

Minutes of the Federal Open Market Committee August 10, 2010

A joint meeting of the Federal Open Market Committee and the Board of Governors of the Federal Reserve System was held in the offices of the Board of Governors in Washington, D.C., on Tuesday, August 10, 2010, at 8:00 a.m.

PRESENT:

Ben Bernanke, Chairman
William C. Dudley, Vice Chairman
James Bullard
Elizabeth Duke
Thomas M. Hoenig
Donald L. Kohn
Sandra Pianalto
Eric Rosengren
Daniel K. Tarullo
Kevin Warsh

Christine Cumming, Charles L. Evans, Richard W. Fisher, Narayana Kocherlakota, and Charles I. Plosser, Alternate Members of the Federal Open Market Committee

Jeffrey M. Lacker, Dennis P. Lockhart, and Janet L. Yellen, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, respectively

William B. English, Secretary and Economist
Matthew M. Luecke, Assistant Secretary
David W. Skidmore, Assistant Secretary
Michelle A. Smith, Assistant Secretary
Thomas C. Baxter, Deputy General Counsel
Richard M. Ashton, Assistant General Counsel
Nathan Sheets, Economist

James A. Clouse, Thomas A. Connors, Steven B. Kamin, Lawrence Slifman, Mark S. Sniderman, and David W. Wilcox, Associate Economists

Brian Sack, Manager, System Open Market Account

Jennifer J. Johnson, Secretary of the Board, Office of the Secretary, Board of Governors

Patrick M. Parkinson, Director, Division of Bank Supervision and Regulation, Board of Governors

Robert deV. Frierson, Deputy Secretary, Office of the Secretary, Board of Governors

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

William Nelson, Deputy Director, Division of Monetary Affairs, Board of Governors

Linda Robertson, Assistant to the Board, Office of Board Members, Board of Governors

Seth B. Carpenter, Senior Associate Director, Division of Monetary Affairs, Board of Governors; David Reifschneider and William Wascher, Senior Associate Directors, Division of Research and Statistics, Board of Governors

Stephen A. Meyer, Senior Adviser, Division of Monetary Affairs, Board of Governors; Stephen D. Oliner, Senior Adviser, Division of Research and Statistics, Board of Governors

Brian J. Gross, Special Assistant to the Board, Office of Board Members, Board of Governors

Eric M. Engen, Assistant Director, Division of Research and Statistics, Board of Governors

David H. Small, Project Manager, Division of Monetary Affairs, Board of Governors

John C. Driscoll and Jennifer E. Roush, Senior Economists, Division of Monetary Affairs, Board of Governors

Penelope A. Beattie, Assistant to the Secretary, Office of the Secretary, Board of Governors

Kimberley E. Braun, Records Project Manager, Division of Monetary Affairs, Board of Governors

Randall A. Williams, Records Management Analyst,
Division of Monetary Affairs, Board of Gov-
ernors

David Sapenero, First Vice President, Federal Re-
serve Bank of St. Louis

Loretta J. Mester and Robert H. Rasche, Executive
Vice Presidents, Federal Reserve Banks of
Philadelphia and St. Louis, respectively

David Altig, Ron Feldman, Craig S. Hakkio, Glenn
D. Rudebusch, Daniel G. Sullivan, and Geoff
Tootell, Senior Vice Presidents, Federal Re-
serve Banks of Atlanta, Minneapolis, Kansas
City, San Francisco, Chicago, and Boston, re-
spectively

Linda Goldberg, Vice President, Federal Reserve
Bank of New York

Annamarie S. Rowe-Straker, Assistant Vice Presi-
dent, Federal Reserve Bank of New York

Pia Orrenius, Research Officer, Federal Reserve
Bank of Dallas

Robert L. Hetzel, Senior Economist, Federal Re-
serve Bank of Richmond

Developments in Financial Markets and the Fed- eral Reserve's Balance Sheet

The Manager of the System Open Market Account (SOMA) reported on developments in domestic and foreign financial markets during the period since the Committee met on June 22–23, 2010. He also reported on System open market operations during the intermeeting period, noting that the Desk at the Federal Reserve Bank of New York had engaged in coupon swap transactions in agency mortgage-backed securities (MBS) to substantially reduce the number of the Committee's earlier agency MBS purchases that remained to be settled. In addition, the Manager briefed the Committee on the System's progress in developing tools for possible future reserve draining operations. The Federal Reserve successfully conducted two more small-value auctions of term deposits to confirm operational readiness for such auctions at the Federal Reserve and at the depository institutions that chose to participate. The Manager noted that the staff was de-

veloping plans for additional small-value tests of the Term Deposit Facility. In early August, the Federal Reserve successfully executed a few small-value term reverse repurchase operations, including the first the Federal Reserve conducted using agency MBS as collateral, to ensure operational readiness for such transactions at the Federal Reserve, the clearing banks, and the primary dealers. There were no open market operations in foreign currencies for the System's account over the intermeeting period. By unanimous vote, the Committee ratified the Desk's transactions over the intermeeting period.

The Manager also noted the staff's projection that, if mortgage rates were to remain near their levels at the time of the meeting, repayments of principal on the agency MBS held in the SOMA likely would reduce the face value of those holdings by roughly \$340 billion from August 2010 through the end of 2011. The level of repayments would be expected to increase further if mortgage rates were to decline from those levels. In addition, about \$55 billion of agency debt held in the SOMA portfolio would mature over the same time frame.

Staff Review of the Economic Situation

The information reviewed at the August 10 meeting indicated that the pace of the economic recovery slowed in recent months and that inflation remained subdued. In addition, revised data for 2007 through 2009 from the Bureau of Economic Analysis showed that the recent recession was deeper than previously thought, and, as a result, the level of real gross domestic product (GDP) at the end of 2009 was noticeably lower than estimated earlier. Private employment increased slowly in June and July, and industrial production was little changed in June after a large increase in May. Consumer spending continued to rise at a modest rate in June, and business outlays for equipment and software moved up further. However, housing activity dropped back, and nonresidential construction remained weak. Additionally, the trade deficit widened sharply in May. A further decline in energy prices and unchanged prices for core goods and services led to a fall in headline consumer prices in June.

Private nonfarm employment expanded slowly in recent months. The average monthly gain in private payroll employment during the three months ending in July was small, considerably less than the average increase over the preceding three months. However, average weekly hours of all employees continued to recover. The net addition of jobs in manufacturing and

related industries, and in nonbusiness services such as health and education, continued to contribute importantly to the net increase in private employment. Employment in construction and financial activities fell further. The unemployment rate moved down in June from its level earlier in the year, and was unchanged in July, as declining civilian employment was accompanied by decreases in labor force participation. Initial claims for unemployment insurance remained at an elevated level over the intermeeting period.

Industrial production was little changed in June after three months of strong increases. The output of utilities was boosted by unseasonably hot weather while manufacturing production declined. The drop in manufacturing output included a reduction in motor vehicle assemblies, but they were scheduled to increase noticeably in July. The June decrease in factory output also reflected weaker production in industries producing non-automotive consumer goods and construction and business supplies. The output of high-technology items and other business equipment continued to rise. Capacity utilization in manufacturing in June stood well above its mid-2009 low, but it was still substantially short of its longer-run average.

Revised data indicated that consumer spending fell more sharply in 2008 and in the first half of 2009, and subsequently recovered more slowly, than previously estimated. Real personal consumption expenditures (PCE) rose gradually during the second quarter. Sales of light motor vehicles continued to move up, on balance, with the level of sales in July slightly higher than the second-quarter average. Real disposable personal income increased at a noticeably stronger pace than spending in recent months, and the personal saving rate moved up further from the upwardly revised level reported in the revisions to the national income and product accounts. Indicators of household net worth—such as stock prices and house prices—were little changed, on net, over the intermeeting period. Consumer confidence fell back in July, with households expressing greater concern about their personal finances and the outlook for the recovery.

The housing market, which had been supported earlier in the year by activity associated with the homebuyer tax credits, was quite soft for a second consecutive month in June. Sales of new single-family homes rebounded some in June after their sharp drop in May, but they remained at a depressed level. Sales of existing homes fell for a second month in June, and the index of pending home sales suggested another decline in

July. Starts of new single-family houses, which had dropped steeply in May, edged down in June to the lowest level since the spring of 2009. The low number of new permits issued in June appeared to signal that little improvement in new homebuilding was likely in July. House prices were largely stable, on balance, in recent months. The interest rate on 30-year fixed-rate conforming mortgages fell further during July, reaching a record low for the 39-year history of the series.

Real business spending on equipment and software rose strongly again in the second quarter, with increases widespread across the categories of spending. New orders for nondefense capital goods excluding aircraft remained on a solid uptrend, although their three-month change for the period ending in June was less rapid than earlier in the year. Survey indicators of business conditions and sentiment softened in July but remained consistent with further gains in production and capital spending in the near term. Business investment in nonresidential structures turned up in the second quarter, with spending boosted by the rise in outlays for drilling and mining structures. The decline in spending for other types of nonresidential buildings appeared to be slowing, and there were a few signs that financial conditions in commercial real estate markets, though still difficult, were stabilizing. In the second quarter, businesses appeared to add to inventories at a faster rate. However, ratios of inventories to sales for most industries did not point to any sizable overhangs.

Inflation remained subdued in recent months. Headline consumer prices declined in May and June because of sizable drops in consumer energy prices. At the same time, the core PCE price index moved up only slightly, and the year-over-year increase in the index in June was lower than earlier in the year. In recent months, prices of core consumer goods continued to decline while prices of non-energy services rose moderately. At earlier stages of production, producer prices of core intermediate materials fell back in June; in contrast, most indexes of spot commodity prices moved up during July. Inflation compensation based on Treasury inflation-protected securities moved down further over the intermeeting period, partly in response to softer-than-expected data on economic activity, but survey measures of short- and long-term inflation expectations were largely stable.

Nominal hourly labor compensation—as measured by compensation per hour in the nonfarm business sector and the employment cost index—rose modestly during the year ending in the second quarter. Average hourly

earnings of all employees rose slowly over the 12 months ending in July. Output per hour in the non-farm business sector declined in the second quarter after rising rapidly in the preceding three quarters. On net, unit labor costs remained well below their level one year earlier.

The U.S. international trade deficit widened sharply in May, as a significant increase in exports was more than offset by a surge in imports. The corresponding decline in real net exports made a significant negative contribution to U.S. GDP growth in the second quarter. The increase in exports was broadly based, with particular strength in exports of capital equipment. Imports of capital goods also were strong, as were imports of consumer goods and automotive products. In contrast, imports of petroleum products fell in May, held back by both lower prices and reduced volumes.

Available data suggested that aggregate GDP growth in foreign economies remained strong in the second quarter. Recent indicators of economic activity for the euro area showed little imprint of the fiscal stresses that emerged in the spring. Industrial production continued to grow in May, with particularly solid gains in Germany and France, and purchasing managers indexes and economic sentiment turned up in July. In Japan, exports continued to support economic growth, even as indicators of household spending remained weak. Machinery orders declined in May, however, and industrial production moved down in June, suggesting some deceleration in economic activity. In the emerging market economies (EMEs), incoming data generally pointed to a moderation of economic growth, albeit to a still-solid pace, with a notable slowing in China in the second quarter. In other EMEs, purchasing managers indexes generally still pointed to expansions in manufacturing activity, though industrial production in many countries began to decelerate. In contrast, Mexican indicators suggested that economic activity rebounded in the second quarter after contracting in the first quarter. Headline inflation rates generally declined abroad, reflecting prior declines in oil and other commodity prices.

Staff Review of the Financial Situation

The decision taken by the Federal Open Market Committee (FOMC) at its June meeting to maintain the 0 to ¼ percent target range for the federal funds rate was about in line with investor expectations and elicited little market reaction; the same was true of the wording of the accompanying statement. Over the intermeeting period, investors appeared to mark down the path for

monetary policy in response to weaker-than-expected economic data releases and Federal Reserve communications that were read as suggesting that policymakers' concerns about the economic outlook had increased.

Reflecting the same factors, yields on nominal Treasury coupon securities fell noticeably on net. Treasury auctions were generally well received, with bid-to-cover ratios mostly exceeding historical averages. Yields on investment- and speculative-grade corporate bonds decreased, and their spreads relative to yields on comparable-maturity Treasury securities declined moderately. Secondary-market bid prices on syndicated leveraged loans rose a bit, while bid-asked spreads in that market edged down.

Conditions in short-term funding markets improved somewhat over the intermeeting period. Spreads of term London interbank offered rates (Libor) over rates on overnight index swaps moved down at most horizons, and liquidity in term funding markets reportedly increased. Spreads on unsecured commercial paper were little changed. In secured funding markets, spreads on asset-backed commercial paper moved down, while rates and haircuts on collateral for repurchase agreements involving Treasury and agency collateral held steady.

Broad U.S. equity price indexes increased slightly, on net, as generally positive corporate earnings news and an easing of investors' worries about the potential effects of fiscal strains in Europe were partly offset by concerns about the strength of the economic recovery. Most firms in the S&P 500 reported second-quarter earnings that exceeded analysts' forecasts. Option-implied volatility on the S&P 500 index declined but remained somewhat elevated by historical standards. The spread between the staff's estimate of the expected real return on equities over the next 10 years and an estimate of the expected real return on a 10-year Treasury note—a rough measure of the equity risk premium—was little changed at an elevated level. Financial stock prices moved about in line with broader indexes, and credit default swap spreads for large financial institutions narrowed moderately.

Gross bond issuance by U.S. investment-grade nonfinancial corporations rebounded in July from relatively subdued levels in May and June. Nonfinancial commercial paper outstanding also increased. Issuance of syndicated leveraged loans rose in the second quarter, but terms on such deals reportedly tightened somewhat. Measures of the credit quality of nonfinancial

firms remained solid. Gross equity issuance was moderate in June and July.

Prices of commercial real estate appeared to have increased in the second quarter, though the number of transactions was small. Nonetheless, commercial real estate markets remained under pressure. Delinquency rates for securitized commercial mortgages continued to rise in June, and commercial mortgage debt was estimated to have contracted by a sizable amount again in the second quarter. However, investor demand for high-quality commercial mortgage-backed securities (CMBS) reportedly was robust, although issuance of CMBS remained muted.

Consumer credit contracted again in the second quarter, as revolving credit continued to decline and nonrevolving credit edged down. Issuance of consumer asset-backed securities slowed a bit in July, reflecting, in part, typical seasonal patterns. Consumer credit quality continued to show improvement. Delinquency and charge-off rates for most types of consumer loans moved down in recent months, although these rates remained elevated. Spreads of credit card interest rates over those on Treasury securities stayed elevated in May, while interest rate spreads on auto loans remained near their average level over the past decade.

Commercial banks' core loans—the sum of commercial and industrial (C&I), real estate, and consumer loans—continued to contract in June and July. However, the recent runoff in core loans was appreciably smaller than the declines posted earlier in the year, reflecting a more modest contraction in C&I loans. The July Senior Loan Officer Opinion Survey on Bank Lending Practices showed, for the second straight quarter, that a small net fraction of respondents had eased standards for C&I loans over the previous three months. Commercial real estate loans continued to decline steeply in June and July, and residential real estate loans also decreased. Consumer loans at commercial banks were about flat, on balance, as reductions in credit card loans about offset an increase in nonrevolving consumer loans. Securities holdings by banks increased substantially in recent weeks.

M2 was little changed in July after expanding slightly in the second quarter. Its subdued growth in recent months likely reflected a continued unwinding of earlier safe-haven flows as well as the very low rates of return on some components of M2, particularly small time deposits and retail money market mutual funds.

In foreign exchange markets, the value of the dollar declined on balance over the intermeeting period, likely reflecting some reversal of flight-to-safety flows, better-than-expected European economic data, and the softer economic outlook for the United States. The release of the results of the European Union stress-test exercise, including data on European banks' exposures to sovereign debt, appeared to ease concerns about the potential for severe financial dislocations in Europe. Investors also seemed to take comfort from several oversubscribed auctions of government debt by Spain, Portugal, Ireland, and Greece. Accordingly, risk spreads on these governments' bonds, though elevated, generally declined, and European banks' access to dollar funding improved somewhat. The lack of any disruption to market functioning following the expiration, on July 1, of the European Central Bank's first one-year refinancing operation also supported investor sentiment. Market indicators of expectations for future overnight rates in the euro area shifted up during the period. No changes were made to policy interest rates in the euro area, the United Kingdom, or Japan. The Bank of Canada tightened policy a step further during the period, raising its target for the overnight rate 25 basis points to $\frac{3}{4}$ percent.

Notwithstanding the improved investor sentiment toward Europe, data releases pointing to lower-than-expected growth in economic activity in the United States and China may have weighed on global sovereign bond yields, which declined on net in Canada, Germany, the United Kingdom, and Japan. Equity prices, while up in Europe over the intermeeting period, were little changed in Canada and down in Japan. By contrast, share prices rose in emerging markets and flows into emerging market equity funds continued to be strong. The central banks of a number of EMEs, including Brazil, Chile, India, Malaysia, South Korea, Taiwan, and Thailand, increased policy interest rates.

Staff Economic Outlook

In the economic forecast prepared for the August FOMC meeting, the staff lowered its projection for the increase in real economic activity during the second half of 2010 but continued to anticipate a moderate strengthening of the expansion in 2011. The softer tone of incoming economic data suggested that the pace of the expansion would be slower over the near term than previously projected. Financial conditions, however, became somewhat more supportive of economic growth. Interest rates on Treasury securities, corporate bonds, and mortgages moved down further over the intermeeting period; the dollar reversed its

April to June appreciation; and equity prices edged higher. Over the medium term, the recovery in economic activity was expected to receive support from accommodative monetary policy, further improvement in financial conditions, and greater household and business confidence. Over the forecast period, the increase in real GDP was projected to be sufficient to slowly reduce economic slack, although resource slack was still anticipated to remain quite elevated at the end of 2011.

Overall inflation was projected to remain subdued over the next year and a half. The staff's forecasts for headline and core inflation in 2010 were revised up slightly in response to the higher prices of oil and other commodities and the depreciation of the dollar. Even so, the wide margin of economic slack was projected to contribute to some slowing in core inflation in 2011, though the extent of that slowing would be tempered by stable inflation expectations.

Participants' Views on Current Conditions and the Economic Outlook

In their discussion of the economic situation and outlook, meeting participants generally characterized the economic information received during the intermeeting period as indicating a slowing in the pace of recovery in output and employment in recent months. Real GDP growth was noticeably weaker in the second quarter of 2010 than most had anticipated, and monthly data suggested that the pace of recovery remained sluggish going into the third quarter. Private payrolls and consumer spending had risen less than expected. Business spending on equipment and software had increased strongly but reportedly was concentrated in replacements and upgrades that had been postponed during the economic downturn. Investment in nonresidential structures continued to be weak. Housing starts and sales remained at depressed levels, falling back after the expiration of the temporary homebuyer tax credits. The incoming data suggested that economic growth abroad had been somewhat stronger than anticipated and remained solid, boosting U.S. exports and supporting a pickup in U.S. manufacturing output and employment, though a surprising surge in imports in the second quarter widened the U.S. trade deficit. Conditions in financial markets had become somewhat more supportive of growth over the intermeeting period, in part reflecting perceptions of diminished risk of financial dislocations in Europe: Medium- and longer-term interest rates had fallen, some risk spreads had narrowed, and the decline in equity prices that had occurred in the months before the Committee's June

meeting had been partly reversed. Moreover, participants saw some indications that credit conditions for households and smaller businesses were beginning to improve, albeit gradually. Thus, while they saw growth as likely to be more modest in the near term, participants continued to anticipate that growth would pick up in 2011.

Revised national income and product account data showed that the contraction in aggregate output during the recent recession had been larger than previously reported. In particular, consumer spending had contracted more over the course of 2008 and the first half of 2009, and recovered less rapidly, than previously estimated, even as households' after-tax incomes had increased more than shown by the earlier data. In combination, these revisions indicated that the personal saving rate had been higher and had risen somewhat more during the past three years than previously thought. Participants recognized that the implications of these new data for the outlook were unclear. On the one hand, the revised data might indicate that households have made greater progress in repairing their balance sheets than had been realized, potentially allowing stronger growth in consumer spending as the recovery proceeds. On the other hand, the revised data might signify that households are seeking to raise their net worth more substantially than previously understood, or to build greater precautionary balances in what they perceive to be a more uncertain economic environment, with the result that growth in consumer spending could remain restrained for some time.

Many participants noted that the protracted downturn in house prices and in residential investment seemed to have ended, although ups and downs in housing starts and home sales associated with the temporary tax credit for homebuyers made it difficult to be certain. A few commented that home sales and prices appeared to be edging up in their Districts. While recognizing that the housing sector likely had bottomed out, participants observed that large inventories of vacant and unsold homes, along with continuing foreclosures that would increase the number of houses for sale, likely would continue to damp residential construction, indicating that a sustained upturn from very low levels was not imminent.

Business investment in equipment and software had grown at a robust pace, but growth in new orders for nondefense capital goods, though volatile from month to month, appeared to have stepped down. Many participants noted that capital investment was heavily con-

centrated in replacement investment and upgrades that firms had postponed during the economic downturn. A number of participants reported that business contacts again indicated that their uncertainty about the fiscal and regulatory environment made them reluctant to expand capacity. Other participants cited business surveys and reports from business contacts indicating that slow growth in sales and uncertainty about the strength and durability of the recovery likely were more important factors. Except in the extractive industries (drilling and mining), investment in nonresidential structures had continued to decline. The near-term outlook for commercial real estate investment remained weak despite a decline in vacancy rates in some markets.

Participants agreed that credit conditions did not appear to be an important restraint on investment spending by larger firms that have access to the capital markets. Such firms were able to borrow readily and at relatively low rates; moreover, many businesses held substantial cash balances. In addition, survey results suggested that a sizable fraction of banks had eased loan terms, and a few had eased lending standards, on C&I loans. Some participants observed that small businesses continued to find credit hard to obtain. However, several participants noted recent survey evidence indicating that most small firms that requested credit were able to borrow, and that relatively few small firms thought that access to credit was their most important problem. Standards for commercial real estate loans and residential mortgages remained very tight, and banks did not appear to be easing standards on such loans. Some limited easing of lending standards was noted for consumer loans, but credit availability remained a constraint and consumer credit continued to contract. However, several participants noted that with credit quality improving, some bankers were more actively seeking loan growth, though the same bankers also indicated that the demand for loans remained weak.

Many participants noted that European countries' efforts to address their fiscal imbalances, and the release of the results of the stress test of European banks along with information about their exposures to sovereign debt, had reduced investor concern about downside risks in Europe. These factors appeared to have supported improvements in financial markets both here and abroad. Moreover, growth in Europe and Asia apparently remained solid, boosting U.S. exports. Nonetheless, a continuation of strong foreign growth would require a pickup in private demand abroad to

offset a decline in policy stimulus and a smaller boost from inventory investment. Several participants noted that the same shift in the sources of demand would need to take place in the United States: Waning fiscal stimulus on the part of the federal government and continuing retrenchment in spending by state and local governments would weigh on the economic recovery, and recent data raised questions as to whether private demand would strengthen enough to increase resource utilization.

The incoming data on the labor market were weaker than meeting participants had anticipated. Private-sector payrolls grew sluggishly in recent months. The unemployment rate declined a bit, but that reflected a decrease in labor force participation rather than an increase in employment. Policymakers discussed a variety of factors that appeared to be contributing to the slow pace of job growth. A number of participants reported that business contacts again indicated that uncertainty about future taxes, regulations, and health-care costs made them reluctant to expand their workforces. Instead, businesses had continued to meet growth in demand for their products largely through productivity gains and by increasing existing employees' hours. Several participants suggested that structural factors such as mismatches between unemployed workers' skills and the needs of employers with job openings, or unemployed workers' inability to move to a new locale, were contributing to the elevated level and long average duration of unemployment. Other participants, while agreeing that such factors could restrain job growth and contribute to high rates of unemployment, noted that employment was lower than a year earlier and that job openings were only slightly above their lowest level in 10 years, indicating that few firms saw a need to add employees. Most participants viewed weak demand for firms' outputs as the primary problem; they saw substantial scope for stronger aggregate demand for goods and services to spur employment in a wide range of industries.

Weighing the available information, participants again expected the recovery to continue and to gather strength in 2011. Nonetheless, most saw the incoming data as indicating that the economy was operating farther below its potential than they had thought, that the pace of recovery had slowed in recent months, and that growth would be more modest during the second half of 2010 than they had anticipated at the time of the Committee's June meeting. Some policymakers whose forecasts for growth had been in the low end of the range of participants' earlier projections viewed the

recent data as consistent with their earlier forecasts for a weak recovery. A few participants, observing that month-to-month data releases are noisy and subject to revision, did not see the recent data as clearly indicating a change in the outlook. Many policymakers judged that downside risks to the U.S. recovery had become somewhat larger; a few saw the incoming data as suggesting a greater risk that private demand for goods and services might not grow enough to offset waning fiscal stimulus and a smaller impetus from inventory restocking. In contrast, most saw a reduced risk of financial turmoil in Europe and attendant spillovers to U.S. financial markets.

Policymakers generally saw the inflation outlook as little changed. They observed that a range of measures continued to indicate subdued underlying inflation and that growth in wages and compensation remained quite moderate. Many said they expected underlying inflation to stay, for some time, below levels they judged most consistent with the dual mandate to promote maximum employment and price stability. Participants viewed the risk of deflation as quite small, but a number judged that the risk of further disinflation had increased somewhat despite the stability of longer-run inflation expectations. One noted that survey measures of longer-run inflation expectations had remained positive in Japan throughout that country's bout of deflation. A few saw the continuation of exceptionally accommodative monetary policy in the United States as posing some upside risk to inflation expectations and actual inflation in the medium run.

Committee Policy Action

In their discussion of monetary policy for the period ahead, Committee members agreed that it would be appropriate to maintain the target range of 0 to $\frac{1}{4}$ percent for the federal funds rate. Members still saw the economic expansion continuing, and most believed that inflation was likely to stabilize near recent low readings in coming quarters and then gradually rise toward levels they consider more consistent with the Committee's dual mandate for maximum employment and price stability. Nonetheless, members generally judged that the economic outlook had softened somewhat more than they had anticipated, particularly for the near term, and some saw increased downside risks to the outlook for both growth and inflation. Some members expressed a concern that in this context any further adverse shocks could have disproportionate effects, resulting in a significant slowing in growth going forward. While no member saw an appreciable risk of deflation, some judged that the risk of further near-term disinflation

had increased somewhat. More broadly, members generally saw both employment and inflation as likely to fall short of levels consistent with the dual mandate for longer than had been anticipated.

Against this backdrop, the Committee discussed the implications for financial conditions and the economic outlook of continuing its policy of not reinvesting principal repayments received on MBS or maturing agency debt. The decline in mortgage rates since spring was generating increased mortgage refinancing activity that would accelerate repayments of principal on MBS held in the SOMA. Private investors would have to hold more longer-term securities as the Federal Reserve's holdings ran off, making longer-term interest rates somewhat higher than they would be otherwise. Most members thought that the resulting tightening of financial conditions would be inappropriate, given the economic outlook. However, members noted that the magnitude of the tightening was uncertain, and a few thought that the economic effects of reinvesting principal from agency debt and MBS likely would be quite small. Most members judged, in light of current conditions in the MBS market and the Committee's desire to normalize the composition of the Federal Reserve's portfolio, that it would be better to reinvest in longer-term Treasury securities than in MBS. While reinvesting in Treasury securities was seen as preferable given current market conditions, reinvesting in MBS might become desirable if conditions were to change. A few members worried that reinvesting principal from agency debt and MBS in Treasury securities could send an inappropriate signal to investors about the Committee's readiness to resume large-scale asset purchases. Another member argued that reinvesting repayments of principal from agency debt and MBS, thereby postponing a reduction in the size of the Federal Reserve's balance sheet, was likely to complicate the eventual exit from the period of exceptionally accommodative monetary policy and could have adverse macroeconomic consequences in future years.

All but one member concluded that it would be appropriate to begin reinvesting principal received from agency debt and MBS held in the SOMA by purchasing longer-term Treasury securities in order to keep constant the face value of securities held in the SOMA and thus avoid the upward pressure on longer-term interest rates that might result if those holdings were allowed to decline. Several members emphasized that in addition to continuing to develop and test instruments to facilitate an eventual exit from the period of unusually accommodative monetary policy, the Committee would

need to consider steps it could take to provide additional policy stimulus if the outlook were to weaken appreciably further. Given the softer tone of recent data and the more modest near-term outlook, members agreed that some changes to the statement's characterization of the economic and financial situation were necessary. All members but one judged that it was appropriate to reiterate the expectation that economic conditions—including low levels of resource utilization, subdued inflation trends, and stable inflation expectations—were likely to warrant exceptionally low levels of the federal funds rate for an extended period. One member argued that the recovery was proceeding about as outlined earlier this year and that starting a gradual process of removing policy accommodation fairly soon would better foster the Committee's long-run objectives of maximum employment and price stability.

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

“The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee seeks conditions in reserve markets consistent with federal funds trading in a range from 0 to ¼ percent. The Committee directs the Desk to maintain the total face value of domestic securities held in the System Open Market Account at approximately \$2 trillion by reinvesting principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities. The Committee directs the Desk to engage in dollar roll and coupon swap transactions as necessary to facilitate settlement of the Federal Reserve's agency MBS transactions. The System Open Market Account Manager and the Secretary will keep the Committee informed of ongoing developments regarding the System's balance sheet that could affect the attainment over time of the Committee's objectives of maximum employment and price stability.”

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

“Information received since the Federal Open Market Committee met in June indi-

cates that the pace of recovery in output and employment has slowed in recent months. Household spending is increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising; however, investment in nonresidential structures continues to be weak and employers remain reluctant to add to payrolls. Housing starts remain at a depressed level. Bank lending has continued to contract. Nonetheless, the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, although the pace of economic recovery is likely to be more modest in the near term than had been anticipated.

Measures of underlying inflation have trended lower in recent quarters and, with substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to be subdued for some time.

The Committee will maintain the target range for the federal funds rate at 0 to ¼ percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period.

To help support the economic recovery in a context of price stability, the Committee will keep constant the Federal Reserve's holdings of securities at their current level by reinvesting principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities.¹ The Committee will continue to roll over the Federal Reserve's holdings of Treasury securities as they mature.

The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to promote economic recovery and price stability.

¹ The Open Market Desk will issue a technical note shortly after the statement provid-

ing operational details on how it will carry out these transactions.”

Voting for this action: Ben Bernanke, William C. Dudley, James Bullard, Elizabeth Duke, Donald L. Kohn, Sandra Pianalto, Eric Rosengren, Daniel K. Tarullo, and Kevin Warsh.

Voting against this action: Thomas M. Hoenig.

Mr. Hoenig dissented because he thought it was not appropriate to indicate that economic and financial conditions were “likely to warrant exceptionally low levels of the federal funds rate for an extended period” or to reinvest principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities. Mr. Hoenig felt that the “extended period” expectation could limit the Committee’s flexibility to begin raising rates modestly in a timely fashion, and he believed that the recovery, which had entered its second year and was expected to continue at a moderate pace, did not require support from additional accommodation in monetary policy. Mr. Hoenig

was also concerned that these accommodative policy positions could result in the buildup of future financial imbalances and increase the risks to longer-run macroeconomic and financial stability.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 21, 2010. The meeting adjourned at 1:35 p.m. on August 10, 2010.

Notation Vote

By notation vote completed on July 13, 2010, the Committee unanimously approved the minutes of the FOMC meeting held on June 22–23, 2010.

William B. English
Secretary