overall PCE prices rose in June following little change in each of the previous three months. The increase largely reflected a sizable increase in gasoline prices, which appeared to have caught up with earlier increases in crude oil prices. The latest available survey data showed that gasoline prices flattened out, on net, in July. Excluding food and energy, PCE prices moved up moderately in June. For the second quarter as a whole, core inflation picked up from the pace in the first quarter, which had been revised down because of smaller increases in the imputed prices of nonmarket services. Median year-ahead inflation expectations in the Reuters/University of Michigan Survey of Consumers held relatively steady in July, as in recent months. Longer-term inflation expectations were about the same as the average over 2008. The producer price index for core intermediate materials turned up in June following a string of monthly declines that likely reflected the pass-through of the large declines in spot prices of commodities in the second half of last year. All measures of hourly compensation and wages suggested that labor costs decelerated markedly this year in response to the considerable deterioration in labor market conditions.

Staff Review of the Financial Situation

The decisions by the Federal Open Market Committee (FOMC) at the June meeting to leave the target range for the federal funds rate unchanged and to maintain

the sizes of its large-scale asset purchase programs, along with the accompanying statement, were broadly in line with market expectations. However, investors initially marked up their expected path for the federal funds rate following the release of the statement, as they apparently interpreted it as suggesting a more favorable assessment of prospects for economic growth than had been anticipated. Subsequently, investors revised down the expected policy path after the June employment report and the Chairman's semiannual monetary policy testimony. These declines were more than offset by the favorable economic information received toward the end of the intermeeting period, including the stronger-than-expected July employment report. On net, the market-implied path of the federal funds rate ended the period about the same as at the time of the June FOMC meeting. Yields on nominal Treasury securities were also little changed, on balance, over the intermeeting period, though there were sizable intraday movements in response to macroeconomic data releases and Federal Reserve communications. Inflation compensation based on five-year Treasury inflation-protected securities (TIPS) declined, on net, over the intermeeting period, while five-year inflation compensation five years ahead rose somewhat. Liquidity in the TIPS market reportedly continued to be poor, making unclear the extent to which movements in TIPS inflation compensation reflected changes in investors' expectations of future inflation.

Functioning in short-term funding markets generally showed further improvement over the intermeeting period. Consistent with reduced concerns about the financial condition of large banking institutions, London interbank offered rates (Libor) continued to edge down. Three- and six-month Libor-OIS (overnight index swap) spreads—while still somewhat elevated by historical standards—declined a bit further and stood at levels last recorded in early 2008. Bid-asked spreads for most types of repurchase agreements edged down. Since June, spreads on A2/P2-rated commercial paper and AA-rated asset-backed commercial paper were little changed, on net, remaining at the low ends of their ranges over the past two years. Indicators of Treasury market functioning were little changed over the intermeeting period, and functioning continued to be somewhat impaired. Bid-asked spreads held roughly steady, and trading volumes remained low. The on-the-run liquidity premium for the 10-year Treasury note was little changed at elevated levels, although it was well below its peak last fall.

Broad stock price indexes rose, on net, over the intermeeting period, as investors responded to strong second-quarter earnings reports and indications that the economy may be stabilizing. The spread between an estimate of the expected real equity return over the next 10 years for S&P 500 firms and an estimate of the real 10-year Treasury yield—a rough gauge of the equity risk premium—narrowed a bit more but remained high by recent historical standards. Option-implied volatility on the S&P 500 index also dropped a bit further. Yields on BBB-rated and speculative-grade corporate bonds declined over the intermeeting period. As a result, corporate bond spreads narrowed further and dropped below the previous peak levels reached in 2002 following the 2001 recession. Conditions in the leveraged loan market continued to improve as secondary-market prices rose further and bid-asked spreads narrowed.

Investor sentiment toward the financial sector improved further over the intermeeting period, boosted, in part, by better-than-expected second-quarter earnings results at larger banking institutions. Over the period, bank equity prices rose, and credit default swap spreads on financial firms declined. Nonetheless, some investors commented that the positive upside surprises at large financial institutions were mostly related to investment banking and trading activities, which may not provide a stable source of earnings, and to mortgage refinancing activity, which may recede if longer-term rates rise. Market participants also focused on the large consumer loan losses reported by many banks. The financial condition of CIT Group, Inc., one of the largest lenders to middle-market firms, worsened sharply over the period, but broader financial market conditions appeared to be largely unaffected by this development.

The level of private domestic nonfinancial sector debt apparently declined again in the second quarter, as household debt was estimated to have dropped and nonfinancial business debt appeared to have been essentially unchanged. Gross issuance of speculative- and investment-grade bonds by nonfinancial corporations slowed in July from its outsized second-quarter pace. Issuance of institutional loans in the syndicated leveraged loan market reportedly remained extremely weak in July, while bank loans and commercial paper continued to run off, leaving net debt financing by nonfinancial corporations at around zero. In contrast, the federal government issued debt at a rapid clip, and state and local government debt was estimated to have expanded moderately.

Commercial bank credit contracted further in June and July. All major loan categories declined, apparently reflecting the combined effects of weaker demand for most types of loans, some substitution from bank loans to other funding sources, and an ongoing tightening of lending standards and terms. Commercial and industrial lending dropped steeply amid subdued origination activity and broad-based paydowns of outstanding loans. In the July Senior Loan Officer Opinion Survey, respondents indicated that the most important reasons for the decline in C&I loans in 2009 were weaker demand from creditworthy borrowers and the deterioration in credit quality that had reduced the number of firms that respondents viewed as creditworthy. The contraction in commercial real estate (CRE) lending accelerated. Large fractions of respondents to the July survey again noted that they had tightened standards and that the demand for CRE loans had weakened further.

M2 was little changed, on net, in June and July. Retail money market mutual funds and small time deposits dropped significantly in June and were estimated to have contracted again in July, likely reflecting the very low rates of interest on these assets and a continued reallocation of wealth toward riskier assets. These declines were partly offset by a net increase in liquid deposits, also suggesting some portfolio reallocation within M2 assets. Currency expanded weakly, apparently because of soft foreign demand.

The tone of financial markets abroad improved further during the intermeeting period. Stock markets rose globally, as positive U.S. earnings reports and news of strong economic rebounds in emerging Asian economies reportedly lifted investor sentiment. European bank stocks rose especially rapidly, spurred by reports of better-than-expected earnings among some European banks as well as some U.S. financial institutions. The dollar depreciated mildly on a trade-weighted basis since late June.

The European Central Bank (ECB), the Bank of England, the Bank of Canada, and the Bank of Japan kept their respective policy rates constant over the intermeeting period. However, overnight interest rates in the euro area declined in the wake of the June 24 injection by the ECB of one-year funds at a fixed rate of 1 percent. The ECB also began its purchases of covered bonds, and yields on intermediate-term European covered bonds declined since the purchases began in early July. After leaving the size of its Asset Purchase Facility (APF) unchanged at its July meeting, the Bank of England, at its August meeting, raised the size of the

APF to £175 billion and widened the set of gilts it would purchase. Benchmark gilt yields fell noticeably on the announcement after moving higher in July.

Staff Economic Outlook

In the forecast prepared for the August FOMC meeting, the staff's outlook for the change in real activity over the next year and a half was essentially the same as at the time of the June meeting. Consumer spending had been on the soft side lately. The new estimates of real disposable income that were reported in the comprehensive revision to the national income and product accounts showed a noticeably slower increase in 2008 and the first half of 2009 than previously thought. By themselves, the revised income estimates would imply a lower forecast of consumer spending in coming quarters. But this negative influence on aggregate demand was roughly offset by other factors, including higher household net worth as a result of the rise in equity prices since March, lower corporate bond rates and spreads, a lower dollar, and a stronger forecast for foreign economic activity. All told, the staff continued to project that real GDP would start to increase in the second half of 2009 and that output growth would pick up to a pace somewhat above its potential rate in 2010. The projected increase in production in the second half of 2009 was expected to be the result of a slowing in the pace of inventory liquidation; final sales were not projected to increase until 2010. The step-up in economic activity in 2010 was expected to be supported by an ongoing improvement in financial conditions, which, along with accommodative monetary policy, was projected to set the stage for further improvements in household and business sentiment and an acceleration in aggregate demand.

The staff forecast for inflation was also about unchanged from that at the June meeting. Interpretation of the incoming data on core PCE inflation was complicated by changes in the definition of the core measure recently implemented by the Bureau of Economic Analysis, as well as by unusually low readings for some nonmarket components of the price index.² After accounting for these factors, the underlying pace of core inflation seemed to be running a little higher than the staff had anticipated. Survey measures of inflation expectations showed no significant change. Nonetheless,

² As part of the July 2009 comprehensive revision of the national income and product accounts, the Bureau of Economic Analysis reclassified restaurant meals from the food category to the services category. As a result, the price index for PCE excluding food and energy (the core PCE price index) now includes prices of restaurant meals.

with the unemployment rate anticipated to increase somewhat during the remainder of 2009 and to decline only gradually in 2010, the staff still expected core PCE inflation to slow substantially over the forecast period; the very low readings on hourly compensation lately suggested that such a process might already be in train.

Participants' Views on Current Conditions and the Economic Outlook

In their discussion of the economic situation and outlook, meeting participants agreed that the incoming data and anecdotal evidence had strengthened their confidence that the downturn in economic activity was ending and that growth was likely to resume in the second half of the year. Many noted that their baseline projections for the second half of 2009 and for subsequent years had not changed appreciably since the Committee met in June but that they now saw smaller downside risks. Consumer spending appeared to be in the process of leveling out, and activity in a number of local housing markets had stabilized or even increased somewhat. Reports from business contacts supported the view that firms were making progress in bringing inventories into better alignment with their reduced sales and that production was stabilizing in many sectors—albeit at low levels—and beginning to rise in some. Nonetheless, most participants saw the economy as likely to recover only slowly during the second half of this year, and all saw it as still vulnerable to adverse shocks. Conditions in the labor market remained poor, and business contacts generally indicated that firms would be quite cautious in hiring when demand for their products picks up. Moreover, declines in employment and weakness in growth of labor compensation meant that income growth was sluggish. Also, households likely would continue to face unusually tight credit conditions. These factors, along with past declines in wealth that had been only partly offset by recent increases in equity prices, would weigh on consumer spending. The data and business contacts indicated very substantial excess capacity in many sectors; this excess capacity, along with the tight credit conditions facing many firms, likely would mean further weakness in business fixed investment for a time. Even so, less-aggressive inventory cutting and continuing monetary and fiscal policy stimulus could be expected to support growth in production during the second half of 2009 and into 2010. In addition, the outlook for foreign economies had improved somewhat, auguring well for U.S. exports. Participants expected the pace of recovery to pick up in 2010, but they expressed a range of views, and considerable uncertainty, about the likely strength of the upturn—

particularly about the pace of projected gains in consumer spending and the extent to which credit conditions would normalize.

Most participants anticipated that substantial slack in resource utilization would lead to subdued and potentially declining wage and price inflation over the next few years; a few saw a risk of substantial disinflation. However, some pointed to the problems in measuring economic slack in real time, and several were skeptical that temporarily low levels of resource utilization would reduce inflation appreciably, given the loose empirical relationship of economic slack to inflation and the fact that the public did not appear to have reduced its expectations of inflation. Participants noted concerns among some analysts and business contacts that the sizable expansion of the Federal Reserve's balance sheet and large continuing federal budget deficits ultimately could lead to higher inflation if policies were not adjusted in a timely manner. To address these concerns, it would be important to continue communicating that the Federal Reserve has the tools and willingness to begin withdrawing monetary policy accommodation at the appropriate time to prevent any persistent increase in inflation.

Developments in financial markets during the intermeeting period were again seen as broadly positive; the cumulative improvement in market functioning since the spring was viewed as quite significant. Markets for corporate debt continued to improve, and private credit spreads narrowed further. With the TALF continuing to provide important support, markets for asset-backed securities also showed improvement, and recent issuance had neared levels observed prior to the second half of 2008. Higher equity prices appeared to result not only from generally better-than-expected corporate earnings, which seemed largely to reflect aggressive cost cutting, but also from a reduction in the perceived risk of extremely adverse outcomes and a consequent increase in investors' appetite for riskier assets. However, participants noted that many markets were still strained and that financial risks remain. The improvement in financial markets was due, in part, to support from various government programs, and market functioning might deteriorate as those programs wind down. While financial markets had improved, credit remained tight, with many banks—though fewer than in recent quarters—having reported that they again tightened loan standards and terms. Increases in interest rates and reductions in lines on credit cards were affecting small businesses as well as consumers. All categories of bank lending had continued to decline.

Worsening credit quality was still cited by banks as an important reason for the tightening of credit conditions, though anecdotal evidence suggested that the deterioration in the credit quality of consumer loans might be slowing. Nonetheless, several participants noted that banks still faced a sizable risk of additional credit losses and that many small and medium-sized banks were vulnerable to deteriorating performance of commercial real estate loans. Participants again observed that obtaining or renewing financing for commercial real estate properties and projects was extremely difficult amid worsening fundamentals in that sector, though some noted anecdotal evidence that the addition of highly rated commercial MBS to the list of securities that can be pledged as collateral for TALF loans had contributed to an improvement in liquidity in that market.

Labor market conditions remained of particular concern to meeting participants. Though recent data indicated that the pace at which employment was declining had slowed appreciably, job losses remained sizable. Moreover, long-term unemployment and permanent separations continued to rise, suggesting possible problems of skill loss and a need for labor reallocation that could slow recovery in employment as the economy begins to expand. The unusually large fraction of those who were working part time for economic reasons and the unusually low level of the average workweek, combined with indications from business contacts that firms would resist hiring as sales and production turn up, also pointed to a period of modest job gains and thus a slow decline in the unemployment rate. Wages and benefits continued to decelerate, reflecting—in the judgment of many participants—substantial slack in labor markets. Several participants noted that the deceleration in labor costs should eventually support a pickup in hiring. Recently, however, it contributed to weakness in household incomes.

Consumer spending remained weak, but participants saw evidence that it was stabilizing, even before the boost to auto purchases provided by the cash-for-clunkers program. Real PCE declined little, on balance, during the first half of 2009 after dropping sharply during the second half of 2008 and was essentially constant during May and June. Several participants noted the recent rebound in equity prices and thus household wealth as a factor that was likely to support consumer spending. Many noted, however, that households still faced considerable headwinds, including reduced wealth, tight credit, high levels of debt, and uncertain job prospects. With these forces restraining spending,

and with labor income likely to remain soft, participants generally expected no more than moderate growth in consumer spending going forward. An important source of uncertainty in the outlook for consumer spending was whether households' propensity to save, which had risen in recent quarters, would increase further: Analysis based on responses to past changes in wealth relative to income suggested that the personal saving rate could level out near its current value; however, there was some chance that the increased income volatility and reduced access to credit that had characterized recent experience could lead households to save a still-larger fraction of their incomes.

Regional surveys and anecdotal reports continued to indicate low levels of activity across many goods-producing industries and in the service sector, but they also pointed to some optimism about the outlook. Firms appeared to be making substantial progress in reducing inventories toward desired levels; indeed, inventories of motor vehicles appeared quite lean following earlier production shutdowns and the recent boost to sales from the cash-for-clunkers program. Accordingly, participants expected firms to slow the pace of inventory reduction by raising production; this adjustment was likely to make an important contribution to economic recovery in the second half of this year. In contrast, business contacts generally reported setting a high bar for increasing capital investment once sales pick up, because their firms now have unusually high levels of excess capacity.

In the residential real estate sector, home sales, prices, and construction had shown signs of stabilization in many areas and were increasing modestly in others, but a still-sizable inventory of unsold existing homes continued to restrain homebuilding. Commercial real estate activity, in contrast, was being weighed down by deteriorating fundamentals, including declining occupancy and rental rates; by falling prices; and by difficulty in refinancing loans on existing properties.

Manufacturing firms appeared to have benefitted recently from an earlier- and stronger-than-expected pickup in foreign economic activity, especially in Asia, and the resulting increase in demand for U.S. exports. Several participants noted that improving growth abroad would likely contribute to greater growth in U.S. exports going forward.

A number of participants noted that fiscal policy helped support the stabilization in economic activity, in part by buoying household incomes and by preventing even larger cuts in state and local government spend-

ing. Participants generally anticipated that fiscal stimulus already in train would contribute to growth in economic activity during the second half of 2009 and into 2010, but the stimulative effects of policy would fade as 2010 went on and would need to be replaced by private demand and income growth.

Committee Policy Action

In their discussion of monetary policy for the period ahead, Committee members agreed that the stance of monetary policy should not be changed at this meeting. Given the prospects for an initially modest economic recovery, substantial resource slack, and subdued inflation, the Committee agreed that it should maintain its target range for the federal funds rate at 0 to $\frac{1}{4}$ percent. The future path of the federal funds rate would continue to depend on the Committee's evolving outlook, but, for now, given their forecasts for only a gradual upturn in economic activity and subdued inflation, members thought it most likely that the federal funds rate would need to be maintained at an exceptionally low level for an extended period. With the downside risks to the economic outlook now considerably reduced but the economic recovery likely to be damped, the Committee also agreed that neither expansion nor contraction of its program of asset purchases was warranted at this time. The Committee did, however, decide to gradually slow the pace of the remainder of its purchases of \$300 billion of Treasury securities and extend their completion to the end of October to help promote a smooth transition in markets. Members noted that, with the programs for purchases of agency debt and MBS not due to expire until the end of the year, it was not necessary to make decisions at this meeting about any potential modifications to those programs. The Committee agreed that it would continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets.

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 seeks conditions in reserve markets consistent with federal funds trading in a range from 0 to $\frac{1}{4}$ percent. The Committee directs the Desk to purchase

agency debt, agency MBS, and longer-term Treasury securities during the intermeeting period with the aim of providing support to private credit markets and economic activity. The timing and pace of these purchases should depend on conditions in the markets for such securities and on a broader assessment of private credit market conditions. The Desk is expected to purchase up to \$200 billion in housing-related agency debt and up to \$1.25 trillion of agency MBS by the end of the year. The Desk is expected to purchase about \$300 billion of longer-term Treasury securities by the end of October, gradually slowing the pace of these purchases until they are completed. The Committee anticipates that outright purchases of securities will cause the size of the Federal Reserve's balance sheet to expand significantly in coming months. The System Open Market Account Manager and the Secretary will keep the Committee informed of ongoing developments regarding the System's balance sheet that could affect the attainment over time of the Committee's objectives of maximum employment and price stability."

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

"Information received since the Federal Open Market Committee met in June suggests that economic activity is leveling out. Conditions in financial markets have improved further in recent weeks. Household spending has continued to show signs of stabilizing but remains constrained by ongoing job losses, sluggish income growth, lower housing wealth, and tight credit. Businesses are still cutting back on fixed investment and staffing but are making progress in bringing inventory stocks into better alignment with sales. Although economic activity is likely to remain weak for a time, the Committee continues to anticipate that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a gradual resumption of sustainable economic growth in a context of price stability.

The prices of energy and other commodities have risen of late. However, substantial resource slack is likely to dampen cost pres-

tures, and the Committee expects that inflation will remain subdued for some time.

In these circumstances, the Federal Reserve will employ all available tools to promote economic recovery and to preserve price stability. The Committee will maintain the target range for the federal funds rate at 0 to $\frac{1}{4}$ percent and continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period. As previously announced, to provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve will purchase a total of up to \$1.25 trillion of agency mortgage-backed securities and up to \$200 billion of agency debt by the end of the year. In addition, the Federal Reserve is in the process of buying \$300 billion of Treasury securities. To promote a smooth transition in markets as these purchases of Treasury securities are completed, the Committee has decided to gradually slow the pace of these transactions and anticipates that the full amount will be purchased by the end of October. The Committee will continue to evaluate the tim-

ing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets. The Federal Reserve is monitoring the size and composition of its balance sheet and will make adjustments to its credit and liquidity programs as warranted.”

Voting for this action: Messrs. Bernanke and Dudley, Ms. Duke, Messrs. Evans, Kohn, Lacker, Lockhart, Tarullo, and Warsh, and Ms. Yellen.

Voting against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday-Wednesday, September 22-23, 2009. The meeting adjourned at 11:40 a.m. on August 12, 2009.

Notation Vote

By notation vote completed on July 14, 2009, the Committee unanimously approved the minutes of the FOMC meeting held on June 23-24, 2009.

Brian F. Madigan
Secretary