Minutes of the Federal Open Market Committee September 22-23, 2009

A joint meeting of the Federal Open Market Committee and the Board of Governors of the Federal Reserve System was held in the offices of the Board of Governors in Washington, D.C., on Tuesday, September 22, 2009, at 2:00 p.m. and continued on Wednesday, September 23, 2009, at 9:00 a.m.

PRESENT:

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

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

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

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

Mr. Madigan, Secretary and Economist
Mr. Luecke, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Ashton, Assistant General Counsel
Mr. Sheets, Economist
Mr. Stockton, Economist

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

Mr. Sack, Manager, System Open Market Account

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

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

Ms. Barger and Mr. English, Deputy Directors, Divisions of Banking Supervision and Regulation and Monetary Affairs, respectively, Board of Governors

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

Ms. Edwards, Messrs. Reifschneider and Wascher, Senior Associate Directors, Divisions of Monetary Affairs, Research and Statistics, and Research and Statistics, respectively, Board of Governors

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

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

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

Mr. Williams, Records Management Analyst, Division of Monetary Affairs, Board of Governors

Mr. Connolly,[1] First Vice President, Federal Reserve Bank of Boston

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Mr. Hakkio, Ms. Mester, Messrs. Rasche, Rudebusch, and Schweitzer, Senior Vice Presidents, Federal Reserve Banks of Kansas City, Philadelphia, St. Louis, San Francisco, and Cleveland, respectively

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

[1] Attended Tuesday's session only.

Mr. McCarthy and Ms. O'Connor, Assistant Vice Presidents, Federal Reserve Bank of New York

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

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

The Manager of the System Open Market Account reported on recent developments in domestic and foreign financial markets. The Manager also reported on System open market operations in Treasury securities, agency debt, and agency mortgage-backed securities (MBS) since the Committee's August 11-12 meeting. By unanimous vote, the Committee ratified those transactions. There were no open market operations in foreign currencies for the System's account during the intermeeting period. Since the Committee met in August, the Federal Reserve's total assets had risen about $125 billion, on balance, to approximately $2.1 trillion, as the System's purchases of securities exceeded a further decline in usage of the System's credit and liquidity facilities.

The staff briefed the Committee on the current status of the asset purchase programs. Participants noted that the primary influence of the programs is likely through the cumulative effect that they generate on the publicly available stocks of securities. However, they also observed that the rate of new purchases could have an effect on asset prices, especially of MBS. Given this possibility, participants remarked that a gradual reduction in the pace at which the Federal Reserve buys agency debt and agency MBS could help promote a smooth transition in markets as the announced asset purchases are completed. Participants observed that such a strategy would be similar to the approach adopted in August for the purchases of Treasury securities and generally viewed it as a useful step to mitigate the risk of a sharp change in yields as purchases end. Participants expressed a range of views about the rate at which asset purchases should be slowed. Some suggested tapering quickly and completing the purchases by year-end, while a few preferred slowing the rate of purchases over a longer period in order to maintain flexibility regarding the pace and the cumulative amount purchased and thus potentially better calibrate the programs to evolving economic and financial market conditions. Most participants supported extending purchases of agency debt and agency MBS through the first quarter of 2010.

The staff also briefed the Committee on the likely implications of very high reserve balances for bank balance sheet management and for the economy. The staff's assessment, based in part on consultations with market participants, was that many banks were currently comfortable holding high levels of reserves as a means of managing liquidity risks, and these balances or further increases along the lines implied by the announced programs were not likely to crowd out other lending through pressures on capital positions. As the economy improves, however, banks could seek to lower their levels of reserve balances by purchasing securities, thereby putting downward pressure on market interest rates, or by easing their credit standards and terms in order to expand lending. Such effects, if significant, would provide further impetus to economic growth. The staff analysis indicated that these effects would likely emerge only gradually and that their magnitude could be quite limited. However, some participants thought that declining demand for reserves might already be putting downward pressure on yields. Participants expressed a range of views about the likely stimulative effect of a further expansion of reserve balances on economic activity, as well as the potential impact of elevated reserves on inflation expectations. Some meeting participants noted that the announced decrease in the balance in the Treasury's Supplementary Financing Account (SFA) would increase reserves in the banking system unless it were offset by Federal Reserve actions or by a further reduction in borrowing from the Federal Reserve's various credit and liquidity facilities, and that these increases could be expansionary. Others noted that the decrease in the SFA could well be temporary and, in any event, that the macroeconomic effects of the increase in reserves would probably be limited in the current environment.

The staff presented an update on the continuing development of several tools that could help support a smooth withdrawal of policy accommodation at the appropriate time. These measures included executing reverse repurchase agreements on a large scale, potentially with counterparties other than the primary dealers; implementing a term deposit facility, available to depository institutions, to reduce the supply of reserve balances; and taking steps to tighten the link between the interest rate paid on reserve balances held at the Federal Reserve Banks and the federal funds rate. Participants expressed confidence that these tools, along with the payment of interest on reserves and possible sales of assets from the System's portfolio, would allow

them to remove policy accommodation at the appropriate time and pace. Completing development of these tools would remain a top priority of the Federal Reserve.

The staff presented proposed schedules for operations under the Term Auction Facility (TAF) and Term Securities Lending Facility (TSLF) through January 2010. As conditions in short-term funding markets had continued to improve, usage of these facilities had diminished. The proposed schedules were consistent with not only the Federal Reserve's previously announced intention to gradually scale back these facilities in response to continued improvements in financial market conditions, but also with a desire to assure market participants that the Federal Reserve will provide sufficient liquidity over year-end. There was general agreement that the Federal Reserve should assess over the next several months whether to maintain a TAF on a permanent basis.

> Secretary's note: On September 24, 2009, the Federal Reserve announced schedules for operations under the TAF and the TSLF through January 2010 and indicated that it would seek public comment on a proposal for a permanent TAF.

Staff Review of the Economic Situation

The information reviewed at the September 22-23 meeting suggested that overall economic activity was beginning to pick up. Factory output, particularly motor vehicle production, rose in July and August. Consumer spending on motor vehicles during that period was boosted by government rebates and greater dealer incentives, and household spending outside of motor vehicles appeared to rise in August after having been roughly flat from May through July. Although employment continued to contract in August, the pace of job losses slowed noticeably from that of earlier in the year. Investment in equipment and software (E&S) also seemed to be stabilizing. Sales and construction of single-family homes during July and August, while still at low levels, were significantly above the readings at the beginning of the year. The sharp cuts in production this year reduced inventory stocks significantly, though they remained elevated relative to the recent level of sales. Core consumer price inflation continued to be subdued in July and August, but higher gasoline prices raised overall consumer price inflation in August.

Firms continued to reduce payrolls, but job losses abated further in August, with the decline in private payroll employment the smallest since that of August 2008. Although employment losses continued to be widespread, the rate of decline diminished in most industries. The length of the average workweek for production and nonsupervisory workers remained steady, albeit at a low level, and the rate of decline in aggregate hours for this group over July and August was the smallest of the past year. In the household survey, although the unemployment rate rose in August to 9.7 percent, the rise in the unemployment rate slowed, on net, in recent months from its pace earlier in the year. The labor force participation rate in August remained at the low level that had prevailed through much of the year. Continuing claims for unemployment insurance through regular state programs fell slightly, on balance, from its earlier peak, but the total including extended and emergency benefits stayed near its recent high level. Initial claims for unemployment insurance fluctuated within a narrow range that was consistent with further declines in employment. With labor markets still weak, the year-over-year increase in average hourly earnings of production and nonsupervisory workers slowed further in August, even with the higher federal minimum wage that went into effect at the end of July.

Industrial production rose in July and August, led by a rebound in motor vehicle production from the extraordinarily low assembly rates in the first half of the year. Manufacturing production outside of motor vehicles increased solidly, likely reflecting stronger demand for materials from the motor vehicle sector and a slower pace of inventory liquidation elsewhere. Business survey indicators suggested further gains in factory output over the near term. Nevertheless, the factory utilization rate in August was only modestly above its recent historical low.

Real personal consumption expenditures increased modestly in July, led by a strong advance in motor vehicle purchases, which were boosted appreciably by the government's "cash-for-clunkers" program. This program contributed to a further surge in motor vehicle sales in August to their highest level since the first half of 2008. After declining in July, sales at retailers, excluding those at motor vehicle dealers, building materials stores, and gasoline stations, rose significantly in August, suggesting an increase in real consumer expenditures on non-motor-vehicle goods for the month. Even so, many determinants of spending continued to be tepid. In particular, the weak labor market continued to restrain growth in household income, and the prior declines in household net worth probably continued to weigh on spending. However, an increase in

household net worth since March, a rise in nominal labor compensation in July, and increases in various measures of consumer sentiment indicated some improvement in the outlook for consumer spending.

Data from the housing sector indicated that a gradual recovery in activity was under way. Although single-family housing starts fell modestly in August, this decrease followed five consecutive monthly increases, and the number of starts in August was well above the record low reached in the first quarter of the year. In contrast, in the much smaller multifamily sector, where credit conditions were still particularly tight and vacancy rates remained high, starts continued to be down, on net, in 2009 after a significant fall in the second half of 2008. The sales data for July indicated further increases in the demand for both new and existing single-family homes. Even though new home sales remained modest, they had been sufficient, given the slow pace of construction, to pare the overhang of unsold new single-family houses: In July, the level of inventories of such homes was about one-half of its peak in the summer of 2006, and the months' supply had fallen considerably from its record high in January. Sales of existing homes in July were at their fastest pace since mid-2007, and pending home sales agreements suggested that resale activity would rise further in following months. Although sales of distressed properties remained elevated, the rise in total sales of existing homes over the summer appeared to have been driven by an increase in transactions involving nondistressed properties. The apparent modest strengthening of housing demand was likely due, in part, to improvements in housing affordability stemming from low interest rates for conforming mortgages, a lower level of house prices, and possibly the first-time homebuyer tax credit. In addition, demand may have been buoyed by a sense that house prices were beginning to stabilize. Through the end of the second quarter, many house price indexes had smaller year-over-year declines than they had shown earlier this year, and some indexes recorded positive changes for the second quarter.

Real spending on E&S appeared to be stabilizing after falling sharply for more than a year. Business purchases of transportation equipment seemed to be expanding solidly in the third quarter. Nominal shipments and orders for high-tech equipment in July were significantly above their second-quarter averages; moreover, a few major producers of high-tech equipment reported some signs of improvement in demand. Business investment in equipment other than high tech and transportation showed tentative signs of stabilization. Some forward-looking indicators of investment in E&S improved, suggesting that conditions had become less adverse than earlier in the year. Monthly surveys of business conditions and sentiment recently recovered to levels consistent with a modest rise in business spending, and corporate bond spreads over Treasury securities narrowed further. In contrast, conditions in the nonresidential construction sector generally remained quite poor, and measures of construction spending excluding energy-related projects stayed on a downward trajectory through July. Vacancy rates continued to rise, property prices fell further, and financing for nonresidential construction projects remained very tight. The nominal book value of businesses inventories continued to fall in July, which contributed to further declines in inventory-to-sales ratios; however, those ratios stayed elevated.

After narrowing to a 10-year low in May, the U.S. international trade deficit widened in June and July, as strong increases in exports were more than offset by sizable rises in imports. The July trade data provided additional evidence that the levels of both exports and imports probably reached their trough in the second quarter. About one-half of the increase in exports of goods and services in July was in exports of automotive products; the other gains were widespread across other major categories of exports. As with exports, the largest increase in imports of goods and services in July was in automotive products, reflecting some recovery in North American motor vehicle production. Imports of consumer goods, capital goods, and industrial supplies also rose markedly. Imports of oil increased more moderately, with the rise wholly reflecting higher prices.

Real gross domestic product (GDP) in the advanced foreign economies contracted more moderately in the second quarter than in the first quarter, with growth resuming in several countries. In Japan, a trade-related rebound in industrial production led to an increase in overall output. Government incentives for motor vehicle purchases contributed to a modest expansion of the German and French economies, but the euro-area economy as a whole contracted slightly as inventory drawdowns weighed on activity. Output also fell in Canada and the United Kingdom. Purchasing managers indexes (PMIs) rose further in the major economies during the intermeeting period, and reached levels consistent with stabilization or moderate expansion of output in the third quarter. Indicators of consumer sentiment continued to increase, but remained well below pre-recession levels, in part because of concerns about

rising unemployment. In most emerging market economies, particularly in Asia, economic activity rebounded in the second quarter; however, output declined again in Mexico. Indicators of activity in the third quarter pointed to a continued expansion of output in most emerging market countries, and PMIs moved into the expansionary range in many of them. International trade in emerging market economies picked up, supported by Chinese demand, while demand from advanced economies still appeared weak.

In the United States, core consumer price inflation remained subdued in July and August, as price increases in housing services moderated and durable goods prices declined. Overall consumer price inflation increased in August, boosted by a sharp upturn in energy prices, particularly those of gasoline. The latest available survey data indicated that gasoline prices edged up further in the first half of September. Consumer food prices were little changed in August. According to the preliminary September release of the Reuters/University of Michigan Surveys of Consumers, median year-ahead inflation expectations decreased modestly in the first half of September, but remained somewhat above the low levels posted at the beginning of the year. Longer-term inflation expectations from this survey stayed in the narrow range that has prevailed over recent years. The producer price index for core intermediate materials rose in August, its third consecutive monthly increase; over those three months, the index retraced about one-third of the decline of the previous eight months. All measures of nominal hourly compensation and wages suggested that labor costs had decelerated markedly this year amid the considerable weakness in labor markets.

Staff Review of the Financial Situation

The decisions by the Federal Open Market Committee (FOMC) at the August meeting to leave the target range for the federal funds rate unchanged and to maintain the maximum sizes of its large-scale asset purchase programs, along with the accompanying statement, were broadly in line with market expectations. The announcement in the statement of the decision to slow the pace of Treasury securities purchases so that the full amount of $300 billion would be completed by the end of October reduced uncertainty about the timing of the end of this program and the ultimate amount of purchases. After the release of the statement, the expected path for the federal funds rate implied by money market futures prices declined modestly. Subsequently, the expected policy path shifted down further, on net, as investors apparently interpreted weak labor market conditions and generally quiescent inflation as consistent with an outlook that would lead the FOMC to maintain low policy rates over the medium term. In addition, investors' uncertainty about the future policy rate path appeared to diminish, which may have also contributed to the lowering of the path implied by futures prices by reducing term premiums. Yields on nominal Treasury securities also decreased since the Committee met in August. A decline in implied volatility on longer-term Treasury yields suggested that some of the drop in yields was due to reduced risk premiums. Inflation compensation based on five-year Treasury inflation-protected securities (TIPS) increased a little, on balance, over the intermeeting period, while five-year inflation compensation five years ahead declined modestly; the decrease in forward inflation compensation partially reversed increases in prior intermeeting periods. Liquidity in the TIPS market reportedly continued to be poor, complicating inferences about investors' expectations of future inflation.

Conditions in short-term funding markets showed modest further improvement over the intermeeting period. Spreads between London interbank offered rates (Libor) and overnight index swaps (OIS) at the one- and three-month maturities returned to near the levels that prevailed before the onset of the financial crisis in August 2007. Longer-term Libor-OIS spreads also narrowed, but they remained high by historical standards. Reports continued to suggest that lending institutions were unusually selective about their counterparties in funding markets. Spreads on A2/P2-rated commercial paper and AA-rated asset-backed commercial paper were little changed, on net, remaining at the low end of their ranges over the past two years. Indicators of Treasury market functioning showed no material change, and functioning continued to be somewhat impaired. Bid-asked spreads held roughly steady, and trading volumes remained low. The on-the-run liquidity premium for the 10-year Treasury note was little changed at an elevated level, although it was well below its peak last fall; the premiums on two- and five-year Treasury securities stayed low.

Amid lower interest rates as well as further indications that the contraction in economic activity may have ended, broad stock price indexes rose, on net, over the intermeeting period. The spread between an estimate of the expected real equity return over the next 10 years for S&P 500 firms and an estimate of the real 10-year Treasury yield—a rough gauge of the equity risk premium—remained high by historical standards. After having dropped significantly in prior months, option-

implied volatility on the S&P 500 index declined modestly, on balance, over the intermeeting period, but was still at a level comparable with that of previous recessions. Yields on corporate bonds fell a bit more than those on Treasury securities of similar duration. Indicators suggested that liquidity in the secondary market for corporate bonds increased a bit further. Conditions in the secondary market for leveraged syndicated loans continued to improve slowly, as secondary-market prices rose slightly and bid-asked spreads narrowed.

Changes in investor sentiment toward claims on financial firms were mixed over the intermeeting period. Equity prices for larger banks increased, but stock prices for regional and smaller banks were little changed. Market participants reportedly took note of the increased number of failures at regional and smaller banks and remained concerned about the credit quality of such banks' loan portfolios and their ability to raise capital. Credit default swap spreads for banking institutions changed little, on net, over the intermeeting period. A number of financial institutions issued debt that was not guaranteed by the Federal Deposit Insurance Corporation.

The level of debt of the private domestic nonfinancial sector declined again in the second quarter, as both household and nonfinancial business debt fell. Consumer credit posted its sixth consecutive monthly decline in July; both revolving and nonrevolving credit showed sizable drops. While issuance of consumer credit asset-backed securities decreased in August, a large volume of securities eligible for the Term Asset-Backed Securities Loan Facility was issued in early September. Gross bond issuance by nonfinancial corporations rose in August following a lull in July; the rebound was particularly robust for speculative-grade firms. However, commercial paper outstanding was unchanged and bank loans fell again; as a result, borrowing by the nonfinancial business sector declined, on net, again in August. In contrast, the federal government continued to issue debt at a rapid pace, and gross issuance of state and local government debt was robust, supported in part by issuance of Build America Bonds authorized under the fiscal stimulus program.

Commercial bank credit contracted further in August; all major loan categories declined. Commercial and industrial (C&I) lending again decreased steeply amid reported broad-based paydowns of outstanding loans. At the same time, the latest Survey of Terms of Business Lending showed that C&I loan spreads over comparable-maturity market instruments rose noticeably in recent months. The contraction of commercial real estate loans held by banks also intensified in August. Even though originations of residential mortgages apparently increased during August, banks sold an unusually large volume of loans to the government-sponsored enterprises; consequently, banks' balance sheet holdings of residential mortgages decreased markedly.

After declining in July, M2 contracted more quickly in August. The reduced demand for M2 assets likely reflected low interest rates on retail deposits and money market mutual fund shares, as well as a continued reallocation of wealth toward riskier assets. Small time deposits and retail money market mutual funds fell more sharply in August than earlier in the year. Liquid deposits increased in August, but at a slower rate than in July. Currency expanded less rapidly in July and August than in the first half of the year, as demand from abroad evidently was restrained.

Global financial markets showed some further signs of stabilization over the intermeeting period. Stock indexes in Europe rose solidly, apparently reflecting an improved economic outlook, but the Japanese stock market declined modestly. In emerging markets, credit default swap spreads on sovereign debt declined slightly, and equity prices in most countries rose moderately; however, stock prices fell notably in China, partly driven by reports that authorities were taking actions to moderate loan growth. Despite fairly positive economic indicators, sovereign yields fell in major industrial economies, reportedly in part because of the reiteration by major central banks of their intention to keep policy interest rates low. On a trade-weighted basis, the dollar depreciated against major foreign currencies, notably against the euro and Japanese yen; it was little changed, on average, against the currencies of the other major trading partners of the United States.

The European Central Bank, the Bank of England, the Bank of Canada, and the Bank of Japan kept their respective policy rates constant over the intermeeting period. On the first day of the FOMC meeting, the Bank of Canada announced the expiration of two temporary liquidity facilities at the end of October 2009.

Staff Economic Outlook

In the forecast prepared for the September FOMC meeting, the staff raised its projection for real GDP growth over the second half of 2009 and over 2010. The information received during the intermeeting period appeared to indicate a more noticeable upturn than anticipated at the time of the August meeting: Sales

and starts of single-family homes provided evidence of some firming in housing activity, capital spending indicators pointed to an earlier-than-anticipated trough for investment in E&S, and some data suggested a modest recovery in consumer spending. These tentative signs of a recovery of economic activity were supported by other factors, including recent rises in house and equity prices that would support household net worth, declines in interest rates on corporate bonds and fixed-rate mortgages, and a stronger outlook for activity in foreign economies. The staff expected that these positive factors would lead to a modest increase in final sales in the second half of 2009, despite continued weakness in commercial construction and some further deterioration in labor markets. As a result of the expected increase in final sales and an anticipated reduction in inventory liquidation, the staff projected that real GDP would increase in the second half of 2009 at a rate somewhat above the growth rate of potential output. For 2010, the staff forecast that output growth would continue to strengthen, supported by an ongoing improvement in financial conditions, a fading of the drag from earlier declines in income and wealth, accommodative monetary and fiscal policy, and recovery in the housing sector. These factors also contributed to an expected further increase in real GDP growth in 2011, despite an anticipated decline in the impetus from fiscal policy. Even though the upward revision to the projection for output was expected to generate larger gains in employment than previously forecast, the staff still projected only a slow improvement in labor markets, with the unemployment rate moving down to about 9¼ percent by the end of 2010 and then falling to about 8 percent by the end of 2011.

The staff forecast for inflation was little changed from that at the August meeting. The recent data on consumer price inflation were a little above staff expectations, but still indicated a slower increase in core prices compared with those of earlier in the year. Survey measures of inflation expectations displayed no significant change. Nonetheless, with the significant underutilization of resources expected to persist through 2011, the staff forecast core inflation to slow somewhat further over the next two years from the pace of the first half of 2009. Because of recent increases in energy prices, overall consumer price inflation was projected to be somewhat above core inflation in the second half of 2009 and 2010, but it was expected to be near the core rate in 2011.

Participants' Views on Current Conditions and the Economic Outlook

In their discussion of the economic situation and outlook, meeting participants agreed that the incoming data and information received from business contacts suggested that economic activity had picked up following its severe downturn; most thought an economic recovery was under way. Many participants noted that since August, they had revised up their projections for the second half of 2009 and for subsequent years. A number of factors were expected to support growth over the next few quarters: Activity in the housing sector was evidently rising, and house prices had apparently stabilized or even increased; consumer spending seemed to be in the process of leveling out; reports from business contacts and regional surveys were consistent with firms making progress in bringing inventories into better alignment with sales and with production stabilizing or beginning to rise in many sectors; the outlook for growth abroad had also improved, auguring well for U.S. exports; and financial market conditions had continued to improve over the past several months. Despite these positive factors, many participants noted that the economic recovery was likely to be quite restrained. Credit from banks remained difficult to obtain and costly for many borrowers; these conditions were expected to improve only gradually. In light of recent experience, consumers were likely to be cautious in spending, and business contacts indicated that their firms would also be cautious in hiring and investing even as demand for their products picked up. Some of the recent gains in activity probably reflected government policy support, and participants expressed considerable uncertainty about the likely strength of the upturn once those supports were withdrawn or their effects waned. Overall, the economy was projected to expand over the remainder of 2009 and during 2010, but at a pace that was unlikely to reduce the unemployment rate appreciably. Subsequently, as the housing market picked up further and financial conditions improved, economic growth was expected to strengthen, leading to more-substantial increases in resource utilization over time.

Nonetheless, most participants anticipated that slack in both labor and product markets would be substantial over the next few years, leading to subdued and potentially declining wage and price inflation. Some participants were skeptical of the usefulness of measures of resource utilization in gauging inflation pressures, partly because of the difficulty of measuring slack, especially in real time. Also, those participants noted that the

degree to which slack reduces inflation depends on the stability of longer-term inflation expectations, which in turn depends on expectations for monetary policy. In any case, all participants recognized that inflation expectations are a key determinant of inflation, and that various measures of inflation expectations, although imperfect, needed to be carefully monitored in the current environment. Participants discussed the extent to which the size of the Federal Reserve's balance sheet would affect inflation expectations going forward. To keep inflation expectations well anchored, all agreed on the importance of the Federal Reserve continuing to communicate that it has the tools and willingness to begin withdrawing monetary policy accommodation at the appropriate time and pace to prevent any persistent increase in inflation. Overall, many participants viewed the risks to their inflation outlook over the next few quarters as being roughly balanced. A few continued to see some risk of substantial further disinflation, but that risk had eased somewhat further over the intermeeting period. Over a longer horizon, a few felt the risks were tilted to the upside.

Developments in financial markets were again regarded as broadly positive; participants saw the cumulative improvement in market functioning and pricing since the spring as substantial. Over the intermeeting period, the strengthening in the economic outlook led to an increase in investors' appetite for riskier assets. Markets for corporate debt continued to improve, private credit spreads narrowed further, and equity prices rose. Given the improved economic prospects, the decline in longer-term Treasury yields and the apparent marking down of the implied path for the policy interest rate were seen as somewhat puzzling but supportive of recovery. Some participants saw the decline in yields on Treasury securities and other instruments as an indication that the expansion of excess reserve balances was putting downward pressure on market rates; some others viewed the configuration of rate movements as consistent with reduced concerns about inflation and with lower term premiums in a more settled economic environment. In any event, the ongoing improvement in broader financial and economic conditions seemed to some participants to reflect the onset of a positive feedback loop in which better financial conditions contribute to stronger growth in output and employment, which in turn bolsters expected returns and strengthens financial firms, leading to a further easing in financial conditions. Others noted, however, that many financial markets and institutions were still strained and that downside financial risks remained. In particular, because the improvement in financial markets was due, in part, to support from various government programs, market functioning might deteriorate as those programs wind down. Moreover, credit remained quite tight for many businesses and households dependent on banks, and many regional and small banks were vulnerable to the deteriorating performance of commercial real estate loans. Participants noted that all categories of bank lending continued to decline.

Participants emphasized that labor market conditions remained weak. Although recent data indicated that the pace at which employment was declining had slowed, job losses remained sizable and the unemployment rate was high. The unusually large fraction of those who were working part time for economic reasons, the unusually low level of the average workweek, and indications from business contacts that firms would be slow to hire additional staff as sales and production turn up all pointed to a period of modest job gains, and thus only a slow decline in the unemployment rate as the economic recovery proceeds. Significant cost cutting by firms was thought to have led to a sizable increase in productivity growth in the first half of the year; sustained outsized gains in productivity could further damp hiring. Finally, high levels of long-term unemployment and permanent separations could lead to losses of skills and greater needs for labor reallocation that could slow employment growth.

Consumer spending had picked up more than expected over the intermeeting period, but participants saw that increase as partly reflecting special factors like the cash-for-clunkers program. Recent increases in house prices and equity prices were positives, but participants generally expected no more than moderate growth in consumer spending over the near term. Households still faced considerable headwinds, including tight credit, high levels of debt, uncertain job prospects, and wealth levels that remained relatively low despite the recent rise in equity prices and stabilization in house prices. In that environment, households' saving behavior remained an important source of uncertainty in the outlook. The household saving rate had risen considerably in recent quarters, and the most likely outcome was for the saving rate to remain near its higher level; however, some participants noted that there was some chance that the sharp drop in household net worth over the past few years, reduced access to credit, and high household debt burdens could lead households to save a substantially larger fraction of their incomes going forward.

Firms appeared to be reducing inventories and fixed investment at a slower pace than earlier in the year and had made substantial progress in reducing stocks toward desired levels. With inventories low, firms were beginning to raise production to meet at least a portion of new demand; this adjustment was likely to make an important contribution to economic recovery in the second half of this year. Recent data on new orders and shipments pointed to an earlier bottoming out in equipment and investment spending than previously anticipated. Some participants reported that while business contacts had expressed relief that the most severe economic outcomes had been avoided, they remained cautious about the recovery. This caution, together with low utilization rates and substantial excess capacity, could hold back the rate of increase of new capital spending.

In the residential real estate sector, home sales and construction had increased from very low levels, and house prices appeared to be stabilizing. Participants welcomed the cumulating evidence that the housing sector was beginning to recover, and many participants had marked up their forecasts for housing activity. However, some viewed the improvement as quite tentative, pointing to the pending termination of the temporary tax credit for first-time homebuyers and the winding down of the Federal Reserve's agency MBS purchase program as potential risks to the outlook for the sector. Also, some participants questioned whether the recent stabilization in house prices would be sustained as likely further increases in foreclosures would probably put downward pressure on prices. Still, a better outlook for house prices was an important input to the improved economic outlook; not only would household wealth benefit from a turnaround in such prices, but the exposure of lenders to real estate losses would be diminished. In contrast to developments in the residential sector, commercial real estate activity continued to fall markedly in most districts, reflecting deteriorating fundamentals, including declining occupancy and rental rates and very tight credit conditions.

Participants marked up their outlook for foreign economies, mainly reflecting better-than-expected incoming data from a range of countries. The pickup in foreign economic activity, especially in Asia, had buoyed U.S. export growth, and several participants noted that higher growth abroad would support growth in U.S. exports going forward.

Committee Policy Action

In their discussion of monetary policy for the period ahead, Committee members agreed that no significant changes to its policy target rate or large-scale asset purchase programs were warranted at this meeting. Although the economic outlook had improved further in recent weeks and the risks to the forecast had become more balanced, the level of economic activity was likely to be quite weak and resource utilization low. With substantial resource slack likely to persist and longer-term inflation expectations stable, the Committee anticipated that inflation would remain subdued for some time. Under these circumstances, the Committee judged that the costs of growth turning out to be weaker than anticipated could be relatively high. Accordingly, the Committee agreed that it was appropriate to maintain its target range for the federal funds rate at 0 to ¼ percent and to reiterate its view that economic conditions were likely to warrant an exceptionally low level of the federal funds rate for an extended period. With respect to the large-scale asset purchase programs, some members thought that an increase in the maximum amount of the Committee's purchases of agency MBS could help to reduce economic slack more quickly than in the baseline outlook. Another member believed that the recent improvement in the economic outlook could warrant a reduction in the Committee's maximum purchases. However, all members were able to support an indication by the Committee of its intention at this time to purchase the full $1.25 trillion of agency MBS that it had previously established as the maximum for this program. With respect to agency debt, the Committee agreed to reiterate its intention to purchase up to $200 billion of these securities. To promote a smooth transition in markets as these programs are concluded, members decided to gradually slow the pace of both its agency MBS and agency debt purchases and to extend their completion through the end of the first quarter of 2010. The Committee agreed that it would continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets. Members discussed the importance of maintaining flexibility to expand the asset purchase programs should the economic outlook deteriorate or to scale back the programs should economic and financial conditions improve more than anticipated.

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 ex-

ecute transactions in the System Account in accordance with the following domestic policy directive:

> "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee seeks conditions in reserve markets consistent with federal funds trading in a range from 0 to ¼ percent. The Committee directs the Desk to purchase agency debt, agency MBS, and longer-term Treasury securities during the intermeeting period with the aim of providing support to private credit markets and economic activity. The timing and pace of these purchases should depend on conditions in the markets for such securities and on a broader assessment of private credit market conditions. The Desk is expected to complete purchases of about $300 billion of longer-term Treasury securities by the end of October. It is also expected to execute purchases of up to $200 billion in housing-related agency debt and about $1.25 trillion of agency MBS by the end of the first quarter of 2010. The Desk is expected to gradually slow the pace of these purchases as they near completion. The Committee anticipates that outright purchases of securities will cause the size of the Federal Reserve's balance sheet to expand significantly in coming months. The System Open Market Account Manager and the Secretary will keep the Committee informed of ongoing developments regarding the System's balance sheet that could affect the attainment over time of the Committee's objectives of maximum employment and price stability."

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

> "Information received since the Federal Open Market Committee met in August suggests that economic activity has picked up following its severe downturn. Conditions in financial markets have improved further, and activity in the housing sector has increased. Household spending seems to be stabilizing, but remains constrained by ongoing job losses, sluggish income growth, lower housing wealth, and tight credit. Businesses are still cutting back on fixed investment and staffing, though at a slower pace; they continue to make progress in bringing inventory stocks into better alignment with sales. Although economic activity is likely to remain weak for a time, the Committee anticipates that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will support a strengthening of economic growth and a gradual return to higher levels of resource utilization in a context of price stability.
>
> With substantial resource slack likely to continue to dampen cost pressures and with longer-term inflation expectations stable, the Committee expects that inflation will remain subdued for some time.
>
> In these circumstances, the Federal Reserve will continue to employ a wide range of tools to promote economic recovery and to preserve price stability. The Committee will maintain the target range for the federal funds rate at 0 to ¼ percent and continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period. To provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve will purchase a total of $1.25 trillion of agency mortgage-backed securities and up to $200 billion of agency debt. The Committee will gradually slow the pace of these purchases in order to promote a smooth transition in markets and anticipates that they will be executed by the end of the first quarter of 2010. As previously announced, the Federal Reserve's purchases of $300 billion of Treasury securities will be completed by the end of October 2009. The Committee will continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets. The Federal Reserve is monitoring the size and composition of its balance sheet and will make adjustments to its credit and liquidity programs as warranted."

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

Voting against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday-Wednesday, November 3-4, 2009. The meeting adjourned at 12:35 p.m. on September 23, 2009.

Notation Votes

By notation vote completed on August 28, 2009, the Committee unanimously approved the designation of Matthew M. Luecke as the Committee's Chief Freedom of Information Act Officer, with authority to subdelegate duties as appropriate.

By notation vote completed on September 1, 2009, the Committee unanimously approved the minutes of the FOMC meeting held on August 11-12, 2009.

Brian F. Madigan
Secretary