FEDERAL RESERVE press release

For Use at 4:30 p.m. July 12, 1985

The Federal Reserve Board and the Federal Open Market Committee today released the attached record of policy actions taken by the Federal Open Market Committee at its meeting on May 21, 1985.

Such records for each meeting of the Committee are made available a few days after the next regularly scheduled meeting and are published in the Federal Reserve Bulletin and the Board's Annual Report. The summary descriptions of economic and financial conditions they contain are based solely on the information that was available to the Committee at the time of the meeting.

Attachment

RECORD OF POLICY ACTIONS OF THE
FEDERAL OPEN MARKET COMMITTEE

Meeting Held on May 21, 1985

Domestic policy directive

The information reviewed at this meeting suggested only a modest pickup in real GNP in the current quarter from the 0.7 percent annual rate of growth reported for the first quarter. Spending by domestic sectors has been relatively well maintained, but a large share of the demand for goods apparently has been met by imports rather than through an expansion of domestic production. Broad measures of prices and wages generally were continuing to rise at rates close to those recorded in 1984.

After declining in March, total retail sales rebounded in April to a level nearly 3/4 percent above the average for the first quarter. Gains were particularly strong at automotive outlets and at food and general merchandise stores. Sales of new domestic automobiles have been running at an annual rate of about 8-1/2 million units since the beginning of April, in line with the strong pace posted in the first quarter and considerably above last year's average. Part of the recent strength in car sales was attributable to below-market financing incentives offered by major manufacturers.

Total private housing starts increased about 14-1/2 percent in March to an annual rate of 1.9 million units and continued at that advanced level in April. Newly issued permits for residential building fell somewhat in April but, at an annual rate of nearly 1.7 million units, remained in the improved range recorded in the first quarter. Sales of new and existing homes improved in March, the latest month for which data were available, as the general decline in mortgage credit costs continued to bolster demand.

The index of industrial production declined 0.2 percent in April, after rising little in the first quarter. Production of defense and space equipment continued to advance, but output in most other major market sectors fell. Reflecting these widespread declines in output, the capacity utilization rate for total industry dropped 1/2 percentage point to 80.6 percent in April, its lowest level since January, 1984.

The decline in industrial production in April was associated with further reductions in manufacturing employment. The loss of 45,000 manufacturing jobs in April brought the cumulative loss in that sector to 130,000 thus far in 1985. Outside of manufacturing, sizable job gains were reported for April in the services industry and in construction. On balance, total nonfarm payroll employment rose 215,000 in April compared with average monthly gains of 285,000 since last fall. The civilian unemployment rate remained at 7.3 percent in April, little changed from the rates recorded over the previous three quarters.

Information on business capital spending suggested that expansion was continuing at a much less rapid rate than earlier in the economic expansion, though trends in business equipment orders placed with domestic producers have been obscured lately by extreme volatility in monthly data for orders of office and computing equipment. Imports apparently have continued to account for a sizable share of outlays for equipment, but shipments of capital goods by domestic producers picked up in February and March. Spending on nonresidential construction has continued at a relatively brisk pace in recent months. Moreover, according to recent surveys of business spending plans, firms still expect to increase nominal outlays for plant and equipment by 8-1/2 to 11 percent in 1985.

The producer price index for finished goods rose 0.3 percent in April, somewhat more than in other recent months. The rise was attributable to a surge in energy prices that apparently reflected a temporary reduction in petroleum inventories; prices of other finished goods changed little or declined. A sharp increase in prices of petroleum products was also the major factor in the 0.4 percent increase in the consumer price index in April. Thus far in 1985 consumer prices had risen at an annual rate of about 4-1/4 percent, close to the 4 percent rate in 1984. On balance, recent wage developments indicated little if any acceleration in wage costs from the pace in 1984. While the index of average hourly earnings increased at an annual rate of 2-1/2 percent in the first four months of this year compared with a rise of about 3 percent in 1984, the increase in hourly compensation in the nonfarm business sector thus far this year was running above its year-earlier pace. The rise in compensation reflected in part legislated changes in social security taxes and higher employers' contributions for unemployment insurance.

Since the Committee's meeting in late March, the trade-weighted value of the dollar against major foreign currencies had continued to fluctuate widely in volatile market conditions and had declined a little more than 4 percent on balance. The U.S. merchandise trade deficit and the current account deficit widened in the first quarter as a rebound in non-oil imports from the low fourth-quarter level extended the pattern of sharp quarter-to-quarter swings experienced since the beginning of 1984.

At its meeting on March 26, 1985, the Committee had adopted a directive that called for maintaining the existing degree of pressure on reserve positions. That action was expected to be consistent with growth in M1, M2, and M3 at annual rates of around 6, 7, and 8 percent respectively during the period from March to June. The members agreed that somewhat lesser restraint might be acceptable in the event of substantially slower growth in the monetary aggregates while somewhat greater restraint might be acceptable in the event of substantially higher growth. In either case, adjustments in the degree of reserve pressures would be considered in the context of appraisals of the strength of the business expansion, progress against inflation, and conditions in domestic credit and foreign exchange markets. The intermeeting range for the federal funds rate was retained at 6 to 10 percent.

Growth in M1, which had slowed markedly in March from the rapid pace of earlier months, remained moderate in April at an annual rate of about 6 percent. M2 and M3, after slowing appreciably in March to annual rates of growth of about 3-3/4 and 5-1/2 percent respectively, were little changed in April. Thus, while expansion in M1 was about in line with the Committee's expectations for the March-to-June period, growth in the broader aggregates was running well below the rates anticipated. Weakness in these aggregates stemmed in large part from a substantial reversal of earlier increases in banks' managed liabilities, as banks obtained funds from a sharp rise in U.S. government deposits after mid-April. Expansion in total domestic nonfinancial debt continued relatively rapid at an annual rate of about 11-3/4 percent in April, the same as in March. For the period from the fourth quarter of 1984 through April, growth in M1 was running above the Committee's range for the year 1985 while M2 and M3 were growing at rates within their long-term ranges; expansion in domestic nonfinancial debt was somewhat above the upper limit of its monitoring range for the year.

The level of adjustment plus seasonal borrowing averaged about $475 million over the three complete reserve maintenance periods between meetings, enlarged by borrowing by some non-federally insured thrift institutions to meet deposit withdrawals. Over the last week or so, total adjustment plus seasonal borrowing was running over $800 million, boosted in part by a further increase in borrowing by thrifts and overnight borrowing by a few large banks faced with unexpected needs for funds.

The federal funds rate had declined from the 8-1/2 percent rate prevailing at the time of the March meeting and had averaged just over 8-1/8 percent in recent weeks. Other market rates had fallen by about 3/4 to 1-1/4 percentage points over the period since the previous Committee meeting until the announcement by the Federal Reserve on May 17 of a reduction in the discount rate from 8 to 7-1/2 percent. On the day before this meeting, when the new discount rate went into effect, the federal funds rate moved lower, with trading averaging around 7-3/4 percent, and most other interest rates fell about 15 to 35 basis points further. The average rate on new commitments for fixed-rate conventional home mortgage loans declined about 30 basis points over the intermeeting period.

The staff projections presented at this meeting suggested that growth in real GNP, after a modest pickup in the current quarter from the reduced pace in the first quarter, would be slightly faster in the second half of the year. The unemployment rate was projected to edge down, and the rate of increase in prices was expected to remain close to that experienced in 1984 and early 1985.

During their review of the economic situation and outlook, Committee members focused with concern on evidence that the economy, despite elements of strength, was expanding at a relatively sluggish pace; and they also stressed the uncertainties that surrounded the prospects for some pickup in the rate of economic growth. The currently mixed pattern of developments greatly complicated the forecasting process, especially against the background of the distortions and pressures associated with massive deficits in the federal budget and the balance of trade, together with persisting strains in financial markets. While acknowledging the considerable risks of unexpected developments in these circumstances, several members commented that improvement in the rate of economic growth remained the most reasonable expectation for the second half of the year. Others gave more weight to the downside risks in the economy and were concerned that the expansion might well remain relatively weak and considerably below the economy's potential.

A number of members expressed particular concern about the depressing impact that the competition of foreign goods was having on domestic production, and some commented that the outlook for the dollar in the exchange markets constituted the major uncertainty in assessing economic prospects. While domestic final demands were being reasonably well maintained, a strong dollar was diverting these demands toward imports, which were growing rapidly, and holding back domestic output. The strength of the dollar was also tending to curb the expansion of exports. Members cited examples of a wide range of manufacturing firms, including small firms, that along with some agricultural and extractive businesses were being severely affected by foreign competition. The exchange value of the dollar also appeared to be curbing expansion in domestic plant and equipment spending and fostering decisions to establish or expand productive facilities abroad rather than in the United States.

Members who were relatively optimistic about the economic outlook stressed the favorable impact that recent declines in interest rates were likely to have on interest-sensitive sectors of the economy. Housing had already responded to earlier reductions in interest rates. Consumer spending was holding up well, with automobile sales continuing to display notable strength, and consumer sentiment remained favorable. Some members commented that the negative impact of growing imports might diminish over the quarters ahead, especially if the dollar fell further from its recent highs. Reference was also made to continuing indications that businesses were planning further, if more moderate, increases in their investment spending. One member expressed the view that rapid growth in M1 during late 1984 and early 1985 would exert an expansive influence on the economy over the months ahead.

Members who felt less comfortable with economic developments referred to the vulnerability of the manufacturing sector and also agriculture to the high value of the dollar on exchange markets. Moreover, business and consumer confidence could be adversely affected by ongoing problems in financial sectors of the economy. Other potential areas of vulnerability in the economy included nonresidential construction and multifamily housing; as they had at previous meetings, members cited instances of apparent overbuilding of office structures and of multifamily dwellings in various parts of the country. In addition, problems in agriculture and related industries might worsen, with retarding consequences for overall economic activity.

With regard to the outlook for inflation, members commented on the highly competitive pricing situation in many industries, and reference was also made to favorable developments in recent labor negotiations. In general, price pressures appeared to be relatively well contained in goods-producing sectors of the economy. Most commodity prices had fallen further to their lowest levels in about 2 years. At the same time, significant increases in prices and costs were continuing to occur in the service industries. Given the relatively low rates of capacity utilization and the outlook for only limited growth in economic activity, members indicated that the risks of an acceleration in the rate of inflation appeared to be low. Some members noted their concern, however, that current inflation rates were too high -- with recent tendencies in consumer prices worrisome -- especially in light of the inflationary implications of a possible decline over time in the foreign exchange value of the dollar.

At its meeting in February the Committee had agreed on policy objectives that called for monetary growth ranges for the period from the fourth quarter of 1984 to the fourth quarter of 1985 of 4 to 7 percent for M1, 6 to 9 percent for M2, and 6 to 9-1/2 percent for M3. The associated range for total domestic nonfinancial debt was set at 9 to 12 percent for 1985. In keeping with the usual procedures under the Humphrey-Hawkins Act, these ranges would be reviewed at the July meeting and provisional ranges would be established for 1986.

In discussing policy implementation for the weeks ahead, Committee members taking account of the recent reduction in the discount rate generally favored maintaining about the same degree of pressure on bank reserve positions as in recent weeks, abstracting from special situation borrowing by thrift institutions. It was recognized that the recent decline in market rates and the lower discount rate would tend to increase the demands for money and credit under those circumstances as compared with what they otherwise would be. Most members found this acceptable particularly in view of the recent weakness in the broader monetary aggregates and sluggishness in the overall economy.

In the course of discussion it was noted that M1 had been growing about as expected at the previous meeting, but that some pickup in growth could develop in the period ahead. A number of members indicated that they were prepared to accept a little more rapid expansion against the background of relatively weak economic performance, strains in financial markets, and the recent behavior of the broader aggregates. It was also pointed out that much of the increase in M1 thus far this year reflected expansion in interest-bearing checking accounts. Banks and thrifts had reduced interest rates on these accounts only slowly in response to declines in market yields that had begun in the latter part of last year, thereby making it relatively more attractive for the public to hold savings in such instruments. Nonetheless, M1 was running above the path associated with its long-run target and some members stressed the desirability of holding down near-term M1 growth, partly because a rate of growth that appeared unduly high could risk having an adverse impact on inflationary sentiment. However, one member also questioned whether the behavior of M1 should be interpreted as in the past given the present institutional environment and taking account of such other factors as the very high level of the dollar in foreign exchange markets.

Given the strength of M1 relative to its long-run target for the year, members indicated that they were prepared to accept slower growth in M2 and M3 for the quarter than they had expected earlier. One member observed, however, that continued weakness in the broader aggregates would be a matter of some concern and that somewhat faster growth than was now expected for the quarter should not be resisted. A differing view emphasized that the broader aggregates had less information content than M1 and that some aberration in their behavior should be tolerated. Another member highlighted the desirability of a decline in long-term interest rates over time, but felt that further monetary ease at this point might work against that objective by fostering inflationary expectations.

In keeping with the Committee's usual practice, the members contemplated that operations might be adjusted during the intermeeting period toward implementing somewhat lesser or somewhat greater restraint on reserve positions if monetary growth should appear to be substantially slower or faster than was currently expected for the quarter. While no member wanted to rule out possible adjustments in either direction, a majority believed that policy implementation should be alert to the potential need for some easing of reserve conditions. Other members, however, put more stress on the desirability of moving promptly, if necessary, to curb unduly rapid monetary expansion. It was understood that any adjustment should not be made automatically in response to the behavior of the monetary aggregates, but should be undertaken only after an appraisal of the strength of economic activity and inflationary pressures and evaluations of conditions in domestic and international financial markets.

In light of recent declines in market interest rates and the reduction in the discount rate, it appeared likely that the degree of reserve restraint contemplated by most of the Committee members would be associated with a lower federal funds rate, on average, than had prevailed until just before today's meeting. Nonetheless, the members anticipated that the rate would remain well within the 6 to 10 percent federal funds range established earlier by the Committee, and no sentiment in favor of changing that range was expressed.

At the conclusion of the Committee's discussion, a majority of the members indicated their acceptance of a directive that, against the background of the recent reduction in the discount rate, called for maintaining the current degree of reserve restraint, abstracting from special situation borrowing by thrift institutions. The members expected such an approach to policy implementation to be consistent with growth of M1 at an annual rate of about 6 percent or a little higher for the period from March to June. Given the weakness in M2 and M3 in April, growth in these broader aggregates over the 3-month period was now expected to be slower than had been anticipated at the time of the previous meeting. The members agreed that somewhat lesser restraint on reserve conditions would be acceptable in the context of substantially slower growth in the monetary aggregates, while somewhat greater restraint might be appropriate if monetary growth were substantially faster. It was understood that the need for lesser or greater restraint would be considered against the background of developments relating to the strength of the business expansion, inflationary pressures, and conditions in domestic credit and foreign exchange markets. The members agreed that the intermeeting range for the federal funds rate, which provides a mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, should be left unchanged at 6 to 10 percent.

At the conclusion of the meeting, the following domestic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests only a modest pickup in real GNP in the current quarter from the reduced rate of growth in the first quarter. Total retail sales rose in April to a level somewhat above the average for the first quarter, and housing starts increased further after rising substantially in the first quarter. Information on business capital spending suggests further growth, though at a much less rapid pace than earlier in the economic expansion. Industrial production declined slightly in April after rising little over the first quarter. Total nonfarm payroll employment increased at a somewhat reduced pace in April with employment in manufacturing registering another decline. The civilian unemployment rate remained at 7.3 percent in April. Broad measures of prices and wages appear to be rising at rates close to those recorded in 1984.
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> Since the Committee's meeting in late March, the trade-weighted value of the dollar against major foreign currencies has continued to fluctuate widely in often volatile market conditions and has declined moderately on balance. The trade and current account deficits widened in the first quarter as a rebound in non-oil imports from their low fourth-quarter level extended the pattern of sharp quarter-to-quarter swings experienced since the beginning of 1984.
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> Growth in M1 slowed markedly in March from the rapid pace of earlier months and remained moderate in April. The broader aggregates showed little change in April after their growth had slowed appreciably in March. Expansion in total domestic nonfinancial debt has remained relatively rapid. Interest rates have declined considerably since the March meeting of the Committee. On May 17, the Federal Reserve Board approved a reduction in the discount rate from 8 to 7-1/2 percent.

The Federal Open Market Committee seeks to foster monetary and financial conditions that will help to reduce inflation further, promote growth in output on a sustainable basis, and contribute to an improved pattern of international transactions. In furtherance of these objectives the Committee agreed at its meeting in February to establish ranges for monetary growth of 4 to 7 percent for M1, 6 to 9 percent for M2, and 6 to 9-1/2 percent for M3 for the period from the fourth quarter of 1984 to the fourth quarter of 1985. The associated range for total domestic nonfinancial debt was set at 9 to 12 percent for the year 1985. The Committee agreed that growth in the monetary aggregates in the upper part of their ranges for 1985 may be appropriate, depending on developments with respect to velocity and provided that inflationary pressures remain subdued.

The Committee understood that policy implementation would require continuing appraisal of the relationships not only among the various measures of money and credit but also between those aggregates and nominal GNP, including evaluation of conditions in domestic credit and foreign exchange markets.

In the implementation of policy for the immediate future, and against the background of the recent reduction in the discount rate, the Committee seeks to maintain about the same degree of pressure on bank reserve positions. This action is expected to be consistent with growth in M1 at an annual rate of around 6 percent or a little higher during the period from March to June, while M2 and M3, in the light of their weakness in April, are expected to grow more slowly over the quarter than the 7 and 8 percent annual rates, respectively, anticipated earlier. Somewhat lesser reserve restraint would be acceptable in the event of substantially slower growth of the monetary aggregates while somewhat greater restraint might be acceptable in the event of substantially higher growth. In either case such a change would be considered in the context of appraisals of the strength of the business expansion, progress against inflation, and conditions in domestic credit and foreign exchange markets. The

Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that pursuit of the monetary objectives and related reserve paths during the period before the next meeting is likely to be associated with a federal funds rate persistently outside a range of 6 to 10 percent.

Votes for this action: Messrs. Volcker, Corrigan, Balles, Forrestal, Gramley, Keehn, Martin, Partee, Rice, Ms. Seger, and Mr. Wallich. Vote against this action: Mr. Black.

Mr. Black dissented because he preferred to direct policy implementation in the weeks immediately ahead toward achieving somewhat slower expansion in M1. In his view, bringing M1 growth more promptly within the Committee's range for the year would help guard against a possible worsening of inflationary expectations and would limit the risk of a potentially unsettling movement in interest rates later in the year.