# Minutes of the Federal Open Market Committee

August 7, 2007

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday August 7, 2007 at 8:30 a.m.

**Present:**

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Mr. Hoenig
Mr. Kohn
Mr. Kroszner
Mr. Mishkin
Mr. Moskow
Mr. Poole
Mr. Rosengren
Mr. Warsh

Ms. Cumming, Mr. Fisher, Ms. Pianalto, and Messrs. Plosser and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Lacker and Lockhart, and Ms. Yellen, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, respectively

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

Messrs. Connors, Evans, Fuhrer, Kamin, Rasche, Sellon, Slifman, Tracy, and Wilcox, Associate Economists

Mr. Dudley, Manager, System Open Market Account

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

Messrs. Clouse and English, Senior Associate Directors, Division of Monetary Affairs, Board of Governors

Ms. Liang and Mr. Reifschneider, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Dale and Reinhart, Senior Advisers, Division of Monetary Affairs, Board of Governors

Mr. Blanchard, Assistant to the Board, Office of Board Members, Board of Governors

Mr. Meyer, Visiting Reserve Bank Officer, Division of Monetary Affairs, Board of Governors

Ms. Dykes, Project Manager, Division of Monetary Affairs, Board of Governors

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

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

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

Mr. Connolly, First Vice President, Federal Reserve Bank of Boston

Messrs. Judd and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of San Francisco and Dallas, respectively

Ms. Mosser and Mr. Sniderman, Senior Vice Presidents, Federal Reserve Banks of New York and Cleveland, respectively

Mr. Cunningham, Vice President, Federal Reserve Bank of Atlanta

Mr. Chatterjee, Senior Economic Adviser, Federal Reserve Bank of Philadelphia

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

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

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In the agenda for this meeting, it was reported that advices of the election of Eric S. Rosengren as a member of the Federal Open Market Committee had been received and that he had executed his oath of office.

By unanimous vote, the Federal Open Market Committee selected Brian F. Madigan to serve as Secretary and Economist until the selection of a successor at the first regularly scheduled meeting of the Committee in 2008.

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 operations in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at the August meeting suggested that economic activity picked up in the second quarter from the slow pace in the first quarter. On average, the economy expanded at a moderate pace during the first half of the year despite the ongoing drag from the housing sector. While the growth of consumer spending slowed in the second quarter from its rapid pace in prior quarters, wages and salaries increased solidly and household sentiment appeared supportive of further gains in spending. Business fixed investment picked up in the second quarter after little net change in the preceding two quarters. Inventories generally appeared to be well aligned with sales at midyear. Overall inflation receded in June because of a decline in energy prices, while the core personal consumption expenditure (PCE) price index rose a bit less than its average pace over the past year.

Private nonfarm payroll employment continued to increase at a healthy pace; the rise in July was about equal to the average increase over the first half of the year. Solid hiring in the service sector was partly offset by declines in construction and manufacturing employment. Most of the drop in construction employment occurred in jobs typically associated with nonresidential construction. Both the average workweek and aggregate hours ticked down in July. The unemployment rate edged up to 4.6 percent; it had remained between 4.4 percent and 4.6 percent since September 2006.

Industrial production picked up in the second quarter after little net change over the preceding two quarters. The increase was largely attributable to a smaller drag from inventory liquidation and a modest improvement in net exports. Manufacturing production rose solidly in the second quarter because of substantial increases in the output of light motor vehicles, other durable consumer goods, business equipment, construction supplies, and materials. Production in high-tech industries rose relatively modestly in comparison to its longer-run growth.

The growth of real consumer spending slowed considerably in the second quarter after substantial increases earlier in the year. The deceleration primarily reflected sharply slower growth in outlays for goods as purchases of motor vehicles decreased noticeably. Although a spike in energy prices eroded real income growth in the second quarter, there were solid gains in wages and salaries. Despite continued softness in house prices, household wealth moved markedly higher in the second quarter, mostly reflecting rising equity prices.

Demand for housing in the second quarter was restrained by higher interest rates and by tightening credit conditions in the subprime mortgage market. Sales of new and existing homes in the second quarter were down substantially from their average levels in the second half of 2006. In June, single-family housing starts held steady at their May rate, although adjusted permit issuance slipped further. The combination of decreased sales and unchanged production left inventories of new homes for sale still elevated. House-price appreciation continued to slow, with some measures again showing declines in home values.

Outlays for nonresidential construction rose rapidly in the second quarter. Business spending on equipment and software, other than transportation equipment, posted a solid increase after being flat, on net, in the preceding two quarters. The rise was led by a rebound in purchases of industrial machinery. Expenditures for computers, software, and communications equipment grew moderately in the second quarter after a brisk first-quarter increase. Spending on transportation equipment again declined sharply. The drop was largely a continuation of the payback from exceptionally strong purchases of heavy trucks in 2005 and 2006 in anticipation of tighter emissions standards on diesel engines. New orders for medium and heavy trucks edged up in the second quarter, though they remained at low levels, suggesting that the downturn in business spending on motor vehicles may be ending.

Real nonfarm inventory investment was a roughly neutral influence on real GDP growth in the second quarter after having held down the growth rate by an average of 1 percentage point in the previous two quarters. Businesses made considerable progress in reducing the apparent inventory overhangs that had emerged at the end of 2006. In the motor vehicle sector, low rates of assemblies in the first half of this year left inventories of domestic light vehicles at the end of the second quarter fairly well aligned with sales; however, inventories rose again in July as production accelerated and sales remained weak. More broadly, the number of purchasing managers who viewed their customers' inventory levels as too high in July only slightly exceeded the number who saw them as too low.

The U.S. international trade deficit widened in May, as a rise in imports more than offset an increase in exports. Within imports, most categories of goods recorded an increase, as did services. The value of oil imports rose sharply, boosted by a jump in the price of imported oil. The increase in exports was largely attributable to capital goods, including aircraft, computers and semiconductors, and industrial supplies.

Economic activity in advanced foreign economies expanded somewhat less rapidly in the second quarter than in the prior quarter, but nonetheless appeared to have grown faster than trend, reflecting upbeat business and consumer confidence as well as favorable labor market conditions. Although many of those economies recently experienced sharp declines in equity prices and widening credit spreads amid deepening concerns about credit quality, these developments occurred too late in the intermeeting period to have any apparent effect on incoming data. In Japan, survey evidence suggested that its economy expanded moderately. Survey evidence indicated high levels of economic sentiment and strong capital spending plans among large manufacturers. In the euro area, survey measures of business and consumer confidence remained near record highs in July, and labor market conditions generally continued to improve in May and June. In the United Kingdom, real GDP growth rose in the second quarter, an increase driven mainly by robust expansion in the service sector. Canada's growth seemed to continue to pick up from its disappointing rate posted in much of last year.

Recent data indicated that economic activity in emerging-market economies remained generally strong. The Chinese economy continued to expand at a rapid pace, and activity elsewhere in emerging Asia appeared to have accelerated. In Latin America, Mexican indicators pointed to a weaker-than-expected rebound in the second quarter, whereas Brazil and Argentina appeared to have experienced solid growth. While equity prices fell and bond spreads widened in several emerging-market economies, particularly in Latin America, there was no evidence that this increased volatility had yet weighed on economic activity.

U.S. headline consumer price inflation slowed in June as energy prices flattened out after a rapid increase over the preceding three months. Core PCE prices rose 0.1 percent in June, as a decline in the price index for core goods nearly offset a rise in the index for core services. The readings on core PCE price inflation in recent months had been held down, in part, by declines in prices of some categories of goods, such as apparel, that tend to be volatile on a monthly basis. Household surveys conducted in early July indicated that the median expectation for inflation over the next year remained unchanged from June's elevated level despite declines in gasoline prices in both months. Median expectations of longer-term inflation ticked up and were near the top of the narrow range that had prevailed over the past few years. The employment cost index rose somewhat faster in the second quarter than over the preceding three months, and the twelve-month change was slightly higher than that of a year ago.

At its June meeting, the Federal Open Market Committee (FOMC) maintained its target for the federal funds rate at 5-1/4 percent. The statement announcing the policy decision noted that economic growth appeared to have been moderate during the first half of the year, despite the ongoing adjustment in the housing sector. The economy seemed likely to continue to expand at a moderate pace over coming quarters. Readings on core inflation had improved modestly in recent months. However, a sustained moderation in inflation pressures had yet to be convincingly demonstrated. Moreover, the high level of resource utilization had the potential to sustain those pressures. The Committee's predominant policy concern remained the risk that inflation would fail to moderate as expected. Future policy adjustments would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Market participants had largely anticipated the FOMC's decision at its June meeting to leave the target for the federal funds rate unchanged, although the accompanying statement expressed greater concern about inflation than investors reportedly had foreseen and caused the expected path for the federal funds rate to edge higher. Expectations for a policy easing diminished somewhat more in the wake of favorable economic news early in the period. Subsequently, the semiannual *Monetary Policy Report to the Congress* and the accompanying testimony, which reported lower projections for real GDP growth than investors apparently expected, appeared to prompt a downward shift in investors' expected path for the federal funds rate. Later in the intermeeting period, growing apprehension that turmoil in markets for subprime mortgages and some low-rated corporate debt might have adverse effects on economic growth led investors to mark down their expectations for the future path of policy considerably further. At the same time, measures of long-horizon inflation compensation based on inflation-indexed Treasury securities edged down.

Financial market conditions were volatile during the intermeeting period, particularly over the last few weeks of the interval. Yields on nominal Treasury securities fell on balance, possibly reflecting an increased preference by investors for safe assets as well as revisions in policy expectations. Conditions in markets for subprime mortgages and related instruments, including segments of the asset-backed commercial paper market, deteriorated sharply toward the end of the period. Credit conditions for speculative-grade corporate borrowers tightened substantially, as investors pulled back from higher-risk assets. Spreads on speculative-grade bonds increased to near their highest levels in the past four years. A number of high-yield bond and leveraged loan deals intended to finance leveraged buyouts were delayed or restructured, though other high-yield bonds were issued. In contrast, credit conditions for investment-grade businesses and prime households were relatively little affected by the market turbulence. Issuance of investment-grade bonds continued. Yields on investment-grade corporate issues rose relative to yields on Treasury securities, but because yields on Treasuries declined, yields on investment-grade bonds were about unchanged on net. Nonfinancial commercial paper outstanding posted a modest gain in July, while the pace of bank lending to businesses picked up from an already solid clip. Mortgage loans and consumer credit appeared to remain readily available to households with strong balance sheets, although late in the period some evidence pointed to diminishing availability of jumbo mortgages.

Broad stock price indexes declined substantially, on net, over the intermeeting period despite generally solid second-quarter earnings reports. Share prices of financial firms fell especially sharply, reportedly a reflection, in part, of concerns about exposures to subprime mortgages and about the effect of a potential slowdown in merger activity on operating profits. The foreign exchange value of the dollar against other major currencies fell, on balance.

Growth of home mortgage debt likely slowed again in the second quarter, mainly reflecting the decline in home-price appreciation over the past year and the drop in home sales. Overall consumer credit expanded moderately through the year ending in May. The debt of nonfinancial businesses expanded at a robust pace in the second quarter but slowed in July. After rising at a rapid pace in the first half of the year, M2 grew at a more moderate rate in July.

In preparation for this meeting, the staff lowered somewhat its forecast of real GDP growth in the second half of 2007 and in 2008. The reduction was in part due to the annual revision of national income and product accounts (NIPA), which revealed somewhat less rapid growth in output and productivity during the past three years than previously reported and led the staff to trim its estimates of the growth rates of structural productivity and potential GDP; the reduction also reflected less accommodative financial conditions and the softer tone of some near-term indicators. The near-parallel revisions to the forecasts for potential and actual GDP left the staff's projections for resource utilization about unchanged. Although part of the recent favorable monthly readings on core PCE price changes was expected to be transitory, the staff revised down slightly its forecast for core PCE price inflation in the second half of 2007; however, in light of slower growth in structural productivity and prospects of somewhat greater pressure from import prices, the staff left its projection for core PCE inflation unchanged for 2008. Overall PCE inflation was expected to slow in the second half of 2007 from the elevated pace of the first half, as the effects of the sizable increases in food and energy prices earlier this year abated, and then to move down a bit further in 2008.

In their discussion of the economic situation and outlook, meeting participants indicated that they still saw moderate economic expansion in coming quarters as the most likely outcome but that the downside risks to growth had increased. Participants reported that economic expansion had continued at a moderate pace in many regions of the country despite further weakness in the housing sector. Going forward, most participants anticipated that growth in aggregate demand would be supported by rising employment, incomes, and exports, with the result that growth in actual output probably would remain close to growth of potential GDP despite the ongoing adjustment in the housing sector. Several mentioned that the revisions to the NIPA pointed to a modest downward adjustment in projected growth of actual and potential GDP, but thought that potential output growth was likely to be a bit higher than forecast by the staff. However, recent spending indicators had been mixed, and credit conditions had become tighter, suggesting greater downside risks to growth. Participants generally expected that core inflation would edge lower over the next two years, reflecting a slight easing of pressures on resources, well-anchored inflation expectations, and the waning of temporary factors that had boosted prices last year and early this year. Participants anticipated that total inflation would slow as well, particularly if market expectations of a modest decline in energy prices in coming quarters were to prove correct. But they were concerned that the high level of resource utilization and slower productivity growth could augment inflation pressures. Against this backdrop, the Committee agreed that the risk that inflation would fail to moderate as expected remained its predominant policy concern.

Participants agreed that the housing sector was apt to remain a drag on growth for some time and represented a significant downside risk to the economic outlook. Indeed, developments in mortgage markets during the intermeeting period suggested that the adjustment in the housing sector could well prove to be both deeper and more prolonged than had seemed likely earlier this year. Participants noted that investors had become much more uncertain about the likely future cash flows from subprime and certain other nontraditional mortgages, and thus about the valuation of securities backed by such mortgages. Consequently, the markets for securities backed by subprime and other non-traditional mortgages had become illiquid, and originations of new subprime mortgages had dropped sharply. While these markets were expected to recover over time, it was anticipated that credit standards for these types of mortgages would be tighter, and interest rates higher relative to rates on conforming mortgages, in the future than in recent years. However, participants also observed that mortgage loans remained readily available to most potential borrowers, and that interest rates on conforming, conventional mortgage loans had declined in recent weeks, providing some support to the housing sector.

Participants thought that consumer expenditures likely would expand at a moderate pace in coming quarters, supported by solid gains in employment and real income. Though growth in consumer spending had slowed in the second quarter, the slowing likely reflected temporary factors in part, including some payback from unusually strong growth in prior quarters and the surge in gasoline prices. Several participants noted the risks that house prices could decline significantly and that credit standards for home equity loans could be tightened substantially as factors that could weigh on consumer spending. However, the sizable upward revision--from negative to positive--in estimates of the personal saving rate during the past three years suggested somewhat less need for households to rebuild their savings.

Participants expected that business investment would be supported by solid fundamentals, including high profits, strong business balance sheets, and moderate growth in output. Recent financial market developments were thought unlikely to have an appreciable adverse effect on capital spending. Although lenders recently appeared to be less willing to extend credit for financial restructuring, the supply of credit to finance real investment did not appear significantly diminished. Funding had become more costly and difficult to obtain for riskier corporate borrowers, but there had been little net change in the cost of credit for investment-grade businesses. Also, businesses in the aggregate continued to have sufficient internally generated funds to finance the expected level of real investment. Nonetheless, participants recognized that conditions in corporate credit markets could change rapidly, and that adverse effects on business spending were possible. Moreover, heightened asset market volatility and the associated increase in uncertainty, if they were to persist for long, could lead businesses to pare capital spending plans. Still, participants judged that continued growth of investment outlays going forward was the most likely outcome.

Rapid economic growth abroad and the decline in the foreign exchange value of the dollar in recent quarters were seen as likely to boost U.S. exports and thus support the economic expansion. Some participants also anticipated that growth in government purchases of goods and services would support continued growth in output.

The data on core inflation received during the intermeeting period were favorable, but meeting participants believed that the readings for the past few months likely had been damped by transitory factors and did not provide reliable evidence that the recent level would be sustained. Still, participants thought that a slight decrease in pressures on resources and the stability of inflation expectations likely would foster over time a gradual moderation in core inflation. Participants anticipated that total inflation would slow as well, particularly if market expectations for a modest decline in energy prices in coming quarters were to prove correct. Participants remained concerned about factors that could augment inflation pressures, including the continuing high level of resource utilization and slower trend growth in productivity. Some also pointed to the strength of aggregate demand worldwide and the depreciation of the dollar, and their potential effects on the prices of imports and globally traded commodities, as contributing to upside risks to U.S. inflation. Several participants noted significant increases in wages in their Districts, particularly in the service sector, but it was also observed that that overall gains in labor compensation had remained moderate, suggesting that sustainable rates of resource utilization could be slightly higher than typically estimated. On balance, participants continued to agree that risks to the outlook for sustained moderation in inflation pressures remained tilted to the upside.

In their discussion of monetary policy for the intermeeting period, Committee members again agreed that maintaining the existing stance of policy at this meeting was likely to be consistent with the overall economy expanding at a moderate pace over coming quarters and inflation pressures moderating over time. The expansion would be supported by solid job gains and rising real incomes that would bolster consumption, and by increasing foreign demand for goods and services produced in the United States. The ongoing adjustment in housing markets likely would exert a restraining influence on overall growth for several more quarters and remained a key source of uncertainty about the outlook. The recent strains in financial markets posed additional downside risks to economic growth. Members expected a return to more normal market conditions, but recognized that the process likely would take some time, particularly in markets related to subprime mortgages. However, a further deterioration in financial conditions could not be ruled out and, to the extent such a development could have an adverse effect on growth prospects, might require a policy response. Policymakers would need to watch the situation carefully. For the present, however, given expectations that the most likely outcome for the economy was continued moderate growth, the upside risks to inflation remained the most significant policy concern. In these circumstances, members agreed that maintaining the target federal funds rate at 5-1/4 percent at this meeting was appropriate.

In light of the recent economic data, anecdotal information, and financial market developments, the Committee agreed that the statement to be released after the meeting should indicate that economic growth was moderate during the first half of the year and that the economy seemed likely to continue to expand moderately in coming quarters, supported by solid growth in employment and incomes and by robust economic growth abroad. Members also agreed that the statement should incorporate their view that downside risks to growth had increased somewhat, and should mention volatile financial markets, tighter credit conditions for some households and businesses, and the ongoing correction in the housing market. In addition, the Committee agreed that the statement should again note that readings on core inflation had improved modestly in recent months but did not yet convincingly demonstrate a sustained moderation of inflation pressures, and that the high level of resource utilization had the potential to sustain inflation pressures. Against this backdrop, members judged that the risk that inflation would fail to moderate as expected continued to outweigh other policy concerns.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal

Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5-1/4 percent."

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

> "Although the downside risks to growth have increased somewhat, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the outlook for both inflation and economic growth, as implied by incoming information."

**Votes for this action:** Messrs. Bernanke, Geithner, Hoenig, Kohn, Kroszner, Mishkin, Moskow, Poole, Rosengren, and Warsh.

**Votes against this action:** None.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 18, 2007.

The meeting adjourned at 1:25 p.m.

Notation Vote

By notation vote completed on July 18, 2007, the Committee unanimously approved the minutes of the FOMC meeting held on June 27-28, 2007.

**Brian F. Madigan**
**Secretary**