Minutes of the Federal Open Market Committee
December 15-16, 2008

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 Monday, December 15, 2008 at 2:00 p.m. and continued on Tuesday, December 16, 2008 at 9:00 a.m.

PRESENT:

Mr. Bernanke, Chairman
Ms. Duke
Mr. Fisher
Mr. Kohn
Mr. Kroszner
Ms. Pianalto
Mr. Plosser
Mr. Stern
Mr. Warsh

Ms. Cumming, Messrs. Evans, Lacker, and Lockhart, and Ms. Yellen, Alternate Members of the Federal Open Market Committee

Messrs. Bullard, Hoenig, and Rosengren, Presidents of the Federal Reserve Banks of St. Louis, Kansas City, and Boston, respectively

Mr. Madigan, Secretary and Economist
Ms. Danker, Deputy Secretary
Mr. Skidmore, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Ashton,[1] Assistant General Counsel
Mr. Sheets, Economist
Mr. Stockton, Economist

Messrs. Connors, English, and Kamin, Ms. Mester, Messrs. Rolnick, Rosenblum, Slifman, and Wilcox, Associate Economists

Mr. Dudley, Manager, System Open Market Account

Mr. Cole, Director, Division of Banking Supervision and Regulation, Board of Governors

Ms. Johnson,[2] Secretary, Office of the Secretary, Board of Governors

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

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

Messrs. Clouse and Parkinson,[1] Deputy Directors, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

Mr. Frierson,[2] Deputy Secretary, Office of the Secretary, Board of Governors

Messrs. Leahy,[2] Nelson,[3] Reifschneider, and Wascher, Associate Directors, Divisions of International Finance, Monetary Affairs, Research and Statistics, and Research and Statistics, respectively, Board of Governors

Mr. Gagnon,[2] Visiting Associate Director, Division of Monetary Affairs, Board of Governors

Ms. Shanks,[2] Associate Secretary, Office of the Secretary, Board of Governors

Messrs. Perli and Reeve, Deputy Associate Directors, Divisions of Monetary Affair and International Finance, respectively, Board of Governors

Mr. Covitz, Assistant Director, Division of Research and Statistics, Board of Governors

Ms. Goldberg,[2] Visiting Reserve Bank Officer, Division of International Finance, Board of Governors

Mr. Zakrajsek,[2] Assistant Director, Division of Monetary Affairs, Board of Governors

[1] Attended Tuesday's session.
[2] Attended the portion of the meeting relating to the zero lower bound on nominal interest rates.
[3] Attended the meeting through the discussion of the zero lower bound on nominal interest rates.

Messrs. Meyer[2] and Oliner, Senior Advisers, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

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

Messrs. Ahmed and Luecke, Section Chiefs, Divisions of International Finance and Monetary Affairs, respectively, Board of Governors

Ms. Aaronson, Senior Economist, Division of Research and Statistics, Board of Governors

Messrs. Gapen and McCabe,[2] Economists, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

Ms. Beattie,[2] 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. Werkema, First Vice President, Federal Reserve Bank of Chicago

Mr. Fuhrer, Executive Vice President, Federal Reserve Bank of Boston

Messrs. Altig, Hilton, Potter, Rasche, Rudebusch, Schweitzer, Sellon, Sullivan, and Weinberg, Senior Vice Presidents, Federal Reserve Banks of Atlanta, New York, New York, St. Louis, San Francisco, Cleveland, Kansas City, Chicago, and Richmond, respectively

Mr. Burke,[2] Assistant Vice President, Federal Reserve Bank of New York

Mr. Eggertsson,[2] Senior Economist, Federal Reserve Bank of New York

[2] Attended the portion of the meeting relating to the zero lower bound on nominal interest rates.

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 December meeting pointed to a significant contraction in economic activity in the fourth quarter. Conditions in the labor market deteriorated considerably in recent months as most major industry groups shed jobs. Private payrolls continued to fall at a faster pace than earlier in the year, and the unemployment rate rose to 6.7 percent. Industrial production, excluding special hurricane- and strike-related effects, fell further in November, and consumer spending declined across a broad range of spending categories over recent months. The housing market weakened again as construction activity, new home sales, and home prices declined further. In the business sector, investment in equipment and software appeared to continue to contract. Financial markets saw a further pullback in risk-taking, spurred in part by the more pessimistic outlook for economic activity; this situation led to lower equity prices, higher risk spreads, and tighter constraints in credit markets, all of which intensified the decline in real activity. On the inflation front, headline consumer prices declined in recent months, as energy prices continued to fall and consumer food price increases moderated.

The labor market continued to worsen. According to the November employment report, payroll employment fell at a rapid pace over the preceding three months, with substantial losses across a wide range of industry groups, including manufacturing, construction, retail, financial activities, and business services. Indicators of hiring plans also dropped steeply in November, and other labor market indicators suggested that jobs remained in short supply. The unemployment rate climbed to 6.7 percent in November, while the labor force participation rate fell after remaining steady for much of the year. New claims for unemployment insurance rose sharply through early December.

Industrial production, excluding special hurricane- and strike-related effects, fell markedly in November after sizable declines in the preceding two months. The recent contraction in industrial output was broadly based. The steep pace of decline in the production of consumer goods reflected not only cutbacks in motor vehicle assemblies but also drops in the output of other goods, such as appliances, furniture, and products related to home improvement. The production of business equipment was held down by declines in the output of both industrial and high-tech equipment. The output of construction supplies extended its decline after a brief pause in the middle of the year, and the contraction in the production of materials intensified. In particular, steel production plummeted, and the output of organic chemicals contracted noticeably. For most major industry groups, factory utilization rates declined relative to their levels in July and remained below their long-run averages. Available forward-looking indicators pointed to a significant downturn in manufacturing output in coming months.

Real personal consumption expenditures (PCE) fell for the fifth straight month in October, with the slowdown evident in nearly all broad spending categories. Sales of light motor vehicles, which slumped in October, fell further in November, but the available information on retail sales suggested a small increase in real outlays for other consumer goods. The annualized three-month change in spending on services in October was just one-third of the rate registered in the first half of 2008. Preliminary data for October and November suggested that overall fourth-quarter real spending would receive a modest boost from recent price declines for gasoline. Real incomes were also boosted by the reversal in energy prices, though the negative wealth effects of continued declines in equity and house prices likely offset this somewhat. Measures of consumer sentiment released in November and December remained low, and available evidence suggested further tightening in consumer credit conditions in recent months.

Real construction activity continued to decline in November. Single-family housing starts and permit issuance fell further. In the multifamily sector, starts dropped sharply in November while permit issuance remained on a downtrend. Housing demand remained weak, and although the number of unsold new single-family homes continued to move lower, inventories remained elevated relative to the current pace of sales. Sales of existing single-family homes changed little, although a drop in pending home sales in October pointed to further declines in the near term. The comparative strength of existing home sales appeared to be attributable partly to increases in foreclosure-related and other distressed sales. Financing conditions for prime borrowers appeared to ease slightly after the Federal Reserve's announcement that it would purchase agency debt and agency mortgage-backed securities (MBS) to support mortgage financing, while the market for nonconforming loans remained impaired. Several indexes indicated that house prices continued to decline substantially.

In the business sector, investment in equipment and software appeared to be contracting at a faster rate in the fourth quarter than during the third quarter. While the decline in the previous quarter was concentrated in computers and transportation equipment, declines in spending in the fourth quarter were more widespread. Shipments of nondefense capital goods excluding aircraft fell in October, and orders continued to decline sharply. Investment demand seemed to be weighed down by weak fundamentals and increased uncertainty about the state of the economy, while prospects for future investment activity reflected in surveys of business conditions and sentiment worsened in recent months. In addition, credit conditions remained tight. Real nonresidential investment declined in the third quarter after nearly three years of robust expansion, and nominal expenditures edged down further in October. Vacancy rates rose and property values fell in the first three quarters of the year.

Real nonfarm inventories (excluding motor vehicles), which had dropped noticeably in the second quarter, fell again in the third quarter. The book value of manufacturing and wholesale trade inventories (excluding motor vehicles) showed a further drawdown in October. However, the ratio of these inventories to sales increased noticeably in September and October. The purchasing managers survey for November indicated that many purchasing agents saw their customers' inventories as too high.

The U.S. international trade deficit widened in October, as a fall in imports was more than offset by a significant decline in exports. Much of the decline in exports was the result of drops in agricultural goods and industrial supplies, which largely reflected a decrease in the prices of these goods. The decline in imports was led by lower imports of non-oil industrial supplies, capital goods, and automotive products, although these declines were partly offset by an increase in the value of oil imports.

Economic activity in most advanced foreign economies contracted in the third quarter, driven by sharp declines in investment and by significant negative contributions of net exports, as the global recession took hold more strongly. Incoming data pointed to an even weaker pace of activity in the fourth quarter. In Canada, however, real gross domestic product (GDP) increased at a faster-than-expected pace in the third quarter, though consumption and investment continued to soften. In the euro area and the United Kingdom, purchasing managers indexes fell in November to levels associated with severe contractions in economic activity. Labor market conditions in the advanced economies deteriorated further, with most countries experiencing rising unemployment rates. In Japan, real GDP fell in the third quarter as domestic demand declined and private investment fell for the second consecutive quarter. After peaking in the third quarter, consumer price inflation moderated in all advanced foreign economies, primarily as a result of falling energy and food prices. Economic activity in most emerging market economies decelerated sharply in the third quarter, though a surge in agricultural output helped to support activity in Mexico, and the Brazilian economy continued to expand rapidly. In Asia, output decelerated significantly, as the pace of real activity moderated in China and several other economies saw declines in real GDP. Recent readings on production, sales, and exports suggest that emerging market economies weakened further in the current quarter. Headline inflation generally declined across emerging market economies, primarily because of lower food and energy prices and, in some cases, weaker economic activity.

In the United States, headline consumer prices declined in recent months while core consumer price inflation slowed further. With energy prices falling sharply and the rate of increase in food prices moderating, headline PCE prices fell in October, and data from the consumer price index (CPI) indicated that the decline extended into November. Core PCE prices were unchanged in October, and based on the CPI, appeared to have been unchanged again in November. The recent slowing in core consumer price inflation was widespread and likely reflected not only the weak pace of economic activity but also the easing of some earlier cost pressures as the prices of crude oil, gasoline, and other commodities declined. Excluding food and energy, producer prices rose modestly again in November, as prices at earlier stages of processing continued to retreat for the third consecutive month. Measures of inflation expectations continued to fall or hold steady during the intermeeting period. Measures of nominal hourly labor compensation continued to increase moderately in the third quarter.

At its October 28-29 meeting, the Federal Open Market Committee (FOMC) lowered its target for the federal funds rate 50 basis points to 1 percent. The Committee's statement noted that economic activity appeared to have slowed markedly, due importantly to a decline in consumer expenditures. Business equipment spending and industrial production had weakened in recent months, and slowing economic activity in many foreign economies was damping the prospects for U.S. exports. Moreover, the intensification of financial market turmoil was likely to exert additional restraint on spending, partly by further reducing the ability of households and businesses to obtain credit. The Committee noted that, in light of the declines in the prices of energy and other commodities and the weaker prospects for economic activity, it expected inflation to moderate in coming quarters to levels consistent with price stability. The Committee also noted that recent policy actions, including the rate reduction that was approved at the October 28-29 meeting, coordinated interest rate cuts by central banks, extraordinary liquidity measures, and official steps to strengthen financial systems, should help over time to improve credit conditions and promote a return to moderate economic growth. Nevertheless, downside risks to economic activity remained and the Committee indicated that it would monitor economic and financial developments carefully and act as needed to promote sustainable economic growth and price stability.

Over the intermeeting period, investors marked down their expectations for the path of monetary policy. Policy expectations were largely unaffected by the outcome of the October 28-29 FOMC meeting, as the Committee's decision to reduce the target federal funds rate was broadly anticipated and the accompanying statement was reportedly in line with investor expectations. Subsequently, however, the expected future path of monetary policy dropped amid data releases that suggested a weaker outlook for economic activity and lower inflation than had been anticipated, along with continued strains in financial markets that weighed on investor sentiment. Yields on nominal Treasury coupon securities declined significantly over the intermeeting period in response to safe-haven demands as well as the downward revisions in the economic outlook and the expected policy path. Meanwhile, yields on inflation-indexed Treasury securities declined by smaller amounts, leaving inflation compensation lower. Although the decline in inflation compensation occurred amid sharp decreases in inflation measures and energy prices, it was likely amplified by increased investor preference for the greater liquidity of nominal Treasury securities relative to that of inflation-protected Treasury securities.

Conditions in short-term funding markets remained strained for most of the intermeeting period, though some signs of improvement were evident. The spreads of London interbank offered rates, or Libor, over comparable-maturity overnight index swap rates declined noticeably across most maturities early in the intermeeting period; however, some of this decline was reversed once maturities began to lengthen past year-end. Trading in longer-term interbank funding markets reportedly remained thin. Credit outstanding under the Federal Reserve's Term Auction Facility (TAF) increased to about $448 billion because of expanded auction sizes. Recent auctions for both 28-day and 84-day credit from the TAF were undersubscribed, and bidding for the two forward TAF auctions during the intermeeting period was very light. Meanwhile, primary credit outstanding remained high, although it had declined somewhat in recent weeks. Use of the Primary Dealer Credit Facility dropped significantly. A number of the Term Securities Lending Facility (TSLF) auctions were oversubscribed, as was the auction of options for 13-day Schedule 2 TSLF loans straddling the end of the year.

Conditions in markets for repurchase agreements, or repos, arranged using certain types of collateral deteriorated over the intermeeting period, and liquidity for repos backed by non-Treasury, non-agency collateral remained poor. Amid high demand for safe investments, the overnight Treasury general collateral (GC) repo rate remained very low and fell to around zero late in the intermeeting period. Still, failures to deliver in the Treasury market declined substantially from the levels reached in October and overnight securities lending from the System Open Market Account portfolio fell sharply. Heavy demand for safe instruments was also apparent in the Treasury bill market, where yields turned negative at times. During the intermeeting period, the Treasury announced that it would not roll over bills related to the Supplementary Financing Program in order to preserve flexibility in the conduct of debt management policy, and uncertainty about supply reportedly exacerbated poor liquidity conditions in the bill market. Despite the decline in spreads of agency and mortgage-backed repo rates over Treasury GC rates later in the period, strains in these markets remained evident, with bid-asked spreads and haircuts very elevated.

In contrast, conditions in the commercial paper (CP) market improved over the intermeeting period, likely as a reflection of recent measures taken in support of this market. Spreads on 30-day A1/P1 and asset-backed commercial paper (ABCP) continued to narrow after the Commercial Paper Funding Facility (CPFF) became operational on October 27, although spreads subsequently reversed a portion of the declines as maturities crossed over year-end. In contrast, spreads on commercial paper not eligible for purchase under the CPFF remained elevated. The dollar amounts of unsecured financial CP and ABCP outstanding rebounded from their October lows, though issuance into the CPFF more than accounted for this increase. Credit outstanding under the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility fell by more than half over the intermeeting period. The Money Market Investor Funding Facility program registered no activity.

As financial market conditions worsened over the intermeeting period, investors seemed to become more concerned about the likelihood of a deep and prolonged recession. In addition, the Treasury Department's announcement that funds from the Troubled Asset Relief Program would not be used to purchase securities backed by mortgage-related and other assets appeared to prompt negative price reactions in several financial markets. Stock prices of financial corporations fell considerably, while broad equity indexes declined, on net, amid high volatility. Yields on investment-grade bonds moved lower, but risk spreads on these instruments over comparable-maturity Treasury securities widened substantially as yields on Treasury securities fell more. Yields and risk spreads on speculative-grade bonds soared, and credit default swap spreads on speculative-grade, as well as investment-grade, corporate bonds widened further. Gross issuance of bonds by nonfinancial investment-grade companies continued at a solid pace, but issuance of speculative-grade bonds remained at zero. Issuance of leveraged syndicated loans was also extremely weak. Strains were evident in a number of other financial markets as well. The functioning of Treasury markets remained impaired, and premiums for the on-the-run ten-year nominal Treasury security rose from levels that were already elevated. The market for commercial mortgage-backed securities experienced a particularly pronounced selloff.

Reflecting investor concerns about the conditions of financial institutions, spreads on credit default swaps for U.S. banks widened sharply, and those for insurance companies remained elevated. To support market stability, the U.S. government on November 23 entered into an agreement with Citigroup to provide a package of capital, guarantees, and liquidity access. In other developments, banking organizations began to take advantage of the Federal Deposit Insurance Corporation's (FDIC) Temporary Liquidity Guarantee Program; eleven institutions issued bonds under the program.

In view of the tightening of credit conditions for consumers and small businesses, the Federal Reserve announced on November 25 the creation of the Term Asset-Backed Securities Loan Facility to support the markets for asset-backed securities collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. The facility, developed jointly with the Treasury, was expected to be operational by February 2009, and discussions with market participants about operational details of this facility were ongoing.

The Federal Reserve also announced on November 25 that, to help reduce the cost and increase the availability of residential mortgage credit, it would initiate a program to purchase up to $100 billion in direct obligations of housing-related government-sponsored enterprises (GSEs) and up to $500 billion in MBS backed by Fannie Mae, Freddie Mac, and Ginnie Mae. Agency debt spreads, which had widened early in the period, narrowed somewhat after the announcement. Subsequent purchases of agency debt by the Open Market Desk at the Federal Reserve Bank of New York led to a further reduction in agency spreads. Likely reflecting in part these developments, conditions in the primary residential mortgage market improved. The interest rate on 30-year fixed-rate conforming mortgages declined, which prompted a noticeable increase in mortgage refinancing.

M2 expanded at a considerably slower rate in November than October. Retail money funds contracted after a surge in October that reflected safe-haven inflows to Treasury-only funds. Small time deposits increased somewhat more slowly than in October, although the rate of expansion remained quite rapid as banks continued to bid aggressively for these deposits. Flows into demand deposits covered by the FDIC's new temporary guarantee program were significant and apparently reflected shifts out of savings accounts as well as redirection of funds by banks' customers away from other money market instruments. Currency continued its strong increase, apparently boosted by solid foreign demand for U.S. banknotes.

Liquidity conditions in the money markets of major foreign economies improved but remained strained over the intermeeting period. Movements in stock prices were mixed in the advanced foreign economies, although equity prices generally rose in emerging market economies. In response to evidence of a slowdown in economic activity and a rapid waning of inflationary pressures, central banks around the world eased policy sharply. Sovereign bond yields fell, reflecting prospects for lower inflation and lower policy rates for an extended period. The dollar declined on balance against the currencies of major U.S. trading partners.

In the forecast prepared for the meeting, the staff revised down sharply its outlook for economic activity in 2009 but continued to project a moderate recovery in 2010. Real GDP appeared likely to decline substantially in the fourth quarter of 2008 as conditions in the labor market deteriorated more steeply than previously anticipated; the decline in industrial production intensified; consumer and business spending appeared to weaken; and financial conditions, on balance, continued to tighten. Rising unemployment, the declines in stock market wealth, low levels of consumer sentiment, weakened household balance sheets, and restrictive credit conditions were likely to continue to hinder household spending over the near term. Homebuilding was expected to contract further. Business expenditures were also likely to be held back by a weaker sales outlook and tighter credit conditions. Oil prices, which dropped significantly during the intermeeting period, were assumed to rise over the next two years in line with the path indicated by futures market prices, but to remain below the levels of October 2008. All told, real GDP was expected to fall much more sharply in the first half of 2009 than previously anticipated, before slowly recovering over the remainder of the year as the stimulus from monetary and assumed fiscal policy actions gained traction and the turmoil in the financial system began to recede. Real GDP was projected to decline for 2009 as a whole and to rise at a pace slightly above the rate of potential growth in 2010. Amid the weaker outlook for economic activity over the next year, the unemployment rate was likely to rise significantly into 2010, to a level higher than projected at the time of the October 28-29 FOMC meeting. The disinflationary effects of increased slack in resource utilization, diminished pressures from energy and materials prices, declines in import prices, and further moderate reductions in inflation expectations caused the staff to reduce its forecast for both core and overall PCE inflation. Core inflation was projected to slow considerably in 2009 and then to edge down further in 2010.

In their discussion of the economic situation and outlook, all meeting participants agreed that the economic downturn had intensified over the fall. Although some financial markets exhibited signs of improved functioning, financial conditions generally remained very strained. Credit conditions continued to tighten for both households and businesses, and ongoing declines in equity prices further reduced household wealth. Conditions in the housing market weakened again and house prices declined further. Against this backdrop, measures of business and consumer confidence fell to new lows, and private spending continued to contract.

Employment and production indicators weakened further as businesses responded very rapidly to the fall-off in demand. Participants expected economic activity to contract sharply in the fourth quarter of 2008 and in early 2009. Most projected that the economy would begin to recover slowly in the second half of 2009, aided by substantial monetary policy easing and by anticipated fiscal stimulus. Meeting participants generally agreed that the uncertainty surrounding the outlook was considerable and that downside risks to even this weak trajectory for economic activity were a serious concern. Indeed, the severe ongoing financial market strains, the large reductions in household wealth, and the global nature of the economic slowdown were seen by some participants as suggesting the distinct possibility of a prolonged contraction, although that was not judged to be the most likely outcome. Inflation pressures had diminished appreciably as energy and other commodity prices dropped and economic activity slumped. Looking forward, participants agreed that inflationary pressures looked set to moderate further in coming quarters, reflecting recent declines in commodity prices and rising slack in resource markets, and several saw risks that inflation could drop for a time below rates they viewed as most consistent over time with the Federal Reserve's dual mandate for maximum employment and price stability.

Meeting participants observed that financial strains continued to exert a powerful drag on economic activity and that the adverse feedback loop between financial conditions and economic performance had intensified. Although improvements were evident in some markets, particularly those for highly rated commercial paper and for interbank funds, financial markets generally remained under severe stress. Equity prices continued to drop amid high volatility, further reducing household wealth. Rising risk spreads kept the cost of issuing corporate bonds at a high level—especially for lower-rated firms—even though Treasury yields had declined sharply since the October 28-29 meeting. Securitization markets, which over recent years had been an important channel in credit intermediation, remained largely dysfunctional, with the exception of those for mortgages guaranteed by the GSEs. The sharp drops and unusual volatility in the prices of many financial assets since the beginning of the fourth quarter were likely to cause more losses for financial institutions, and a number of participants noted that loan delinquencies were increasing significantly in the consumer sector, adding to pressures on banks' balance sheets and reinforcing banks' cautious lending stance. As a consequence, credit conditions for both businesses and households had tightened further, with banks generally adopting stricter lending standards and declining to renew or paring back existing credit lines.

Participants observed that the effects of the financial turmoil, increased uncertainty, and drops in confidence and demand were becoming increasingly evident in the business sector. Business contacts across the country expected considerable near-term weakness in sales and declining pricing power. Some meeting participants reported especially sharp drops in new orders in their Districts. Even sectors that had performed relatively well until recently, such as mining and drilling, were experiencing reduced activity, mostly due to the decline in commodity prices. Agricultural activity was also showing signs of weakness. Business sentiment had deteriorated sharply since September, likely contributing to steep drops in employment and production. Participants anticipated that, with the deteriorating economic outlook and tightening of credit conditions, capital expenditures were likely to be soft in coming quarters.

Many participants noted that the decline in household wealth resulting from large drops in equity and house prices, together with tighter credit conditions, rapidly increasing unemployment, and deteriorating consumer sentiment, was contributing to a sharp contraction in consumer spending. Some participants pointed out that reduced consumer wealth and concerns about employment could lead to a further increase in saving, which, although desirable in the longer term, could put additional downward pressure on consumer spending in coming quarters. The latest housing data suggested a continued substantial contraction in that sector. The recent decline in mortgage rates had sparked some refinancing and purchase activity, but the extent of the longer-term impact of lower rates on housing demand remained uncertain.

Meeting participants noted that economic conditions had deteriorated substantially in recent months in both advanced and emerging market economies. As a consequence, demand for U.S. exports had weakened, held back also by the strengthening of the dollar since the summer. Going forward, global demand was expected to remain weak, and thus growth in exports was unlikely to provide much support for U.S. activity. However, the weakness in the global economy was contributing to lower prices of energy and other commodities, which should boost real incomes and provide modest support to household spending.

Participants agreed that falling prices for energy and other commodities and diminished economic activity had resulted in an appreciable reduction in inflationary pressures. Those pressures were seen as likely to continue to abate because of the emergence of substantial slack in resource utilization and diminishing pricing power. Participants were uncertain about the extent to which inflation would fall. Some saw inflation leveling out near desired levels, while others expressed concern that inflation might decline below levels consistent with price stability in the medium term. Participants generally agreed that inflation expectations were an important determinant of future price dynamics. Some noted that those expectations, especially at longer horizons, appeared well anchored. However, some survey evidence suggested that firms expected prices to continue to decline as they had over the previous few months. Several participants observed that monitoring measures of inflation expectations for signs of disinflationary dynamics would be especially important going forward.

In a joint session of the Federal Open Market Committee and the Board of Governors, meeting participants discussed extensively how in current circumstances the Committee could best support the resumption of sustainable economic growth and promote the maintenance of price stability over the medium term. Participants noted that very low levels of the federal funds rate had the potential to help buoy aggregate demand and economic activity, but they also had potential costs in terms of the functioning of certain financial markets and some financial institutions. Most participants judged that the benefits in terms of support for the overall economy of federal funds rates close to, but slightly above, zero probably outweighed the adverse effects. With the federal funds rate already trading at very low levels as a result of the large volume of excess reserves associated with the Federal Reserve's liquidity operations, participants agreed that the Committee would need to focus on other tools to impart additional monetary stimulus to the economy in the near term. One broad class of such tools was the use of FOMC communication with the public to provide more information regarding future policy intentions. In particular, participants judged that communicating the Committee's expectation that short-term interest rates were likely to stay exceptionally low for some time could be useful because it could lead to pricing of longer-term interest rates consistent with the path of monetary policy that policymakers saw as most likely. Participants emphasized the importance of explicitly conditioning communication regarding future policy on the evolution of the economic outlook. Another possible form of communication that participants discussed was a more explicit indication of their views on what longer-run rate of inflation would best promote their goals of maximum employment and price stability. The added clarity in that regard might help forestall the development of expectations that inflation would decline below desired levels, and hence keep real interest rates low and support aggregate demand.

Meeting participants also discussed how best to employ the Federal Reserve's balance sheet to promote monetary policy goals. The Federal Reserve had already adopted a series of programs that were providing liquidity support to a range of institutions and markets, and participants generally agreed that a continued focus on the quantity and the composition of Federal Reserve assets would be necessary and desirable. Specifically, participants discussed the merits of purchasing large quantities of longer-term securities such as agency debt, agency mortgage-backed securities, and Treasury securities. The available evidence indicated that such purchases would reduce yields on those instruments, and lower yields on those securities would tend to reduce borrowing costs for a range of private borrowers, although participants were uncertain as to the likely size of such effects. Participants also generally believed that the special liquidity and lending facilities implemented or announced recently would support the availability of credit to businesses and households and thus help sustain economic activity. Many participants thought that the Federal Reserve should continue to consider whether expanding some of the existing facilities and creating new facilities could be helpful. Participants emphasized that the ultimate objective of special lending facilities and asset purchases was to support overall market functioning, financial intermediation, and economic growth. Participants acknowledged that the effective federal funds rate probably would need to remain very low for some time. However, they also recognized that, as economic activity recovered and financial conditions normalized, the use of certain policy tools would need to be scaled back, the size of the balance sheet and level of excess reserves would need to be reduced, and the Committee's policy framework would return to focus on the level of the federal funds rate.

A number of participants observed that, under the approach of conducting monetary policy by acquiring a variety of assets as needed to address financial and macroeconomic strains, the quantity of excess reserves and the size of the Federal Reserve's balance sheet would be determined by the Federal Reserve's asset purchases and the usage of its lending facilities. It was likely that, during the period of financial turmoil, the size of the Federal Reserve's balance sheet would need to be maintained at a high level. Participants discussed the potential advantages and disadvantages of setting quantitative targets for bank reserves or the monetary base. Some were of the view that quantitative targets for an increasing reserve base could be effective in preventing deflationary dynamics and useful in communicating to the public the Committee's determination to take the steps needed to avoid such an outcome. Several other participants, however, noted that increases in excess reserves or the monetary base, by themselves, might not have a significant stimulative effect on the economy or prices because the normal bank intermediation mechanism appeared to be impaired, and banks may not be willing to lend their excess reserves. Conversely, a decline in excess reserves or the monetary base would not necessarily be contractionary if it occurred in the context of improving financial market conditions. A few of those who supported quantitative base or reserve targets did so because they saw them as helping to coordinate the actions of the Board of Governors, which is responsible for authorizing most special liquidity and lending facilities, and the Committee, which is responsible for open market operations. Most participants, however, were of the view that such coordination would best be achieved by continued close cooperation and consultation between the Committee and the Board. Going forward, consideration will be given to whether various quantitative measures would be useful in calibrating and communicating the stance of monetary policy.

In the discussion of monetary policy for the intermeeting period, Committee members recognized that the large volume of excess reserves had already resulted in federal funds rates significantly below the target federal funds rate and the interest rate on excess reserves. They agreed that maintaining a low level of short-term interest rates and relying on the use of balance sheet policies and communications about monetary policy would be effective and appropriate in light of the sharp deterioration of the economic outlook and the appreciable easing of inflationary pressures. Maintaining that level of the federal funds rate implied a substantial further reduction in the target federal funds rate. Even with the additional use of nontraditional policies, the economic outlook would remain weak for a time and the downside risks to economic activity would be substantial. Moreover, inflation would continue to fall, reflecting both the drop in commodity prices that had already occurred and the buildup of economic slack; indeed some members saw significant risks that inflation could decline and persist for a time at uncomfortably low levels.

Members debated how best to communicate their decisions regarding monetary policy actions. Since the large amount of excess reserves in the system would limit the Federal Reserve's control over the federal funds rate, several members thought that it might be preferable not to set a specific target for the federal funds rate. Indeed, those members felt that lack of an explicit target could be helpful, in that it would focus attention on the shift in the policy framework from targeting the federal funds rate to the use of balance sheet policies and communications about monetary policy as a way of providing further monetary stimulus. A few members stressed that the absence of an explicit federal funds rate target would give banks added flexibility in pricing loans and deposits in the current environment of unusually low interest rates. However, other members noted that not announcing a target might confuse market participants and lead investors to believe that the Federal Reserve was unable to control the federal funds rate when it could, in fact, still influence the effective federal funds rate through adjustments of the interest rate on excess reserves and the primary credit rate. The members decided that it would be preferable for the Committee to communicate explicitly that it wanted federal funds to trade at very low rates; accordingly, the Committee decided to announce a target range for the federal funds rate of 0 to ¼ percent. Members also agreed that the statement should indicate that weak economic conditions were likely to warrant exceptionally low levels of the federal funds rate for some time. The members emphasized that their expectation about the path of the federal funds rate was conditioned on their view of the likely path of economic activity.

Members also discussed how best to communicate the focus of the Federal Reserve's policy going forward. Members agreed that the statement should indicate that all available tools would be employed to promote the resumption of sustainable economic growth and to preserve price stability. They also agreed that the statement should note that it was the Committee's intention to sustain the size of the Federal Reserve's balance sheet at a high level through open market operations and other measures to support financial markets and stimulate the economy. In addition to the already-announced asset purchases and liquidity programs, members concurred that the statement should indicate that the Committee stands ready to expand purchases of agency debt and agency mortgage-backed securities, and that it is evaluating the potential benefits of purchasing longer-term Treasury securities.

In light of the use of additional tools for implementing monetary policy, the Committee revised the form of the directive to the Open Market Desk of the Federal Reserve Bank of New York. In addition to specifying that it now seeks conditions in reserve markets consistent with federal funds trading in a range of 0 to ¼ percent, the Committee instructed the Desk to purchase up to $100 billion in housing-related GSE debt and up to $500 billion in agency-guaranteed MBS by the end of the second quarter of 2009. Members agreed that they should not specify the precise timing of these purchases, but that they should leave discretion to the Desk to intervene depending on market and broader economic conditions. The directive also noted that the Manager of the System Open Market Account and the Secretary of the FOMC would keep the Committee informed of developments regarding the System's balance sheet that could affect the attainment of the Committee's statutory objectives. At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee seeks conditions in reserve markets consistent with federal funds trading in a range of 0 to ¼ percent. The Committee directs the Desk to purchase GSE debt and agency-guaranteed MBS during the intermeeting period with the aim of providing support to the mortgage and housing markets. The timing and pace of these purchases should depend on conditions in the markets for such securities and on a broader assessment of conditions in primary mortgage markets and the housing sector. By the end of the second quarter of next year, the Desk is expected to purchase up to $100 billion in housing-related GSE debt and up to $500 billion in agency-guaranteed MBS. 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.:

> "The Federal Open Market Committee decided today to establish a target range for the federal funds rate of 0 to ¼ percent.
>
> Since the Committee's last meeting, labor market conditions have deteriorated, and the available data indicate that consumer spending, business investment, and industrial production have declined. Financial markets remain quite strained and credit conditions tight. Overall, the outlook for economic activity has weakened further.
>
> Meanwhile, inflationary pressures have diminished appreciably. In light of the declines in the prices of energy and other commodities and the weaker prospects for economic activity, the Committee expects inflation to moderate further in coming quarters.
>
> The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability. In particular, the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.
>
> The focus of the Committee's policy going forward will be to support the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve's balance sheet at a high level. As previously announced, over the next few quarters the Federal Reserve will purchase large quantities of agency debt and mortgage-backed securities to provide support to the mortgage and housing markets, and it stands ready to expand its purchases of agency debt and mortgage-backed securities as conditions warrant. The Committee is also evaluating the potential benefits of purchasing longer-term Treasury securities. Early next year, the Federal Reserve will also implement the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses. The Federal Reserve will continue to consider ways of using its balance sheet to further support credit markets and economic activity."

Votes for this action: Mr. Bernanke, Mses. Cumming and Duke, Messrs. Fisher, Kohn, and Kroszner, Ms. Pianalto, Messrs. Plosser, Stern, and Warsh.

Votes against this action: None.

Ms. Cumming voted as the alternate for Mr. Geithner.

The Committee also continued its discussion of possible refinements to the Committee's approach to projections that could provide additional information about participants' views of longer-run sustainable rates of economic growth and unemployment and the measured rates of inflation that would be consistent with price stability, but it made no decisions regarding these issues. Finally, staff briefed the Committee on the progress of plans for implementing the Federal Reserve's Term Asset-Backed Securities Loan Facility, which had initially been announced on November 25, 2008.

It was agreed that the next meeting of the Committee would be held on Tuesday-Wednesday, January 27-28, 2009.

The meeting adjourned at 3:00 p.m. on December 16, 2008.

Notation Votes

By notation vote completed on November 18, 2008, the Committee unanimously approved the minutes of the FOMC meeting held on October 28-29, 2008.

By notation vote completed on November 26, 2008, the Committee unanimously approved the extension until April 30, 2009, of its authorization for the Federal Reserve Bank of New York to engage in transactions with primary dealers through the Term Securities Lending Facility, subject to the same collateral, interest rate, and other conditions previously established by the Committee.

Brian F. Madigan
Secretary