FEDERAL RESERVE press release

For Use at 4:30 p.m. July 10, 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 May 19, 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 May 19, 1987

Domestic policy directive

The information reviewed at this meeting suggested that economic activity has been expanding at a moderate pace, despite some weakness in the industrial sector. However, the rate of inflation has risen in recent months, reflecting especially the impact of higher prices for energy and non-oil imports.

Labor demands grew at a brisk pace in April. The household survey indicated a sharp increase in employment and an unusually large decline in unemployment. As a result, the unemployment rate fell to 6.3 percent, 0.4 percentage point below its first-quarter average. Payroll employment rose considerably in April with gains concentrated again in trade and services. Manufacturing employment has changed little on balance so far this year, and the factory workweek dropped sharply in April, partly because of the observance of religious holidays during the survey week.

The industrial production index declined 0.4 percent in April following a smaller drop in March. Most of the decline in output in April was associated with cutbacks in motor vehicles, although small but widespread reductions were evident in other areas. Cutbacks in auto production and a pickup in sales slowed the growth in dealer stocks, but the level of stocks remained high. Outside of autos, trade inventories did not appear excessive, while inventory-sales ratios in manufacturing were near record lows.

As a result of the higher auto sales, real consumer spending appeared to be strong. Excluding autos and nonconsumer items, retail sales rose moderately in April. Housing starts were down somewhat from their first-quarter average. Total starts were at an annual rate of 1.7 million units in April. Single-family starts rose during the month, but multifamily starts fell sharply as high vacancy rates and the elimination of some tax advantages for investment in income properties continued to depress apartment construction.

Business fixed investment has shown signs of improvement from the depressed level early in the year. Shipments of nondefense capital goods rose and orders inched up in February and March. Outlays for construction of commercial and industrial structures have continued trending down in recent months. New commitments, however, have firmed recently.

Inflation rates have been higher so far this year. The CPI rose at a 6.2 percent annual rate between December and March, compared with a rate of 2.5 percent in the fourth quarter. Much of the first-quarter acceleration was caused by the rebound in energy prices, which now appear to have adjusted to the bulk of the year-end runup in the price of imported crude. Larger price increases also were posted for a number of consumer goods, probably reflecting the influence of higher import prices. At the producer level, too, large price increases were posted in a few industries that had been subject to strong import competition, such as chemicals and paper. Commodity prices began moving higher in the latter part of 1986 and have risen noticeably since the Committee's meeting on March 31. However, wage growth has continued at relatively moderate rates, with the index for average hourly earnings rising at about the same pace as in 1986.

In foreign exchange markets, the dollar was under heavy downward pressure over much of the intermeeting period, and intervention purchases were substantial. In the latter part of the period, the dollar was bolstered by slightly firmer monetary conditions in the United States and by easier conditions in Japan, Germany, and the United Kingdom. On balance, the dollar dropped 1 percent, with declines of about 4 percent against the yen and 3-1/2 percent against sterling, the two strongest major currencies over this interval. Economic activity in most major foreign industrial nations continued to be relatively sluggish in the first quarter, except in the United Kingdom and Italy. In March, the merchandise trade deficit was close to the average for January and February and about the same as the fourth-quarter rate.

At its meeting in March, the Committee adopted a directive that called initially for maintaining the existing degree of pressure on reserve positions. The members decided that somewhat greater reserve restraint might be acceptable depending on developments in foreign exchange markets, taking into account the behavior of the monetary aggregates, the strength of the business expansion, progress against inflation, and conditions in domestic credit markets. M2 and M3 were expected to grow at annual rates of about 6 percent or less from March through June, while growth in M1 was expected to slow substantially from the pace in 1986. The intermeeting range for federal funds was left unchanged at 4 to 8 percent.

In light of downward pressures on the dollar, the provision of reserves was cautious at times during the intermeeting period, and open market operations were adjusted in a slightly less accommodative direction in late April. At the same time, uncertainty associated with transactions related to a huge volume of tax payments in mid-April complicated the management of reserves during the intermeeting period. Demands for reserves strengthened substantially, reflecting increases in required reserves associated with a steep rise in transactions balances near midmonth. In the second half of the month, as these payments cleared, Treasury balances at Federal Reserve Banks rose sharply and absorbed reserves, at times more rapidly than had been estimated. This decline in reserves was largely offset by a sizable volume of outright purchases of U.S. government securities, which necessitated two temporary increases in the intermeeting limit on changes in the System's portfolio, as well as by large temporary injections of reserves through repurchase agreements. Nevertheless, partly reflecting technical factors, borrowing at the discount window rose substantially, averaging around $800 million over the intermeeting period.

The federal funds rate firmed somewhat over the period. Most other interest rates also rose with the largest increases occurring in long-term markets. The downward pressures on the dollar created uncertainty among market participants about private demands for dollar assets, the prospects for U.S. inflation, and the response of monetary policy. In addition, rising commodity and producer prices both reflected and added to concerns about the inflation outlook. Most bond yields increased slightly over a percentage point since the March meeting. Commitment rates for fixed-rate mortgages rose somewhat more, reflecting increased lender caution in a volatile rate environment. Short-term rates were up 1/4 to 1 percentage point, including three one-quarter percentage point increases in the prime rate.

Growth of all of the monetary aggregates picked up substantially in April. M1 was boosted by the tax-related surge in transactions balances. Partly reflecting these tax effects, growth in M2 also picked up, though remaining fairly moderate. Growth in M3 was boosted by the need to fund stronger expansion in bank credit. The growth of the broader aggregates was consistent with the Committee's expectations for the March to June period and left these aggregates in April just below the lower ends of their ranges established by the Committee for the year. Liquid deposits ran off at the end of April and in early May as the tax payments cleared, reversing much of the previous bulge in M1.

The staff projections continued to suggest that real GNP would grow at a moderate rate through the end of 1987. A primary contributor to the projected growth remained the foreign sector. The decline in the value of the dollar was expected to make American products more competitive, boosting exports despite the effects of relatively weak foreign economic growth and damping expansion in the volume of imports. The growth in domestic purchases was likely to be restrained by constraints on government spending, high vacancy rates in the office and rental housing markets, and increased mortgage rates. In addition, rising import prices were expected to moderate the growth of real personal incomes and thus consumer expenditures, especially in the light of an already low personal savings rate. However, business equipment spending was projected to resume a moderate uptrend partly in response to a growing export market. Inflation was expected to moderate after accelerating in the first quarter but to remain appreciably above the average pace in 1986. With output growing at a rate approximating that of potential GNP, the unemployment rate was expected to remain close to the lower level achieved recently.

In the Committee's discussion of current and prospective business conditions, the members gave attention to indications that inflationary expectations had worsened in recent weeks. Some commented that the somewhat faster rise of various price measures thus far in 1987 was not unexpected, given the depreciation of the dollar, the energy situation, and supply conditions for some agricultural products. To a considerable extent, those developments appeared to involve special factors that might normally be expected to result in one-time adjustments to the general level of prices. However, it also was noted that the rising prices, including the upturn in commodity prices in recent weeks, had become associated with an appreciable deterioration in inflationary attitudes, judging from conditions in financial markets and contacts with many business executives around the country. There were regional differences in inflationary expectations, to be sure, and some members observed that reactions in financial markets had probably been overdone. Nonetheless, most of the members believed that there was an increased risk of more inflation than they had expected earlier, particularly if inflationary attitudes became imbedded in future wage settlements. On the other hand, some members pointed out that underlying pressures on resources could remain damped and inflation relatively subdued, given the outlook for less than robust economic growth in the United States and abroad and a worldwide oversupply of some commodities.

The prospective behavior of the dollar in foreign exchange markets was a key uncertainty bearing on the outlook for inflation and on that for overall business activity. Earlier declines in the exchange value of the dollar had resulted in higher import prices -- an adjustment process that undoubtedly was still under way -- and further dollar depreciation, if it occurred, would add to future inflation pressures. In this regard, members noted that some domestic producers were raising their prices as those of competing imports went up, thereby adding to the inflation impact of a lower dollar. In general, however, while the depreciation of the dollar had undoubtedly contributed to inflationary expectations, direct evidence of an inflation impact on domestic pricing was still fairly limited.

With respect to the course of domestic business activity, a number of members commented that developments in recent months were in line with earlier projections, and while there were both domestic and foreign risks to sustained expansion, further growth at a moderate pace remained a reasonable expectation. As at previous meetings, the members generally expected domestic demands to be relatively sluggish over the quarters ahead, and they felt that significant progress in reducing the nation's foreign trade deficit was needed to support the expansion. Some members expressed concern that the improvement in the trade balance would be limited over the quarters ahead. While further progress could be anticipated as exporters and importers continued to adjust to a lower value of the dollar, such progress might be restrained in particular by sluggish economic growth in foreign industrial nations. Nonetheless, the members generally expected continuing improvement in net exports and many felt that it would provide considerable impetus for domestic growth.

On the domestic side no sector of the economy was believed likely to contribute much strength to the expansion, and weaknesses persisted in a number of key sectors such as energy, agriculture, and nonresidential construction. Moreover, the recent rise in mortgage rates was likely to have some impact on housing demand. However, in their review of business developments in different parts of the country, several members reported on indications of some improvement recently in local conditions and others noted that difficulties in the agriculture and energy sectors were, at the least, no longer intensifying. Business sentiment also appeared to have improved in many parts of the country. More generally, while the members recognized the risks of a shortfall from current projections, especially given the persisting weaknesses and financial problems in some sectors of the economy, current developments on the whole appeared to be consistent with continuing moderate growth in overall business activity.

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 1986 to the fourth quarter of 1987 of 5-1/2 to 8-1/2 percent for both M2 and M3. The associated range for growth in total domestic nonfinancial debt was set at 8 to 11 percent. The Committee anticipated that growth in M1 would slow in 1987 from its very rapid pace in 1986, but the members decided not to establish a numerical target for the year; instead, the appropriateness of M1 changes would be evaluated during the year in the light of the behavior of M1 velocity, developments in the economy and financial markets, and the nature of emerging price pressures.

In the Committee's discussion of policy implementation for the weeks immediately ahead, members noted that unsettled reserve conditions associated with tax payments and related flows of funds had produced a greater degree of pressure on reserve positions from time to time in recent weeks than had deliberately been sought, even after the slight firming move of late April. Market expectations about Federal Reserve policy intentions also seemed to contribute to higher short-term interest rates at times. All but one of the members indicated that they wished at least to maintain the generally firmer reserve conditions that had prevailed most recently, even though such conditions had not been fully anticipated in Desk operations, and a number felt that some slight further firming might be appropriate. The members generally agreed that some firming of reserve conditions had been desirable to counter the apparent intensification of inflationary expectations in recent weeks and to help stabilize the dollar in the foreign exchange markets. In another view any monetary restraint beyond what had been sought recently would not be desirable, because additional tightening would incur an undue risk of stalling the economic expansion at a time when, in this view, underlying inflation pressures were likely to remain in check. Most members saw a lesser and relatively limited risk to the expansion under current economic conditions and one that needed to be accepted given the pressures on the dollar and the potential for inflation.

In the view of several Committee members, the desired reserve restraint might be more appropriately achieved by means of an immediate increase in the discount rate, providing a more overt means of reassuring financial markets with regard to the System's continuing commitment to an anti-inflationary policy; others felt a possible discount rate increase should, in effect, be held in reserve for use if a more visible signal became desirable. In any event, any decision with respect to the discount rate lay with the Board of Governors, and all but one of the Committee members agreed that, in the absence of a near-term rise in the discount rate, open market operations would be directed toward some increase in the degree of reserve pressure beyond that sought in recent weeks (but not necessarily greater than that prevailing recently). If the discount rate were increased shortly after the meeting, such firming through open market operations would not be necessary, at least in the early part of the intermeeting period.

With regard to factors that might trigger some adjustment in open market operations during the intermeeting period, the members generally agreed that both inflationary developments and the dollar should receive special emphasis. In particular, should inflation or inflationary expectations seem to be intensifying or the dollar come under renewed downward pressure, the Committee would be ready to see some prompt further firming of reserve conditions. At the same time, the members did not rule out the possibility of some easing during the period ahead, but they viewed the potential need for a correction in that direction as less likely. In keeping with the Committee's usual approach toward policy implementation, any decision to alter reserve objectives during the intermeeting period should take account of the behavior of the monetary aggregates and the overall performance of the economy.

In their consideration of the near-term outlook for growth of the monetary aggregates, the members took note of an analysis which suggested that the broader aggregates would expand at moderate rates over the balance of the second quarter. The outsized tax payments of mid-April had continued to affect the broad aggregates as well as M1 through early May. Beyond that, M2 was likely to grow a little more slowly than income, given the slight restraining effects of the recent rise in interest rates that would be felt in coming months. M3 expansion was less likely to be affected by interest rate movements, at least in the near term, and was expected to be sustained by issuance of managed liabilities to support credit growth at depository institutions. On a cumulative basis through June, growth in M2 would remain somewhat below the lower bound of the growth "cone" representing the Committee's 5-1/2 to 8-1/2 percent range for the year, though within the parallel lines associated with the end points of that range; growth in M3 would be very near the lower bound of its growth cone and well within its parallel band. Under prevailing circumstances, Committee members indicated that they were willing to accept relatively limited growth in the broader aggregates, at least for now, but a few observed that such growth signaled the need for caution. Growth in M1 also was believed likely to moderate greatly on average in May and June, after its surge in April. However, because of the persisting uncertainties about the behavior of M1, most of the members indicated a continuing preference for not specifying a numerical growth expectation for this aggregate in the Committee's policy directive.

At the conclusion of the Committee's discussion, all but one of the members indicated that they favored or could accept a directive that called for some increase in the degree of reserve pressure beyond that sought in recent weeks, taking account of the possibility that such firming might be accomplished through an increase in the discount rate. Subsequent to some initial firming in reserve conditions through a reduced availability of reserves or through an increase in the discount rate, the members indicated that somewhat greater reserve restraint would be acceptable, and somewhat lesser reserve restraint might be acceptable, over the intermeeting period depending on developments relating to inflation and the performance of the dollar in foreign exchange markets, while also giving consideration to the behavior of the monetary aggregates and the strength of the business expansion. This approach to policy implementation was expected to be consistent with growth in M2 and M3 at annual rates of around 6 percent or less for the three-month period from March to June. Over the same period growth in M1 was expected to remain well below its pace in 1986; the members would continue to evaluate this aggregate in the light of the performance of the broader monetary aggregates and other factors. 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 Resrve Bank of New York:

> The information reviewed at this meeting suggests on balance that economic activity is expanding at a moderate pace in the current quarter. Total nonfarm payroll employment rose considerably further in April,

with most of the gains continuing to be in the service-producing sectors. The civilian unemployment rate fell to 6.3 percent from 6.6 percent in March. In April, industrial production declined after increasing at a moderate rate in the first quarter. Total retail sales changed little but were up somewhat from their average level in the first quarter. Housing starts were down somewhat in April from their first-quarter average. Recent indicators of business capital spending point to some recovery over the near term from a depressed level in the first quarter. Consumer and producer prices have risen more rapidly this year, primarily reflecting sizable increases in prices of energy and non-oil imports. Labor cost increases have remained relatively moderate in recent months.

Growth of M2 and M3 strengthened in April from a sluggish pace in February and March, but for 1987 to date expansion of these two aggregates has been slightly below the lower ends of their respective ranges established by the Committee for the year. M1 surged in April prompted by exceptionally large tax payments. Expansion in total domestic nonfinancial debt has moderated somewhat thus far this year. Most interest rates have risen considerably since the March 31 meeting of the Committee, with the largest increases occurring in longer-term markets.

In foreign exchange markets, the dollar was under heavy downward pressure over most of the intermeeting period and intervention purchases of dollars were substantial. Recently the dollar has tended to stabilize, but on balance its trade-weighted value against the other G-10 currencies declined over the period. In March the merchandise trade deficit was close to the average for January and February.

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 at its February meeting 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 at the February meeting not to establish a precise target for its growth over the year as a whole. 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 increase somewhat the degree of reserve pressure sought in recent weeks, taking into account the possibility of a change in the discount rate. Somewhat greater reserve restraint would, or somewhat lesser reserve restraint might, be acceptable depending on indications of inflationary pressures and on developments in foreign exchange markets, as well as the behavior of the aggregates and the strength of the business expansion. This approach is expected to be consistent with growth in M2 and M3 over the period from March through June at annual rates of around 6 percent or less. Growth in M1

> is expected to remain well below its pace during 1986. 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, Boehne, Boykin, Heller, Johnson, Keehn, and Stern. Vote against this action: Ms. Seger.

Ms. Seger dissented because she did not want to lean on the side of any tightening of reserve conditions beyond the firming that had occurred since the March meeting. She was concerned that the degree of reserve pressure prevailing recently, which was somewhat greater than intended, represented a risk to an already weak economic expansion. She noted that the negative effects of recent increases in interest rates had not yet been felt in the economy. She also referred to recent indications of moderating growth in the monetary aggregates, and she did not expect inflationary pressures to persist in the context of excess production capacity and commodity surpluses worldwide.