

Minutes of the Federal Open Market Committee

January 27-28, 2004

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., starting at 2:00 p.m. on Tuesday, January 27, 2004, and continuing at 9:00 a.m. on Wednesday, January 28, 2004.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Messrs. McTeer, Moskow, Santomero, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

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

Mr. Connors, Ms. Cumming, Messrs. Fuhrer, Hakkio, Howard, Madigan, Rasche, Slifman, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Etti¹, Deputy Director, Division of Research and Statistics, Board of Governors

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

Messrs. Clouse¹, and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

Mr. Kamin and Ms. Zickler², Deputy Associate Directors, Divisions of International Finance and Research and Statistics respectively, Board of Governors

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

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

Messrs. Nelson and Wood², Senior Economists, Divisions of Monetary Affairs and International Finance respectively, Board of Governors

Mr. Carpenter², Economist, Division of Monetary Affairs, Board of Governors

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

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

Messrs. Eisenbeis, Evans, Goodfriend, Ms. Mester, Messrs. Rolnick and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Chicago, Richmond, Philadelphia, Minneapolis, and Dallas respectively

Messrs. Elsasser and Rudebusch, Vice Presidents, Federal Reserve Banks of New York and San Francisco respectively

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 2004, and ending December 31, 2004, had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

Timothy F. Geithner, President of the Federal Reserve Bank of New York, with a vacancy in the position of alternate member for the Federal Reserve Bank of New York

Cathy E. Minehan, President of the Federal Reserve Bank of Boston, with Anthony M. Santomero, President of the Federal Reserve Bank of Philadelphia, as alternate

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

William Poole, President of the Federal Reserve Bank of St. Louis, with Robert D. McTeer, Jr., President of the Federal Reserve Bank of Dallas, as alternate

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

Following this meeting the board of directors of the Federal Reserve Bank of New York appointed Christine M. Cumming to the position of First Vice President of the Bank, effective February 6, 2004. The directors also elected her to serve as an alternate member of the Federal Open Market Committee representing the Federal Reserve Bank of New York. Subsequently, Ms. Cumming executed her oath of office as an alternate member of the Committee, effective for the period from February 20 to December 31, 2004.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first regularly scheduled meeting of the Committee after December 31, 2004, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee:

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| Alan Greenspan | Chairman |
| Timothy F. Geithner | Vice Chairman |
| Vincent R. Reinhart | Secretary and Economist |
| Normand R. V. Bernard | Deputy Secretary |
| Michelle A. Smith | Assistant Secretary |
| J. Virgil Mattingly, Jr. | General Counsel |
| Thomas C. Baxter, Jr. | Deputy General Counsel |
| Karen H. Johnson | Economist |
| David J. Stockton | Economist |
| Thomas A. Connors, Christine M. Cumming, Jeffrey C. Fuhrer, Craig S. Hakkio, David H. Howard, Brian F. Madigan, Robert H. Rasche, Lawrence Slifman, Mark S. Sniderman, and David W. Wilcox | Associate Economists |

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first regularly scheduled meeting of the Committee after December 31, 2004.

By unanimous vote, Dino Kos was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York³.

By unanimous vote, the Committee amended its Program for Security of FOMC Information on January 27, 2004, by making small clarifying additions or changes relating especially to

electronic transmissions of confidential information.

By unanimous vote, the Authorization for Domestic Open Market Operations was amended in the form shown below.

AUTHORIZATION FOR DOMESTIC OPEN MARKET OPERATIONS

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than \$12.0 billion during the period commencing with the opening of business on the day following such a meeting and ending with the close of business on the day of the next such meeting;

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

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

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

determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York and accounts maintained at the Federal Reserve Bank of New York as fiscal agent of the United States pursuant to Section 15 of the Federal Reserve Act, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities in 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and such foreign, international, and fiscal agency accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

The amendment to the authorization for domestic open market operations involved the addition of a reference in paragraph 3 to accounts held at the Federal Reserve Bank of New York pursuant to fiscal agency instructions from the Secretary of the Treasury. Accounts listed in paragraph 3, which include those maintained by the Bank on behalf of official foreign and international accounts, are eligible for participation in the Bank's short-term investment facility, the so-called "repo pool."

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

AUTHORIZATION FOR FOREIGN CURRENCY OPERATIONS

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

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

Bank for International Settlements, and with other international financial institutions:

Canadian dollars

Danish kroner

Euro

Pounds sterling

Japanese yen

Mexican pesos

Norwegian kroner

Swedish kronor

Swiss francs

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

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

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

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

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

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

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

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

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

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

7. The Chairman is authorized:

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

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

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

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

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

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

FOREIGN CURRENCY DIRECTIVE

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

2. To achieve this end the System shall:

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

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

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

3. Transactions may also be undertaken:

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

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

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

4. System foreign currency operations shall be conducted:

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

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

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

By unanimous vote, the Procedural Instructions with Respect to Foreign Currency

Operations were reaffirmed in the form shown below.

PROCEDURAL INSTRUCTIONS WITH RESPECT TO FOREIGN CURRENCY OPERATIONS

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$300 million on any day or \$600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding \$150 million, or \$300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

On January 9, 2004, the continuing rules, regulations, and other instructions of the Committee had been distributed with the advice that, in accordance with procedures approved by the Committee, they were being called to the Committee's attention before the January 27-28 organization meeting to give members an opportunity to raise any questions they might have concerning them. Members were asked to indicate if they wished to have any of the instruments in question placed on the agenda for consideration at this meeting, and no requests for consideration were received. Accordingly, all of these instruments remained in effect in their existing form.

The Committee considered a report from the Manager of the System Open Market Account that discussed the feasibility and costs of purchasing mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA), a federal government agency. A potential advantage of transactions in such GNMA obligations was their use to supplement

purchases of direct Treasury securities in periods when large federal surpluses reduced market supplies of Treasury debt. However, the resumption of large federal deficits had led to sizable increases in market supplies of Treasury obligations, which members saw as the preferred vehicle to supply the need for permanent additions to the System Open Market Account. The report concluded that outright transactions in mortgage-backed GNMA securities were feasible but would involve sizeable start-up costs and would tend to complicate the conduct of System open market operations. Against this background the Committee decided not to initiate outright transactions in mortgage-backed GNMA obligations. It was understood, however, that such GNMA obligations would continue to be eligible as collateral for System repurchase agreements.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on December 9, 2003, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's Account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period December 9, 2003 to January 27, 2004. By unanimous vote, the Committee ratified these transactions.

At this meeting the Committee engaged in a broad-ranging discussion of its communication practices.

A portion of this discussion focused on the report of a working group that had been directed to study how the Committee's announcements might be improved. In the course of the discussion, members stressed the importance that they attached to conveying clearly to the public information regarding the reasons for policy decisions and how those decisions related to the Committee's longer-term objectives. However, only limited support emerged for the use of particular standard wording to express the Committee's appraisals of the economic outlook and views about the balance of risks. Indeed, several members were in favor of discontinuing the use of statements regarding the balance of risks to the outlook and instead focusing mostly on the reasons for their policy decisions in the announcement. At the same time, all the members indicated that they could support a flexible approach in which the wording of the Committee's announcements, including the assessment of the balance of risks going forward, would be adjusted gradually over time in keeping with evolving economic conditions.

In further discussion the members reviewed the potential value and drawbacks of accelerating the publication of Committee minutes. Possible benefits would include the provision of more complete information sooner after meetings on the considerations that led the Committee to adopt the current stance of policy. Some members expressed concern, however, that accelerated release of the minutes might have the potential to feed back adversely on the deliberations of the Committee and on the minutes themselves. The members also emphasized the importance of allowing sufficient time for them to review and comment on the minutes and for reconciling differences of opinion among the members of a large and geographically dispersed committee. At the conclusion of this discussion, staff was

asked to study the issue further.

The members also discussed the possible advantages of making some changes in the content, time horizon, and frequency of the individual forecasts that are summarized in the semi-annual Monetary Policy Reports to the Congress. In general, the members saw little to be gained by altering the Committee's current practices in any significant way, although some proposed relatively minor changes. It was agreed that there was no need to reach a decision on such changes at this time, but staff was instructed to ascertain the degree of interest on the part of the members in making possible minor adjustments to current procedures.

The Committee then turned to a discussion of the economic outlook and the conduct of monetary policy over the intermeeting period.

The economy appeared to have expanded at a robust pace in the fourth quarter, though well below the exceptional pace recorded in the third quarter. Consumer spending continued to increase at a solid rate over the final three months of the year, and activity in the residential sector remained at a very high level. On the business side, outlays for equipment and software likely posted moderate gains in the fourth quarter, and firms apparently accumulated inventories for the first time in three quarters. Despite the strong pace of economic activity, the labor market was improving only slowly, with private payrolls showing a small acceleration in the fourth quarter. Core consumer price inflation continued to slow, and inflation expectations remained subdued over the closing months of 2003.

The December employment report suggested that the labor market had not gained as much momentum as previously appeared to be under way. Private nonfarm payrolls increased only slightly in that month, and their level in November was revised down appreciably. The average monthly increase in employment in the fourth quarter was indicative of a fairly weak recovery in the labor market, although it was a clear improvement over the average monthly loss during the first half of the year. Manufacturing payrolls continued to shrink in December at about the same pace as in the previous few months, and holiday-related hiring in retail trade was below average. In other sectors, job gains were recorded in construction, education and health services, and professional and business services. Average weekly hours of production or nonsupervisory workers declined somewhat in December, reversing the gains of the previous two months. Aggregate hours worked by nonfarm employees fell in December but in the fourth quarter as a whole posted their first quarterly increase since 2000. Despite the weak payroll data, the unemployment rate, which is measured by the household survey, fell to 5.7 percent in December, in part because of a further decline in the labor force participation rate. Initial claims for unemployment insurance continued to drift down in the weeks following the reference week for the December employment report, suggesting improved job growth in January.

The pace of expansion in the industrial sector picked up in the fourth quarter. Total industrial production rose at the fastest rate since the second quarter of 2002, and manufacturing production posted solid and widespread gains. High-tech industries, including those producing semiconductors, computers, and communications equipment, accounted for nearly one-third of the increase in total industrial production in the fourth quarter. After having surged in the third quarter, the production of motor vehicles and parts moved up in the fourth quarter at about the same rate as overall manufacturing. Outside the manufacturing sector, output at mines increased modestly in the quarter, while output at utilities rose appreciably,

led by a solid advance in electricity generation that mirrored the strengthening in the manufacturing sector. Capacity utilization was unchanged in December and remained well below its long-term average.

Sales of light vehicles jumped in December, and the fourth-quarter average, although below the torrid third-quarter pace, was well above that recorded for the first half of the year. These data, along with those on retail sales excluding autos, were consistent with a solid increase in real personal consumption expenditures in the fourth quarter. Real disposable personal income advanced smartly in November. Spending was also supported by the recent stock market gains, and by greater consumer confidence as reflected in the Michigan Survey Research Center's index of consumer sentiment and the Conference Board's index of consumer confidence, both of which stood significantly above their average readings for 2003.

Activity in the housing market remained very robust. In December, single-family starts edged down only a bit from the exceptional rate they had reached in November, and multifamily starts moved up to the highest level in almost four years. New home sales declined in November for the third consecutive month, but they were still not far below the record highs registered earlier in the year. Existing home sales had fallen back from September's high, though the level in November was still noticeably higher than average monthly sales in the first half of 2003.

The available data suggested that business purchases of transportation equipment strengthened in the fourth quarter and that spending on other capital goods advanced at a moderate pace. Business expenditures on aircraft rebounded noticeably in the fourth quarter, albeit to a level that was still far below the levels that prevailed before the downturn following the terrorist attacks in 2001. Both fleet sales of light vehicles and truck sales also rose significantly. In the high-tech sector, real outlays for computing equipment and for software again appeared to have posted sizable increases in the fourth quarter, while spending on communications equipment was little changed after three quarters of double-digit growth. Outside transportation and high tech, nominal shipments were about unchanged in the fourth quarter, but the upward trend in orders established since the beginning of last year was consistent with further gains in spending. After holding roughly steady, on balance, in the first half of 2003, real spending on private nonresidential construction appeared to have slipped further in the third and fourth quarters. In the commercial and health-care sector and in the manufacturing sector, average nominal outlays in October and November were about unchanged from the previous quarter. However, spending on other types of construction moved down.

The book value of manufacturing and trade inventories excluding motor vehicles posted the third consecutive significant monthly increase in November. Stocks at manufacturers were down a little on average in October and November, but non-auto wholesalers and retailers accumulated inventories at a brisk pace. Strong increases in sales, however, kept book-value inventory-sales ratios at or near their recent lows. Motor vehicle and parts inventories ended the year noticeably above the level at the end of the third quarter.

The international trade deficit in November shrank to its lowest level in about a year. Exports of goods and services increased to a level not recorded since early 2001, while imports fell moderately. Recent data indicated that the pickup in economic activity in the major foreign industrial countries continued in the fourth quarter. Japanese exports, machinery orders, and

industrial production rose strongly in October and November. Euro-area manufacturing data exhibited increasing strength, particularly in Germany. In the United Kingdom, indicators of business and retail sales in December pointed to a maintained expansion. And Canadian employment and sales data were strong in the fourth quarter, with the housing sector continuing to make a significant contribution to growth.

Prices of consumer goods and services other than food and energy continued to decelerate through the end of 2003. Overall consumer prices were flat, on balance, over the past three months, as a small increase in core prices and a large rise in food prices were offset by a sizable drop in energy prices. Over the year, the consumer price index posted a moderate increase that was noticeably below that in the previous year. Core consumer prices decelerated more sharply and rose only slightly over the year. Producer prices for finished goods were up moderately over the year, and the advance was substantially above that over the previous year. The rise last year was due almost entirely to substantial increases in food and energy prices as core producer prices rose only a little after having edged down over 2002. With regard to labor costs, the average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls rose modestly in the twelve months ending in December, an increase somewhat below that over 2002.

At its meeting on December 9, 2003, the Federal Open Market Committee (FOMC) adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the federal funds rate at around 1 percent. In reaching this decision, the Committee members generally perceived the upside and downside risks to the attainment of sustainable growth for the next few quarters to be roughly equal. They also judged that the probability of an unwelcome fall in inflation had diminished in recent months and now appeared almost equal to that of a rise in inflation. Nevertheless, with inflation quite low and resource use slack, the Committee believed that policy accommodation could be maintained for a considerable period.

The Committee's decision at the December meeting to keep its target for the federal funds rate at 1 percent appeared to have been fully anticipated in financial markets, and interest rate futures for the first half of 2004 were essentially unchanged after the announcement. But futures rates for the second half of the year rose a few basis points, presumably in response to the Committee's assessment that the probability of an unwelcome decline in inflation had fallen in recent months to a level almost equal to that of a rise in inflation. Subsequently, however, the release of the minutes for the October FOMC meeting, which indicated that at that time the Committee was concerned about the possibility of persistent slack arising from rapid productivity growth, and the publication of surprisingly modest growth in employment in December led most market participants to push back the date of the expected onset of tightening by several months to some time in the fall. Reflecting the change in policy expectations, intermediate- and longer-term nominal Treasury yields declined substantially over the intermeeting period. Yields on inflation-indexed debt fell by nearly as much, suggesting that the drop in nominal yields owed more to lower real interest rates than to reduced inflation compensation. Yields on investment-grade and most speculative-grade securities moved down by about the same amount as Treasury yields. Major equity indexes rose strongly in response to the declines in yields and positive news about the outlook for profits.

The exchange value of the dollar, as measured by the major currencies index, declined moderately on net over the intermeeting period. Ongoing investor concerns about the ability

of the United States to finance its current account deficit reportedly were again a primary factor exerting pressure on the dollar.

M2 fell in December, the fourth consecutive monthly decline. The decline in M2 over the fourth quarter was the largest on record since the start of consistent data collection in 1959. The weakness was concentrated in liquid deposits and, to a lesser extent, in retail money market mutual funds and appeared to be due in large part to the unwinding of a previous buildup in deposits associated with heavy mortgage refinancing activity and to portfolio shifts by households into equities.

The staff forecast prepared for this meeting indicated that the momentum in economic activity that had built up in the second half of 2003 would carry over into the first half of the current year and that the ongoing gains in spending and production would soon result in a more visible improvement in labor market conditions. The considerable stimulus being provided by fiscal and monetary policies was expected to keep aggregate demand on a solid uptrend. In addition, improving labor market conditions and the effects of strong productivity growth on permanent income were projected to support household spending, while business investment spending was seen as strengthening in response to the acceleration in business output, swelling profits, and continued favorable financing conditions. Some slight downward pressure on core consumer price inflation was anticipated in the forecast given the ongoing slack in labor and product markets.

In the Committee's discussion of current and prospective economic developments, the members commented that the information that had become available since the December meeting had tended to validate their earlier assessment that the expansion was firmly established and that robust economic growth, under way since about mid 2003, was likely to continue as the year progressed. Many emphasized that business expenditures now appeared to be on a solid upward trajectory amid widespread reports of much improved business sentiment. Indeed, business expenditures had broadened the sources of significant strength in the expansion, which earlier had been sustained mainly by household and government spending. Factors underlying a favorable outlook for economic activity continued to include stimulative fiscal and monetary policies, accommodative conditions in financial markets, and the positive effects of a strong uptrend in productivity on business investment incentives and, with some lag, on household incomes. The members nonetheless expressed disappointment that the acceleration in economic activity had thus far failed to generate significant strengthening in employment, though they pointed to a number of positive signs in labor markets. Given their expectations of persisting above-trend economic growth, they saw increasing demand for workers as a likely prospect going forward. Regarding the outlook for inflation, members observed that wide margins of slack in labor and product markets continued to hold down wages and prices, especially given the concurrent strength in productivity. Core consumer inflation appeared to have drifted lower recently, and a number of members mentioned the possibility of a modest further decline in such inflation from its current subdued level. Over the year ahead, however, the members generally anticipated little net change in consumer price inflation.

In keeping with the practice at meetings preceding the Federal Reserve's semi-annual report to the Congress on the economy and monetary policy, the members of the Board of Governors and the presidents of the Federal Reserve Banks had provided individual projections of the growth of GDP, the rate of unemployment, and consumer price inflation for the year 2004. The forecasts pointed to a continuation of relatively vigorous growth in

economic activity, some further decline in unemployment, and a quite low rate of inflation. Specifically, the forecasts of the expansion in real GDP between the fourth quarter of 2003 and the fourth quarter of 2004 had a central tendency of 4-1/2 to 5 percent and a full range of 4 to 5-1/2 percent. The projections of the civilian unemployment rate in the fourth quarter of 2004 were all in a range of 5-1/4 to 5-1/2 percent. Forecasts of consumer price inflation for the year, as measured by the PCE chain-type price index, were centered in a range of 1 to 1-1/4 percent, with a full range of 1 to 1-1/2 percent.

In their discussion of developments across the nation, members emphasized growing indications of rising business confidence and, despite persisting softness in a number of industries, more widespread signs of increasing business spending for equipment and software and for inventories. The members cited a variety of factors that pointed to a further pickup in business capital expenditures over the coming year, including the strength in new orders and shipments, increasing profits and cash flow, the improved financial condition of many business firms, the general availability of financing on favorable terms, and the temporary tax incentive on expenditures for new equipment. Anecdotal reports from business contacts about capital spending plans were indicative of appreciable further acceleration in business expenditures on a widening range of capital goods. While many contacts indicated that replacement demand or the cost-saving opportunities provided by more productive new equipment were still the driving factors in guiding investment decisions, there were more reports of investment spending to expand capacity.

The members also viewed business inventory investment as likely to provide some support to the economic expansion over the year ahead. Business inventories were at exceptionally low levels in relation to sales, and if further brisk growth in demand broadly in line with current forecasts materialized this year, business firms could be expected to make commensurate additions to their inventories. Indeed, inventories appeared to have turned up in the fourth quarter after declining on balance earlier in 2003 as businesses evidently became more confident that increases in their sales would be sustained.

While business expenditures had turned up, employers had continued to display a high degree of caution in hiring new workers. Employment had trended up since mid-2003 after a protracted period of job losses, but the gains were significantly weaker than was typical at similar stages of earlier business cycles. A key factor that had tended to hold down hiring was the continuing ability of business firms to meet increasing demand by improving productivity with existing workforces rather than hiring new workers. Against this background, labor markets continued to be described as soft in most areas, albeit with more signs of at least modest improvement. In this regard, members referred to positive developments such as the decline in initial claims and the rise in aggregate hours worked in the fourth quarter. Looking ahead, the members saw considerably faster growth in employment as a likely prospect in the context of further strengthening in aggregate demand and expectations of some slowing in the growth of productivity from its extraordinary pace in recent quarters. Several emphasized, however, that the timing and extent of the improvement in employment were subject to considerable uncertainty.

The household sector was continuing to supply major impetus to the expansion. Household spending was benefiting from stimulative fiscal and monetary policies, the wealth effects of rising real estate and equity prices, and increased consumer confidence about the economic outlook. Members noted that retailers in many parts of the country reported solid sales during the holiday period. With respect to the outlook for overall consumer spending, it was

suggested that the elevated growth of productivity could be expected to raise incomes over time and thereby help to buttress consumption even as the stimulus from earlier tax cuts faded. Residential construction activity remained at a high level, evidently supported in part by recent declines in mortgage interest rates. Contacts in the housing industry indicated that they expected a high level of construction activity in 2004, though perhaps not as robust as in 2003.

Fiscal policy was providing considerable stimulus to the economy and would continue to do so in the first part of this year, reflecting the large tax refunds anticipated as a result of overwithholdings in 2003. Beyond the nearer term, however, the fiscal stimulus was projected to diminish under existing legislation. In this regard, one member questioned whether a robust expansion would be sustained once the fiscal impulse was removed. Some members expressed concern about the longer-run prospects for large federal deficits and their implications for the future performance of the economy.

In their comments about the international economy, members noted that the strengthening in economic activity abroad and the decline in the foreign exchange value of the dollar had boosted exports. Even so, the ongoing strength in imports was still producing a widening trade deficit, and net exports were expected to be a small arithmetic drag on domestic economic activity over the year ahead. Some members indicated that they were concerned about the implications of the nation's rapidly growing external debt for domestic financial markets and the economy over time.

In the Committee's discussion of the outlook for inflation, the members agreed that increases in core consumer prices were likely to remain muted this year, with ongoing strength in the expansion only gradually reducing the current output gap and anticipated gains in productivity exerting downward pressure on costs and prices. Some members commented, however, that the relationship between the output gap and inflation was quite loose and that the outlook for productivity remained uncertain. Accordingly, while members agreed that changes in core consumer price inflation were likely to be limited, there was some divergence of opinion about the most probable direction. In the view of many, some modest further disinflation appeared to be the most likely prospect. A few members noted that such disinflation, if it was associated with rapid growth in productivity, could be viewed as non-threatening. Moreover, the expected strength in aggregate demand would curb the extent of disinflation over time. A few members expressed the differing view that core consumer prices might well edge up over the course of the year in light of the considerable stimulus stemming from current monetary and fiscal policies and the possibility that the expected pickup in economic activity and employment, especially if it were on the high side of current forecasts, would be associated with slower growth in productivity. The evidence pointing to the possibility of an uptick in inflation was still quite limited, but some members noted that in addition to sizable advances in the prices of many commodities including oil, reports from business contacts indicated that a few firms had been able to raise their selling prices and maintain them at higher levels in an effort to pass on increases in costs. Overall, however, the pricing power of business firms remained quite limited.

In the Committee's discussion of policy for the intermeeting period ahead, all the members favored an unchanged policy stance that was directed toward maintaining reserve conditions consistent with a target federal funds rate of 1 percent. While the members were persuaded that a relatively vigorous economic expansion was now firmly established and was likely at some point to call for a move toward a more neutral policy stance, they concluded that such

an adjustment was not warranted under current circumstances. In this regard they stressed that unused labor and other resources remained substantial, that inflation was at a very low level, and that inflation was not expected to change appreciably in either direction over the year ahead. Members acknowledged that there were risks in maintaining what might eventually prove to be an overly accommodative policy stance, but for now they judged that it was desirable to take risks on the side of assuring the rapid elimination of economic slack.

With regard to the wording of the Committee's press statement to be released shortly after the meeting, members discussed at some length the desirability of retaining a reference from earlier statements to the prospect that an accommodative policy could be maintained "for a considerable period." The existing language had been explicitly qualified at the December meeting by tying it to low inflation and slack in resource use, thereby underscoring the notion that a move away from the current degree of policy accommodation would depend on economic conditions rather than simply on the passage of time. All the members agreed that a change in wording was desirable, not to signal a policy tightening move in the near term, but rather to increase the Committee's flexibility to take such an action when it was deemed to be desirable and to underline that any such decision would be made on the basis of evolving economic conditions. However, some differences of opinion arose with regard to the specific proposal under consideration, namely to remove the reference to "considerable period" and to substitute one referring to "patience." Those who fully endorsed the proposal believed that the new wording conveyed important information about the Committee's strategy in an environment of price stability and economic slack and under those circumstances was unlikely to have outsized effects in financial markets. A number of members commented that expectations of sustained policy accommodation appeared to have contributed to valuations in financial markets that left little room for downside risks, and the change in wording might prompt those markets to adjust more appropriately to changing economic circumstances in the future. A few members, while expressing agreement with respect to the merits of a language change, nonetheless preferred to drop the reference to a "considerable period" entirely without substituting a reference to the Committee's ability to be patient. In this view, even the replacement language would tend to shape expectations in ways that could complicate the conduct of policy, and with the economy in a strong uptrend, the Committee no longer needed to utilize such special language.

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

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

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

The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation. With inflation quite low and

resource use slack, the Committee believes that it can be patient in removing its policy accommodation.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pinalto, and Mr. Poole.

Vote against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, March 16, 2004.

The meeting adjourned at 1:45 p.m. on January 28, 2004.

Vincent R. Reinhart
Secretary

Footnotes

1. Attended Wednesday's session only. [Return to text](#)
2. Attended portion of meeting relating to the Committee's review of the economic outlook. [Return to text](#)
3. Secretary's note: Advice subsequently was received that the selection of Mr. Kos as Manager was satisfactory to the board of directors of the Federal Reserve Bank of New York. [Return to text](#)

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