FEDERAL RESERVE press release

For Use at 4:30 p.m. Arpil 3, 1987

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 February 10-11, 1987.

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 February 10-11, 1987

Domestic policy directive

The information reviewed at this meeting suggested on balance that economic activity was continuing to grow at a moderate pace. Nonfarm payroll employment expanded sharply in January, partly reflecting unusual seasonal developments. Industrial production rose considerably in December and over the fourth quarter as a whole. However, consumer spending in real terms changed little during the last quarter of 1986 and business capital spending generally appears to have remained sluggish. Activity in the housing sector picked up toward year-end. The deficit in the merchandise trade balance apparently increased slightly in the fourth quarter; however, net exports of goods and services, after adjusting for changes in prices, improved somewhat during the quarter. Basic trends in wage and price inflation still appear to have been moderate in recent months, although prices of oil and some other industrial commodities have turned up.

Total nonfarm payroll employment rose almost 1/2 million further in January, after picking up in the latter part of the year. Service-producing industries were responsible for much of this growth. Outside of the service-producing sector, the construction industry accounted for the balance of job growth in January, reflecting favorable weather conditions during the survey reference week. Manufacturing employment was essentially unchanged in January, after some improvement in the fourth quarter. The civilian unemployment rate held at 6.7 percent.

The industrial sector of the economy expanded appreciably in the latter part of the year. The index of industrial production rose 0.5 percent in December and for the fourth quarter as a whole increased at an annual rate of 3-1/4 percent, the largest quarterly advance since late 1984. Recent gains were widespread, with particularly sharp increases in home goods and in defense and space equipment. Production of business equipment, however, remained lackluster. Capacity utilization in manufacturing, mining, and utilities rose 0.2 percentage point in December to 79.6 percent, but was still below its level at the end of 1985.

Consumer spending declined slightly in real terms in the fourth quarter as new car and truck sales slumped. Auto sales revived temporarily in December, when consumers took advantage of sales tax deductions that were to be eliminated after year-end, but fell dramatically in January. Consumer expenditures on items other than autos continued to rise somewhat at the end of 1986 but at a pace considerably slower than that experienced earlier in the year.

Business investment appears to have remained sluggish. On the equipment side, capital outlays were depressed in the fourth quarter by the drop in motor vehicle purchases. However, that drop was almost offset by a pickup in spending on other equipment, which was motivated in part by efforts to take advantage of the favorable depreciation schedules for some types of equipment placed in service before January 1, 1987. Leading indicators of investment spending suggested that overall outlays will remain sluggish in the early months of 1987. New orders for nondefense capital goods other than aircraft dropped in the last quarter of 1986.

Also, outlays for nonresidential construction have continued to trend down in recent months, and the value of construction put-in-place in December was more than 10 percent below a year earlier.

Activity in the housing sector picked up at the end of the year. Housing starts rose to an annual rate of 1.8 million units in December, after drifting lower since late spring. Single-family starts were near the pace recorded earlier in the year. In addition, sales of both new and existing homes rose in December partly in response to lower mortgage interest rates. Multi-family starts rebounded in December, but declined for the fourth quarter as a whole as high vacancy rates and recent tax changes constrained construction of rental housing.

Price and wage increases remained relatively moderate in the latter part of 1986, although the prices of a number of commodities, including oil, have posted large gains in recent months. Consumer prices rose 0.3 percent in November and 0.2 percent in December, remaining within the range of monthly increases evident since last summer. World crude oil prices rose in mid-December following the latest agreement by OPEC to restrict output, and that rise pushed retail energy prices up in December. At the same time, increases in consumer food prices slowed after several months of sharp advances. Consumer prices, apart from food and energy, continued to rise about in line with the pace registered for 1986 as a whole. Wage increases slowed in 1986 from the rates in other recent years.

The trade-weighted value of the dollar against other G-10 currencies declined about 7-3/4 percent, on balance, since the December 15-16 FOMC meeting. Since that meeting, the dollar has depreciated 10 percent against the mark and about 6 percent against the yen. Over the period, exchange rates were affected in part by data on the U.S. trade balance for November. However, the announcement by the German Federal Bank in late January of a cut in the discount rate and the improvement in U.S. trade figures shown when preliminary December data were released, along with indications of a stronger U.S. economy, tended to relieve downward pressures on the dollar, which had rebounded from its lows in late January. Indicators of economic activity in the major foreign industrial countries still showed low rates of expansion. Available data for the U.S. merchandise trade deficit in the fourth quarter suggested a slight increase from the third quarter as nonpetroleum imports increased more than exports. However, after allowing for price changes, net exports of goods and services improved somewhat during the quarter.

At its meeting in December, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions. This action was expected to be consistent with growth in both M2 and M3 at an annual rate of about 7 percent from November to March. The Committee agreed that the growth in M1 would continue to be evaluated in light of the behavior of the broader monetary aggregates and other factors. The members also decided that slightly greater or somewhat lesser reserve restraint would be acceptable depending on the behavior of the monetary 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 intermeeting range for federal funds was maintained at 4 to 8 percent.

Growth of M2 and M3 accelerated in December before slowing a little in January. Expansion of these two aggregates for 1986 as a whole was near the upper end of their respective ranges established by the Committee for the year. M1 growth slowed in January from an exceptionally rapid pace in late 1986. Growth of the monetary aggregates was boosted by an unusually large volume of transactions around year-end prompted in part by incentives to complete certain types of transactions before the new tax law took effect at the start of 1987. As a result of these transactions, demand deposits rose at an unprecedented rate from mid-December through early January; by late January the bulge in such deposits had run off. In addition, banks stepped up their issuance of managed liabilities, especially CDs, over the past two months to help fund the rise in credit.

Paralleling the bulge in transaction balances around year-end, growth in total reserves surged in December, but then subsided during January. Excess reserves also increased rapidly in December. The federal funds rate rose sharply at year-end and adjustment plus seasonal borrowing averaged around $900 million in the statement period ending December 31. Borrowing receded to $290 million in the first half of January but bulged again in the second half, reflecting another rise in excess reserves. The federal funds rate dropped back to 6 percent or a little above after early January.

Most other short-term rates rose around year-end as credit demands intensified and the federal funds market tightened, but subsequently those increases were largely reversed. On balance, rates on short-term Treasury securities were up about 25 basis points over the intermeeting period, while rates on private obligations were narrowly mixed. In long-term markets, yields on Treasury securities also were higher than at the time of the December meeting, reflecting market reactions to incoming economic data, but rates in corporate and mortgage markets declined into more typical alignment with Treasury rates. Stock prices soared to new highs over the intermeeting period.

The staff projections presented at this meeting suggested that real GNP would continue to grow at a moderate rate through the end of 1987. A key element shaping the forecast continued to be the prospects for an improvement in real net exports of goods and services. Export growth was expected to accelerate and import growth to slow as U.S. competitiveness increased. At the same time, the growth in domestic demand was expected to be moderate, primarily reflecting the damping influence of higher import prices on real income gains, a less expansive fiscal policy, and the weakness in nonresidential construction. In contrast, equipment spending was projected to grow moderately as domestic production expanded, and residential construction was expected to provide some stimulus to economic activity over the projection horizon. The rate of inflation was anticipated to rise somewhat as a result of the depreciation of the dollar and a firming in world oil prices. However, the remaining margins of slack in labor and product markets were expected to exert a moderating influence on prices and wages during the year.

In the Committee's discussion of the economic situation and outlook, most of the members viewed recent developments as pointing on balance toward continuing expansion at a moderate pace, in line with that experienced on average over the past two to three years. The members generally agreed that special factors -- the delayed effects of the dollar's depreciation and the turnaround in oil prices -- were likely to contribute to a modest upturn in the rate of inflation during 1987. The members acknowledged that there were appreciable risks that economic activity and prices might deviate significantly from current expectations, especially given the uncertainties stemming from persisting -- though hopefully diminishing -- imbalances in the federal budget and the balance of trade. Financial strains associated with weaknesses in important sectors of the economy such as agriculture and energy and generally rising debt burdens also were cited as sources of vulnerability in the economy.

In keeping with the usual practice at meetings when the Committee considers its long-run objectives for monetary growth, the members of the Committee and the Federal Reserve bank presidents not currently serving as members had prepared specific projections of economic activity, the rate of unemployment, and the overall level of prices. For the period from the fourth quarter of 1986 to the fourth quarter of 1987, the forecasts for growth of real GNP had a central tendency of 2-1/2 to 3 percent and a full range of 2 to 4 percent. Forecasts of nominal GNP centered on growth rates of 5-3/4 to 6-1/2 percent and ranged from 4-1/2 to 7-1/2 percent. Estimates of the civilian rate of unemployment in the fourth quarter of 1987 were in a range of 6-1/2 to 6-3/4 percent. With regard to the rate of inflation, as indexed by the GNP deflator, the projections centered on rates of 3 to 3-1/2 percent and had an overall range of 2-1/2 to 4 percent. In making these forecasts, the members took account of the Committee's objectives for monetary growth in 1987. The members also assumed that future fluctuations in the foreign exchange value of the dollar would not be of sufficient magnitude to have any significant effect on the projections. In addition, the members anticipated that considerable progress would be made in reducing the size of the federal budget deficit.

As they had at previous meetings, members emphasized that sustained economic expansion would depend to an important extent on the achievement of significant improvement in the nation's balance of trade. While indications of some improvement in net exports were multiplying, the members expressed a range of views regarding prospects for the year ahead. On the export side, several observed that the outlook for relatively sluggish economic activity in key industrial nations -- and indeed around the world more generally -- suggested that continuing gains in exports might be relatively limited. Nonetheless, reports from many parts of the country indicated that the depreciation of the dollar and the concomitant improvement in the competitive position of U.S. firms were being reflected in new exporting opportunities, if not in a substantial increase in actual exports to date.

With regard to imports, some members saw considerable potential for the substitution of domestic goods for foreign imports as prices of the latter rose. In this view the more recent depreciation of the dollar would tend to be felt more fully in import prices because foreign suppliers had less room than earlier to absorb a depreciated dollar through reductions in their profit margins. Other members were less optimistic about the outlook for imports. In their view, foreign competitors would tend to hold down their prices to maintain their sales, especially given the ample availability of production resources worldwide. Moreover, the import penetration into U.S. markets had become imbedded in contractual and other trading arrangements that were difficult to change, and competitive gains against imports would be restrained to the extent that domestic producers responded to rising import prices by raising their own prices, as had already occurred in a major U.S. industry. However, as in the case of exports, a growing number of business contacts were reporting increasing opportunities to compete with imports on the basis of price, including examples of actual or prospective sales to domestic firms that previously had tended to look abroad to meet their outsourcing requirements.

With regard to domestic developments bearing on the outlook, several members commented that the evidence of the last few months suggested, on the whole, that the expansion retained momentum despite its comparative longevity. To some extent, the favorable year-end statistics undoubtedly reflected tax-related spending that had been moved up from 1987 into late 1986, and a number of members observed that the recent statistics should therefore be viewed with a degree of caution. Looking ahead, members observed that overall demands from domestic sectors might moderate over the year. They referred in particular to the possibility that growth in consumer spending, which had been a mainstay of the expansion, might provide less stimulus, especially in the context of an already low saving rate. One member noted that the underlying demand for new automobiles appeared to be relatively weak, after allowing for the year-end surge related to tax considerations and for the impact of temporary sales incentive programs. Another commented, however, that reduced withholdings of personal income taxes were seen by some business firms as a positive development for retail sales.

In the Committee's discussion of the prospects for inflation, the members generally agreed that the outlook remained basically favorable even though rising import prices and the apparent turnaround in oil prices could be expected to result in somewhat higher average prices over the next several quarters. Price competition remained intense in many industries, notably those subject to competition from abroad, and recent labor contract settlements continued favorable in terms of holding down business costs. Moreover, many business firms were still making vigorous efforts to improve their operating efficiencies and otherwise to curb costs. Nonetheless, several members suggested that the risks of a deviation, if any, from current inflation forecasts appeared to be in the direction of more inflation. Some referred to the risk that rapid monetary growth and buildup of liquidity might exert a delayed impact on future prices, though there was no current evidence of such an impact. One member expressed the view that a key uncertainty in the outlook for inflation was not so much the direct effects of rising import prices, but the price responses of competing domestic producers. Members also noted that for technical reasons the rise in import and oil prices, to the extent that they occurred, would have a relatively large effect on consumer prices. The latter, because of their high visibility, could exacerbate inflationary expectations, with adverse implications for future price and wage decisions. Disappointing progress toward reducing the federal budget deficit also could tend to fuel inflationary sentiment.

At this meeting the Committee completed the review, begun at the December meeting, of the ranges for growth in the monetary and debt aggregates in 1987; those ranges had been set on a tentative basis in July in keeping with the requirements of the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act). The tentative ranges included growth of 5-1/2 to 8-1/2 percent for both M2 and M3 for the period from the fourth quarter of 1986 to the fourth quarter of 1987. In the case of M1 the Committee had indicated in July on a more tentative basis than usual that it might retain the 1986 range of 3 to 8 percent for 1987, but there had been considerable sentiment against using any numerical range for M1 at the December meeting. The associated range for growth in total domestic nonfinancial debt had been set provisionally in July at 8 to 11 percent for 1987.

During the Committee's discussion of appropriate ranges for growth of M2 and M3 in 1987, most of the members expressed a preference for retaining the tentative range of 5-1/2 to 8-1/2 percent for both of the broader aggregates. That range represented a reduction of 1/2 percentage point from the one that had been targeted for 1986. Several members stressed the importance of some moderation in money growth and the desirability of adopting reduced ranges from the standpoints of both the substance and the perception of an appropriately anti-inflationary monetary policy. Moreover, a substantial slowing in money growth -- perhaps to around the middle of the ranges -- could well be consistent with satisfactory economic performance, given the assessment of the economy by Committee members and assuming considerably less movement in interest rates than had been experienced in recent years. Members also commented that the ranges in question were likely to provide adequate room for any policy adjustments that might be needed during the year, assuming that developments bearing on policy formulation did not diverge greatly from current expectations.

While a range of 5-1/2 to 8-1/2 percent for M2 and M3 was acceptable to all of the members, there was some sentiment for slightly higher or lower ranges. Retention of the slightly higher 6 to 9 percent ranges employed in 1986 would accommodate more comfortably the possibility of another sizable decline in the velocities of the broader aggregates (i.e., the ratios of nominal GNP to the aggregates). Such a decline might be induced if substantial further reductions in interest rates were needed to sustain economic expansion. On the other hand, slightly lower ranges would provide more leeway on the downside in the event that velocity growth rebounded from the previous marked declines. Insofar as the risks were on the side of greater inflation, a rebound in velocity appeared more likely and in such circumstances a lower range could provide needed scope for a policy designed to maintain progress towards price stability.

Turning to M1, the members recognized that its prospective behavior remained subject to exceptional uncertainties. To a greater extent than for the broader aggregates, the demand for M1 balances had become highly sensitive to movements in interest rates over the course of recent years; this development evidently reflected in considerable measure the deregulation of deposit rate ceilings and a related increase in the interest-bearing components of M1 as a repository for savings as well as for transactions funds. Adaptations to deregulation were probably not completed and in conjunction with an accelerated pace of other financial innovations and a surging volume of financial transactions, it had become very difficult to assess or predict the implications of specific rates of M1 growth for the future course of business activity and the rate of inflation.

Accordingly, while most members clearly wished to take account of changes in M1 in reaching policy judgments, they felt the meaning of fluctuations in M1 could only be appraised in the light of other economic developments. Consequently, they did not want to specify a numerical target range for this aggregate, at least at this time. Some slowing in 1987 was expected and was felt to be necessary to sustain progress toward price stability, but the appropriate amount of slowing was difficult to predict, given the uncertainties about velocity behavior. These members felt that it would not be meaningful to establish a range that was so wide that it would cover all foreseeable circumstances or a conventional range that might well need to be exceeded in either direction. For example, relatively slow growth in M1 might be desirable -- and might require some firming of reserve conditions -- if in the context of expanding economic activity, inflation appeared to be worsening, possibly because of a weakening dollar, and the broader monetary aggregates were growing rapidly. Conversely, relatively rapid expansion in M1 might be indicated -- and accommodated -- in a situation where economic activity was relatively sluggish, progress was being maintained toward achieving eventual price stability and a sustainable pattern of international transactions, and interest rates were declining.

A few of the members preferred that a specific, numerical range be established for M1 growth in 1987, although they also wanted to make clear that growth outside the range might be desirable or acceptable under some circumstances. These members gave considerable emphasis to the possible usefulness of targeting on a narrow monetary aggregate, as well as on the broader aggregates, in underscoring the System's longer-run commitment to an anti-inflationary policy. They also felt the Committee might well want to increase emphasis on M1 in the future, and that a current target would represent appropriate continuity. Moreover, a specific range would have the advantage of indicating the Committee's best judgment regarding appropriate M1 growth if economic and financial conditions did not deviate markedly from current expectations. In contrast, one member felt that M1 provided little or no useful information at present and a more predictable relationship between M1 and economic performance was not likely to be reestablished. Consequently, the Committee should concentrate instead on other broad financial aggregates including the measure for liquidity.

After discussion, the members agreed that the Committee would need to monitor and evaluate M1 developments closely in the light of the behavior of its velocity, the performance of the economy, including the nature of emerging price pressures, and conditions in domestic and international financial markets. While the precise circumstances under which M1 developments might directly influence operating decisions could not be predicted, the members contemplated the possible desirability of reintroducing M1 explicitly during the year as a benchmark, along with the broader monetary aggregates, for making short-run operating decisions. For now, the Committee would indicate in broad terms that the operational significance of M1 could only be judged in the perspective of concurrent economic and financial developments, including the behavior of M2 and M3.

The Committee members also agreed on the desirability of continuing to monitor the growth of total domestic nonfinancial debt. The growth in total debt had exceeded the expansion in nominal GNP by substantial margins in recent years, and some members expressed concern about the resulting increase in the financial vulnerability of the economy. One member observed that under some circumstances a further rapid growth in debt might lend some weight toward implementing some policy restraint that also was deemed to be advisable for other reasons. The growth in total domestic nonfinancial debt was expected to moderate considerably in 1987, but it appeared likely to remain in excess of the expansion in nominal GNP. The members agreed that the tentative range of 8 to 11 percent contemplated last July for 1987 continued to encompass likely developments.

At the conclusion of the Committee's discussion, all of the members indicated that they favored, or could accept, the ranges for M2 and M3 and the monitoring range for total debt that had been adopted on a tentative basis in July. No numerical range would be established for M1 growth in 1987, but M1 developments would receive careful evaluation in the context of emerging economic and financial conditions and the behavior of the broader monetary aggregates. It was understood that under some circumstances M1 might again be targeted explicitly during the year to provide a guide, along with M2 and M3, for the short-run implementation of monetary policy.

Thereupon, the Committee approved the following paragraphs relating to its objectives for monetary and debt aggregates in 1987:

> 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 established growth ranges of 5-1/2 to 8-1/2 percent for both M2 and M3, measured from the fourth quarter of 1986 to the fourth quarter of 1987. The associated range for growth in total domestic nonfinancial debt was set at 8 to 11 percent for 1987.
>
> With respect to M1, the Committee recognized that, based on experience, the behavior of that aggregate must be judged in the light of other evidence relating to economic activity and prices; fluctuations in M1 have become much more sensitive in recent years to changes in interest rates, among other factors. During 1987, the Committee anticipates that growth in M1 should slow. However, in the light of its sensitivity to a variety of influences, the Committee decided not to establish a precise target for its growth over the year as a whole at this time. Instead, the appropriateness of changes in M1 during the course of the year will be evaluated in the light of the behavior of its velocity, developments in the economy and financial markets, and the nature of emerging price pressures.
>
> In that connection, the Committee believes that, particularly in the light of the extraordinary expansion of this aggregate in recent years, much slower monetary growth would be appropriate in the context of continuing economic expansion accompanied by signs of intensifying price pressures, perhaps related to significant weakness of the dollar in exchange markets, and relatively strong growth in the broad monetary aggregates. Conversely,

continuing sizable increases in M1 could be accommodated in circumstances characterized by sluggish business activity, maintenance of progress toward underlying price stability, and progress toward international equilibrium. As this implies, the Committee in reaching operational decisions during the year, might target appropriate growth in M1 from time to time in the light of circumstances then prevailing, including the rate of growth of the broader aggregates.

Votes for this action: Messrs. Volcker, Corrigan, Angell, Guffey, Heller, Johnson, Keehn, Melzer, Morris, and Ms. Seger. Votes against this action: None. Absent and not voting: Mrs. Horn. Mr Keehn voted as alternate for Mrs. Horn.

In the Committee's discussion of policy implementation for the weeks immediately ahead, most of the members indicated that they were in favor of directing open market operations, at least initially, toward maintaining the existing degree of pressure on reserve positions. One member preferred to move promptly towards somewhat firmer reserve conditions. A number of others observed that they would be prepared to accept some firming later if recent indications of some strengthening in economic activity were to persist in the context of further rapid monetary expansion and signs of growing inflationary pressures. However, these members felt that the desirability of an immediate move toward restraint had not been established. In particular, they felt that economic and financial developments in the period around the year-end needed to be interpreted with caution, especially because of the tax effects that were probably involved, and that confirming evidence should be awaited before any adjustments in policy implementation were undertaken.

The members anticipated that current conditions in reserve markets were likely to be associated with slower growth in M2 and M3 over the period ahead than the average pace in recent months. To a considerable extent, the anticipated slowing would represent a reversal of special factors that had contributed to faster expansion--including a bulge in M1--around the year-end. Because of the distortions created by year-end developments, the members generally agreed that use of a January base, instead of November as in the previous directive, or December, would convey more meaningful information regarding the Committee's expectations for growth of the broader aggregates through the remainder of the first quarter. Given the uncertainties that were involved and in keeping with the Committee's decision on the longer-run targets, the members accepted a proposal not to indicate a numerical expectation for the growth of M1 over the period immediately ahead, but to note in a general way that the expansion of this aggregate was likely to moderate substantially. Over a longer perspective, the growth of the aggregates, especially M1, might display a moderating trend as the effects of earlier declines in interest rates subsided.

With regard to possible adjustments during the intermeeting period, the members generally felt that policy implementation should be especially alert to the potential need for some firming of reserve conditions. In this view, somewhat greater reserve restraint would be warranted if monetary growth did not slow in line with current expectations and there were concurrent indications of intensifying inflationary pressures against the background of stronger economic data. One indicator of the possibility of potential pressures on prices might be a further tendency for the dollar to weaken. One member preferred a directive that did not contemplate any easing during the weeks ahead, but most of the members did not want to rule out the possibility of some slight easing during the intermeeting period, although they did not view the conditions for such a move as likely to emerge.

At the conclusion of the Committee's discussion, all but one member indicated that they could vote for 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 about 6 to 7 percent over the two-month period from January-to-March. Over the same interval, growth in M1 was expected to moderate substantially from an extraordinarily high rate in the closing months of 1986. The members indicated that somewhat greater reserve restraint would be acceptable, and slightly less reserve 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 on balance that economic activity continues to grow at a moderate pace. Total nonfarm payroll employment grew sharply in January in part reflecting unusual seasonal developments. The civilian unemployment rate remained

at 6.7 percent in January. Industrial production increased considerably in December and over the fourth quarter as a whole. Total retail sales rose substantially in December, largely reflecting a year-end surge in automobile sales, but were little changed on balance in the fourth quarter. Housing starts also strengthened in December after trending lower since late spring. Business capital spending generally appears to have remained sluggish. Available data for the U.S. merchandise trade deficit in the fourth quarter suggest a slight increase from the third quarter; however, after allowing for price changes, net exports of goods and services improved somewhat during the quarter. In late 1986 consumer and producer prices generally were continuing to rise at moderate rates, although prices of crude oil and some other industrial commodities firmed. Labor cost increases were more restrained in 1986 than in other recent years.

Growth of M2 and M3 picked up substantially in December before slowing a little in January. For 1986 as a whole, expansion of these two aggregates was near the upper end of their respective ranges established by the Committee for the year. Growth of M1 slowed in January from an exceptionally rapid pace in late 1986. Expansion in total domestic nonfinancial debt remained appreciably above the Committee's monitoring range for 1986. Although short-term interest rates generally firmed around year-end, on balance interest rates have shown small mixed changes since the December 15-16 meeting of the Committee; rates on Treasury securities, including bonds, have risen a little over the period while rates on most private obligations have declined slightly. In foreign exchange markets the trade-weighted value of the dollar against the other G-10 currencies has declined substantially on balance since the December meeting.

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 established growth ranges of 5-1/2 to 8-1/2 percent for both M2 and M3, measured from the fourth quarter of 1986 to the fourth quarter of 1987. The associated range for growth in total domestic nonfinancial debt was set at 8 to 11 percent for 1987.

With respect to M1, the Committee recognized that, based on experience, the behavior of that aggregate must be judged in the light of other evidence relating to economic activity and prices; fluctuations in M1 have become much more sensitive in recent years to changes in interest rates, among other factors. During 1987, the Committee anticipates that growth in M1 should slow. However, in the light of its sensitivity to a variety of influences, the Committee decided not to establish a precise target for its growth over the year as a whole at this time. Instead, the appropriateness of changes in M1 during the course of the year will be evaluated in the light of the behavior of its velocity, developments in the economy and financial markets, and the nature of emerging price pressures.

In that connection, the Committee believes that, particularly in the light of the extraordinary expansion of this aggregate in recent years, much slower monetary growth would be appropriate in the context of continuing economic expansion accompanied by signs of intensifying price pressures, perhaps related to significant weakness of the dollar in exchange markets, and relatively strong growth in the broad monetary aggregates. Conversely, continuing sizable increases in M1 could be accommodated in circumstances characterized by sluggish business activity, maintenance of progress toward underlying price stability, and progress toward international equilibrium. As this implies, the Committee in reaching operational decisions during the year, might target appropriate growth in M1 from time to time in the light of circumstances then prevailing, including the rate of growth of the broader aggregates.

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 January through March at annual rates of about 6 to 7 percent. Growth in M1 is expected to slow substantially from the high rate of earlier months. Somewhat greater reserve restraint 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 the short-run operational paragraph: Messrs. Volcker, Corrigan, Angell, Guffey, Heller, Johnson, Keehn, Morris, and Ms. Seger. Vote against this action: Mr. Melzer. Absent and not voting: Mrs. Horn. Mr. Keehn voted as alternate for Mrs. Horn.

Mr. Melzer favored some tightening of reserve conditions. He noted the strong growth in bank loans in the November through January period and the firm federal funds rate which had prevailed despite the extraordinary pace of reserve growth. In addition, he cited the recent declines in the foreign exchange value of the dollar. Finally, looking ahead, he pointed out the potential for a further rise in inflationary expectations and, accordingly, he believed that prompt action toward restraint might avert the need for more substantial tightening later.

At a telephone conference on February 23, the Committee heard a report from the Chairman regarding the deliberations in Paris during the previous weekend of the Ministers of Finance and Central Bank Governors of several major industrial countries. The Committee members discussed the possible implications of the decisions reached in Paris for U.S. intervention in the foreign exchange markets.