

# FEDERAL RESERVE press release



For Use at 4:30 p.m.

July 1, 1988

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 17, 1988.

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 17, 1988

Domestic policy directive

The information reviewed at this meeting suggested continuing strength in the economic expansion, supported by strong sales in both domestic and export markets, and relatively high utilization levels of labor and capital resources. In this setting, consumer and producer prices have risen more rapidly recently. In addition, labor costs increased substantially in the first quarter.

Nonfarm payroll employment continued to increase in April, though at a more moderate pace than in other recent months. The rise included sizable growth in the manufacturing sector and was accompanied by a sharp increase in the average workweek. Employment as measured by the household survey was up very sharply in April and the civilian unemployment rate declined 0.2 percentage point to a level of 5.4 percent; that level was down appreciably since the start of the year and was the lowest since 1974.

Growth in industrial production picked up considerably in April from a reduced pace earlier in the year. Auto assemblies posted large gains and the output of business equipment remained exceptionally strong. Capacity utilization rates in manufacturing and mining and in the production of industrial materials increased appreciably in April and on balance have risen substantially over the past several quarters to relatively high levels.

Consumer spending for durables and services was strong in the first quarter. Retail sales, as revised, showed substantial gains in February and March but fell in April. Auto sales declined somewhat in April, apparently reflecting reduced sales incentives, but household spending on other durables and on services remained strong. Outlays on nondurable goods continued sluggish.

A surge in business fixed investment during the first quarter reflected large gains in spending on information-processing and other equipment. New orders for nondefense capital goods softened recently, but order backlogs were still high and suggested that output would remain at an advanced level in the current quarter. Spending on structures declined in the first quarter, and forward commitments for nonresidential building were essentially flat in nominal terms. While inventories of motor vehicles declined during the first quarter, nonauto inventory investment remained close to the high rate of the fourth quarter. Sales of new and existing homes increased late in the first quarter. After showing weakness early in the year, housing starts picked up to a 1.55 million annual rate in March, a level marginally above that in the fourth quarter but still appreciably below that in earlier quarters.

The U.S. merchandise trade deficit declined substantially in both nominal and real terms in the first quarter. Exports reached a record level; oil imports fell, but non-oil imports continued to expand. Indicators of economic activity in the major foreign industrial

countries during the first months of 1988 showed continued strength in Japan and, on balance, in Europe as well.

The consumer price index increased substantially in March, despite a limited rise in retail food prices and flat retail energy prices. At the producer level, prices of finished goods rose rapidly in March and April, largely reflecting increases in the food and energy sectors. Prices of intermediate goods advanced considerably further in both months, continuing their uptrend of the past year and a half that has coincided with increased capacity utilization rates. Commodity prices strengthened recently after registering mixed changes in the first quarter. Broad measures of labor costs indicated a substantial advance in the first quarter, in part because of a rise in payroll taxes.

Dollar exchange rates moved within a narrow range during most of the intermeeting period, with uncertainties regarding U.S. trade and price performance apparently offset by indications of U.S. monetary tightening; also, weakness at the time of the release of the February trade data was met by concerted central bank intervention. On a weighted-average basis, the dollar appreciated slightly on balance in relation to the other G-10 currencies until late in the period; it strengthened with respect to the mark and weakened slightly with respect to the pound and the yen. The dollar then appreciated about 1 percent on the morning of the May 17 meeting in response to news of the improved U.S. trade deficit in March.

At its meeting in February the Committee agreed on policy objectives that called for monetary growth ranges of 4 to 8 percent for both M2 and M3 for the period from the fourth quarter of 1987 to the fourth quarter of 1988. The associated range for growth in total domestic nonfinancial debt was set at 7 to 11 percent. The Committee decided not to establish a numerical target for M1 growth; instead, the appropriateness of changes in M1 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.

At its previous meeting on March 29, the Committee adopted a directive calling for a slight increase in the degree of pressure on reserve positions. These reserve conditions were expected to be consistent with growth in both M2 and M3 at annual rates of about 6 to 7 percent over the period from March through June. Taking account of conditions in financial markets, the members agreed that somewhat greater or somewhat lesser reserve restraint would be acceptable, depending on the strength of the business expansion, indications of inflationary pressures, developments in foreign exchange markets, and the behavior of the monetary aggregates. The intermeeting range for the federal funds rate was left unchanged at 4 to 8 percent.

Some slight firming of reserve conditions was implemented immediately after the March meeting. In the two reserve maintenance periods ending April 20, adjustment plus seasonal borrowing rose to an average of about \$330 million; in the subsequent period ending May 4,

borrowing averaged about \$440 million, reflecting the impact of a tax-related bulge in Treasury deposits at the Federal Reserve Banks that affected reserve market conditions and complicated the management of reserves. More recently, open market operations were adjusted toward the implementation of further slight firming in reserve conditions in relation to what had been sought earlier in the period. This action was taken in light of information that indicated considerable strength in the economy and a related increase in concerns about the potential for greater inflation. Growth of M2 and M3 for the year to date was at rates in the upper portions of the Committee's ranges for 1988. Monetary growth was boosted in April by a temporary buildup in transaction balances associated with very large tax payments by individuals. Although preliminary data for early May indicated substantial weakness of money growth, the cumulative expansion of the broad aggregates remained relatively high in their annual ranges. Total and nonborrowed reserves rose at rapid rates in April in conjunction with the increase in required reserves against transaction deposits.

The firming of reserve conditions was reflected in a rise in the federal funds rate from around 6-1/2 percent at the time of the March meeting to around 7 percent most recently. Other short-term rates also rose about 1/2 percentage point over the intermeeting period, while yields on Treasury and corporate bonds increased somewhat less. Banks raised their prime lending rate from 8-1/2 to 9 percent during the first half of May. Broad indices of stock prices changed little on balance over the period.

The staff projection reviewed at this meeting suggested that the economy had considerable underlying strength, reflecting both an improving trade balance and continuing momentum in domestic demands. With unemployment already a little lower and capacity utilization a little higher than had been anticipated, the risks of higher rates of price and wage inflation had increased. The actual course of the economy would depend in part on how these developments affected financial markets. Pressures in those markets could restrain domestic final demands. Relatively sluggish growth in such demands, along with indications of overstocking in the retail sector, would encourage a reduced rate of inventory investment. Growth in business fixed investment was projected to slow substantially and federal purchases, in constant dollar terms, were expected to be weak. Under such circumstances, while prices and wages might rise somewhat more rapidly in the quarters ahead, reflecting the effects of the lower dollar on market prices and reduced margins of unutilized production resources, the extent and duration of any pickup of inflation might be limited.

In the Committee's discussion of the outlook for economic activity and prices, the members focused on the strong performance of the economy in recent months and, in the context of diminishing margins of unused labor and other production resources, they expressed considerable concern about the potential for higher rates of inflation in the year ahead. Members referred to widespread evidence of strength in the manufacturing sector and to indications that many firms were producing at very high levels of capacity use. Manufacturing was

continuing to benefit from the nation's improved ability to compete internationally as a result of the depreciated dollar, and strength in manufacturing was feeding through to other related sectors of the economy. On the negative side, members referred to indications that inventories were higher than desired in some industries, notably at the retail level, and some saw a relatively weak outlook for construction, both residential and nonresidential. Weaknesses in the financial sectors of the economy and relatively heavy debt burdens also increased the downside risks in the economy. But, on balance, while some slowing from the current rate of expansion was a reasonable expectation, the risks were on the side of faster than desired growth and more inflationary pressures. Some members observed that in these circumstances fiscal restraint, especially if supplemented by measures to reduce the inflationary consequences of many government programs, could greatly facilitate the effort to control inflation while encouraging sustained economic expansion.

Turning to the outlook for inflation, members reported rising costs of materials and other manufacturing inputs. With profit margins under more pressure, numerous firms were looking for opportunities to pass on rising costs, and there were reports of some increase in successful efforts by businesses to raise prices, especially on crude and intermediate producer goods. However, while many specific instances of sizable price increases could be cited, broad measures of prices, including commodity prices as a group, did not indicate at this point that a significant worsening had occurred in the overall rate of

inflation. Likewise, while reports of shortages of qualified labor were multiplying and business resistance to higher wages seemed to be diminishing in some areas, the members did not currently detect any appreciable acceleration in wage rate increases. Nonetheless, several expressed concern that, unless the expansion in overall demands were to slow markedly from the recent pace, which exceeded the trend growth of potential output, a substantially higher rate of price and wage inflation could not be avoided in the relatively near future. Others were less ready to conclude that an inflationary surge might be imminent, but they believed that the situation needed careful watching.

In the Committee's discussion of policy for the intermeeting period ahead, the members generally agreed that some further tightening of reserve conditions was needed to counter the risks of rising inflationary pressures in the economy. A failure to act in timely fashion not only would be inconsistent with the Committee's commitment to achieving price stability over time but would in fact compound the difficulties of accomplishing that objective. Views differed, however, regarding the desirable extent of such firming and the appropriate timing for its implementation. A majority favored only a slight move toward more restraint, at least pending an evaluation of further developments, and most of these members preferred to delay the tightening action for a short period. Other members felt that current and potential pressures on prices and wages argued more urgently for a prompt move to somewhat greater restraint.

The members who favored only slight further firming, whether immediately or after a short delay, saw a considerable risk that an appreciable further tightening would be unexpected so soon after the most recent firming and might well have an exaggerated impact on financial markets. Among other effects, it might give rise to anticipations of an increase in the discount rate, and foster unwarranted expectations about the System's intentions. Some members also stressed the adverse impact that any marked weakening of financial markets could have on troubled depository institutions. In these circumstances, marginal further tightening in the near term would provide an appropriate balance between the need to curb the emergence of excessive demand pressures in the economy and the risks of further restraint for financial markets and depository institutions. A few members also expressed the view that the two firming actions since late March, taken together, already represented a significant move to greater restraint and more time was needed to appraise their impact on the economy before any substantial further tightening was implemented.

Members who favored moving promptly to a somewhat greater degree of restraint gave more emphasis to the risks of more inflation as demand pressures encountered labor and capacity constraints in many industries. In this view the System's recent firming actions were helpful, but they did not go far enough toward restraining the growth in total demands to a noninflationary pace. These members recognized that appreciable further firming could have some adverse impact on financial markets in the short run and on the condition of many already weakened

depository institutions. However, a prompt and somewhat stronger response to inflationary developments at this point would have a favorable effect on inflationary expectations, and over time also on long-term debt markets, and would reduce the need for greater and more disruptive tightening actions later. Some of these members indicated that a relatively modest move now, or in the very near future, and a readiness to tighten further later during the intermeeting period would constitute an acceptable compromise, given concerns about the risks of unwarranted reactions in the financial markets.

During the discussion members referred to a staff analysis prepared for this meeting which concluded that expansion of the monetary aggregates, especially M1 and M2, was likely to moderate substantially from the pace in April. The projected slowing reflected in part a reversal of the tax-related buildup in transaction accounts during April, which was already occurring, and the impact of increased opportunity costs of holding money balances in response to the rise in market interest rates. While M2 and M3 currently appeared to be growing at rates that were consistent with the Committee's expectations for the second quarter, their cumulative growth thus far this year was at rates in the upper part of the Committee's ranges. One member stressed that any tendency for monetary growth to exceed the ranges should be firmly resisted under prevailing circumstances. Another commented that reduced growth, which brought the expansion for the year to around the middle of the Committee's ranges, would be a desirable outcome.

With regard to adjustments in the degree of reserve pressure during the intermeeting period, the slight firming after a short interval following today's meeting that was favored by a majority of the members would be implemented unless economic and financial conditions in the period ahead were to differ markedly from current expectations. Should unanticipated developments of that sort occur, the Chairman would call for a special consultation of the Committee. On the question of any subsequent adjustment in policy, a majority believed that policy implementation should remain especially alert to incoming information that might call for further firming. Given the recent tightening of reserve conditions and the presumption that at least marginally firmer reserve conditions would be implemented in the intermeeting period, the members decided to raise the intermeeting range for the federal funds rate by 1 percentage point to 5 to 9 percent. With such an increase the average trading level expected for the federal funds rate in the period ahead would be aligned somewhat more symmetrically around the middle of the range.

In further discussion most of the members indicated that they now favored dropping from the directive the special reference to sensitive conditions in financial markets and the related reference to the need for flexibility in the conduct of open market operations. Members noted that these references, while helpful in describing the Committee's approach to operations for an extended period following the October disturbances in financial markets, no longer served a clarifying purpose in communicating the Committee's intentions. While still

somewhat volatile, market conditions were now closer to those prevailing prior to the October break in the stock market, and the Committee anticipated that the earlier approach to open market operations generally would be followed. A few members felt, however, that still quite sensitive conditions in financial markets continued to warrant more than the usual amount of flexibility in the conduct of open market operations.

In advance of the discussion of long-term monetary growth ranges at its next meeting, the Committee considered the role that the monetary base might play in monetary policy. One proposal was to set fairly wide limits on quarterly fluctuations in the monetary base, but to adjust policy promptly if the limits were breached. The Committee also discussed whether a range for the base comparable to the existing ranges for M2 and M3 and nonfinancial debt might usefully supplement the current ranges. Most members expressed reservations about the reliability of the base as a guide to or restraint on policy, given their questions about the behavior of currency and reserves relative to income. However, there was sentiment for a continuing review of possible monetary indicators of future price trends.

At the conclusion of the Committee's discussion, all but two of the members indicated that they favored or could accept a directive that called initially for maintaining the current degree of pressure on reserve positions. Some slight firming would be implemented after a short interval following today's meeting, assuming that economic and financial conditions remained reasonably consistent with current

expectations. In particular, and in keeping with the Committee's usual approach to policy, the conduct of open market operations would take account of conditions in financial markets, the strength of the business expansion, indications of inflation, the performance of the dollar in foreign exchange markets, and the behavior of the monetary aggregates. Later in the intermeeting period, some added reserve restraint would be acceptable, or some slight lessening of reserve pressure might be acceptable, depending on ongoing economic and financial developments. The contemplated reserve conditions were likely to be associated with slower monetary growth, but given their relatively rapid expansion in April, M2 and M3 were still expected to grow at the rates of 6 to 7 percent established in late March for the period from March to June. The members agreed that the intermeeting range for the federal funds rate, which provides one mechanism for initiating consultation of the Committee when its boundaries are persistently exceeded, should be raised by 1 percentage point to 5 to 9 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 continuing strong expansion in economic activity and rising levels of resource utilization. In April, total nonfarm payroll employment rose further; the increase included sizable growth in the manufacturing sector. The civilian unemployment rate fell to 5.4 percent, down appreciably from its level at the start of the year. Growth in industrial production picked up considerably in April from a reduced pace earlier in the year. Retail sales fell appreciably last month but estimates of sales in February and March were revised substantially higher. Indicators of business capital spending point to substantial gains thus far this year, notably for equipment. The nominal U.S. merchandise trade deficit in the first quarter was

substantially smaller than that for the fourth quarter. Consumer and producer prices have risen more rapidly recently following a period of relatively modest increases. Broad measures of labor costs indicate a substantial advance in the first quarter, in part because of a rise in payroll taxes.

Interest rates have risen somewhat since the Committee's meeting on March 29. The trade-weighted foreign exchange value of the dollar in terms of other G-10 currencies had increased slightly on balance over the intermeeting period prior to May 17 and jumped following release of the March trade data.

M1 and M2 grew rapidly in April, owing in part to a buildup in transaction balances associated with tax payments, while M3 expanded at a slower pace than in previous months. Through April, expansion of M2 and M3 was in the upper portion of the ranges established by the Committee for 1988. Expansion in total domestic nonfinancial debt appears to be continuing at a pace close to that in 1987.

The Federal Open Market Committee seeks monetary and financial conditions that will foster 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 meeting in February established growth ranges of 4 to 8 percent for both M2 and M3, measured from the fourth quarter of 1987 to the fourth quarter of 1988. The monitoring range for growth in total domestic nonfinancial debt was set at 7 to 11 percent for the year.

With respect to M1, the Committee decided in February not to establish a specific target for 1988. The behavior of this aggregate in relation to economic activity and prices has become very sensitive to changes in interest rates, among other factors, as evidenced by sharp swings in its velocity in recent years. Consequently, the appropriateness of changes in M1 this year will continue to 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 the initial implementation of policy, the Committee seeks to maintain the existing degree of pressure on reserve positions. Taking account of conditions in financial markets, the strength of the business expansion, indications of inflationary pressures, developments in foreign exchange markets, and the behavior of the monetary aggregates, the Committee expects that a slight increase in the degree of pressure on reserve positions would be appropriate in the weeks ahead. Depending on further developments in these factors, somewhat greater reserve restraint would, or slightly lesser reserve restraint might, also be acceptable later in the intermeeting period. The contemplated reserve conditions are expected to be consistent with growth in M2 and M3 over the period from March through June at annual rates of about 6 to 7 percent. 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 5 to 9 percent.

Votes for this action: Messrs. Greenspan, Corrigan, Angell, Black, Forrestal, Heller, Johnson, Kelley, and Seger. Votes against this action: Messrs. Hoskins and Parry.

Messrs. Hoskins and Parry dissented because they favored a prompt move to a greater degree of reserve restraint. In their view the risks were considerable that price and wage inflation would accelerate from rates that were already too high. A more substantial firming was needed to moderate underlying pressures and to foster reasonable progress toward price stability. In the absence of such a move at this time, even greater tightening might well be required later, with attendant costs to financial markets and the economy. Mr. Hoskins noted that the M2 and M3 aggregates were near the upper bound of their target ranges. He also referred to the strengthening of business activity

abroad, which had implications, potentially, for more widespread price pressures, and to the desirability of increasing the credibility, and thus the effectiveness, of monetary policy through timely, anti-inflationary measures. He emphasized that monetary policy should be directed toward a steady reduction of inflation and not toward meeting shorter-term business cycle goals. Mr. Parry noted that the two tightening actions in recent weeks were of insufficient magnitude to have much effect on the economy in the context of strengthened prospects for growth and already tight labor markets.