FEDERAL RESERVE press release

For Use at 4:30 p.m. November 7, 1986

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 September 23, 1986.

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

Held on September 23, 1986

Domestic policy directive

The information reviewed at this meeting suggested a moderate pickup in economic growth from the slow pace in the second quarter. Payroll employment expanded further in August with gains widespread by industry. Consumer spending has continued to increase at a relatively rapid pace, and construction of single-family homes has remained at a high level. Business capital spending, however, has been sluggish, particularly for new structures. Wages rates have continued to increase slowly in recent months, while producer and consumer prices have tended to firm reflecting developments in food and energy markets.

Total nonfarm payroll employment continued to expand in August, rising about 1/4 million further after adjusting for strike activity, somewhat faster than the average gain so far this year. Hiring at service establishments accounted for two-thirds of the increase, but construction employment also was up substantially, and manufacturing employment rose for the first time since January. The civilian unemployment rate edged down again in August to 6.8 percent, nearly 1/2 percentage point below the second-quarter average.

After declining on balance over the first half of the year, industrial production has picked up recently. According to revised data, output was flat in June and rose 0.3 percent in July, rather than declining in both months as previously reported. In August industrial production edged up 0.1 percent.

Gains in output in July and August were particularly large for defense and space equipment. Production of business equipment, consumer goods, and construction supplies also registered strong increases. Capacity utilization in manufacturing, mining, and utilities fell 0.1 percentage point in August to 79 percent, about the same as the rate in the preceding three months but 1.6 percentage points below a year ago.

Retail sales rose 0.8 percent in August, after a July increase of 0.3 percent. Sales in the automotive group strengthened noticeably in response to incentive plans offered at the end of the month by domestic auto producers. Total car sales rose to an annual rate of 12.2 million units in August, compared with 10.9 million units in July. In the early part of September, sales of domestically produced autos soared to an annual rate of 17 million units. Outlays for durable goods other than autos, which were strong earlier in the year, dropped back in August, but sales at general merchandisers posted another large gain.

Residential construction activity remained relatively high through the summer. Housing starts totaled 1.8 million units at an annual rate in July and August. Single-family starts remained close to the vigorous pace of the first half of the year, while multifamily starts were appreciably below their average level in that period. In July sales of new homes dropped below the extraordinary levels recorded earlier in the year, but sales of existing homes remained at about the advanced pace of the second quarter.

Business capital spending has remained sluggish, reflecting continued weakness in nonresidential construction. Although the contraction in oil and gas-well drilling appears to be subsiding, the downtrend in commercial and industrial building has continued partly because of high vacancy rates and the impact of the tax reform legislation. The value of nonresidential construction put-in-place fell in July for the fifth time in six months. Business outlays for equipment, however, have expanded somewhat in recent months; shipments of nondefense capital goods in August were 1-1/4 percent above the second-quarter average. New orders fell in August, partially reversing gains in the previous two months, largely because orders for aircraft and parts dropped. Bookings for office and computing equipment, however, have rebounded from their level earlier this year.

Wage rates have continued to rise moderately over the past few months, while producer and consumer prices have firmed somewhat on balance due to developments in food and energy markets. Prices other than those for food and energy, however, have risen at about the same pace as earlier in the year. In August, the producer price index advanced 0.3 percent, after changing little on balance over the previous three months and declining sharply earlier in the year. The consumer price index increased 0.2 percent in August. The index had risen on balance in other recent months after falling somewhat during the first four months of the year. In the commodity markets, spot prices for precious metals rose sharply during August, reflecting supply disruptions and, perhaps, renewed inflationary expectations. The latter appeared to be associated in part with oil price developments and the lower foreign exchange value of the dollar. Lumber prices also rose significantly during August.

The trade-weighted value of the dollar against major foreign currencies had changed very little on balance since the August 19 meeting of the Committee, although it fluctuated over a fairly wide range. Exchange rates appeared to be affected mainly by news about prospects for economic activity in the United States and abroad. Germany and Japan did not follow the Federal Reserve's reduction in the discount rate, and short-term interest rates abroad were little changed while money market rates in the United States were somewhat lower. At the same time, long-term rates in the United States moved up sharply relative to comparable foreign interest rates. Preliminary data for the U.S. merchandise trade deficit in July indicated a substantially larger deficit than on average in the first half of the year as non-oil imports surged. Real economic growth appeared to have picked up on balance in the foreign industrial countries during the second quarter after a weak performance in the first quarter.

At its meeting in August, the Committee adopted a directive that called for decreasing slightly the existing degree of pressure on reserve positions, taking account of the possibility of a change in the discount rate. The members expected such an approach to policy to be consistent with growth in M2 and M3 over the period from June to September at annual rates of about 7 to 9 percent. Over the same period growth in M1 was expected to moderate from the rapid pace during the second quarter. The Committee agreed that it would continue to evaluate growth of M1 in light of the expansion of the broader aggregates and other factors. The members also decided that somewhat greater or lesser reserve restraint might be acceptable depending on the behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The intermeeting range for the federal funds rate was maintained at 4 to 8 percent.

The discount rate was reduced by 1/2 percentage point shortly after the August meeting. In the two complete reserve maintenance periods ending after the meeting, adjustment plus seasonal borrowing at the discount window averaged close to $460 million, somewhat higher than in the previous intermeeting period. In the first week of the current maintenance period, borrowing dropped back to around $280 million.

Growth in the broader monetary aggregates slowed in August; M2 and M3 grew at annual rates of about 10-3/4 percent and 8-1/2 percent, respectively. In August, both aggregates were close to the upper limits of their longer-run ranges. In contrast to the broader aggregates, growth in M1 accelerated, but it appeared to have slowed considerably in the early weeks of September.

Federal funds generally have traded around 5-7/8 percent since the reduction in the discount rate shortly after the August 19 meeting of the Committee. Other short-term interest rates fell about 30 basis points following the discount rate cut. Longer-term bond yields changed little immediately after the discount rate action but have increased noticeably in recent weeks, with rates on Treasury securities rising as much as 60 basis points. The recent behavior of long-term rates apparently has reflected, at least in part, some concerns by market participants about whether inflationary pressures could develop in the context of some strengthening in economic activity, the declining dollar, firmer oil prices, and rapid monetary growth in the United States and abroad.

The staff projections presented at this meeting suggested that growth in real GNP likely would pick up a bit further in coming months. Growth was forecast to continue at a moderate pace in 1987. Through 1987, the key element supporting expansion in domestic production was a projected improvement in the U.S. trade position. Growth in domestic spending was forecast to slow over the next several quarters. The staff outlook for inflation indicated a limited increase from the current pace due to some firming in world oil prices and the effects of the dollar's depreciation. The civilian unemployment rate was expected to decline slightly over the projection horizon.

In the Committee's discussion of the economic situation and outlook, the members expressed general agreement with the staff projection that moderate growth through the forecast horizon was the most likely outcome. However, the outlook remained subject to substantial uncertainties relating to both domestic and international factors. On the favorable side, consumer spending and construction of single-family housing remained elements of strength in the domestic economy, and members reported that business sentiment appeared to have improved recently in several, but not all, parts of the country. One member noted that reduced personal income taxes could help to sustain consumer expenditures next year. Another commented that the emergence of apparently more stable conditions in agriculture and energy would tend to remove the retarding influences that those key sectors had been exerting on overall economic activity. On the negative side, the demand for automobiles undoubtedly would weaken after the currently attractive incentive programs expired, and the apparent overbuilding of multifamily housing in many areas would tend to restrain overall residential construction. Business fixed investment was not expected to provide much, if any, impetus to the expansion despite indications of improvement recently in the demand for equipment. Adverse factors bearing on the investment outlook included the current oversupply of office buildings and other commercial facilities in many parts of the country and the negative effects of the tax reform legislation on investment incentives that many businessmen were reporting. The outlook for fiscal policy remained uncertain; several members noted that some of the proposed measures for reducing the deficit in 1987 did not deal with underlying imbalances and that the prospects beyond 1987 were especially unclear. However, one member observed that a reduction in government borrowing, if achieved, would tend to have a favorable impact on financial markets and thus on the economy generally.

On balance, while a few members supported the view that some pickup in domestic demand was a reasonable expectation, most believed that growth in domestic demand would probably taper off over the next several quarters. In their view, therefore, the prospects for sustained economic growth depended on an improvement in the foreign trade balance. The members generally agreed that the substantial depreciation of the dollar against several major foreign currencies provided a basis for anticipating a reduction in the trade deficit in real terms, but the timing of such a reduction still was subject to a great deal of uncertainty. Moreover, several expressed concern that the improvement might well be relatively modest, especially in the absence of stronger economic growth in key industrial nations abroad; and some members also commented on the inertia on both the import and export sides associated with long-term contracts and established marketing relationships. It also was noted that the currencies of a number of developing countries had changed relatively little vis-a-vis the dollar over the past year or so, raising a question as to the speed of adjustment in the trade balance. With regard to currently available information on trade developments, a few members referred to limited indications in reports from firms in their districts that tended to suggest some gains in the international competitive position of U.S. firms and better prospects for greater stability, if not some improvement, in the overall trade balance. However, broadly confirming evidence of such a development had not materialized thus far.

Against the background of the dollar's depreciation, the members agreed that some upward pressure on prices could be expected over the next several quarters, a tendency that would be reinforced if world oil prices continued to rise. Moreover, most commodity prices appeared to have stabilized recently, after declining earlier, while prices of precious metals had increased considerably and these developments along with conditions in financial markets suggested increased concern about the possibility of a pickup in inflation. On the other hand, a number of members observed that wages generally were rising somewhat less this year than in 1985 and some members also commented on the continuing efforts of many business firms to hold down their costs. And while productivity gains had been relatively limited in recent quarters, many labor contracts incorporated provisions on work rules that should help to improve efficiency and moderate pressures on costs.

At its meeting in July the Committee reviewed the basic policy objectives that it had established in February for growth of the monetary and credit aggregates in 1986 and set tentative objectives for expansion in 1987. For the period from the fourth quarter of 1985 to the fourth quarter of 1986, the Committee reaffirmed the ranges established in February for growth of 6 to 9 percent for both M2 and M3. The associated range for expansion in total domestic nonfinancial debt also was reaffirmed at 8 to 11 percent for 1986. With respect to M1, the Committee decided that growth in excess of the 3 to 8 percent range set in February would be acceptable and that such growth would be evaluated in the context of the velocity of M1, the expansion of the broader aggregates, developments in the economy and financial markets, and price pressures. For 1987 the Committee agreed on tentative monetary growth objectives that included a reduction of 1/2 percentage point to a range of 5-1/2 to 8-1/2 percent for both M2 and M3. In the case of M1 the Committee expressed the preliminary view that retention of the 1986 range of 3 to 8 percent, which implied a considerable reduction from the likely rate of growth in 1986, appeared appropriate for 1987 in the light of most historical experience. The Committee also retained the range of 8 to 11 percent for growth of total domestic nonfinancial debt in 1987. It was understood that all the ranges were provisional and that, notably in the case of M1, they would be reviewed in early 1987 against the background of intervening developments.

In the Committee's discussion of policy implementation for the weeks immediately ahead, nearly all the members were in favor of directing open market operations, at least initially, toward maintaining unchanged conditions of reserve availability. Several emphasized that monetary policy had moved toward an increasingly accommodative posture over the course of recent months and that it was now time to pause and observe developments, given the rapid growth in the broad as well as the narrow monetary aggregates, a few indications of more strength in the economy, and some signs of increasing inflationary expectations. One member expressed the view, however, that some tightening of reserve conditions was desirable at this time against the background of recent economic and financial developments, notably the persistence of rapid growth in the monetary aggregates.

In their discussion of policy implementation over the near term, the members took into account an analysis which suggested that if current conditions of reserve availability were maintained and if short-term interest rates did not deviate significantly from their existing levels, the growth of the monetary aggregates could be expected to slow over the months ahead, relative to the very rapid pace over the summer months, even assuming somewhat stronger expansion in economic activity. The most recent behavior of the monetary aggregates lent some weight to such an expectation. However, the anticipated slowing still would result in growth of the broad aggregates around the upper bound of their long-term ranges. Also, the members recognized that the extent of any slowing in monetary growth was subject to perhaps more than the usual uncertainties, reflecting for example questions about the pace of further adjustments in offering rates on various types of interest-bearing deposits as depository institutions continued to respond to earlier declines in short-term market rates. The members also noted that the monetary aggregates might well continue to grow very rapidly if short-term interest rates were to decline appreciably further.

In the course of the discussion, a number of members expressed concern about the potential for the broad monetary aggregates to exceed their longer-term ranges. While recognizing the need to evaluate the aggregates in the context of economic and financial developments more generally, these members emphasized the potential for inflation stemming from the buildup in money balances, and in liquid assets more generally, and these members attached considerable importance to constraining the growth of the broader monetary aggregates to within the Committee's ranges for the year. A slightly different view acknowledged that the Committee's objectives for M2 and M3 appeared to remain appropriate for the year, but in this view actual growth marginally in excess of those ranges should be tolerated -- and the added risks of some future inflation accepted -- if such growth occurred in the context of continuing sluggish economic expansion. One member stressed that if the velocity of money continued to decline, further rapid expansion might indeed be needed to sustain an acceptable rate of economic growth.

Turning to the question of possible adjustments in the degree of reserve pressure during the intermeeting period, the members did not foresee as likely any developments that might call for more than a slight change, if any, in the availability of reserves during the weeks ahead. In this context, however, a number believed that policy implementation should be especially alert to the potential need for some slight firming of reserve conditions, particularly if monetary growth did not slow in line with expectations, though this growth would continue to be viewed in the context of other economic and financial developments. Most of these members did not want to rule out the possibility of some easing in the weeks immediately ahead, but they saw the prospects for such a move as less likely, and two favored a directive that would not contemplate any easing. Other members felt that there should be no presumptions about the likely direction of any intermeeting adjustments, given the many uncertainties that existed about the behavior of the monetary aggregates and about prospective economic and financial developments. The members agreed that the behavior of the dollar on foreign exchange markets could be an important factor influencing any small intermeeting adjustments.

At the conclusion of the Committee's discussion, all but one member indicated that they favored a directive that called for no change in the current degree of pressure on reserve positions. The members expected this approach to policy implementation to be consistent with some reduction in the growth of M2 and M3 to annual rates of 7 to 9 percent over the four-month period from August to December. Over the same interval, growth in M1 was expected to moderate from the exceptionally large increase during the past several months. Because the prospective behavior of M1 remained subject to unusual uncertainty, the Committee again decided not to specify a rate of expected growth for this aggregate in the operational paragraph of the directive but to continue to evaluate M1 in the light of the performance of the broader aggregates and other factors. The members indicated that slightly greater reserve restraint would, or slightly lesser restraint might, be acceptable over the intermeeting period depending on the behavior of the monetary aggregates, taking into account the strength of the business expansion, the performance of the dollar in foreign exchange markets, progress against inflation, and conditions in domestic and international credit 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 4 to 8 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 some pickup in the growth of economic activity from the slow pace in the second quarter. In August total nonfarm payroll employment grew considerably further, with employment in manufacturing rising for the first time since January. The civilian unemployment rate edged down further to 6.8 percent. Industrial production rose slightly in July and August after declining on balance during the first half of the year. Consumer spending has remained relatively strong in recent months, with gains in retail sales in August paced by a sharp rise in auto sales. Housing starts in July and August stayed at a relatively high level. Business capital spending appears to have remained sluggish, reflecting weakness in nonresidential construction. A more moderate rate of wage increases has been sustained in recent months, while broad measures of prices have firmed somewhat due to developments in food and energy markets.
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> The trade-weighted value of the dollar against major foreign currencies is essentially unchanged on balance since the August 19 meeting of the Committee. Preliminary data for the U.S. merchandise trade deficit in July indicate a larger deficit than in previous months.
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> Growth of M2 and especially of M3 moderated in August, but expansion of these two aggregates for the year through August has been at the upper end of their respective ranges established by the Committee for 1986. In August M1 continued to grow very rapidly. Expansion

in total domestic nonfinancial debt remains appreciably above the Committee's monitoring range for 1986. Short-term interest rates have declined further since the August meeting of the Committee while long-term market rates have risen on balance. On August 20, the Federal Reserve Board approved a reduction in the discount rate from 6 to 5-1/2 percent.

The Federal Open Market Committee seeks monetary and financial conditions that will foster reasonable price stability over time, 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 the July meeting to reaffirm the ranges established in February for growth of 6 to 9 percent for both M2 and M3, measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate is subject to substantial uncertainties in relation to economic activity and prices, depending among other things on the responsiveness of M1 growth to changes in interest rates. In light of these uncertainties and of the substantial decline in velocity in the first half of the year, the Committee decided that growth of M1 in excess of the previously established 3 to 8 percent range for 1986 would be acceptable. Acceptable growth of M1 over the remainder of the year will depend on the behavior of velocity, growth in the other monetary aggregates, developments in the economy and financial markets, and price pressures. Given its rapid growth in the early part of the year, the Committee recognized that the increase in total domestic nonfinancial debt in 1986 may exceed its monitoring range of 8 to 11 percent, but felt an increase in that range would provide an inappropriate benchmark for evaluating longer-term trends in that aggregate.

For 1987 the Committee agreed on tentative ranges of monetary growth, measured from the fourth quarter of 1986 to the fourth quarter of 1987, of 5-1/2 to 8-1/2 percent for M2 and M3. While a range of 3 to 8 percent for M1 in 1987 would appear appropriate in the light of most historical experience, the Committee recognized that the exceptional uncertainties surrounding the behavior of M1 velocity over the more recent period would require careful appraisal of the target range at the beginning of 1987. The associated range for growth in total domestic nonfinancial debt was provisionally set at 8 to 11 percent for 1987.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. This action is expected to be consistent with growth in M2 and M3 over the period from August to December at annual rates of 7 to 9 percent. While growth in M1 is expected to moderate from the exceptionally large increase during the past several months, that growth will continue to be judged in the light of the behavior of M2 and M3 and other factors. Slightly greater reserve restaint would, or slightly lesser reserve restraint might, be acceptable depending on the behavior of the aggregates, taking into account the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 4 to 8 percent.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Heller, Mrs. Horn, Messrs. Johnson, Melzer, Morris, Rice, and Ms. Seger. Vote against this action: Mr. Wallich.

Mr. Wallich dissented because he preferred a slight tightening of reserve conditions. He was concerned about the persistence of rapid monetary expansion and the associated potential for inflation. In his view some reduction in the availability of reserves was needed to increase the likelihood of significant slowing in monetary growth over the months ahead.